

## DOES INTEREST ARISE IN THE UK?

by David Goy QC

Section 874 of the Income Tax Act 2007 sets out a variety of circumstances in which tax must be deducted at source when yearly interest is paid. For present purposes the relevant circumstance is when interest is paid to a “person whose usual place of abode is outside the United Kingdom.” In all cases the obligation only exists

“...if a payment of yearly interest *arising* in the United Kingdom is made.”<sup>1</sup>

The question of where interest arises is an issue that has been with us for a long time, but limited authority has hitherto existed on the point.<sup>2</sup> Further light has now been thrown on the issue by a decision of the Upper Tribunal in two cases heard together, *Ardmore Construction Limited* and *Perrin*<sup>3</sup> (“*Ardmore*”).

The Revenue’s view, at least historically is set out in the Savings and Investment Manual<sup>4</sup> where the following is said:

“Where or not interest has a UK source depends on all the facts and on exactly how the transactions are carried out. HMRC consider the most important factor in deciding whether or not interest has a UK source to be

- the residence of the debtor and the location of his/her assets.

Other factors to take into account are

- the place of performance of the contract and the method of payment;
- the competent jurisdiction for legal action and the proper law of contract;
- the residence of the guarantor and the location of the security for the debt.

This list of factors is derived from the leading case on

the source of interest, Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA (46 TC 472).

HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan. 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction."

The two cases heard in *Ardmore* both involved UK residents paying interest to non-residents where the source of funds, both to enable payment and enforcement, were in the UK. In both cases it was held that the interest paid had a UK source. The UT specifically rejected the argument that the source of interest was where the lender carried on his business and provided the credit. A "multi-factorial approach", was the correct approach, following the House of Lords decision in the *Greek Bank*<sup>5</sup> case.

The *Ardmore* case is interesting because the UT is specific about a number of factors that are either not relevant or have little relevance in deciding the issue. The UT was clear that it followed from the *Greek Bank* case that the legal situs of a debt is not a relevant factor for income tax purposes.<sup>6</sup> It gave no reason, however, why this is the case. Nevertheless, it must now be assumed, that speciality debts, where the speciality is kept outside the UK, will not for that reason alone produce interest arising outside the UK.

Further, based on what was said in the *Greek Bank* case, the UT in *Ardmore* regarded the following factors as of little or no weight:-

- (i) The residence of the creditor or the place of activity of the creditor.
- (ii) The place where the credit was advanced.

- (iii) The place of payment of the interest.
- (iv) The jurisdiction in which proceedings might be brought to enforce payment.
- (v) The proper law of the contract.

Both (iv) and (v) are factors that the Revenue refer to in their manual as being relevant. The UT disagrees.

Relevant factors that remain are in particular the residence of the debtor, the location of the security and the ultimate source of discharge of the debtor's obligation.

The UT did not follow the Revenue's guidance its stress on the overwhelming importance of the debtor's residence. The UT said that

“Residence is... only one factor, and it cannot be elevated into the most important factor, whether alone or when combined with the question of the location of the debtor's assets: the *Greek Bank* case did not determine any hierarchy of materiality or weight and none can be inferred.”

The problem that this gives rise to is that genuine uncertainty may remain as to where the source of interest is found. In the two cases considered in *Ardmore*, it is not difficult to see that balancing the relevant factors, most particularly of residence and the ultimate source of funds, they pointed to a UK source. But what is the position where important factors conflict? Let us suppose that the debtor is resident in the UK but his only source of funds is abroad? Alternatively let it be supposed that the debtor is non-resident but the source of funds is in the UK. There is a lack of clarity in such cases as to the location of the source concerned. Hitherto it has generally been assumed that if a loan is made charged on UK property, there is a UK source, but it cannot be said that this is entirely clear.

Reliance on the ultimate source of funds as indicating the source of interest may be problematic. Let it be assumed that a non-resident debtor has his only source of funds in the UK, out of which he pays the interest. Clearly this will be a significant

factor pointing to a UK source. Let it be supposed that in a later period other sources of income are acquired abroad, out of which the interest is on occasion paid. In these circumstances it would seem odd that the source of the interest could change. The UT's ultimate answer to the question would doubtless be that all relevant factors need to be considered, but this provides little help for the taxpayer who must decide whether he must deduct tax.

One last point arises where both the debtor and creditor are non-resident and do not carry on business in the UK. A question that arises is whether, on *Clark v Oceanic Contractors*<sup>7</sup> grounds, the section 874 procedure, if it might otherwise be held to apply because of there being a UK source, is subject to a territorial limitation based on effectiveness. This is a point not hitherto considered by the courts.

#### *Endnotes*

1. S.874(1) ITA 2007
2. The Greek Bank case is the principal relevant authority (1990) 46 TC 472
3. [2015] UKUT 0633
4. SAIM 9090
5. Ardmore para 46
6. (supra) para 45
7. [1983] STC 35