THE TERRITORIAL SOURCE OF INTEREST PAYMENTS

Alexander Thornton[1]

The Problem

Identifying the territorial source of interest payments is an important exercise. It is also fraught with difficulties. It is important because only those payments with a United Kingdom source fall within Case III of Schedule D.[2] It is difficult because payments are covered by the umbrella of authority only when their features point uniformly towards one source. In this article I address the problem arising when interest payments have different features which point towards different sources. I analyse which of the relevant features carries most weight when they are in conflict.[3]

For example, suppose that X, an individual resident in Ireland, makes an unsecured loan to Y, an individual resident in the Isle of Man. Y invests the loan money in the United Kingdom by purchasing and leasing properties. Collecting agents in the United Kingdom are appointed by Y to collect the rents. Y uses the proceeds from the rents to make interest payments on the loan to X in Ireland. Where is the territorial source of the interest payments? There are two clear factors which can be identified. Firstly, the debtor is resident in the Isle of Man and the debt can be enforced there. Secondly, the interest payments are made from funds raised in the United Kingdom. Which factor carries the most weight?

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1 Alexander Thornton, Barrister, c/o, 24 Old Buildings, Lincoln's Inn, London SW2A 3UJ. Tel: (0171) 242 2744 Fax: (0171) 831 8095.

2 *Colquhoun v Brooks* (1889) 14 App. Cas. 493 at 504; Income and Corporation Taxes Act 1988 s.18.

3 This difficult issue has been addressed before in an article by Robert Venables QC, 'The Territorial Source of Income: *Hang Seng Bank, HK-TVB International* and *Orion Caribbean*', *The Offshore Taxation Review*, 1997, Volume 7, Issue 3, pages 177-210.

The National Bank of Greece Case

Any theory about which feature of an interest payment conclusively determines territorial source should dovetail with the leading case, *Westminster Bank Executor and Trustee Company (Channel Islands Ltd) v National Bank of Greece SA*.[4] In this case the House of Lords identified a number of relevant factors, albeit without giving their relative significance, which determine territorial source.

A successor of a foreign bank which had guaranteed sterling mortgage bearer bonds, issued by another foreign bank, resumed payments of interest to a holder of the bonds. In doing so it deducted tax at the standard rate on the basis that the payments of interest came within Case III of Schedule D. Lord Hailsham, who gave the leading speech, stated that, following *Colquhoun v Brooks*, the only issue was whether or not the source of the payments was situated within the United Kingdom. He continued:

> I have come to the conclusion that the source of the obligation in question was situated outside the United Kingdom. This obligation was undertaken by a principal debtor which was a foreign corporation. That obligation was guaranteed by another foreign corporation which, as was conceded before us, had at no time any place of business within the United Kingdom. It was secured by lands and public revenues in Greece. Payment by the principal debtor of principal or interest to residents outside Greece was to be made in sterling and either at the offices of Hambros Bank or Erlangers Ltd. [i.e. London banks] or (at the option of the holder) at the National Bank of Greece in Athens, Greece, by cheque on London. Whichever method of payment was selected, it was pointed out before us that, whatever use were made of the option, discharge of the principal debtor's obligation would have involved in the ordinary course either a remittance from Greece to the paying agents specified in the bond or, at the option of the holder, a cheque issued within Greece though draw on London, and presumably payable there out of funds remitted by the debtors from abroad. It was also pointed out that the bond contained no provision for payment by the guarantor at any particular place or in any particular country. The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the United Kingdom were as follows. Although the original guarantor had no branch in the United Kingdom, the present Appellants had acquired one on their universal succession in London. Moreover, it was urged that, since the discharge of the obligations under the bond in Greece had been caught by the moratorium enacted by the Greek Government, it followed that the only place at which the obligation could have bee discharged or enforced was in London. Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that one guarantor had been substituted for another, or by reason of the fact that the second guarantor so substituted subsequently acquired a London place of business, or by reason of the fact that the Government of Greece had by retrospective legislation altered by

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4 46 TC 472.

> moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor. The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds. In my view, the bond itself is a foreign document, and the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.[5]

Both the residence of the debtor and the situs of the funds for the interest payments are on Lord Hailsham's list of relevant factors. Applying the *National Bank of Greece* case to the example of the loan between an Irish resident individual and an Isle of Man resident individual illustrates the problem to be addressed. The debtor is resident in the Isle of Man. Following the *National Bank of Greece* case this indicates a non-United Kingdom source. Conversely, the funds from which the interest payments are made are situated in the United Kingdom. This indicates a United Kingdom source.

Unfortunately, the Inland Revenue guidance on the territorial source of interest payments does not solve the problem. The Revenue have indicated four factors which they regard as important in supporting the existence of a United Kingdom source. These are as follows:

- the residence of the debtor, i.e. the place in which the debt will be enforced;
- the source from which interest is paid;
- where the interest is paid; and
- the nature and location of the security for the debt.

"If all of these are located in the United Kingdom," the Revenue concludes, "then it is likely that the interest will have a United Kingdom source."[6] This begs the question of what happens when there is a debtor with a non-United Kingdom residence who is paying interest with funds raised in the United Kingdom.

It is clear that a simple reading of the *National Bank of Greece* case and the Revenue guidance can only serve to locate the territorial source of the most uncomplicated interest payments.

Residence of the Debtor

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5 46 TC 472 at 493-494.

6 RI 58 of November 1993. Further references to the source of interest payments can be found in the following places in the Inland Revenue Manuals: *The Inspector's Manual* at 3940; *The International Tax Handbook* at 1103; and *The Double Taxation Relief Manual* at 1730.

Given that the territorial source of all interest payments cannot be identified by reference to the *National Bank of Greece* case alone, what other authority is of use? Historically, the Revenue used to say that a loan with a United Kingdom source was one with the debtor resident in the United Kingdom. Equally, the Courts have looked to the general law principle that a debt is situated wherever it can be enforced. If this approach is grafted onto the *National Bank of Greece* case, the result is that the residence of the debtor (i.e. the place where his obligation can be enforced) takes on decisive significance whenever the source of interest payments is to be determined.

The *Kwok* Case

A recent manifestation of this line of authority is the Privy Council case of *Kwok Chi Leung Karl (Executor of Lamson Kwok) v Commissioner of Estate Duty*.[7] The source of a debt, the Privy Council held, is the place where the debtor is resident and where, under the contract creating it, the primary obligation to pay is expressed to be performed.

Kwok involved a scheme for the removal from Hong Kong immediately prior to the death of Lamson Kwok of a substantial part of his extremely valuable property and the consequent avoidance of Hong Kong estate duty.[8] The deceased was resident in Hong Kong and died there on 27th April 1983. Only some two months prior to his death a limited company called Tolu Ltd was incorporated in Liberia under the laws of that country. The company was formed in order to acquire assets from the deceased in return for conveniently worded promissory notes. The entire issued share capital of the company consisted of 100 bearer shares which were owned by the widow and the four sons of the deceased. An agreement was entered into on 26th April 1983 between Tolu Ltd and the deceased for the purchase of the deceased's shares in return for a promissory note executed by Tolu Ltd for US $1,807,839.24. The principal and interest thereon was expressed to be due and payable on demand after 60 days in the City of Monrovia, Republic of Liberia. At the same time Tolu Ltd executed a promissory note in the required terms.

The issue was whether, at the date of death, the obligation represented by the promissory note was property which was situate within Hong Kong. Lord Oliver said:

> The matter falls, in their Lordships' opinion, to be determined by reference to first

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7 [1988] SAC 728. This case is cited as the leading authority on the territorial source of interest under Case III of Schedule D in the Inland Revenue *Double Taxation Relief Manual* at 1730. See also *The International Tax Handbook* at 1103 where the residence of the debtor is cited as "an important factor in determining the source of interest". The rest of the factors in the *National Bank of Greece* case are described as merely "other factors to be taken into account".

8 The facts are taken from the speech of Lord Oliver.

principles. In the first place, the notion that a debt or other chose of action, because incorporeal, can have no situs was laid to rest by the House of Lords in *English, Scottish and Australia Bank Ltd v IRC* [1932] AC 238. It is clearly established that a simple contract debt is locally situate where the debtor resides - the reason being that is, prima facie, the place where he can be sued (see *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101, per Warrington LJ at 114). A debt which is payable in futuro is no less a debt and there is no logical reason why it should, as regards its locality, be subject to any different rule. It is simply a chose in action and like any chose in action is subject to the general rule which is conveniently stated in [r 114 in Dicey and Morris, *The Conflict of Laws* (12th ed, 1993) vol 2, p.922] as follows:

(1) Choses in action generally are situate in the country where they are properly recoverable or can be enforced.[9]

Normally, Lord Oliver went on to say, this situs would be where the debtor resided. He noted the exceptions of speciality debts and negotiable instruments which are respectively situate in the place where the deed is located or the market exists for negotiation.

On these grounds, since a physical person can only be resident for the purpose of enforcing a debt in one place at a time, the situs of a debt owed by him is easy to determine. In *Kwok* the debtor was a corporation which was found to have two places of residence: Hong Kong and Liberia. "It is clearly established", Lord Oliver concluded, "that the locality of the chose in action falls to be determined by reference to the place - assuming it to be also a place where the company is resident - where, under the contract creating the chose in action, the primary obligation is expressed to be performed (see the *New York Life Insurance* case already referred to; *Re Russo-Asiatic Bank* [1934] Ch 720 at 738; and *Jabbour (F&K) v Custodian of Israeli Absentee Property* [1954] 1 WLR 139 at 146)."[10]

Monrovia was the situs of the debt in *Kwok* because the debtor was resident there and the expressed contractual obligation to pay was after 60 days in Liberia and on presentation in the City of Monrovia.

Rejecting the *Kwok* Case

Residence of the debtor was one of the factors on Lord Hailsham's list in the *National Bank of Greece* case. Does the line of authority culminating in *Kwok* make it the most important factor for determining the source of interest payments? In my view

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9 [1988] SAC 728 at 732e-g.

10 *Ibid*, at 733f-g.

residence of the debtor is not the most important factor in determining the territorial source of income. This is a view which has already been expressed by Robert Venables QC.[11] Firstly, *Kwok* itself is a Privy Council decision on Hong Kong estate duty. Secondly, *Kwok* and the earlier authorities were not decided on the territorial source of interest payments for the purposes of Case III of Schedule D. Thirdly, for these purposes it cannot be correct to conflate the source of interest payments with the situs of a debt.

Fourthly, the *National Bank of Greece* case was not cited in Kook. If, at this submission, a devil's advocate rises and cries "of course not, it was not remotely relevant to the issue in *Kook*", the answer must be "why is *Kook* and all that it brings of any relevance to issues that are to be determined in accordance with the *National Bank of Greece* case?" Fifthly, the line of authority represented by *Kook* was disavowed for the purposes of determining the source of interest payments by both the Court of Appeal and the House of Lords in the *National Bank of Greece* case. I shall develop further the last three of these submissions below.

Conflating the source of interest payments with the situs of the loan is not the right approach. Even if one accepts that the source of income from the loan is the payment of the principal and interest, one still has to jump from the situs of the debt to the source of the interest payment for tax purposes. This leap of faith has not been made in the authorities. In fact the Courts have refused to make it and instead have relied on a different test. Taking the example of the Irish individual making a loan to an individual resident in the Isle of Man, the loan may be situated in the Isle of Man but the interest payments are raised in the United Kingdom and made in Ireland. It is true that, if the payments are not made, the obligation will be enforceable in the Isle of Man. It is submitted that the issue here is not the source of unpaid interest. The issue is the source of paid interest. The test for the source of interest payments is not the situs of the debt, although this may be a factor among other factors.

Turning to the authorities, the leap between the situs of the debt and the source of the interest payments was attempted in *Halton Properties Ltd v McHugh (Inspector of Taxes)*.[12] The Revenue fell short. Halton, a company resident in the United Kingdom, acquired property in Philadelphia subject to a mortgage in favour of the Dollar Savings Bank of New York. Monthly interest payments were made to the Dollar Bank by local agents out of the rents collected on the property. No money was sent from the United Kingdom. The issue was whether the interest payments had a United Kingdom source and fell within Case III of Schedule D.

Residence of the debtor fixed the situs of the debt, the Revenue submitted in *Halton*,

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11 Robert Venables QC, 'The Territorial Source of Income' op cit at page 182.

12 [1987] SAC 16 at 20-21. The submission was made before the Special Commissioner. This part of the Special Commissioner's decision was not appealed.

and the situs of the debt located the source of the income. Since Halton was resident in the United Kingdom, the source of the interest payments was in the United Kingdom.

The Special Commissioner rejected these submissions in favour of the *National Bank of Greece* case. He identified the nationality of the document creating the obligation as the United States and relied on the Lord Hailsham's view that the "the bond itself is a foreign document, and the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document".[13] It is respectfully submitted that Lord Hailsham did not mean by these words that the source of interest payments was determined by the nationality of the document creating the obligation. Looking at the sentences preceding these words it is clear that Lord Hailsham meant that once the source of interest is fixed it cannot change. In his speech he relied upon several factors which were external to document creating the obligation, for example he emphasised that in practice the funds from which the payments would be paid would be remitted from Greece. In the end the Special Commissioner found that Halton had not become the debtor and the source of the interest payments was in the United States.

Halton highlights the fact that in decisions on the source of interest payments the Courts have rejected submissions based on the primacy of the residence of the debtor. This can most clearly be seen in the *National Bank of Greece* case. Before the Court of Appeal a submission which in essence was to become the ratio of *Kook* 17 years later was made by an amicus curiae for the Revenue. Relying on the *New York Life Insurance* case and the test for the situs of debts as put forward by Dicey and Morris, the amicus curiae argued that the true test for determining whether payments are income arising in the United Kingdom was: in what country is the obligation primarily enforceable.[14] This was to form the core of Lord Oliver's speech in *Kook*. In the *National Bank of* Greece case, Lord Denning MR rejected this submission.[15] While this does not mean that *Kook* is wrong, it does mean that any attempt to use *Kook* to shed new light on the *National Bank of Greece* is doomed to failure. The line of authority based on the situs of the debt does not produce a new test, based on the primacy of the debtor's residence, for determining the territorial source of interest payments.

Even more damaging is the fact that the House of Lords did not adopt the *New York Life Insurance* submission. The case was cited but not referred to in the speech of Lord Hailsham. The submission that the bonds were only enforceable in the United Kingdom and that therefore the source of the payments was the United Kingdom was

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13 46 TC 472 at 494.

14 The submission is reported in [1970] QB 256 at 267-268.

15 46 TC 472 at 486.

rejected.[16] Further, Lord Hailsham did not restrict himself to examining where, under the contract creating it, the primary obligation to pay is expressed to be performed. He also looked to factors external to the document creating the bond, for example the situs of funds from which the payments would be made. In the event, the residence of the debtor was adopted only as one of many factors. The reluctance of the Court of Appeal and the House of Lords to give it any further significance undermines any attempt to place the residence of the debtor as the foremost factor in determining the source of interest payments.

Indeed, the situs of the debt - whether determined by the debtor's place of residence, wherever the debt can be enforced or, in the case of specialities, wherever the deed is situated - is not a conclusive factor. This signals that principles derived from general law cannot be stretched too far when determining the decisive factor in locating the source of interest payments for the purposes of Case III of Schedule D.

Situs of Funds for Interest Payments

If the residence of the debtor is not the decisive factor, what is? Clearly, one must exist in order to solve the problem of interest payments which have different factors pointing to different sources. Equally clearly, the decisive factor must be one of the factors identified by Lord Hailsham.[17] In my view, it is the situs of the funds from which the payments are made. This is a view which has already been expressed by Robert Venables QC.[18]

Examples given by the Revenue in the Inspector's Manual support this theory. Where the debtor is an individual resident in the United Kingdom but interest is payable abroad on an overseas loan taken out to buy an overseas asset, or for some other purpose with no United Kingdom connection and the loan is not secured on United Kingdom assets, the interest is regarded as having a foreign source. Another example relating to companies also emphasises the importance of the situs of funds from which interest payments are made:

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16 46 TC 472 at 494.

17 There is dicta which emphasises the place where the money was lent. See the Privy Council case of *Commissioner of the Inland Revenue v. Hang Seng Bank Ltd* [1990] STC 733 in which Lord Bridge said, at page 740, "if the profit was earned by the exploitation of property assets as by... lending money... the profit will have arisen in or derived from the place... where the money was lent". Lord Bridge's dicta was qualified by Lord Nolan in *Commissioner of Inland Revenue v Orion Caribbean Ltd* [1997] STC 923. The place where money was lent was not mentioned in nor do these authorities mention the *National Bank of Greece* case. These cases are discussed fully in the article by Robert Venables QC at page 208.

18 See note 2 above.

> Where a United Kingdom resident company has raised a loan overseas for the purpose of the business of an overseas branch and *the interest is paid by the overseas branch, the interest is regarded as having a foreign source*. Conversely, where a non-resident company raises a loan in the United Kingdom for the purposes of the business of a United Kingdom branch and *the interest is paid by the United Kingdom branch, the interest is regarded as having a United Kingdom source*.[emphasis added][19]

In conclusion, when the territorial source of interest payments falls to be determined, the most decisive factor is not the residence of the debtor. Instead, it is the situs of funds from which the interest payments are made.

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19 *The Inspector's Manual* at 3940.