Analysis

Ardmore: withholding and UK source

Speed read

The Court of Appeal dismissed the appeal in *Ardmore Construction v HMRC*, holding that whether or not a payment has a UK source is a question of fact and that the Upper Tribunal's decision was not one which could be overturned on *Edwards v Bairstow* principles. In doing so, an opportunity has been missed to clarify this difficult area of the law. There are a number of comments made in the judgment which temptingly hint at general principles that have a wider application. However, there is a danger of taking them out of context. For now, HMRC's guidance remains the best place to start when considering source.

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The appeal in *Ardmore Construction v HMRC* [2018] EWCA 1438 was about the territorial scope of income tax. As a general principle a non-resident is only taxed on income that has a UK source (often, but not always, by way of withholding). There is little useful UK case law on the meaning of source, and so market practice has developed around HMRC guidance. This decision had the potential to cut right across that guidance and so upset years of practice.

As it happened, the Court of Appeal declined to lay down any general principles and simply concluded that as a question of fact it would not be appropriate to overturn the Upper Tribunal's decision. It would have been better if the HMRC guidance had been specifically approved. It would have been a lot worse if it had been held to be wrong.

Permission to appeal to the Supreme Court seems unlikely, and so we should sit back and be pleased that what could have been for some a disaster has been avoided.

Background to the case

The question of source most commonly arises in my experience when a company that is incorporated outside of the UK pays interest on a loan which (wholly or partly and directly or indirectly) funds UK assets or is serviced out of UK income. So for example, a non-resident landlord borrows to fund UK property. How does one decide whether the interest paid has a UK source notwithstanding the foreign borrower (and consequentially whether it is in principle subject to withholding)?

The most important case has been the House of Lords' decision in *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* (1970) 46 TC 472. The case is not particularly helpful though because it does not lay down any general principles which can be applied to borderline or marginal cases, but rather concludes that the interest under consideration there did not have a UK source because all relevant factors pointed to Greece.

In the absence of case law, the market has come to rely on what is a particularly useful piece of HMRC guidance now found in the *Savings and Investment Manual* at SAIM9090. This states that the most important factors are:

- the residence of the debtor; and
- the location of his/her assets.

Other factors are:

- the place of performance of the contract and method of payment;
- the competent jurisdiction for legal action and the proper law of contract; and
- the residence of guarantor and location of security for the debt.

The facts of this case

The facts were extreme (see the box above right). There was a UK resident borrower with a UK business and UK assets which borrowed money from a connected Gibraltarian trust under the terms of a loan governed by the laws of Gibraltar and with a Gibraltar exclusive jurisdiction clause.

On the basis of SAIM9090, the interest clearly had a UK source.

It was never likely that the Court of Appeal would find for the taxpayer. The risk was that the Court of Appeal would find for HMRC by laying down general principles more onerous than SAIM9090; that is making more remote connections with the UK sufficient for a UK source. One specific point of concern was that the Upper Tribunal had held that the substantive or ultimate source of the payments used to discharge the debt was a relevant factor: the difficulty being how far must you dig (or follow the cash) before you find the ultimate source? Nothing was said about the substantive or ultimate source by the Court of Appeal.

The decision

Lady Justice Arden gave the leading judgment with which the other two judges agreed. The precedent that she set is pretty limited:

- the correct approach is to apply a multifactorial test, and all available facts are relevant, even those which carry little weight;
- this multifactorial test must be applied by asking what a practical person would regard as the source of the payment (preferring substantive to theoretical factors); and
- as such, this is a question of fact to be determined by the First-tier Tribunal, and should only be overturned on appeal if the tribunal got the legal test wrong (by not approaching the question from a practical perspective), or came to a decision about the facts or the practical implications of those facts which no reasonable tribunal could have reached.

So far, so uncontroversial. While the decision makes it clear that the residence of the debtor and the location of its assets are not necessarily the most relevant factors, it does not say that those two factors are not generally the most relevant factors. HMRC's guidance to that effect remains in my view reasonable and sensible.

What follows is then two paragraphs in which Arden LJ makes numerous complimentary remarks about the Upper Tribunal's decision. Strictly, this is in the context of explaining why she felt unable to overturn the Upper Tribunal's decision: that is, why the decision was one which

a reasonable tribunal could have reached, as opposed to one which all tribunals would have been required to reach as a matter of law.

These comments do not therefore set a precedent for the factors that must be taken into account in determining source. It will therefore be unsurprising if HMRC was to respond to the decision by saying that it is specific to its facts and has no more general application (similar to its response to the Supreme Court's decision in *Anson v HMRC* [2015] UKSC 44).

However, and whatever HMRC's position in practice, remarks made by a Court of Appeal judge will inevitably be persuasive before a tribunal of fact if a case about source ever gets that far again.

The residence of the creditor

Arden LJ remarked that the conclusion of the Upper Tribunal that the residence of the creditor carried little weight cannot be criticised. One reason given was that while the loan might have arisen (and therefore interest been paid) because credit was advanced by the creditor, the creditor is not the immediate source of the interest. This reasoning is entirely consistent with SAIM9090.

An active business versus a passive investment

The second reason given for concluding that the residence of the creditor carried little weight was that the lending of money by the creditor was merely a passive activity, whereas the business of the borrower was carried on actively.

In this case the borrower was a major UK building company. What if a borrower carried on an investment business – for example, lending money? It could be tempting to apply Arden LJ's comments by analogy and conclude that the residence of such a debtor also carries little weight.

Any such suggestion that there is a distinction between a passive investment and an active business is interesting and novel. I think this would be to take Arden LJ's comments out of context. Personally I think that she was merely reformulating the first reason in a slightly different way: a creditor can hardly be said to be the source of interest when all they do is sit back and collect the interest. The business of the borrower that generates the funds to pay the interest is far more relevant.

The commercial basis for establishing a company in a particular jurisdiction

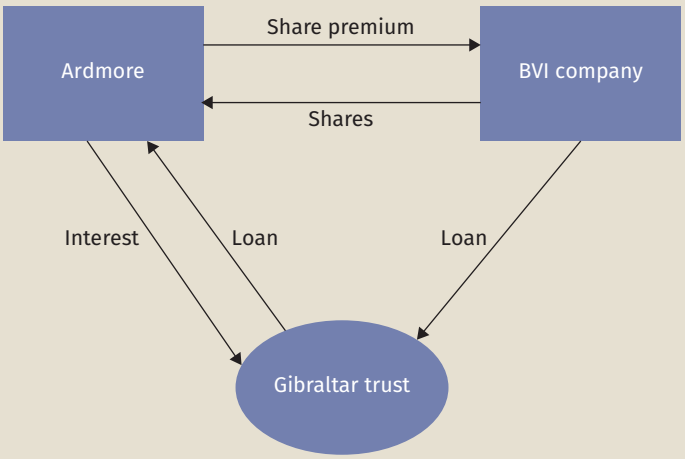
The third reason given for concluding that the residence of the creditor carried little weight was that it was not clear what commercial purpose (if any) it served for the creditor to have been established in Gibraltar.

While Arden LJ does not say this, an inference might be that if it had been the borrower (rather than the creditor) that had been incorporated or established in a particular jurisdiction for no commercial purpose without any other substantial link to that jurisdiction, then the source might be questionable.

I do not think that this would be a particularly controversial position to take where there are no other substantial links to the jurisdiction in which the borrower is incorporated.

To me, the important point is that the judgment says nothing about how substantial the other links with the jurisdiction would need to be – and so says nothing about the efficacy of arrangements that have more than a *de minimis* link with the jurisdiction of the borrower.

The facts in *Ardmore*



Place of enforcement

Arden LJ also remarked that the Gibraltarian exclusive jurisdiction and governing law clauses would only matter if there were a default, but there was no default and so they had limited relevance.

It is this statement that puts the most pressure on SAIM 9090, which explains that the residence of the debtor and the location of its assets are the most relevant factors because they influence where the creditor would sue for payment of the interest and repayment of the loan on a default.

The suggestion that place of enforcement carries little weight until a default actually occurs seems unlikely to me. This would surely be inconsistent with the House of Lords' decision in the *National Bank of Greece* case, which implied if not held that the location of security and the residence of a guarantor are relevant from day one (that is, not just from when the debt is enforced against the security or the guarantor).

I take little more from this remark than that this case involved an (arguably artificial) intra-group arrangement between connected creditor and debtor, and so there was never going to be a default. What might happen on a theoretical default when realistically none would ever occur should therefore be of little relevance.

In most real commercial contexts, however, what happens on a default is crucially important and so a First-tier Tribunal may well conclude (consistently with what was said in the *National Bank of Greece* case) that the place where enforcement would take place is a material factor.

What should advisers and business do now?

I would say little. It will generally be easier to overreact to this decision than under react.

HMRC's response will be important of course, but until then, and while some remarks made in the decision could upset the status of quo if taken out of context, the guidance in SAIM9090 seems to me to remain broadly sensible and accurate. ■

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- Cases: *Ardmore Construction v HMRC* (26.6.18)