The Offshore Taxation Review

A NOTE ON GEOFFREY SIMPSON'S 'THE SOURCE OF INTEREST: A PRACTICAL, HARD MATTER OF FACT'

Robert Venables QC[1]

Although Mr Simpson's views set out in the above article, in Volume 8, Issue 2, page 109 of this *Review*, to some extent differ from my own, as set out in my article in Volume 7, Issue 3, page 177 'The Territorial Source of Income: *Hang Seng Bank HK-TVB International* and *Orion Caribbean*' ('my Article'), I am in substantial agreement with him on several points in this very difficult area.

I agree with Mr Simpson that if the lender's activities in generating interest income are on a sufficient scale to be regarded as having an "independent vitality" distinct from the individual loan contracts entered into then that financial business may become the source of the income earned therefrom. See 4.1 and 4.3 of my Article on trading activities, My comments apply in principle equally to a financial trade, such as that of a banker.

At 4.2, I considered the source of investment income. I stated the proposition with which Mr Simpson is not in full agreement: "In the case of investment income, broadly speaking, the test is: 'Where does the income in fact come from?' I added in a footnote that "This is not a test which has been laid down judicially in terms but is in my view the only test which enables one to reconcile (most of) the authorities."

After considering the cases of payment for the use of land or chattels and dividends from a company, I continued:

> "The source of interest is rather more difficult. Does one simply look at where the debtor is resident? In many cases, the country of residence of the

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debtor will no doubt also be the source of the interest, but it is not in my view conclusive. The United Kingdom Revenue used to take this view that it was, but have, wisely, hedged their bets in RI 58 of November 1993. In my view, the most important factor is the situs of the funds from which the interest is to be paid, but the matter is complicated and further discussion outside the scope of this article."

At 5.4.4, I discussed some questionable dicta of Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd*[2], in particular the sentence "But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected..." I suggested that "Lord Bridge's statement that when money is lent the source of the profit is where the money was lent is contrary to all United Kingdom authority. The *National Bank of Greece*[3] case is the latest and most authoritative House of Lords decision on the territorial source of interest. Although the loan was raised in London in sterling,[4] the House of Lords held that payments of interest had a foreign source. So insignificant was the place where the money was lent that they did not even refer to it! Lord Bridge could never have made the statement had he been aware of the decision (which was not cited to the Board)."

The Privy Council's error in the *Hang Seng Bank* case had been to ignore the importance of the fact that the Bank carried on a trade. In *Commissioner of Inland Revenue v HK-TVB International Ltd*,[5] which had concerned the exploitation of video copyrights by way of trade, the Privy Council had reached the right answer without expressly stating that *Hang Seng Bank* was wrong.

In *Commissioner of Inland Revenue v Orion Caribbean Ltd*,[6] the taxpayer was a financial trader, borrowing from associated companies and on-lending on their recommendation. It had the misfortune to have its appeal heard by a Board presided over by Lord Nolan, the member of the Privy Council most experienced in tax matters. The Board of Review in Hong Kong had concluded that: "if the facts of a case do not bring it within any of the examples given by Lord Bridge in the *Hang Seng Bank* case, the operations test should be applied in determining the question whether the profits arose in or derived from Hong Kong. Taking the present case as one of lending money coming within the example given by Lord Bridge in the *Hang Seng Bank* case, we

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2 [1990] STC 733.

3 (1970)46 TC 472.

4 See per Karminski LJ at 489C-D.

5 [1992] STC 723.

6 [1997] STC 923.

have looked to the place where the money was lent as the test."

On behalf of OCL, Mr Christopher Clarke QC invited their Lordships to uphold the decision of the Board of Review and the Court of Appeal on the simple basis that where the gross income in question is interest on a loan the source of the income is located, as a matter of law, in the place where the money is advanced. For this proposition he relied upon the example given by Lord Bridge. I dealt with Lord Nolan's answer at 7.4 of my Article:

> "Lord Nolan dealt with the argument as follows:
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> > 'There are three difficulties inherent in this proposition. The first is that it attributes to Lord Bridge's words, even if they are taken in isolation, a rather broader meaning than that which they naturally bear. Lord Bridge speaks of profit earned 'by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities'. The reference to 'property assets' in relation to the letting of property or the lending of money may have been intended to refer simply to the exploitation of property or money owned by the taxpayer. If ORPL lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York. If, on the other hand, Lord Bridge was intending to cover, by his examples, a case such as that of OCL where the money has to be borrowed before it can be lent - like the commodities which have to be bought before they can be resold - it would be surprising if he were suggesting that regard should be had solely to the place of lending, to the exclusion of the place of borrowing.'
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> "Here, Lord Nolan is making the crucial distinction between lending as an investment and lending in the course of a trade. In the example he gives, the source of the interest will normally be New York if the borrower is resident there and is going to pay the interest out of funds which arise there, but not because the money is lent there. That is why he expresses himself in such guarded language. It was not, of course, necessary for him to go further in expressing disagreement with Lord Bridge.
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> "Lord Nolan continued:
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> > 'Secondly, and more generally, the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place where

> the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the *HK-TVB* case, nor with the whole range of authority starting from the judgment of Atkin LJ in *F L Smidth & Co v Greenwood (Surveyor of Taxes)* onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words employed, again by Lord Atkin, in *Rhodesia Metals (in liq) Ltd v Comr of Taxes* [1940] AC 774 at 789. No simple, single, legal test can be employed.'
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> "This is again correct in principle. My only comment is that while it is perfectly true that no simple, single, legal test can be employed, that does not mean that there are not some legal tests which will usually help to determine the question of the territorial source of income. Lord Nolan was, of course, delivering a judgment and not writing a text-book."[7]

I agree with Mr Simpson that "ordinarily the source of interest receivable under a loan arrangement does not change from that which is established at its inception." I further agree with his comments on the *National Bank of Greece*[8] case. It would be most inconvenient if the source of income were constantly to vary depending on the location of the pool of funds from which the borrower chose from time to time to make payment.

CIR v Lever Brothers & Unilever Ltd[9] is in my view of rather doubtful authority in a UK court. On identical facts, I consider it somewhat unlikely that money borrowed by a New Zealand borrower for the purpose of its business in New Zealand, intended to be serviced and in fact serviced out of its New Zealand revenues, would be held in the United Kingdom to have a non-New Zealand source. The fact that the loan documentation was entered into and loan funds passed in London did not cut any ice with the House of Lords in the *National Bank of Greece* case.

Much water has gone under the bridge since 1946. It is so easy nowadays, with the abolition of exchange controls and the expansion of world financial markets, to arrange for loan transactions to be entered into and loans to be drawn down wherever in the world one wishes, that I suspect that the courts would be reluctant to let taxpayers in effect opt in or out of the UK taxation net by such simple devices.

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7 Lord Nolan had a third reply, which depended on the fact that: "The present case is far removed from the simple type of loan transaction contemplated by Lord Bridge in *Hang Seng Bank*."

8 (1970)46 TC 472.

9 (1946) 14 S.As Tax Cas.1.

Finally, I agree with Mr Simpson's conclusion that when one is planning in advance, the more factors one can build in which distance the source of the interest from a given jurisdiction, such as the United Kingdom, the better.