The Offshore Taxation Review

THE SOURCE OF INTEREST: A PRACTICAL, HARD MATTER OF FACT

Geoffrey Simpson[1] FCA, FTII, TEP

Alexander Thornton's article in Issue 2 of Volume 6 of *The Offshore Taxation Review*, on 'The Territorial Source of Interest Payments' sought to establish which one feature within loan arrangements is the decisive factor for determining the source of interest for the purposes of UK tax law in the light of relevant guidance given by our Courts and the Privy Council. The article closed by concluding that the situs of funds from which the interest payments are made is the most decisive factor, effectively accepting that no one factor is decisive but that possibly one feature might be the most influential factor. My own contrary view is that no one aspect of loan arrangements will always or generally be more significant than any others. Even if it was correct to conclude that case law did give greater importance to a particular aspect, in practice how is one to determine the weight to be given to it in reaching a conclusion where two or more other features point to the source being elsewhere?

Although the term "source" is not used in the UK tax legislation governing withholding tax on interest, the House of Lords' judgments in *Colquhoun v Brookes* (2 TC 490), *Pickles v Foulsham* (9 TC 261) and the *National Bank of Greece* case (46 TC 472) focus on this term and so legitimise it as being the basis for any enquiry into the question of withholding tax. These cases also emphasise that, despite discussions on the source of interest payments often focusing on the payer and whether his interest payments can be said to be foreign source, the correct procedure is to look at the matter from the viewpoint of the recipient of the interest and ask whether they should regard the interest receivable as properly being income having a foreign source. For example, if the lenders 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

1 Geoffrey J Simpson, FCA, FTII, TEP, Simpson Froud 207 High Street, Orpington, Kent BR6 0PF. Tel: (01689) 898222 Fax: (01689) 898333.

income earned therefrom, as was recognised by the House of Lords in *Carson v Cheyneys Executors* (38 TC 240 at 258) in relation to intellectual property income and in the Parliamentary written answer of 10th November 1969 (Hansard, Vol 791, Col 31) confirming that UK copyright royalties have a foreign source when paid from here by UK residents to an overseas author as part of their business profits. Looking at matters from the lender's viewpoint is also consistent with the principle from the *National Bank of Greece* case that ordinarily the source of interest receivable under a loan arrangement does not change from that which is established at its inception.

Similar considerations would suggest that the subsequent change of the residence of the borrower or a subsequent change in the location of the pool of funds from which the borrower chooses to make payment should not alter, for the lender, the source of his interest income. Indeed the proper way in which one should arguably view the *National Bank of Greece* case is as a decision primarily on the point that the source of interest income of a creditor is to be established at the outset when the loan arrangements are entered into. Although the decision also made reference to various factors which would be taken into account in reaching a conclusion on the specific circumstances which that case involved, this does not prevent the issue of source being overall a conclusion of fact to be arrived at in the light of all the circumstances of each particular case.

Difficult issues similar to concluding on the source of interest in the light of complex facts are often referred to by the Courts as being matters of impression, but it must be borne in mind that in this area first impressions can be misleading as the *National Bank of Greece* case itself shows. There the interest was held to be foreign source despite relating to funds which were probably originally raised in London and where payment was likely to be enforced against the London office of the payer company, where the documentation provided for a payment to be made in London (unless the creditor opted for Greece, which he would not do because of unenforceability under Greek law), where recovery was in practice only available through the Courts in London where the payer had a branch (as the UK Courts had upheld the debt despite Greek law having cancelled it) and where both the debt and its interest were designated as payable in Sterling. Only by focusing on the position at the original date the funds were raised is a different impression obtained.

The treatment of the source of income as being a "practical, hard matter of fact", a phrase coined by Isaacs J in the Australian decision of *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, has been consistently applied by the Privy Council since *Rhodesia Metals* (1940) AC 774 where it was pointed out "that, at any rate for different taxing systems, income can quite plainly be derived from more than one source even where the source is a business". The practical, factual approach was also taken in *Orion Caribbean* (1997) STC 923 where the place at which the lender organised its financial business was held to be the source of its interest income (rather than the locations where it lent the loan funds to overseas borrowers). Although these Privy Council cases are only of persuasive value, such decisions were relied on in determining source of income in the double taxation relief case of *Yates*

v GCA International Ltd (1991) STC 157 and there seems no reason not to apply the same approach to the concept of source of interest for UK tax law generally.

A goldmine of comments on the concept of source of interest can be found in the 1954 decision of the Court of Appeal in New Zealand in the case of *CIR v N V Philips*, which included a review of the judgments in various Australian cases and those in *CIR v Lever Brothers & Unilever Ltd* (1946) 14 S.Af. Tax Cas.1 from South Africa. It was observed that the term source naturally connoted the origin or the originating, chief or prime cause from which interest income sprang, as in the source of a river. In *CIR v N V Philips* funds had been raised from London under a contract made in the Netherlands where the lender was based; but the borrower was a New Zealand company which used the funds for its business in New Zealand and paid the interest out of resulting revenues. The source of the income of the borrower out of which the interest was paid to the lender was rejected as determinative of the source of the interest. In place of the source of the borrowers ongoing ability to pay interest, or the pool of funds from which he might choose to pay the interest, the following were regarded as more appropriate to select from as the source of the lenders interest income:

1. Where the loan transaction was entered into (i.e. where the loan agreement was made from which the obligation to pay interest derived).

2 Where the loan funds passed to the borrower (i.e. where the initial provision of credit occurred for which the interest represented ongoing payment).

3. Where the loan obligation was located, by the initial residence of the borrower, in the case of a simple debt.

4. The location of the debt documentation for a speciality debt under seal (although this was thought only likely to be relevant in cases where other factors did not point conclusively to another location).

Although the decision in the New Zealand case was that the source of the interest income arising to the lender for the supply of credit was the loan agreement transaction itself, as carried out in the Netherlands and from which the debt derived, that decision was simply one applicable to the facts of that case. Both the High Court and the Court of Appeal confirmed the findings of the Magistrates Court that the source of interest was not New Zealand and did not say that in every case the place where the loan transaction is carried out should be decisive. Equally the view in the UK Inland Revenue's Inspectors Manual at 3940 that where a resident of Country A raises a loan in Country B for the purpose of the business of its branch in Country B which pays the interest then the source is Country B need not be taken as treating payment out of branch revenues as the decisive factor locating the source of the interest, but as simply recognising that this aspect coupled with the other features

mentioned will normally give Country B as the common sense conclusion to reach as to the factual source of the interest.

Accordingly one should weigh up all factors to identify, once and for all at the time the loan agreement is entered into and the loan funds are advanced, where the source of the interest is to be. With a loan which a borrower is free to use for any purposes whatsoever, the purpose to which he actually puts the loan funds and the source of income out of which he pays the interest may or may not be of particular weight depending on the other surrounding facts. Accordingly the source of interest on a loan to the parent company of a conglomerate group with numerous subsidiaries and interests world-wide and which left it free to pay interest out of foreign dividends, UK rents, etc could hardly be determined by the actual selection the borrower company made of the income it would use to meet its interest obligations. In contrast, however, with a loan made for a particular purpose which in practice at the outset was known to generate income that would be used to meet the interest payments this could well be a relevant factor even if the loan documentation did not specifically bind the borrower to using the funds for the intended purpose.

In practice, when putting together arrangements where one wishes to avoid a UK source for interest payments, regard would be had to making sure as many of the potentially relevant factors as possible have not only an overseas location but as also being located in one particular place. Accordingly one might organise loan arrangements involving interest payable by a Bahamas subsidiary to its Bahamas parent on a loan for an advance of funds from the Bahamas bank account of the parent to the Bahamas bank account of the subsidiary under a loan contract executed as a Deed under Seal kept in the Bahamas, governed by Bahamas law, expressed as only enforceable in its Courts, with the debt and interest denominated in Bahamas Dollars, payable to a specified Bahamas bank account of the lender from a specified one there of the borrower, with the first interest payment being made out of a separate Bahamas deposit account of the subsidiary funded by its initial share capital rather than from particular revenues, and being an account which was also made security for the borrowings. Then, in the light of all the case law mentioned, it would not seem appropriate to consider the interest to have a UK source just because shortly after the funds were borrowed a UK rent producing property was acquired and, subsequent to the first interest payment from the Bahamas deposit account, UK rents started to arise which were later transmitted to the Bahamas subsidiary for use in paying its future interest obligations. Furthermore, despite the decisions in *Lord Mantons Trustees v Steele* (11 TC 549) and *Viscount Broomes Executors v CIR* (19 TC 667) that interest from a simple contract debt should normally be regarded as having its source where the borrower resides, even a relocation of the business activities, directors and residence of the Bahamas subsidiary might not, in the light of the *National Bank of Greece* case, involve a change in the source of the interest.

In conclusion an analysis of all the facts surrounding a loan transaction appears necessary to determine the source of the interest therefrom and while no one element would seem particularly decisive, focusing as many features as possible towards one overseas jurisdiction should normally secure any desired foreign source outcome for the lenders interest income.