Hamel-Smith FORUM

ATTORNEYS-AT-LAW, TRADEMARK & PATENT AGENTS

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CROSS BORDER FINANCING: THE CHALLENGES OF WITHHOLDING TAX

Nicole Ferreira-Aaron

For local borrowers raising finance on the international market the mitigation of withholding tax exposure on interest payments is a primary commercial objective. To meet this need, lenders have devised financing structures that take advantage of withholding tax relief available under relevant double taxation treaties.

Because the structure is driven by withholding tax a borrower will generally negotiate an early redemption clause, giving it the right to prepay (usually without a premium) in the event that the withholding tax treatment changes to its detriment. Lenders do not like being prepaid without a premium and will therefore seek to strictly limit such prepayment option.

A recent decision of the English Court of Appeal (on 2nd March, 2006) provides an interesting and important perspective on:

- the interpretation of an early redemption clause in relevant circumstances; and
- the general trend of taxing authorities to more stringently regulate improper use of tax treaties.

In the case of Indofood International Finance Limited v JP Morgan Chase Bank, N.A.; London Branch Indofood International Finance Limited (the 'Issuer') a company incorporated in Mauritius issued loan notes (the 'Notes'). The Issuer was a wholly owned subsidiary of PT Indofood Sukses Makmur Tbk. (the 'Parent') a company incorporated in Indonesia.

The Issuer on-loaned the proceeds of the Notes to the Parent. Under the Notes the Issuer was obliged to make interest payments net and free of any tax. Under the inter company loan the Parent was to pay interest to the Issuer to enable it to meet interest payments due under the Notes.

At the time of the issue of the Notes a double taxation agreement between Mauritius and Indonesia reduced the rate of withholding tax payable on the interest payments due to the Issuer from the Parent from 20% to 10%. As such the Parent was obliged to gross up its interest payments to the Issuer by 10%.

The Notes permitted early redemption if as a result of change in the relevant laws or treaties the withholding tax on any payment by the Parent to the Issuer to enable the Issuer to make any payment under the Notes required the deduction of withholding tax in excess of 10 percent. The Issuer's right to early redemption was however available if and only if such additional withholding tax obligation could not be avoided by the Issuer taking 'reasonable measures' available to it.

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APPELLATE MOOTING COMPETITION

Timothy Affonso

The Hamel-Smith Appellate Moot Court Competition is in its second year, and already it has established itself as a major competition in the Hugh Wooding calendar of events. As the new academic year begun, whispers can be heard in the corridors of the Law School, "Is the list for the Appellate Moot up as yet?" or "Are you on a team?" The growing interest in the competition is due in large measure to the great experience it offers. Both last year and this year, representatives from the Hugh Wooding Law School to the Margaret Forte Inter-Law Schools Competition, comprised participants from the Hamel-Smith Moot.

The Competition is not only limited to legal discussions, but also teaches life lessons, including perseverance in its purest sense. The team that ended up winning the competition had been knocked out in the preliminary round. Based on the odd number of teams participating, the highest scoring team that did not make it through to the semi-final round was given a second chance. However, as if that were not sufficient to make this story interesting, the other team that ended up in the finals was the same team that had knocked out the "second chancers." Despite this *deja vu* experience for the mooters, the competition was fun, lively and filled with emotion.

The Author Timothy Affonso (far right) and his team mates Kerry-Ann Harrison, and Westmin James accept the challenge trophy from Philip Hamel-Smith, Managing Partner .

The case dealt with the power of the Minister of Labour to apply for a Mareva injunction under section 65 of the Industrial Relations Act and the corollary power of the Industrial Court to grant the said injunctive relief and deem the Minister to be a party to the trade dispute. Strong legal arguments were put forward during the competition by both the teams for the Appellant and Respondent. In the end, the Respondent won the case, as the Court of Appeal upheld the decision of the Industrial Court to grant the injunction, and exercise its deeming powers in the way that it did. The experience was made even more fulfilling and realistic, by having the bench comprise Justices of Appeal Kangaloo and Archie and Justice Bernard of the Caribbean Court of Justice, all of whom treated the exercise like a real case before the Court of Appeal.

The final of the competition was energetic, intense and surprisingly relaxing. It was an opportune time to see and feel the human side of the court and the potentially unassuming nature of the Court of Appeal.

The Lessons I learnt

The competition was truly an unforgettable experience, and I learnt a few vital lessons which are worth sharing:

Firstly, competition should be healthy and fun. At times, mooting can turn into a full contact sport, but remember it is a make-believe case! While friendly rivalry is good, we must make concerted efforts to prevent it from turning into war.

Secondly, having lost in the first round, my team experienced a dramatic paradigm shift: from an overriding desire to win at all cost to a strong belief in doing our best! This change in approach made the entire experience more fulfilling and less stressful for each of us.

Thirdly, select your mooting partners carefully. Ideally, they should be persons who share your values of professionalism, respect and dedication. Success can only be attained if members of the team are working towards a common goal. If your mark of success is not a higher score or a better grade, but a personal sense of achievement, then no one can take this away from you.

Finally, have fun! Mooting, while stressful at times, is fun and is in many ways a passion of mine. Participants owe it to themselves to have fun and thoroughly enjoy the Moot.

PE-ACTION PROTOCOLS CRISIS OR OPPORTUNITY?

Peter Rajkumar

In November 2005, the Supreme Court introduced Pre-Action Protocols to be applied alongside the new Civil Proceedings Rules ("CPR"). The general effect of the Pre-Action Protocols as set out therein is to encourage the exchange of early and full information about the prospective legal claim so as to enable the possibility of avoiding litigation by exploring settlement of the claim before the commencement of proceedings and / or supporting the efficient management of those proceedings that do continue under the CPR.

There are cost implications in the event of non-compliance with the Protocols. Generally a claimant is required by the Pre-Action Protocol to provide sufficient information and details of the claim. The defendant is also required to make a preliminary response to the letter of claim and to make a full response within the time fixed by the Protocol, including disclosure of documents.

The Claimant's Letter

It should be specifically noted that claimant's letter should:

- Give sufficient details to enable the recipient to understand and investigate the claim without extensive further information;
- Enclose copies of the essential documents on which the claimant relies;
- Require a prompt acknowledgment;
- Require a full response within a reasonable period (stated to be one month);
- Request and ask for copies of any essential documents which the claimant wishes to see; and
- State whether the claimant wishes to enter into mediation or another alternative method of dispute resolution.

The Defendant's Letter In Response

The defendant's response should:

- Give detailed reasons why the claim is not accepted, identifying which of the claimant's contentions are accepted and which are in dispute;
- Enclose copies of the essential documents which the defendant relies on;
- Enclose copies of the documents asked for by the claimant or explain why they are not enclosed;
- Identify and ask for copies of any further essential documents which the defendant wishes to see;
- State whether the defendant is prepared to enter into mediation or another alternative method of dispute resolution.

The parties may also at that stage engage an agreed expert.

Opportunity?

The introduction of the Pre-Action Protocol therefore requires significant case preparation to be completed by both the claimant and by the defendant prior to litigation being commenced. This provides opportunities for the diversion of matters from a litigation track in that either claimant or defendant or both can indicate at a very preliminary stage their receptiveness to a mediated, negotiated or arbitrated resolution which, if appropriate in the circumstances, can provide an avenue for a cost effective solution without or prior to the excessive build -up of legal costs.

However, it does require that comprehensive instructions be provided at a very early stage. Even prior to an action being filed, documents and records need to be produced with expedition.

Conclusion

The significant burden of case preparation at the inception of a matter, even prior to a claim form being filed in the High Court, may appear to impose a burdensome consumption of resources and time. However, it carries with it at the same time, the advantage of allowing parties, both potential claimant

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CROSS BORDER FINANCING (cont'd)

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Two and a half years after the Notes were issued the double taxation agreement between Indonesia and Mauritius was terminated increasing the Parent's grossing up obligation to 20%.

The Issuer claimed entitlement to early redemption for tax reasons which the Note trustee rejected claiming that by restructuring the loan agreement and interposing a company in the Netherlands the withholding tax increase could be avoided. The trustee claimed such restructuring as "reasonable measures".

As a matter of interest between the date of issue of the Notes and the termination of the taxation agreement the financial market rates had moved in favour of borrowers so that the Parent was in a position to replace its loan from the Issuer with a loan from other sources at a materially reduced rate of interest.

The High Court held that the test of "reasonable measures" was an objective one, the burden of proof being on the Issuer to show with 'reasonable certainty' that the increased withholding tax could not be avoided by taking "reasonable measures".

The parties agreed that whether or not the restructuring would constitute "reasonable measures" depended upon:

- whether the Parent would be eligible for double taxation relief under the Netherlands/Indonesian treaty under the proposed restructure; and
- whether the costs of the proposed restructure could be considered reasonable.

The High Court (unusually) taking a view of the likely decision of the Indonesian tax court held that the benefits of the Netherlands/Indonesian tax treaty should be available to the Parent. In so doing it rejected the Issuer's argument that the interposition of a Dutch resident company could be regarded as "treaty shopping" stating that if the original structure did not constitute treaty shopping then the proposed one should not.

In determining whether the costs was reasonable the High Court compared the cost of the setting up the restructure and its on-going running costs with the amount of the additional withholding tax payable without the restructure. The estimated restructure cost was $490,000.00 and the increase in withholding tax if no restructuring took place would be $1.8 million. The Judge thought the restructure costs did not exceed the standard of reasonableness and thereby concluded that the Issuer was not entitled to redeem the Notes early.

At the Court of Appeal the appeal by the Issuer of the judgment of the High Court was allowed on the basis that on a balance of probabilities:

- the Dutch company (NEWCO) could not have been the beneficial owner of the interest paid by the Parent under the Loan Agreement for the purpose of the Dutch treaty;
- NEWCO would have not been resident in the Netherlands but in Indonesia; alternatively;
- the doubts whether these two conditions for the application of the Dutch treaty would have been met were so great as to render the proposed interposition of NEWCO unreasonable.

Accordingly, the Court of Appeal concluded that there were no reasonable measures available to the Parent to avoid the additional withholding tax and therefore no bar to early redemption. It should be noted, however, that the Chancellor did make the point that had the conditions of beneficial ownership and residence been satisfied the cost of the restructure would not have outweighed the benefits to be derived from it. In other words the restructure would have constituted "reasonable measures".

The case illustrates several important points:

- In the absence of the proviso, the Parent and the Issuer would have been entitled to prepay the debt with cheaper money benefiting from the co-incidence of a tax change and a favourable shift in interest rates.

PE-ACTION PROTOCOLS CRISIS OR OPPORTUNITY? *(cont'd)*

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and Defendant, to confront at a very early stage, the reality of the strength of the case.

That assessment in turn can inform the parties approach to a potential claim. The protocol recognises this and provides the opportunity for considerable saving of legal costs and the diversion of resources from trial preparation to alternative dispute resolution.

Early consultation with legal advisors can therefore even convert the crisis of a letter before action into an opportunity for dispute resolution and the saving of trial and other costs.

CROSS BORDER FINANCING : THE CHALLENGES OF WITHHOLDING TAX ***(cont'd)***

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- The inclusion of the proviso imposes on the Borrower a duty to seek out reasonable alternative structures which can be an expensive duty to fulfil;
- Had the Dutch structure been available to the borrower the costs of putting same in place would have outweighed the additional withholding tax payable and would have been deemed reasonable;
- The Indonesian taxing authorities like the Netherlands taxing authorities (and we dare say authorities worldwide) are growing wiser to the trend of taxpayers to treaty shop by organising or using a legal entity in one contracting state to serve as a conduit for income earned in another contracting state purely to obtain the benefits of a tax treaty. Such authorities are responding by either amending or terminating tax treaties or by imposing greater surveillance on taxpayers to prevent treaty abuse.

Stay tuned for a House of Lords decision, perhaps?

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