The Personal Tax Planning Review

RELIEF FOR INTEREST PAID

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Where a property is acquired for investment purposes with the assistance of borrowings, it will invariably be crucial to the purchaser that he obtains tax relief for the interest paid on the loan against any rent received from letting the property. In recent years, borrowers (and those who seek to benefit from lending them the money) have been in a state of some uncertainty about the Inland Revenue's interpretation of s.353 Taxes Act 1988. Fortunately, this uncertainty has now been largely resolved.

Let us assume that an individual obtains a loan from a bank for the purpose of purchasing a property in the UK which he intends to let. A number of conditions must be satisfied regarding the letting which are contained in ss.354 to 356 TA 1988. However, meeting those conditions will be insufficient to afford relief. It is also necessary for the terms of the loan to satisfy the conditions of s.353(1) and, in the case of bank interest, the relevant part is s.353(1)(b), which contains two principal requirements. The first is that the interest must be "payable in the UK or the Republic of Ireland" and the question arises whether a loan from a bank outside the UK or from the foreign branch of a UK bank gives rise to interest payable in the UK. The reference to interest "payable" in the UK indicates that the interest should be capable of being paid in the UK under the terms of the loan; it is not necessary for the interest actually to be paid in the UK, and the interest should be deductible even if it is paid outside the UK, providing the payer is entitled, had he so wished, to have tendered payment of the interest in the UK.

This reasoning is supported by *CIR v Maude* 23 TC 63, where a Guernsey resident arranged borrowings from her local branch of a major clearing bank. The interest was paid by debiting her Guernsey bank account. The court decided that because the Guernsey branch was part of the UK bank she would have been entitled to pay the interest at the head office in London and the interest was therefore "payable in the UK". This decision was affirmed in the more recent case of *Hafton Properties Ltd v McHugh* [1987] STC 16. Furthermore, no requirement exists for the loan to be made in sterling. A loan denominated in another currency and the payment of interest in that or any other currency will be eligible for relief, providing the other conditions are fulfilled.

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However, the matter does not end there because s.353(1)(b) contains a second requirement that the interest must be paid.

> *"on an advance from a bank carrying on a bona fide banking business in the UK"*

and it is here that the problem arises. Four different possibilities would seem to arise. The loan could be from:

a) A UK branch of a UK bank.
b) A foreign branch of a UK bank.
c) A UK branch of a foreign bank.
d) A foreign branch of a foreign bank which has branches in the UK.

It is assumed that in each case the bank and the relevant branch are carrying on a bona fide banking business.

It is well settled that each branch does not carry on a separate trade but represents part of the single trade carried on by the bank as a whole through its various branches. (The same would not be true of a bank which operated through different subsidiaries in each country, although they may be colloquially referred to as branches.) In each case the loan would be from a bank and the bank would be carrying on a bona fide banking business in the UK. It should not matter that the loan is taken out with the foreign bank in some other part of the world. The terms of s.353(1)(b) do not require the banking business to be carried on only in the UK; it can also carry on its banking business in every other country in the world without infringing the condition.

Until recently, the Inland Revenue took the view that a distinction could be made between an advance from a UK branch and an advance from a foreign branch. They suggested that an advance from a foreign branch did not fall within s.353(1)(b), but this could only have been correct if the foreign branch was treated as a distinct entity, separate from the rest of the bank and not part of the same trade.

It may be noted in passing that in *Maude* some references were made to other cases (unrelated to tax) which indicate that for some banking purposes branches can be regarded as distinct trading bodies. One example given is that a customer can only insist on a cheque being cashed at the branch at which his account is kept. This seems to be based on banking policy, and must be of extremely restricted application, particularly having regard to the confirmation that there is no general rule that a transaction between banker and customer automatically has a local character. Even if the branches could be regarded as distinct trading bodies, this would not seem to be enough to fall outside s.353. Providing it could be shown that the loan was from the bank (which must necessarily be the case, as it is the

bank which would sue if the borrower were to default, the branch having no separate legal existence), and then that the bank does carry on a bona fide banking business in the UK, relief should be assured. Fortunately, the Inland Revenue now acknowledge that no such distinctions should be made.

However, the position can become more complicated. Let us assume that for the purposes of acquiring a property in the UK a loan is taken out with the Bank of Argentina, which has branches in Chile, Peru and London. A Bolivian resident arranges a loan in Chile, and the interest is paid in Peru in US dollars, although it is able to be paid at any one of the bank's branches. Is the interest deductible? The answer would seem to be yes. The interest is payable in the UK because the borrower is entitled to pay the interest to the London branch. It does not matter that he chooses to pay the interest in Peru. The bank carries on a bona fide banking business in the UK through its branch in London. The conditions are satisfied, notwithstanding that the loan has absolutely nothing to do with the UK at all; it was not arranged here, it is not repayable here, the interest is not paid here, nor is it in sterling.

Relief is available only because the bank happens to have a working branch in the UK. This sounds bizarre, and it is no surprise that the Inland Revenue are not prepared to go so far as to agree that s.353(1)(b) applies to such a loan. However, there seems no technical reason why they should deny relief. After all, the loan, with all its foreign characteristics, does have to be used in purchasing a property in the UK, and the interest will only be deductible against rents from the property which would otherwise be chargeable to UK tax. The example is of course extreme, but the reasoning applies in much more sensible circumstances. A resident of, say, Hong Kong may well want to borrow money for UK property investment, and it would be much more convenient for him to borrow the money in local currency from a local branch of an international bank and to pay the interest locally. He could arrange everything through London in sterling and remit money to pay the interest here, but that would be a cumbersome process and would expose him to risk of loss from currency fluctuations which he would prefer to avoid. Perhaps the argument is not so bizarre after all, and perhaps Somerset House will eventually agree that a further revision to their view would be appropriate.