THE SOURCE OF INTEREST FOR TAX PURPOSES

James Kessler Q.C.[1]

1.1 Interest: location of source

Foreign source interest is outside the scope of withholding tax and qualifies for the remittance basis, so the question of source matters to both creditor and debtor.

There are three rival tests, or approaches, to the source of interest:

(1) The situs approach: the source of interest is in principle the situs of the debt as determined by the IHT/international law situs rules[2] ("the situs rules").

(2) The multi-factorial approach: the source is identified by weighing up all relevant factors.

(3) The place of credit test: the source is the place that credit was provided.

The correct approach is currently disputed. In short:

(1) The situs approach was universally accepted until 1993.

(2) HMRC adopted one multi-factorial approach in 1993, and a different multi-factorial approach in 2007; there is (in short) no UK case law supporting this except two tribunal cases now under appeal.

(3) International case law supports the place of credit test but there is no UK case law supporting this.

---

1 Member of Tax Chambers at 15 Old Square, Lincolns Inn, London, WC2A 3EU. Tel: 020 7242 2744 This article is drawn from Chapter 18 of the 13th edition of James Kessler's book *Taxation of Non-residents and Foreign Domiciliaries 2014-15* published by Key Haven Publications plc

2 See 1.3 (Rejection of the situs approach).

1.2 The situs approach

1.2.1 The consensus until 1993

The situs approach is readily understandable when one recalls the terms of the legislation in force before the ITTOIA rewrite. Section 18 ICTA 1988 provided (so far as relevant):

Case III: tax in respect of… any interest of money…[3]

Case IV: tax in respect of income arising from securities out of the UK

Case V: tax in respect of income arising from possessions out of the UK;

What was the test to determine whether income was from securities or possessions "outside the UK" and so taxed under case IV or V (now, relevant foreign income)? The natural reading of the phrase "out of the UK" was situate outside the UK, ie, the situs approach.

From the earliest times, up to about 1993, the situs approach was universally adopted. In argument and in the decisions, the textbooks cited were private international law textbooks on situs; and case law cited was situs case law.

1.2.2 *Bank of Greece*

Against that background, we can consider the *Bank of Greece* case.[4] The key facts were straightforward:

(1) A Greek bank issued bearer bonds.

(2) The bank defaulted and the guarantor[5] paid the interest.[6]

---

3 Case III was not expressed to have any territorial limitation at all! That had to be read in: interest arising from securities or possessions "outside the U K" was taxed under case IV or case V and did not fall within case III.

4 *Westminster Bank Executor and Trustee Co v National Bank of Greece* 46 TC 472.

5 For completeness: the payments were made by a company which succeeded to the original guarantor, follow ing an amalgamation, and which was subject to the same obligations as the original guarantor; but that made no difference.

6 For completeness: it was not completely clear that guarantee payments should be classified as "interest". However even if it was not interest it is sensible that location of the source of guarantee income should be determined on principles similar to those which apply to interest income, and the House of Lords proceeded on the basis that there is no difference.

The Revenue took the situs approach: the "basic test" for the source of interest was the IHT/private international law situs test:[7]

The basic test for determining whether the payments are income arising in the UK is to be found in Dicey and Morris on The Conflict of Laws, 8th ed. (1967), p. 508, rule 79, on the determination of the situs of things.[8]

The Revenue argued that although the debt was originally situate in Greece, it had moved and become situate in the UK:

> Applying that rule here, the debt is enforceable only in England where it is situate and this is the place where the income arises.

The House of Lords held that the interest had a foreign source. First they summarised the facts:

> '[1] I have come to the conclusion that the source of the obligation in question was situated outside the United Kingdom.
>
> [a] This obligation was undertaken by a principal debtor which was a foreign corporation.
>
> [b] That obligation was guaranteed by another foreign corporation which, as was conceded before us, had at no time any place of business within the UK.
>
> [c] It was secured by lands and public revenues in Greece.
>
> [d] Payment by the principal debtor of principal or interest to residents outside Greece was to be made in sterling[9] and either at the offices of [UK banks in London] 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, … 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 drawn on London,

---

7 [1970] 1Q B256, at p.266; the Revenue w ere not called on to argue the point in the House of Lords but there is no reason to think they changed their view.

8 Now Dicey, Morris & Collins, (15th ed., 2012), rule 129. The text has not materially changed.

9 For completeness: in 1935 this changed so that Greek residents could only be paid in drachm as: see *National Bank of Greece v Metliss* [1958] A C 509 at p.510. But nothing turns on that.

and presumably payable there out of funds remitted by the debtors from abroad.[10]

[e] … the bond contained no provision for payment by the guarantor at any particular place or in any particular country.'

This is a straightforward case of a foreign company raising funds by issuing debentures. Why was it argued the interest had a UK source?

'[2] The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the United Kingdom were as follows.

[a] Although the original guarantor had no branch in the United Kingdom, the present Appellants had acquired one on their universal succession in London.[11]

[b] Moreover, it was urged that, since 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 been discharged or enforced was in London.'

That is, circumstances had changed, and

(1) The guarantor (who originally had no branch in the UK) now had a branch in the UK.

(2) The bonds (which were originally enforceable in Greece) were now enforceable in the UK.[12]

These changes (though seemingly fundamental) did not change the location of the source of the interest:

'[3] 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

[a] one guarantor had been substituted for another, or

[b] … the second guarantor so substituted subsequently acquired a London place of business, or

10 The point is that payment would in the ordinary course have ultimately derived from funds situate in Greece.

11 That is, the guarantors who succeeded to the original guarantor acquired a branch in London on their succession to the original guarantor.

12 *National Bank of Greece v Metliss* [1958] A C 509.

> [c] … the Government of Greece had by retrospective legislation altered by 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.
>
> [4] 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.'

Only one (quite narrow) proposition of law can be inferred from this. *Bank of Greece* is authority for the (sensible) proposition that the location of a source of interest is fixed and does not move with changes of circumstances.[13]

It was clear, and all sides accepted, that interest paid by the principal debtor (the Bank of Greece, which issued the bonds) had a Greek source.[14]

The question whether the interest on the bonds originally had a UK source was not raised, not argued, and not answered. The practice at the time that interest paid by a non-resident was in principle within case IV or V was applied without need for consideration. In any event, almost[15] all the features of the debt pointed to Greece.

HMRC argue that paragraph [1] of the quoted passage supports the multi-factorial

---

13 More accurately, the case is authority for the proposition that the changes which occurred in the Bank of Greece case did not change the location of the source. However the changes which occurred there w ere so fundamental that there will be few if any cases w here the location of a source of interest will move.

14 In the Court of Appeal at p.487 "it has been com m on ground both in this Court and at first instance that if the payments of the coupons had been made by the principal debtors (the Mortgage Bank) they would have fallen within Case IV as being in respect of foreign securities." Likewise the case for the respondents in the House of Lords states at para 6:

> "It is common ground that if payment of the interest due on presentation of the coupons had been made by the principal debtor, those payments would have fallen with in case IV of Schedule D as being in respect of foreign securities."

15 The following features in Bank of Greece did not cause the interest to have a UK source:

(1) payment made in sterling
(2) English proper law
(3) interest paid in England.
(4) The loan was "raised in London": 46 TC at p.489.

approach: all the features listed in the paragraph were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. This is a misreading.

In short: the passage sets out a list of facts, not factors.
The short sentence at [4] ("the bond is a foreign document") was a paraphrase of the then statutory phrase, securities out of the UK). It was not intended to be a test for location of the source of interest. It is not an statement of the law: it is the conclusion.

1.3 Rejection of the situs approach

1.3.1 HMRC view 1993–2008: Multi-factorial test

HMRC made the break from the situs approach in RI 58 (1993):

> 'Schedule D Case III—meaning of "source"
>
> …The current [HMRC] view on the location of the source for interest is based on … the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were—
>
> [1] there was an obligation undertaken by a principal debtor which was a foreign corporation;
>
> [2] the obligation was guaranteed by another foreign corporation with no place of business in the UK;
>
> [3] the obligation was secured on lands and public revenues outside the UK;
>
> [4] funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided
>
> [i] either by a remittance from Greece or
>
> [ii] funds remitted by debtors from abroad[16]
>
> (even though a cheque might be drawn in London).
>
> Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and [HMRC] regard the most important as—

16 I am not sure what is meant by this.

[a] the residence of the debtor, that is the place in which the debt will be enforced;

[b] the source[17] from which interest is paid; [c] where the interest is paid; and

[d] the nature and location of the security for the debt.

If all of these are located in the UK then it is likely that the interest will have a UK source.'

This adopted a multi-factorial approach. This is not supported by *Bank of Greece*.

Assuming one does adopt that approach, "likely" was a timid word to use when all four of what HMRC identified as the "most important" connecting factors point the same way. The RI acknowledged the problem but did not offer an answer:

> It is not possible for [HMRC] to comment individually in advance on the many cases in which the location of the source of interest may be relevant since the precise tax treatment depends on all the factors and on exactly how the transactions are in fact carried out.[18]

1.3.2 Changes made by the tax law rewrite

The tax law rewrite explained why they replaced the expression securities/possessions "out of the UK" with the expression "source outside the UK":

> '3081. The definition [in the rewrite legislation, ITTOIA] uses "source" rather than "possessions" (the expression in Schedule D Case V). "Possessions", in the context of Schedule D Cases IV and V, appeared in the first income tax Act of 1799 when the word carried associations with, in particular, colonial property that it no longer has. The definition employs the more widely used term "source".
>
> 3082. The meaning of "possessions" [out of the UK] in Schedule D Case V has been interpreted by case law. It covers any and every source of income arising outside the United Kingdom. Income charged to tax under Schedule D Cases IV and V by virtue only of section 18(3) of ICTA (that is, excluding amounts treated as income by

17 [Author's Note] I think this means the situs (on IHT /international law principles) of the funds used to pay the interest. It does not mean the location on IT principles of the source of the income used to pay the interest (which could of course be different).

18 R I 58 ended with wishful thinking:
"[HMRC] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located."

> another provision in the source legislation and charged under Schedule D Case IV or V) has an identifiable source.'

The current wording, referring to the source of income, removes the inference of the former wording, that the situs test should be the test for the source of interest. But it sheds no light on what the test for source is or ought to be.

1.3.3 HMRC view from 2009: Multi-factorial test with different factors

From 2008 HMRC's Savings and Investment (SAI) Manual adopts a different version of the multi- factorial test. This version of the multi-factorial approach expands the list of relevant factors from four to eight, and give an inkling of priority:

> 9090. Yearly[19] interest: UK source: The general rule [August 2013]
>
> … Whether 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 of factor in deciding whether or not interest has a UK source to be
>
> [1] the residence of the debtor and
>
> [2] the location of his/her assets. Other factors to take into account are
>
> [3] the place of performance of the contract and
>
> [4] the method of payment;
>
> [5] the competent jurisdiction for legal action and
>
> [6] the proper law of contract;
>
> [7] the residence of the guarantor and
>
> [8] 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 Co v National Bank of Greece (46 TC 472).

Bank of Greece provides no support for a multi-factorial approach or for this particular selection of eight factors.[20]

> 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

19 [Author's note] Although the Manual heading refers to yearly interest, the same rules should apply to the source of short interest.

20 See 1.2.2 (Bank of Greece).

> the creditor will sue for payment of the interest and repayment of the loan.

The SAI Manual then defines "residence":

> 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction.

I refer to the concept as "jurisdiction-residence" to distinguish it from tax-residence. It seems surprising to use the term residence in a non-tax sense but this arises for historic reasons: the concept comes from common law/IHT debt situs rules which in the past governed the rules for the source of interest.[21]

What is the test of jurisdiction-residence? In the case of an individual it is the same as tax-residence (or as near as makes no difference); but in the case of a company, it is place of business, which is quite different from tax-residence.

The SAI Manual provides:

> 9095. Yearly[22] interest: UK source: Companies [July 2007]
>
> Interest paid by companies
>
> In deciding whether or not interest has a UK source, in addition to the factors described in SAIM9090, there are other matters to be taken into account for companies.
>
> Companies and branches
>
> Where the debtor is a company it may of course have more than one residence – for example it may be registered in a US state but managed and controlled from the UK.[23] Jurisdiction in relation to a corporation will in general depend on where the corporation does business (except where the EU Regulation or the 1968 Convention apply – see SAIM9090). So for these purposes it will be resident where it carries on business. If a debtor company has a number of places of residence/business then to decide the location of the debt you have to look at the terms of the loan agreement. The loan agreement should say where the interest and loan are payable, which (if the company is also resident in that place) will determine whether or not the interest has a UK source.

---

21 See paragraph 8 2 .13.1 (Meaning of "residence") *Taxation of Non-residents and Foreign Domiciliaries 2014-15* James Kessler (13th edn, 2014).

22 [Author's note] Although the Manual heading refers to yearly interest, the same rules should apply to short interest.

23 The example given is muddled, or using "Residence" in an idiosyncratic w ay, but it does not matter.

> When it comes to considering loans made to a branch of a UK company the source of the interest is overseas if all the following factors apply:
>
> [1] an overseas branch of a UK resident company has entered into a loan agreement overseas;
>
> [2] the loan is for the business of the overseas branch;
>
> [3] the overseas branch pays the interest from its income;
>
> [4] the loan agreement obligations are enforceable in the jurisdiction in which the branch is situated.

The paragraph does indicate a "safe haven" situation where one can be confident that the interest paid by a person who is UK tax-resident does not have a UK source.

The SAI Manual continues:

> Conversely, where a branch of a non-UK resident company enters into a loan agreement in the UK for the business of its UK branch and the UK branch pays the interest then the interest is regarded as having a UK source.

1.3.4 Interest from securities

The Residence, Domicile and Remittance Basis Manual provides:

> 33550 - Remittance Basis: Identifying Remittances: Specific Topics: Accrued Income Scheme [July 2010]
>
> … Securities are "foreign" where income (in practice, interest) from them would be relevant foreign income. This will include, for example, a security issued in registered form by a non UK company, which maintains the register of note-holders outside the UK.[24]

The rule that the source of interest on registered bonds of a foreign company is the location of the register seems a sensible rule but that will normally be the same as the place of residence.

The same applies to bearer securities: that is consistent with Bank of Greece.

---

24 The comment is made in relation to the Accrued Income Scheme remittance basis, but the point made here relating to the source of interest has a more general application. The text is also found in E N FB 2008.

1.3.5 Tribunal and Special Commissioner decisions

There have been three decisions.

The first is an unreported Special Commissioners decision, *Poldi (UK) Ltd v IRC* (25 November 1985). Unreported decisions cannot properly be cited as precedents, or even published, so this decision is not relevant.

The second is a tribunal decision, *Perrin v HMRC* [2014] UKFTT 223 (TC). Unfortunately *Poldi* was cited and relied on by the Tribunal, a serious procedural irregularity, with the result that the case cannot be relied on as a precedent.

The third is *Ardmore Construction v HMRC* T [2014] UKFTT 453 (TC).

Perrin and *Ardmore* are under appeal (listed for October 2015). In *Ardmore*:

> 42. Applying such a multi-factorial approach to the facts of this case, in particular given that Ardmore was resident for all purposes in the United Kingdom, the situs of the debt, although not a determinative factor, is also located where Ardmore is resident. The United Kingdom, in addition to being the source or origin of the funds for payment, would be the place of enforcement of the debt. We therefore conclude that the interest arose in the United Kingdom.

In *Perrin*, the conclusion was:

> 71. The following factors appear to me to be relevant:
>
> (1) The proper law of the agreement. This was that of the Isle of Man. This factor however I judge to be of very little weight.
>
> (2) The place in which payment was actually made, namely, for the two payments at issue, the Isle of Man. I regard this as of little weight.
>
> (3) The jurisdiction in which judgement could be obtained, namely the Isle of Man.
>
> (4) The country in which Mr Perrin was resident, namely the UK.
>
> (5) The country from or in which Mr Perrin's obligations to pay would be contemplated to be enforced or would substantively originate, namely the UK.

> 72. Taking all these together I conclude that the interest arose in the UK and did not arise from a source outside the UK. The factors of residence and the source of funds for payment or enforcement outweighed that of jurisdiction and actual payment. In particular I do not regard the fact that the two interest payments at issue in this appeal were made from Mr Perrin's Isle of Man bank account as having substantial weight. Lord Hailsham equated the source of payment with the source of the obligation. The obligation he refers to must comprise the totality of the loan obligations not simply some of the payments of interest; those interest payments do not have a separate source from the obligation to pay capital, and that seems to me to be in the UK.

1.4 Objection to multi-factorial approach

There are two objections to the multi-factorial approach.

(1) As a matter of principle: it does not provide a clear test.

(2) As a matter of precedent, it has no support in the case law and the rival place of credit test is well supported.

1.5 Foreign case law

In the absence of UK cases, the UK courts should pay regard to decisions in other common law jurisdictions, especially appellate courts.

1.5.1 *IRC v Philips' Gloeilampenfabrieken*

Philips[25] is a case where money was borrowed to pay an existing debt:

(1) The debtor (a New Zealand company) owed a trading debt to the creditor (a Dutch company) ("the old debt").

(2) The debtor borrowed to pay the old debt. So the old debt was paid off and a new debt ("the new debt") came into existence: in technical terms there was a novation.

(3) The new debt arose under a loan agreement made in Holland and

25 10 ATD 435 [1955] NZLR 868
http://www .kessler.co.uk/w p-content/uploads/2012/04/C IR vP hilips.pdf.

> governed by Dutch law. The money was not received in New Zealand: it was set against the old debt.[26]

The New Zealand Revenue sought to tax the non-resident company on the grounds that the interest was income from a source in New Zealand. *Philips* does what *Bank of Greece* does not do: it considers what should be the test to determine the source of interest. It rejects the situs rules. It rejects the location of funds used to pay the interest.[27] It adopts the place of credit test.

> The lender ... gives credit to the borrower and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender
>
> … the source is located where the transaction from which the debt took its origin took place…

On the facts of *Philips* the credit was not provided in New Zealand, so the source of the interest was not in New Zealand. It did not matter that the interest was paid out of trading profits in New Zealand.

1.5.2 Hong Kong cases and practice

In *IRC v Hang Seng Bank* [1990] STC 733 at p.740 the Privy Council state the position quite clearly:

> If the profit was earned by … lending money … the profit will have arisen in or derived from the place where … the money was lent …[28]

---

26 This was done in a convoluted way:
(1) The Dutch company creditor drew a cheque and sent it to the New Zealand company.
(2) The New Zealand company debtor endorsed it and returned it to the Dutch company in satisfaction of the old debt.
I do not think anything turns on those mechanics.

27 See *IRC v Philips Gloeilampenfabrieken* [1955] N Z L R 868 at p.898: "It is not sufficient to ascertain the fund out of which the income was in fact paid, which is no more than the reservoir from which it was draw n. It is not whence it was paid, but why it was paid, that is the determining factor. The emphasis is not upon the receipt, but upon the derivation of the income. Consequently, it does not constitute the source within the meaning of the section that the money [used to pay the interest] was drawn from or provided by the trading profits in New Zealand. The New Zealand company [the debtor] was free to obtain the funds with which to perform its obligation anywhere it chose, from deposits in England, if it had any, or from borrow ing in England, or from the profits of its trading in New Zealand. That was a domestic matter. The money could "com e from" any of these "sources", but none of them would be the source from which the [creditor] derived what it received as income."

28 [1990] ST C 733 at p.740.

1.6 Source of interest: conclusion

It is submitted that the courts ought to adopt the place of credit test, i.e. the source of interest is where the credit is provided, or where money is lent, i.e. where the money lent is received (the two phrases being understood to come to the same thing). This is consistent with case law, principle, international practice and provides a reasonable element of certainty. The rival multi-factorial approach is supported by *Commissioner of Taxation v Spotless Services* 71 ALJR 81 and (after dithering) HMRC practice. However it would need at least half a dozen reported cases before one could have much idea of the relevant factors and their relative priority, and in practice it is unlikely that the law would ever be clear. In particular, Spotless is not consistent with HMRC's view that the residence of the debtor is the most important factor.

If (contrary to my view) such an approach were adopted, it is suggested that the position should be as follows:

(1) Suppose a debt were wholly non-UK connected but secured on UK land; that is, the UK situate security is the only UK aspect of the debt. For instance, a debt from one non-resident to another non-resident, which arises under a contract governed by a foreign proper law. It is suggested that interest on such a debt has a foreign source. It would be wiser to avoid the issue.

By contrast, suppose a debt was made unsecured (or secured on non-UK assets) and later became secured on UK land. It is considered that this would not turn a non-UK source into a UK source.

(2) Suppose a debt were wholly non-UK connected but paid out of funds derived from UK source income (eg rents of UK land). This cannot be enough to make the interest UK source. The origin of funds used to pay interest is a weak connecting factor. (I would submit it should not be a connecting factor at all.)

(3) Suppose a debt were wholly non-UK connected but had a UK resident debtor. It is suggested that this alone does not give the source of interest a UK location.