

***Ardmore Construction v HMRC* – deduction of UK income tax and source of loan interest**

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Introduction

The territorial scope of UK income tax for non-UK resident persons is generally limited to certain types of income that have a UK source. These include payments of UK source 'yearly' interest under a loan. To help Her Majesty's Revenue and Customs (HMRC) collect the tax due on the interest received by a non-UK resident lender, the debtor is required to deduct income tax at the basic rate (currently 20%) from the interest payments. In *Ardmore Construction Limited v HMRC* ([2018] EWCA Civ 1438), the Court of Appeal confirmed that a multifactorial test is the correct approach for establishing the source of such loan interest.

Barring new legislation on the source of interest payments, which seems unlikely since HMRC has twice dropped proposals to introduce reforms, the elevation of two of the three judges in *Ardmore* to the Supreme Court suggests that this multifactorial approach is settled law for the time being.

Facts

Ardmore was a UK-incorporated (and therefore tax resident) company owned by two brothers. The company had almost all of its assets and business activities in the United Kingdom. Each brother established trusts resident in Gibraltar and the trustees lent sums to the company on interest bearing and unsecured terms. The law of Gibraltar governed the loan instruments and the parties submitted to the exclusive jurisdiction of the Gibraltar courts.

HMRC considered that the interest had a UK source and that Ardmore should have deducted income tax from the interest payments. On appeal, both the First-Tier Tribunal and the Upper Tribunal dismissed Ardmore's argument that the source of interest was the place where the credit was provided. The lower tribunals both held that the correct approach was to apply the multifactorial test.

The Upper Tribunal indicated that, when applying the multifactorial test to simple loans, the following factors were relevant:

- the debtor's residence;
- the location of the security; and
- the ultimate, or substantive, source of discharge of the debtor's obligation.

In addition, the factors listed below were said to carry little or no weight:

- the creditor's residence or place of activity;
- the place where the credit was advanced;
- the place of payment of the interest;
- the jurisdiction in which proceedings might be brought to enforce the obligation to pay interest; and
- the proper law of the loan instrument.

Decision

Lady Justice Arden delivered the sole reasoned judgment. She reiterated that the multifactorial test was the correct one for determining the source of loan interest. Whilst certain factors might carry little weight, she considered that it was a mistake to view them as being irrelevant.

The judge acknowledged that the test gave no indication of the determinative factors. The answer was to apply the 'practical approach' when weighing up the various factors. In other words, what would a practical person consider to be the source of the interest from a "practical, or realistic, point of view" that focused on the "substantive matters rather than theoretical factors".

She stressed the test's fact-specific nature, noting that it was "acutely fact-sensitive... [and] the tribunal must examine all the available facts both singly and cumulatively".

The exercise of considering the relative weight of the various factors meant that appellate courts should be slow to interfere with decisions reached by the fact-finding tribunal, unless the lower tribunals misdirected themselves on matters of law or reached a perverse decision.

On applying this approach to the case, Arden made the following observations:

- The Upper Tribunal could not be criticised for attaching little weight to the creditor's residence. The objective was to find the source of the interest rather than to ascertain the source of the loan. Once the trustees made the loans, the activities of the creditors became passive, whilst Ardmore actively carried on its business to generate funds to pay the interest.
- The provisions on jurisdiction and governing law would have mattered only if there had been a default. The fact that any judgment against Ardmore would need to be enforced in the United Kingdom, where all of the company's assets were located, further lessened the weight attributable to those two factors.

On this basis, there were no grounds to overturn the Upper Tribunal's decision and Ardmore should have deducted income tax from the UK source interest.

Comment

A practical person, when faced with the prospect of applying the multifactorial test, may wonder how the approach delivers certainty, an attribute that they are likely to value. Where the position is not clear, a pragmatic solution may be for the lender to consider applying for any interest to be paid free of any UK tax deduction under a double tax treaty (if applicable).

The fact-specific nature of the test severely limits the taxpayer's ability to appeal a decision of the First-Tier Tribunal. Accordingly, vigilance is required to ensure that factors pointing towards the United Kingdom do not mistakenly arise. For example, in *Ardmore*, the company was due to pay the interest from a source outside the United Kingdom but the payments were actually made using funds realised by the UK business.

In principle, HMRC should amend its guidance in the Savings and Investment Manual 9090 on how to determine the source of interest following the decision in *Ardmore*. Strictly, it is not correct to say that "*the residence of the debtor and the location of his/her assets*" is the most important factor. However, in the case of a simple unsecured loan, if the debtor resided in the United Kingdom and the substantive source of the funds to pay the interest were UK-based, it is likely that the interest would have a UK source.

The practical approach and emphasis on substantive matters suggests that the relative weight accorded to the various factors referred to by the Upper Tribunal is correct for most cases.

Under the multifactorial test, in theory, interest payable by a UK-resident debtor, where the loan has no other connections to the United Kingdom, should not have a UK source. Similarly, in principle, if the debtor were a non-UK resident and the only factor pointing towards the United Kingdom were the source of the funds to meet the interest payments, the interest should have a non-UK source.

However, this outcome may rely on there being no other substantive UK connections, such as security, that could tip the scales in favour of the interest having a UK source.

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