Financial Instruments
TAX AND ACCOUNTING REVIEW

The monthly briefing service for tax and treasury specialists

May 2014

None the wiser: *Perrin* and the scope of UK withholding tax

Andrew Howard provides commentary on some of the key arguments in the Perrin *case with particular reference to the question of determining UK source interest for withholding tax purposes.*

When I read the *Perrin* case[1] and sat down to write this article I was excited. I was going to build on some of the perceptive comments in the judgment, point out a couple of inconsistencies in its logic which I thought I had spotted, and generally write the definitive article on UK source. I was going to avoid getting bogged down in arcane questions of conflicts of law too. I expect Charles Hellier, the Tribunal judge, had a similar feeling when he sat down to write his judgment.

Then I read further into the articles, the cases, the commentaries, the guidance and the legislation. I re-read the *Perrin* judgment. The questions were clearer than they had been previously, but the answers were no closer. I revised my goals and sat down to try and shed some light on how this fundamental question came to be such a puzzle.

Determining the source of interest

There are four candidates for the correct test of UK source interest for UK withholding tax purposes:

1. it is a pure question of situs of the relevant debt obligation;
2. it is a multifactorial test – the exact factors and the weight to be placed on each are discussed below but essentially the question is how close the connection is between the interest payments and the UK;
3. it is a question of where the loan is made; or
4. it is a question of where the borrower is tax resident (or where its relevant permanent establishment is).

The first two points are the leading candidates based on UK case law. Number 3 is the test adopted by several other common law jurisdictions and, at a stretch, some obiter support can be found for it in UK caselaw. Number 4 has some foundation in double tax treaties and has previously been suggested as apt for adoption into UK legislation.

There is precedence in the UK caselaw[2] for payments of interest by a UK tax resident company to be treated as not having a UK source for withholding tax purposes. I cannot think of a decision that specifically decided that a payment of interest by a non-UK resident was UK source but there is little doubt that this is possible.

The facts of the case

Andrew Perrin, who was resident and domiciled in the UK, borrowed money from an Isle of Man trust under a loan agreement governed by the laws of the Isle of Man and subject to the exclusive jurisdiction of the Isle of Man. The money was advanced to Mr Perrin's Isle of Man bank account, and he left some of the borrowed funds in that account in order to pay some of the interest. He on-lent most of the remainder to a UK resident company which he controlled. He does not otherwise appear to have been connected with the Isle of Man. His assets and sources of income were in the UK.

Mr Perrin contended that interest on the loan was not UK source and so not subject to UK withholding tax.

Instinctively, this seems a bold contention. In order to succeed, Mr Perrin would have required test 1 or 3 to be determined as the correct test. Even if he succeeded on test 1 (his best bet) he needed a further question of technical uncertainty to be decided in his favour: that the situs of a simple debt should be determined by reference to the territory with jurisdiction over the loan agreement and not by reference to the residence (for the purposes of jurisdiction) of the debtor. The Tribunal decided both questions against Mr Perrin.

The conclusion was that test 2 is the correct test. This is broadly consistent with HMRC guidance and can be reconciled with the caselaw. So has the Tribunal succeeded in putting to bed tests 1, 3 and 4?

Situs

The argument in favour of test 1 is fairly simple. The source of interest is the relevant debt obligation and international law has well developed rules for determining where a debt obligation is situated. It is admittedly difficult to see why this should be the relevant test under the current legislation but under previous legislation part of the relevant question was whether the interest arises "from any property whatever in the United Kingdom[3]".

The basic question asked by the rewritten legislation is whether the interest is "arising in the UK[4]". The judge noted that this appears to be a slightly different question from that as to whether the interest "arises from a source in the UK" and was troubled by this. The distinction in the emphasis of the question identified by the judge was that the emphasis of the first question is "where did the interest come from?" and of the second question "what did it come from?".

Counsel in the case were agreed that these are not separate questions, but the judge was not entirely convinced and came back to this distinction to add support for his conclusion that the situs of the debt does not determine the source of the interest.

This carries an implication that the law on this point was fundamentally changed in the rewrite, which is difficult to accept, particularly as the explanatory notes to the Income Tax Act 2007 do not identify any change in law here.

In any case, even on the rewritten legislation, subject to some uncertainties noted by the judge, while requiring interest to arise in the UK, the legislation also excludes "relevant foreign income"– income "which arises from a source outside the UK[5]". If there is a slight difference of emphasis between the "where" test and the "what" test, it appears that the answer to both would need to be the UK before the withholding tax can apply. The judge did not return to the possibility of the two-stage test in reaching his conclusion on situs. Under the previous legislation there was a similar issue relating to the interaction between Cases III and IV of Schedule D.

The judge's conclusion on situs is based primarily on Lord Hailsham having referred to other considerations in determining the *National Bank of Greece* case[6]. This could be explained on the basis that Lord Hailsham was only answering the "where" question and having determined that the answer was non-UK he had no need to also answer the "what" question.

However, particularly when you consider that the relevant bonds in that case were bearer bonds, in my view it is difficult to reconcile Lord Hailsham's judgment with a world in which the situs of the debt alone determines the source of interest.

There is no doubt that the situs of a debt alone does not make a very good test for imposing withholding tax. It is fairly easy to manipulate in the case of many types of debt obligation[7]. However, I think it will need binding authority before practitioners are content to accept once and for all that situs is not determinative. It is therefore to be hoped that Mr Perrin appeals.

Where the loan is made

Counsel for Mr Perrin advanced an argument based on the decision of the Privy Council in the *Hang Seng* case[8]. This was not a case about withholding tax at all but was concerned with whether trading profits made by dealing in securities arose in Hong Kong. Lord Bridge commented by way of analogy:

> *"but if the profit was earned by… lending money… the profit will have arisen in… the place where… the money was lent."*

The Tribunal doubted whether Lord Bridge was equating the place of the advance of the principal of a loan with the place of the source of the interest. However, I understand that this is the relevant test in Hong Kong, derived from caselaw in New Zealand and South Africa. It does not seem to be altogether clear in its application – the question is more involved than simply asking where was the account located into which the advance was paid.

The Tribunal's rejection of this as the relevant test is not surprising given the pre-existing UK caselaw. It does beg the question, though, as to whether the question as to the source of interest for withholding tax is different from the question as to the source of income for other UK tax purposes, for example determining the scope of the charge to tax on other types of income for non-residents.

The multifactorial test

The judge was clear that the multifactorial test is the correct test. This is consistent with HMRC's view as set out in the guidance in its manuals[9]. HMRC also has an earlier view expressed in Revenue Interpretation 58. The judgment in the *Perrin* case is useful as it summarises the relevant factors on the basis of the caselaw and gives some indication of the relative weight to be given to each factor. The various factors are summarised in Table 1. To my mind the most interesting feature is that the judge includes situs as a relevant factor rather than discounting it entirely.

I have tried to apply the test to a commonly encountered situation, a non-UK SPV borrowing to acquire UK real estate, which will form the security for the loan and provide the income for payment of interest on it.

The judgment places significant emphasis on the place on enforcement of any judgment, a factor which ties in with the location of any security and the substantive origin of funds for the payment of the obligation. The judge is quite circumspect in the absence of authority but I get the strong impression that he regards these factors as more significant than the place of residence for the purposes of jurisdiction. As non-UK residence is likely to be the main factor in favour of non-UK source in this scenario, the result of applying the *Perrin* criteria seems to me to be that tax should be withheld. Under HMRC's SAIM test, which gives great significance to residence, I think you come down on the side of non-UK source, particularly if some of the lesser factors such as governing law and location of bank accounts are non-UK.

Factor in determining source	SAIM 9090	Revenue Interpretation 58	Perrin
Residence of the debtor	Very important	Important	Important
Residence of the creditor	Not mentioned	Not mentioned	Not important at all
Residence of the guarantor	Quite important	Not mentioned	Not mentioned
Situs of debt	Not mentioned	Not mentioned	Important (but not determinative)
Location of the debtor's assets (in general)	Very important	Not mentioned (although see source of payments below)	Not mentioned (although see source of payments below)
Location of security	Quite important	Important	Important
Contemplated source of payments	Not mentioned	Important	Important
Place of performance of the contract	Quite important	Important	Not very important
Method of payment	Quite important	Not mentioned	Not very important
Proper law of the agreement	Quite important	Not mentioned	Not very important
Competent jurisdiction for legal action	Quite important	Not mentioned	Quite important (but less important than place of contemplated enforcement)
Place of contemplated enforcement	Not mentioned	Not mentioned	Important

Table 1: UK source interest guidance – comparison

Overall, however, I'm afraid I don't find the new test any easier to apply than the old ones. As soon as different factors point in two different directions, it is difficult to apply the test with any certainty. Several of the factors are also very difficult to apply or unclear in their application.

Tax residence

Adopting test 4 would have the great benefit of simplicity.

HMRC has shown little enthusiasm for collecting withholding tax from non-UK taxpayers. This seems logical if you consider that the purpose of a withholding tax is to enable the collection of tax from taxpayers which are outside the jurisdiction.

HMRC has a fairly bizarre practice whereby it will refuse to give Treaty clearance to non-resident borrowers unless the borrowers acknowledge in writing that the relevant interest is UK source. This creates something of a dilemma for those borrowers who need to have a clearance in case the interest is UK source but who would rather not make the acknowledgement given the uncertain legal position.

Given the UK's broad treaty network, market practice is to take a cautious view and do whatever is necessary to acquire the clearance. However, the rise of shadow banking may increasingly put pressure on this approach as lenders to borrowers in this position may not wish to prejudice their ability to include hedge funds as potential transferees of the relevant debt by acknowledging that their interest is UK source when they may subsequently want to argue that it is not.

I do not imagine that HMRC is very comfortable with accepting that UK corporation tax payers will receive a deduction for interest that they pay but that such interest will not be taxable in the hands of a tax haven recipient. There is no technical connection between the deductibility of interest and the scope of UK withholding tax but to draw one appeals to the modern notion of there being equity in a tax after all.

This remains an area which could benefit significantly from clarification. It is not unusual to be asked if a non-UK SPV with a UK bank account in an otherwise non-UK transaction might be subject to UK withholding tax. While the answer must be no, it is difficult to reach a fully satisfactory conclusion on the multifactorial test once you factor in the likelihood of English law documents and security over the account. Very cautious taxpayers and advisers may even allow this to affect the choice of location of bank accounts and governing law of documents.

Andrew Howard *is counsel in the Tax & Benefits group at Ropes & Gray in London. He can be reached on 0203 122 1230 or by email at andrew.howard@ropesgray.com*

Post script

This article was written before the publication of the decision of the First Tier Tribunal in *Ardmore Construction Ltd v HMRC* [2014 UKFTT 453(TC)], in which a differently constituted tribunal also concluded that the multifactorial test was the correct approach, rejecting the taxpayer's arguments that test 3 was the appropriate test. On a matter of procedure the Tribunal, while reaching a similar conclusion, expressly declined to follow *Perrin* on the basis that the decision relied to some extent on an unpublished decision of the Special Commissioners. It will be interesting to see if this prompts an appeal in the *Perrin* case. The substantive decision in *Ardmore Construction* does not shed much new light on the issues discussed in this article.

References

1. *Andrew Colin Perrin v HMRC [2014] UKFTT 223 (TC).*
2. *Hafton Properties Ltd v McHugh [1987] STC 16.*
3. Section 18(1) of the Income and Corporation Tax Act 1988.
4. Section 874(1) of the Income Tax Act 2007.
5. Section 884 of the Income Tax Act 2007.
6. *Westminster Bank Executor and Trustee Co (Chanel Islands) Limited v The National Bank of Greece SA 46 TC 472 (1970).*
7. The law was recently changed to make this more difficult (see section 874(6A) of the Income Tax Act 2007), just in case situs was relevant.
8. *Commissioner of Inland Revenue v Hang Seng Bank Ltd 1990 STC 733.*
9. SAIM 9090.