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INTERNATIONAL TAX & COMMERCIAL LAW FIRM

ITALY - NEW YORK

BENEFICIAL OWNERSHIP, TAX TREATIES AND INTERNATIONAL TAX PLANNING

in light of the UK Court of Appeal's decision of March 2, 2006 in
Indofood International Finance Ltd.

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International Fiscal Association, USA Branch, Westchester/Connecticut Region
Hyatt Regency, Old Greenwich, CT
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I. Beneficial Ownership Provisions

A. Tax Treaties

- Treaty reduction in withholding tax on portfolio income if recipient is beneficial owner of payment.
 - dividends (art. 10);
 - interest (art. 11);
 - royalties (art. 12).

Origin: 1966 Protocol to 1945 US-UK Treaty and 1966 Canada-UK Treaty,
1977 OECD Model

I. Beneficial Ownership Provisions (cont'd)

B. EU Directives

- Elimination of withholding tax on inter-company dividends between EU companies (EC Parent-Subsidiary Directive of 1990).
- Elimination of withholding tax on interest, rents and royalties paid between affiliated EU companies (EU Interest and Royalties Directive of 2003).
- Exchange of information or back-up withholding on income from savings (EU Savings Income Directive of 2003).

I. Beneficial Ownership Provisions

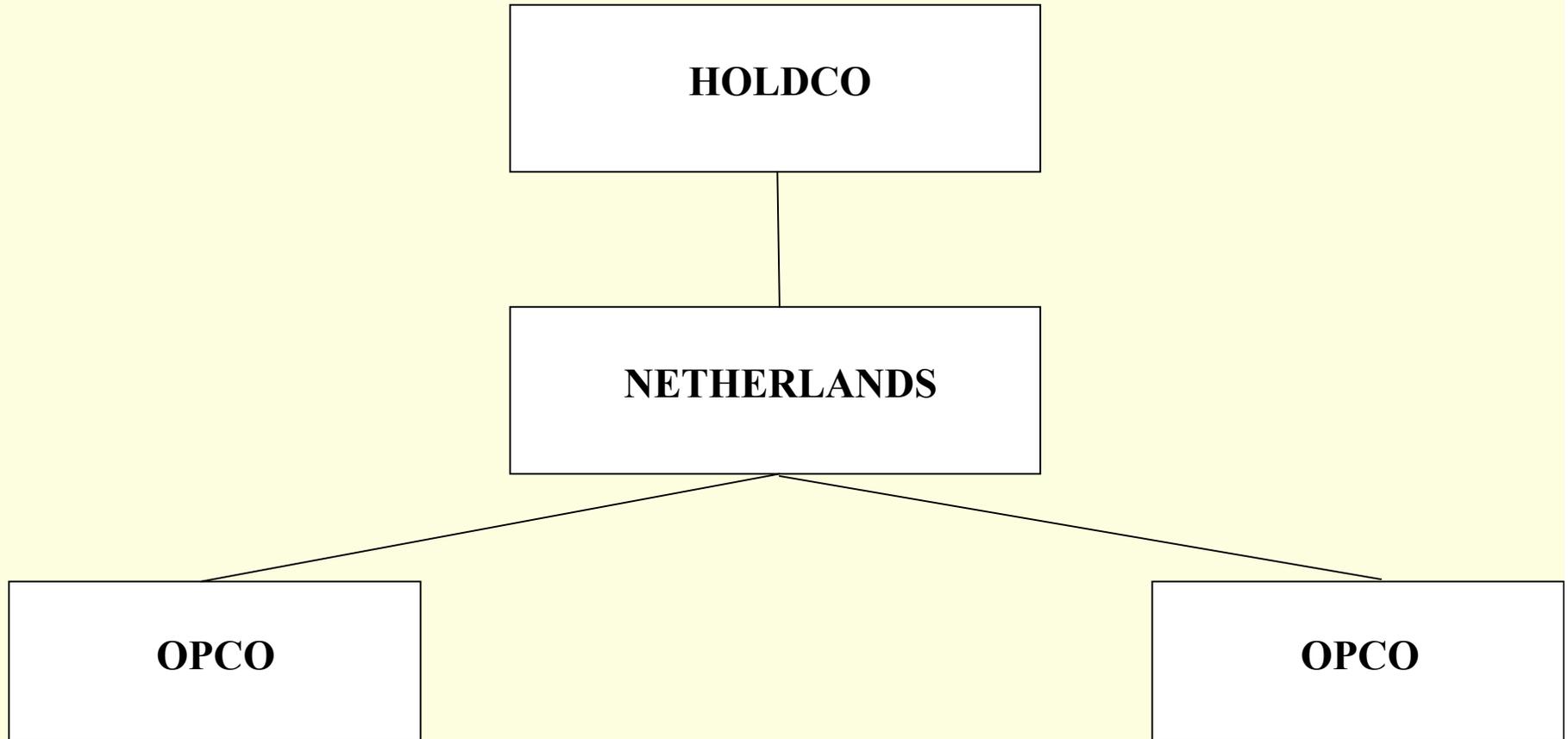
C. Domestic Law

- Italy: elimination of withholding tax on certain items of portfolio income earned by nonresidents based in qualified jurisdictions:
 - interest on “big issuers” (banks, publicly traded companies) long term (>18 months) bonds;
 - income from derivative contracts;
 - income from mutual funds and REITs;
 - income from repos and securities lending transactions

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II. Definition Of Beneficial Ownership

- **Treaty definition?**

- ▶ **U.S./Germany Tax Treaty:**

*“ With reference to Articles 10, 11 and 12:
a Contracting State shall deem the recipient of dividends, interest and royalties who is a resident of the other Contracting State to be the beneficial owner for the purposes of Articles 10, 11 and 12 if the recipient is the person to which the income is attributable for tax purposes under the laws of the first-mentioned State.”*

- ▶ **Germany/Italy Tax Treaty:**

*“9. With reference to Articles 10, 11 and 12:
the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived there-from is attributable to him under the tax laws of both States.”*

II. Definition Of Beneficial Ownership (cont'd)

- ▶ US Treasury Department Technical Explanation on pending US/Italy Treaty:

“The term “beneficial owner” is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e. the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State.”

II. Definition Of Beneficial Ownership (cont'd)

- **Commentary to OECD Model Treaty:**

Articles 10 to 12 OECD clarifications on the meaning of term “beneficial owner”.

- 1977 “Agent or Nominee” test (narrow technical sense).
- 2003 “Substance Over Form Approach”: *the term “beneficial owner” is not used in a narrow technical sense; rather, it should be understood in its context in light of the objectives and purposes of the Convention including avoiding double taxation and the prevention of fiscal evasion and tax avoidance*
- **1986 OECD Report on conduit companies**

II. Definition Of Beneficial Ownership (cont'd)

- **2003 OECD Commentary implemented the conduit case as follows**

“It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties”

II. Definition Of Beneficial Ownership (cont'd)

- EU law definition?

EU interest and royalties directive (2003/49/EC)

- *“A company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorized signatory, for some other person.”*
- *“A permanent establishment shall be treated as the beneficial owner (...) if (a) the debt-claim, right or use of information in respect of which interest or royalty payments arise is effectively connected with that permanent establishment; (b) the interest or royalty payments represent income in respect of which that permanent establishment is subject to [corporate income] in the member state in which it is situated (...). No other part of the company shall be treated as the beneficial owner or payor.*

II. Definition Of Beneficial Ownership (cont'd)

- EU law definition?

EU savings income directive (2003/48/EC)

- Directive aims at making sure that cross-border interest payments are actually taxed in the residence MS of the “beneficial owner” through an efficient exchange of information (preamble) Automatic exchange of information on the payment of interest between a pay agent in one MS to a beneficial owner in another MS
- Article 2 provided a definition of beneficial owner: *“any individual who receives an interest payment or any individual for whom an interest is secured, unless he provides evidence that it was not received or secured for his own benefit”*.
- The direct individual recipient of the interest payment is therefore deemed to be the BO unless it is proved otherwise

II. Definition Of Beneficial Ownership (cont'd)

- **Domestic law definition?**

Italy's definition of beneficial owner for EU interest and royalties directive:

- Recipient must be subject to tax on the income in its state of residence (Legislative Decree n. 143 on May 30, 2005).
- Recipient must receive the income for its own economic benefit (Circular 47 of November 2, 2005).
- Recipient must have the power of realization and disposition of the income (Circular 47 of November 2, 2005).

II. Definition Of Beneficial Ownership (cont'd)

- **Domestic law definition?**

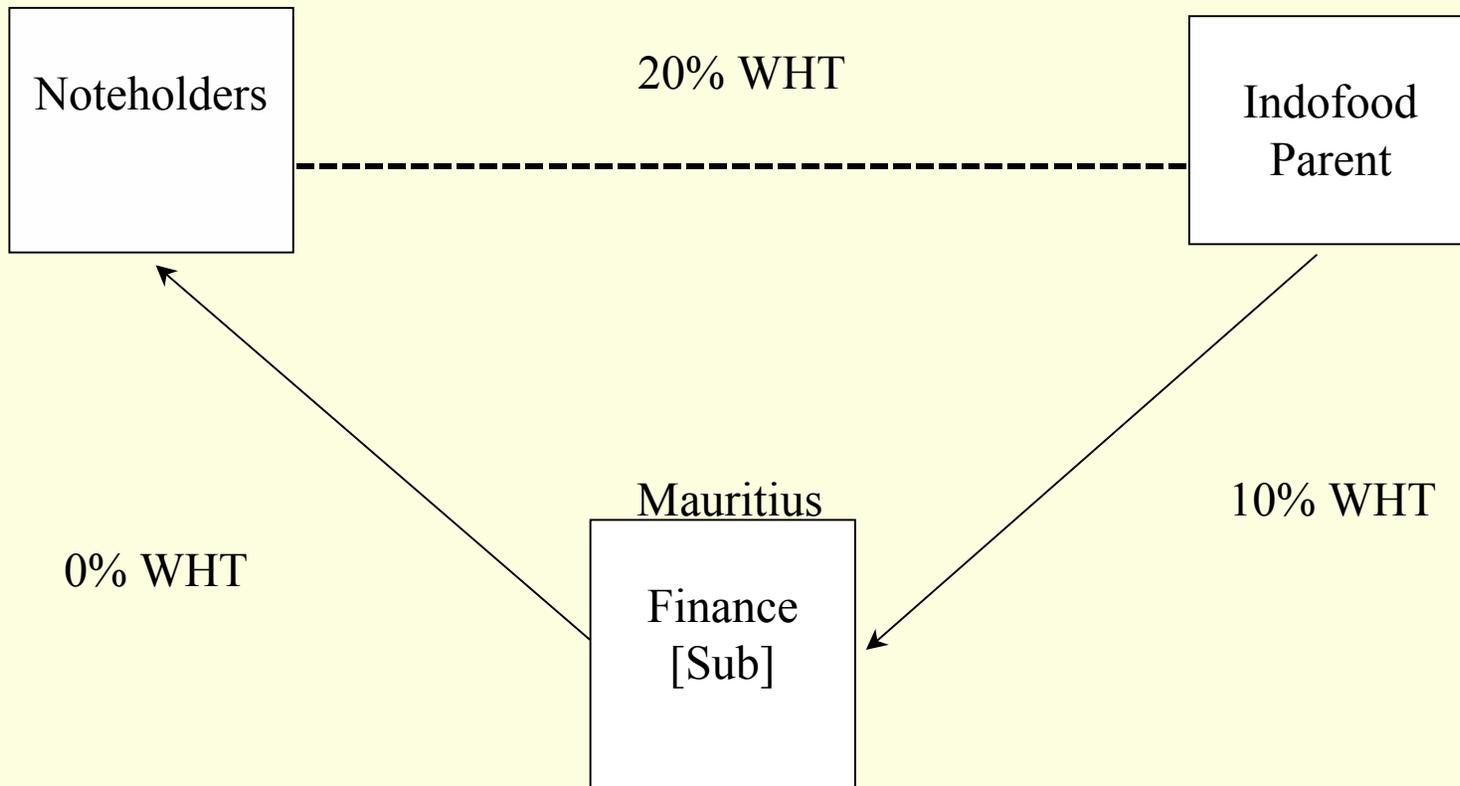
Italy's definition of beneficial owner for portfolio income exemption purposes:

- person to whom income “is attributed for tax purposes” (Cir. n. 306/E of 12.23.1996);
- qualified foreign fiscally transparent entity automatically beneficial owner.

Indofood International Finance Ltd. vs. JP Morgan Chase Bank

Trustee (JP Morgan)

Indonesia



I. Key Facts

- *PT Indofood Sukses Makmur TBK* (“Parent”) wished to raise capital by issuing notes on the international markets.
- It set up a financing subsidiary in Mauritius, *Indofood International Finance Ltd* (“Finance”), which in 2002 issued US\$ 280 million 10.375% loan notes guaranteed Parent. Interest after WHT: 29.05M. WHT:3.23m p.a. Total cost: 32.3m p.a.
- Proceeds from the notes were on-lent to Parent under a separate loan agreement entered into on substantially the same terms.
- Interest on the loan was due 2 days before interest on the notes.
- Finance had to transfer interest on the notes to Trustee at least 1 day before due date. Trustee paid interest to note holders on the due date.
- The notes could be redeemed at par plus accrued interest if change in law caused an increase in withholding tax on interest paid by Parent to Finance under the loan to rate higher than 10%.
- Early redemption was subject to Finance having taken all reasonable measures to avoid the increased WHT.

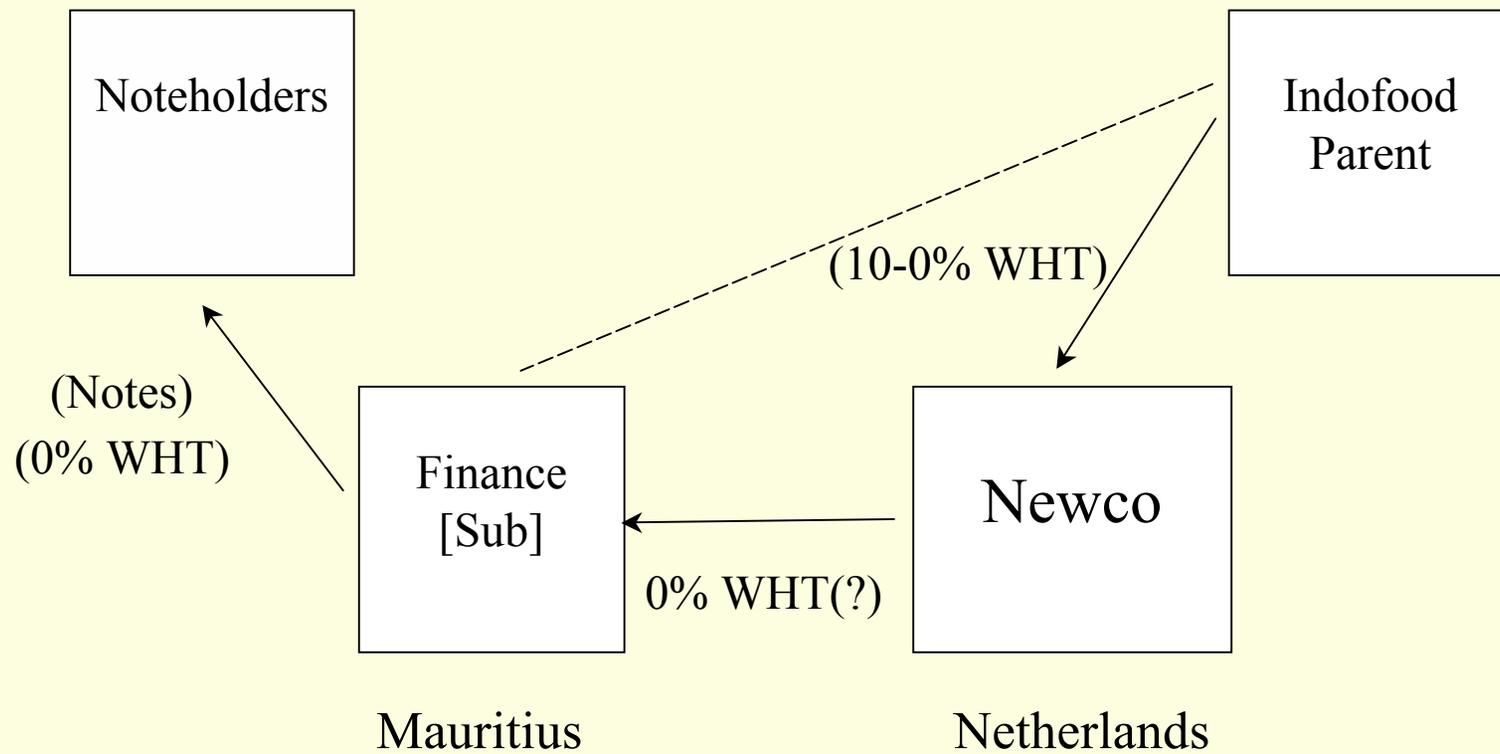
I. Key Facts (cont'd)

- On June 24, 2004 Indonesia notified the intention to terminate the Mauritius Treaty with effect from January 1, 2005.
- On August 20, 2004 Finance notified the intention to redeem the notes.
- On November 22, 2004 the Trustee refused to give its consent on the basis that reasonable measures could be taken to avoid the increased withholding tax.
- The Trustee argued that a new company (“Newco”) could be incorporated in the Netherlands and interposed between Parent and Finance
- Newco should have had the following characteristics: keep books and records in NL, be audited in NL; have solely Dutch residents as directors; meet the “substance and risk” requirements of Dutch law (min. capitalization and min. spread?); have no place of management or place of business in Indonesia; receive the benefits of Finance Parent loan, assume risk (of Parent’s default).
- Finance disagreed and brought the case to court.

II. New Structure Suggested by Trustee:

Trustee (JP Morgan)

Indonesia



III. Relevant Legal Questions

Is the proposed structure sufficient to reduce the WHT?

Is the proposed structure a reasonable measure to reduce the WHT?

Tax Issue:

Is Newco Eligible for Indonesia-NL Tax Treaty Benefits (elimination or reduction of withholding tax on interest on the loan)?

Trust deed governed by English law, jurisdiction of UK courts. UK courts decide on the basis of how Indonesia tax court would resolve it.

IV. Tax Issue

Two requirements for Eligibility for treaty benefits: residency and beneficial ownership.

Article 11 - Interest - 2002 Indonesia/NL Tax Treaty:

1. Interest arising in [*Indonesia*] and paid to a resident of [*the Netherlands*] may be taxed [*the Netherlands*].
2. However, such interest may also be taxed in [*Indonesia*] and according to the laws of [*Indonesia*], but if the beneficial owner of the interest is a resident of [*the Netherlands*], the tax so charged shall not exceed 10 per cent of the gross amount of the interest
4. ... interest arising in [*Indonesia*] shall be taxable only in [*The Netherlands*] if the beneficial owner of the interest is a resident of [*The Netherlands*] and if the interest is paid on a loan made for a period of more than 2 years
5. The competent authorities of the two states shall by mutual agreement settle the mode of application of paragraphs 2, 3 and 4.

V. Indonesian Tax Administration Ruling of June 24, 2005

- One of the underlying objectives of tax treaties is the prevention of tax evasion and tax avoidance.
- A financing structure designed to avoid the increased withholding tax taking advantage of a treaty with another country amounts to treaty shopping or treaty abuse.
- The term beneficial owner is an *anti abusive rule* intended to limit the accession to the benefits provided by a treaty.
- Therefore, the term “beneficial owner” means the actual owner of the interest income who truly has the full right to enjoy directly the benefits of that interest income.
- Consequently, *conduit company* and *nominee* such as the Newco will be regarded as the actual owner of the income.

VI. Indonesian Tax Administration Circular Letter - June 7, 2005

- **Beneficial Ownership:**

The term “beneficial owner” means the actual owner of the income who has the full rights to enjoy directly the economic benefits of the income

- **Special Purpose Vehicle:**

SPV in form of “conduit company”, “paper box company”, “pass through company” or other similar entities is not the beneficial owner of income as defined above.

VII. UK High Court's Decision

- Conduit companies are not automatically not the beneficial owners of the income that they receive;
- Beneficial ownership is a different - and narrower - concept than treaty shopping or treaty abuse (basically applying only to the “agent or nominee case”).
- Indonesia accepted Finance as beneficial owner for purposes of Indonesia-Mauritius Treaty.

VIII. UK Court of Appeal's Decision

- The term “beneficial owner” is to be given an international fiscal meaning not derived from the domestic laws of the contracting states, and would require the “full privilege to directly benefit from the income”.
- The meaning to be given to the term “beneficial owner” is plainly not be limited by so technical and legal an approach. Regard is to be had to the substance of the matter.
- In practical terms, it is impossible to conceive of any circumstances in which either the Issuer or Newco could derive any ‘direct benefit’ from the interest payable by the Parent Guarantor except by funding its liability to the Principal Paying Agent or the Issuer respectively.

IX. Reactions

Diane Hay, UK Deputy Director of Revenue Policy - International

“Presents a very strong ruling against treaty shopping”

“In a way, it is a very awkward situation for us, since now we have to look what was previously OK .. and see if we can say structured finance is still going to be OK using these arrangements”.

IX. Reactions (cont'd)

Patricia Brown, Former US Treasury Deputy International Tax Counsel

Beneficial ownership is “being used now against taxpayers in a variety of circumstances to deny treaty benefits in cases where I do not think it is really appropriate”.

Reference to “international fiscal meaning” of the term beneficial ownership is disturbing.

The Court “didn’t have to do that in order to resolve the case. It could have said that Indonesia believes it is not the beneficial owner and that is enough”.

IX. Reactions (cont'd)

Brian Ernewein, Canada's Department of Finance Director of Tax Legislation:

Not sure if a wholesale gift for governments. “It does help us when we are trying to constrain a given country when that country is trying to constrain treaty benefits on what it thinks may be an abusive situation ... but it does help us if another country is applying it in a situation we do not think is appropriate to constrain treaty benefits”

IX. Reactions (cont'd)

2006 Indonesia Ruling Letter S-95/2006

Concerns a multinational company's interest payments to a foreign affiliate
Sets forth the requirements for determining beneficial ownership for general
treaty purposes:

- subject to tax requirement;
- active business requirement;
- full right to income; or
- publicly traded requirement.

X. UK Guidance (Released on October 9, 2006)

Strongly limits the impact of UK Court of Appeal decision.

No need to search for an “international fiscal meaning” of the beneficial ownership requirements if no treaty abuse.

Tax avoidance test to determine treaty abuse: the interposition of an intermediate lender results in an improvement of the withholding tax position of interest paid to a UK borrower.

Safe harbors:

- ultimate lender based in a treaty jurisdiction granting the same or lower WHT (equivalent beneficiary);
- ultimate lender a UK bank beneficially entitled to the interest;
- the intermediate lender is funded by Quoted Eurobonds.

XI. Last Minute Update

PT. Indah Kiat Pulp & Paper Tbk vs. US Bank National Association et. al

- US\$ 480 million loan notes issued in 1994 through a Dutch intermediate financing company. WHT reduced from 20 to 10 per cent. Very similar fact pattern.
- Indonesia tax courts found the transaction to be illegal tax evasion (treaty shopping). Therefore, higher withholding tax will be assessed with interest and penalties.
- Indonesia Supreme Court upheld lower courts' decision

So, beware, review/study your financing arrangements and make sure they work

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