

# WHERE IS THE SOURCE OF INTEREST? AND WHAT SHOULD BE DONE IF THE SOURCE IS UNCLEAR?

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*These notes are mostly drawn from Taxation of Foreign Domiciliaries (8<sup>th</sup> edition)*

## Why does it matter where is the source of interest?

*Taxation of the interest*

Section 368 ITTOIA provides:

### **368 Territorial scope of Part 4 charges**

- (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
- (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK.

*Remittance basis*

Section 830(1) ITTOIA provides the definition of “RFI”:

In this Act “relevant foreign income” means income which

- (a) arises from a source outside the UK, and
- (b) is chargeable under any of the provisions specified in subs.(2) (or would be so chargeable if s.832 did not apply to it).

*Withholding tax*

Section 874 ITA provides:

### **874 Duty to deduct from certain payments of yearly interest**

- (1) This section applies if a payment of yearly interest arising in the UK is made—
  - (a) by a company,
  - (b) by a local authority,
  - (c) by or on behalf of a partnership of which a company is a member, or
  - (d) by any person to another person whose usual place of abode is outside the UK.
- (2) The person by or through whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

Section 884(1) ITA provides:

The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest which is chargeable to income tax as relevant foreign income.

The location of a source is also important for double tax treaties. However DTTs sometimes lay down specific rules for locating a source (for treaty purposes) so it may be necessary to distinguish the concepts of domestic source location and treaty-source location.

### **IHT/private international law situs**

Situs of assets matters for IHT. IHT situs is largely decided on common law (private international law) principles:

As to the locality of many descriptions of effects, household and moveable goods, for instance, there never could be any dispute; but to prevent conflicting jurisdictions between different ordinaries, with respect to choses in action and titles to property, it was established as law, that judgment debts were assets, for the purposes of jurisdiction, where the judgment is recorded; leases, where the land lies; specialty debts, where the instrument happens to be; and simple contract debts, where the debtor resides ...<sup>1</sup>

I refer to this as the place-of-debtor rule.

#### *Meaning of “residence” and dual resident debtor*

For this purpose the test of residence for a company is not the usual test (management and control) but where the company carries on business:

Now, when you are dealing with a corporation, you are dealing again with a legal notion, and you have to examine the question where the debt can be said to be situate. It appears to me plain that a corporation according to our law is deemed to reside for the purposes of suit in the place where it carries on business in its own name ...<sup>2</sup>

The *rule* has a certain logic, for situs of a simple debt is (or at least, in the past broadly was) decided by reference to jurisdiction, and jurisdiction over a company depends (or at least, in the past broadly depended) on its place of business and not its tax-residence.<sup>3</sup>

The *terminology* used in the rule is unfortunate, and it would be better if some other word were used, rather than using (or rather, misusing) the word “residence” in this non-standard meaning.

Where the debtor is dual resident, the place-of-debtor rule does not provide a solution. A tie-

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1 *Att Gen v Bouwens* (1838) 4 M & W 171 accessible [www.commonlii.org](http://www.commonlii.org).

2 *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 at p.120 followed *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.733.

3 See Dicey on the Conflict of Laws, 14<sup>th</sup> ed 2006, para 14-059 and 30-007.

breaker is need, and the solution adopted in *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101 is, where the debt was payable.

### *Place-of-debtor rule v. jurisdiction where debt enforced*

The reason for the place of debtor rule is that (1) the debt is situate where it can be enforced, and (2) it is enforced where the debtor resides.<sup>4</sup> However the background law (that is, conflict of law or private international law) has moved on considerably since *New York Life Insurance* was decided in 1924. Jurisdiction is now largely governed by international conventions, under which it is only very approximately correct to say that residence of the debtor is the test of jurisdiction.

This raises a difficulty where the debtor resides in one jurisdiction but the debt is enforceable in another. Do we continue to apply the historic residence tests, or do we say the debt is situate where it is enforceable, ignoring the place that the debtor resides? *Raiffeisen Zentralbank v Five Star Trading* [2001] QB 825 notes the difficulty:

[36] In the case of intangible property, English law has, for various purposes (e.g. inheritance), traditionally allocated to it a situs at the place of the debtor's residence. This is on the basis that the debtor is there directly subject to the coercive power of the courts to enforce the obligation. The location of a right of action in this or any way is, however, evidently artificial. Parenthetically, I add that "coercive power" would itself appear to be an unstable international concept, capable of widely differing interpretation ...

[37] Modern conditions underline the artificiality of selecting supposed control at the debtor's residence as an appropriate basis for characterisation or choice of the relevant law to determine questions regarding the validity or effect as against the debtor of an assignment. Jurisdiction may be grounded on consent and various other bases apart from residence. Obligations are commonly enforced today not against the person, but against assets. Debtors often trade or hold some or even all of their assets overseas. Proceedings are as a result often begun and enforced against debtors in countries other than that of their residence, as in this case. The move towards single legal markets, like those involving countries party to the Brussels and Lugano Conventions, makes judgments readily exportable between countries.

It is considered that although jurisdiction was the historic reason for adopting the place-of-debtor rule, now the rule has been chosen, one should continue to look to residence, regardless of where the debt would be enforced.

### **Income tax location of source v. IHT/private international law situs**

The IT rules for the location of an income source are different from the situs of asset rules for IHT/private international law.

It is not illogical or inconsistent to say that the situs of a debt for IHT/international law purposes is in one country but the location of the source of interest on that debt for income tax purposes is in another. This is the case for shares, which may be non UK situate for IHT/international law but whose dividends may be UK source (if the company is UK resident.) One might simply say that the two taxes apply different rules. Alternatively, and more subtly, one might say that the

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<sup>4</sup> *New York Life Insurance v Public Trustee* [1924] 2 Ch 101

source of interest (for IT purposes) is not the debt but the transaction which gives rise to the debt (which may be located in a different place from the location of the debt).<sup>5</sup> Either way, the IHT/international law situs rule is not determinative.

### **Interest: location of source**

There are many possible connecting factors. The following is not a complete list but it includes the main factors:

- (1) the debtor:
  - (a) residence of debtor;
  - (b) place of business of debtor;
- (2) payment of the interest:
  - (a) place where interest is paid;
  - (b) situs of funds out of which interest is paid;<sup>6</sup>
- (3) contract under which interest is paid:
  - (a) proper law;
  - (b) place where contract would be enforced;
  - (c) place where contract is made;
- (4) situs of debt on which interest is due under IHT/international law principles (i.e. location of deed if debt is a specialty);
- (5) place where debtor uses the money borrowed (e.g. to purchase UK/non-UK situate asset);
- (6) place where money is lent or where credit is provided;
- (7) situs of security for debt (if any);
- (8) residence of guarantor (if any);
- (9) residence of creditor.

#### *Residence and place of business of debtor*

Residence of the debtor is in principle a satisfactory connecting factor. In the case of dual resident debtors, the place of business connected with the loan would usually act as a suitable tie-breaker.

#### *Payment of the interest (place where interest is paid or situs of funds out of which interest is paid)*

This is not a suitable connecting factor as it can and often will change from year to year. This view is supported by *IRC v Philips' Gloeilampenfabrieken*:

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 drawn. 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

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<sup>5</sup> *Philips* takes this approach.

<sup>6</sup> This is often called the “source” of the payment but it is hopelessly confusing to use the word “source” in that way.

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 borrowing in England, or from the profits of its trading in New Zealand. That was a domestic matter. The money could “come from” any of these “sources”, but none of them would be the source from which the [creditor] derived what it received as income.<sup>7</sup>

In other words, one should not equate the location of the source of the interest with the situs of the *resources* that the debtor uses to pay the interest.

*Contract under which interest is paid: (a) proper law, (b) place where contract would be enforced, (c) place where contract is made*

These are not suitable connecting factors as they are within the control of the parties.

*Situs of debt: location of deed if debt is a specialty*

This is obviously an unsuitable connecting factor. The debtor will not have possession of the deed and may not know its location. The location is easily changeable, and the rule would allow easy tax planning.

This view is supported by *Philips*:

If the location of the debt were to be selected as the test, the source would be located differently according as whether the contract was a simple contract or a specialty; and, in the latter case, its location would arbitrarily change with the actual situation of the deed itself. Such a test would, indeed, be far from the practical commonsense test prescribed by the authorities; and I cannot think it proper to apply it here if some other is available.<sup>8</sup>

The High Court of Australia rejected the same argument for similar reasons in *Studebaker Corporation of Australasia v Commissioner of Taxation for New South Wales*.

My view could also obtain support from *Bank of Greece* where although the court did not seriously address the question of the location of a source of interest, its approach was certainly not consistent with the IHT/international law approach.

*Purpose for which the loan is made*

This is not such a suitable connecting factor, for it will often not be possible to identify a purpose with any particular location. Also money borrowed for one purpose may later be used for another.

*Place where money is lent (where money is received)*

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<sup>7</sup> See *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR at p.898.

<sup>8</sup> See *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR at p.898.

This is a sensible connecting factor. It may be objected that it allows tax planning where money is lent in one jurisdiction and then immediately transferred to another. But the courts could easily look through transient arrangements of that kind to identify the place where the money is substantially received. But sometimes it may not be clear where money or value is received.

#### *Situs of security for debt*

A rule that source of interest on a secured debt depends on the location of the property on which the debt is secured is not sensible or workable, for the following reasons:

- (1) A debt may be charged on property in two different countries.
- (2) The rule becomes absurd if a large debt is secured on an asset of a small value. Would one say that a £100 million debt is situate in Jersey if it is secured on property there worth £100,000? Also, one cannot have a rule where the location of interest depends on the relative value of the debt or the security, which may fluctuate from time to time (though that might be resolved by looking only at the position at the time the debt arises.)
- (3) If land determines the location of interest from of a debt secured on land, then a debt charged on (say) shares should be situate where the shares are situate.

This rule would sometimes allow scope for tax planning.

#### *Residence of guarantor (if any)*

No weight should be given to the residence of a guarantor, since in the normal course of events a guarantor would not be called on to make any payment.

#### *Residence of creditor*

No weight should be given to the residence of the creditor, since one is looking for the source and not the destination of the interest; also this may change easily as debts are usually assignable and frequently assigned. A single debt may be owed to two creditors resident in different places, but the interest on that debt cannot have two different sources.

#### *Unsatisfactory approaches*

The most unsatisfactory approach of all is to say that it is a question of fact.<sup>9</sup> The meaning of “source” is a question of law and so is the question of whether known facts (which will usually be simple) fall within that meaning. It is the task of the courts to provide an answer to that question.

Equally unsatisfactory is to say that the answer is whatever a “practical man would regard as the real source”. The only way in which a man, practical or otherwise, can locate a source of interest

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<sup>9</sup> Sometimes a “practical hard” matter of fact, the phrase derives from *Nathan v Federal Commissioner of Taxation* [1918] HCA 45; (1918) 25 CLR 183 and is also mentioned in *Rhodesia Metals v CT* [1940] AC 774 at p.789, but the adjectives are meaningless.

(other than tossing a coin) is to apply a theory as to the priority of rival connecting factors.<sup>10</sup> It is not satisfactory to say that all the features listed are relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. We need guidance on which factor has priority or there is no law on the subject at all. The formulation derives from Commonwealth cases on the source of *trading* income.<sup>11</sup> There it seems more apt as the circumstances in which trading income arises differ very widely indeed. But even in that context experience has shown that it has not worked well, because no consistent pattern has developed as to which factors have the greatest weight.<sup>12</sup> However that may be, the questions of the source of *interest* and the source of *trading* income are entirely different. There is no reason why the test should be the same. The point is made correctly in *Philips*:

The location of the source of profits of a business, for instance furnishes a kind of investigation quite different from that of the source of interest on moneys lent, and decisions on sources of one kind of income may be of little assistance when considering sources of a different kind of income.<sup>13</sup>

### Case law on source of interest

#### *Bank of Greece*<sup>14</sup>

The case concerned bearer bonds issued by a Greek bank in 1927. The bonds had the following features (using the numbering of the list in the above paragraph):

- (1) The debtor was non-resident (a Greek bank).
- (2) (a) Payment was to be made in sterling.<sup>15</sup> Payment was to be made in London or (at the option of the creditor) in Athens, by cheque on London.
- (b) Payment would in the ordinary course have ultimately derived from funds situate in Greece.<sup>16</sup>

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10 See *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR 868 at pp.895–6: “What sort of thing is to be looked for when it is sought to discover a *source of income*? This is a question less simple than it seems at first sight, and its difficulty does not seem to me to be greatly lessened by taking the ‘practical’ approach to it first put forward in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183. ... I am attracted by an approach by which an attempt is made to state lucidly what must be meant by the word ‘source’ in the phrase ‘source of income’ in given circumstances.”

11 *Rhodesia Metals v CT* [1940] AC 774.

12 See *Taxation of Foreign Domiciliaries* 14.3 (Non-resident trader rules).

13 See *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR 868 at p.896.

14 *Westminster Bank Executor and Trustee Company (Channel Islands) v National Bank of Greece* 46 TC 472.

15 For completeness, in 1935 this changed so that Greek residents could only be paid in drachmae: see [1958] AC 509 at p.510 but nothing turned on that.

16 I think this is what Lord Hailsham means in the somewhat convoluted sentence at p.494A.

- (3) The bonds were governed by English law and were enforceable in England.<sup>17</sup> (Enforceability was originally recognised in Greece, but that ceased to be the case following a moratorium under Greek law, raising conflict of law issues which twice went to the House of Lords.)
- (7) The debt was originally secured by lands in Greece but these properties were taken over or disappeared following the German occupation of Greece in 1941.<sup>18</sup>
- (8) The guarantor was non-resident.

It is fairly clear (and all sides accepted) that the interest on the bonds originally had a Greek source. Almost<sup>19</sup> all the features of the debt pointed the same way, to Greece. The House of Lords held that the interest had a foreign source in these words:

- [1] the bond itself is a foreign document, and
- [2] the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.

This was adequate for the decision as it related to a point not in dispute. However, the *dictum* is inadequate as a basis for ascertaining the location of a source of interest in other cases. The court did not say how it reached its conclusion: it just described the loan and stated the conclusion.

The conclusion that some have drawn from this case is that all the features listed in the list above were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise (how one goes about that is never explained). This is a complete misreading. *Bank of Greece* provides no support for that approach whatsoever. The speech in the case had no need to say anything about the location of source of interest paid by the principal debtor, because that location was not in dispute. The court heard no argument about the principles of identifying the location of the source of interest. The relevant cases were not cited. In my view *Bank of Greece* gives no guidance at all on what is the test for the location of the source of interest. The fragment of the sentence (“the bond is a foreign document”) was merely descriptive of the facts of the case and not intended to lay down a general test for location of a source of interest. If it lays down a test at all, it is imponderable. In a marginal case, how does one decide if a bond is a foreign document? The test can only be applicable to interest on securities.

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17 [1958] AC 509.

18 46TC 472 at p.483H.

At p.493H Lord Hailsham says that the debt was secured by lands *and public revenues* in Greece, As far as I can tell from the case reports this seems to be a slip, or perhaps Lord Hailsham was referring to the income of the bank as “public revenues” as the National Bank of Greece was publically owned. Nothing turns on that point but it is important to note that the bonds were bank bonds and not government bonds.

19 The following features in *Bank of Greece* did not cause it to have a UK source:

- (1) payment made in sterling
- (2) English proper law
- (3) interest paid in England.
- (4) Karminski LJ adds that “the loan was raised in London”: 46 TC at p.489.

The actual dispute in *Bank of Greece* concerned the location of the source of income consisting of guarantee payments. It was not completely clear that income in the form of guarantee payments was to be classified as “interest”.<sup>20</sup> However if it was not interest it is sensible that location of the source of such income should be determined on principles similar to those which apply to interest, so that makes no difference.

Why was it argued the income had a UK source?

The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the UK were as follows.

- [1] Although the original guarantor had no branch in the UK, the present Appellants had acquired one on their universal succession in London.<sup>21</sup>
- [2] Moreover, it was argued 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 of the guarantor could have been discharged or enforced was in London.<sup>22</sup>

There is some strength in this argument but it did not win the day. These changes did not affect the location of the source of income:

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

- [1] one guarantor had been substituted for another, or ...
- [2] the second guarantor so substituted subsequently acquired a London place of business, or ...
- [3] 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.<sup>23</sup>

*Bank of Greece* is authority for the (sensible) proposition that sources of interest are fixed and do not move with changes of circumstances of the debt.<sup>24</sup> It is not relevant to any other aspect of the location of a source of interest.

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20 Two of the three judges in the CA held that the payments were interest, and in the House of Lords this was said to be “attractive”. But nothing turned on this point.

21 Lord Hailsham means that the guarantors who succeeded to the original guarantor acquired a branch in London on their succession to the original guarantor.

22 46 TC at p.494.

23 46 TC at p.494.

24 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. It is open to a court to distinguish that from other types of changes. However the changes which occurred there were so fundamental that it is considered that there will be few if any cases where the location of a source of interest will move.

This concludes:

the actual source of this income was the credit made available by way of loan under the agreement made in the Netherlands in the course of the respondent's business in that country.... the source of the income was the business transaction carried out in the Netherlands...<sup>26</sup>  
... the source is located where the transaction from which the debt took its origin took place...<sup>27</sup>

This is the place of credit test. It was said to be equivalent to the test of asking where the loan was made.<sup>28</sup> A particular attraction of this test is that it is fixed at the time the loan is made and does not change

Unfortunately this test does not resolve all the issues as one then has to ask where the credit was provided. The answer may not be obvious. The facts of *Philips* illustrate that. The debtor (a New Zealand company) owed a trading debt of £80k to the creditor (a Dutch company). The debtor was unable to pay. Rather than leave that debt outstanding:

- (1) the creditor lent £80k to the debtor
- (2) the debtor used the £80k to pay the trading debt

(ie the old debt was paid and a new one came into existence).

The loan agreement was made in Holland and governed by Dutch law. The the money was not received in New Zealand though payment of the borrowed money was made 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 endorsed it and returned it to the Dutch company.

On these facts the credit was not provided in New Zealand, so the source of the interest was not in New Zealand.

The High Court of Australia applied the same test in *Studebaker Corporation of Australasia v Commissioner of Taxation for New South Wales* a straightforward case of trade interest: an Australian debtor paid interest on a trade debt arising on the purchase of cars from America. The interest did not have source in Australia.<sup>29</sup>

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25 10 ATD 435 [1955] NZLR 868 accessible [www.kessler.co.uk](http://www.kessler.co.uk).

26 [1955] NZLR] at p. 809, 891.

27 p.898.

28 p.899.

29 (1921) 29 CLR 225 accessible [www.austlii.org](http://www.austlii.org) at p.233: "The attribution of locality to the obligation to pay interest is not decisive. The facts must be examined, and when we find that the interest arises from business transacted and wholly carried out in America the conclusion must be that it was not derived from any source within new South Wales."

The Appeal Division of South Africa applied the same test in *IRC v Lever Bros* where a South African debtor paid interest on a debt arising on the purchase of UK shares from a UK vendor under a UK contract. The interest did not have a source in South Africa.<sup>30</sup>

The High Court of Singapore has adopted the same test.<sup>31</sup>

### *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 ...

In *IRC v Orion Caribbean* [1997] STC 923 at p.930 the same court made (I think) the same point, but more cautiously:

If [a company] lent its own money to a borrower in, say, New York,<sup>32</sup> then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York.

Both these cases were trading cases, i.e. the issue was the source of trading income. The Hong Kong Revenue explain:<sup>33</sup>

2. Only interest arising in or derived from Hong Kong is liable to profits tax. For many years, the Department has taken the view that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source. In essence, the place of derivation of interest is the place where the credit was provided to the borrower, i.e. *the place where the funds from which the interest is derived were provided to the borrower*, commonly known as the “provision of credit” test. This view is based on the decisions in *IRC v Philips Gloeilampenfabrieken*, and *IRC v Lever Brothers & Unilever*.

3. If the originating cause is situated in Hong Kong, the source of the interest is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where the debtor employs the capital.

### *Spotless*

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30 [1946] AD 441, 14 SATC 1 accessible [www.kessler.co.uk](http://www.kessler.co.uk).

31 *CH Pte Ltd v Comptroller of Income Tax* (1988) 1 MSTC 7022 accessible [www.kessler.co.uk](http://www.kessler.co.uk). In this case an agreement was made in Malaysia, but (which is considered to be the key fact) the money lent was received in Singapore. (A cheque received outside Singapore but paid into a Singapore account constitutes a receipt in Singapore.)

32 I assume this means that the money was lent (received) in New York.

33 Departmental Interpretation and Practice Notes No. 13 (Revised) Profits Tax: Taxation of Interest Received, December 2004, accessible [www.ird.gov.hk/eng/pdf/e\\_dipn13.pdf](http://www.ird.gov.hk/eng/pdf/e_dipn13.pdf).

In *Commissioner of Taxation of the Commonwealth of Australia v Spotless Services*<sup>34</sup> the court took a balancing exercise approach:

52. Where, as in the present case, the transaction is complex in terms of its background, its nature and its execution, and where, as here, important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated. To attribute “source” is a matter of judgment, and of assessment, of the relative weight of all of the relevant surrounding circumstances.

However, the place where the money was lent was a major factor in the balancing exercise:

11. In weighing the factors to be taken into account when reaching a conclusion as to the source of the income, his Honour gave considerable weight to the place where the contract was made and where the money was lent. These events, his Honour found, occurred in the Cook Islands. His Honour continued (25 ATR at 361; 93 ATC at 4,411):-

“There are other facts and circumstances that in my view point strongly in the direction of the conclusions that the interest was derived by the taxpayers in the Cook Islands.

[1] The borrower, EPBCL, was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia.

[2] The deposit was repaid, together with interest, less withholding tax, from the Cook Islands.

[3] It is impossible to ignore the legal effect of the arrangements entered into by the parties with respect to the lending of the money. Until the cheque for \$40m was handed over on 11 December in the Cook Islands (10 December CI time) and the certificate of deposit received in return there was no contract between the lender (the taxpayer) and the borrower (EPBCL). If EPBCL failed to honour the certificate of deposit on the due date the taxpayers could have sued on the certificate and there would have been no answer in law to their right to judgment.”

12. Once the contention that the contract was in reality made in Australia and that what occurred in the Cook Islands was a mere “formal step designed to screen the reality” is rejected and the banker’s letter of credit issued by Midland is seen for what it was, a security to secure performance by EPBCL of repayment of the loan with interest, and not as an investment in itself, the matters contended for by the Commissioner as matters of practical substance sourcing the interest in Australia are either not factually correct or not sufficient to outweigh the Cook Islands elements.

## **HMRC view(s)**

*HMRC view before 1979: IHT/private international law situs rules*

The IR consultative document *Tax Treatment of Interest paid by Companies to Non-residents*<sup>35</sup> provides:

“In the case of a simple contract debt it is settled law that the source is where the debtor is

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34 I could not find the case on [www.austlii.org](http://www.austlii.org) so have put it on [www.kessler.co.uk](http://www.kessler.co.uk). The case went on to the High Court of Australia but the source point was discussed only at first instance and in the Court of Appeal.

35 January 1983 accessible [www.kessler.co.uk](http://www.kessler.co.uk).

resident. Before the ending of exchange control, the Revenue was normally able to accept that interest paid abroad in a foreign currency under a specialty contract (ie a contract under seal governed by foreign law) to a non-resident could have a foreign source, even though the payer was a UK resident company.”

This (more or less) adopts the IHT/international law situs approach to location of a source, which is wrong on principle and rejected in every reported case.<sup>36</sup>

This view survives in the Double Taxation Relief Manual:

**1730. Interest**

There is sometimes some difficulty in deciding whether interest is treated as having a UK source where the borrowing is made by a UK branch. ...

The leading case on this subject is a Privy Council decision on a Hong Kong estate duty matter (*Kwok Chi Leung Karl* [1988] STC 728). The Privy Council decided that where a debtor company has two places of residence where a debt may be enforced, the locality of the debt (and its source for tax purposes in the absence of statutory provision to the contrary) falls to be determined by reference to the place of residence where under the contract creating the debt the primary obligation is expressed to be performed (that is where the creditor would apply first for his money).

*Kwok* concerned situs for estate duty, applying IHT/international law rules.

*HMRC view 1979–1993: residence of debtor*

The consultative document continues:

The abolition of exchange control has meant that a transaction in the form of a foreign specialty contract can now take place entirely between UK residents. The Revenue therefore now generally has to regard interest paid by a UK borrower as having a UK source, whatever the nature of the contract ...

This (more or less) equates source with residence of the debtor. The Revenue forthrightly admit that their change of view was made for pragmatic reasons and not by reference to the law. There is no support for this view in any of the case law, though in practice a residence test will often lead to the same result as other better established tests.

*HMRC view 1993–2008: balance all factors*

HMRC next changed their position in RI 58 (November 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;

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36 Apart perhaps from the stray comment of the Special Commissioner in *Hafton Properties*.

[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<sup>37</sup>

(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—

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

[b] the source<sup>38</sup> 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.

(Emphasis added)

This adopted a balance all the factors approach. This is not supported by *Bank of Greece*. *Spotless* does support this approach, but it does not support the selection of these four factors as the most important.

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 problem is when different connecting factors point different ways as they frequently do. Here the RI copped out:

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.

*HMRC view from 2009: balance all factors*

HMRC did not announce a change of view, but from 2008 the SAI Manual takes a slightly different line, and RI 58 is now described as “superseded by SAIM 9090 onwards”.<sup>39</sup> I take that to be notice that HMRC have withdrawn from it.<sup>40</sup>

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37 I am not sure what is meant by this.

38 [Author’s Note] I think this means the situs (on IHT/international law principles) of the funds from which the interest is paid. It does not mean the location on IT principles of the source of income out of which the interest is paid (which could of course be different).

39 See the HMRC online version of tax bulletin 9, [www.hmrc.gov.uk/bulletins/tb9.htm](http://www.hmrc.gov.uk/bulletins/tb9.htm) also recorded in the Yellow Book 2008/09.

40 However International Manual para 342030 [October 2007] still supports RI 58:  
“The onus is on the payer to decide whether tax is properly to be deducted having regard to settled case law principles [!] and all the facts surrounding the loan. In particular, the payer should refer to the approach and criteria endorsed by the House of Lords in the National Bank of Greece case (46 TC 472).

The SAI Manual also adopts a balance all the factors approach but it offers an expanded selection of eight relevant factors, and an inkling of priority:

**9090. Yearly interest: UK source: The general rule** [January 2009]

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 Company (Channel Islands) Ltd v National Bank of Greece SA* (46 TC 472).

In fact *Bank of Greece* provides no support for a balance the factors approach or for this particular selection of eight factors.

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 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.

It would greatly assist clarity of thinking not to use the word "residence" (which has a specific meaning in tax) to mean something else. I reluctantly refer to the concept as "**jurisdiction-residence**" to distinguish it from tax-residence.

What is the test of jurisdiction-residence? In the case of an individual it means tax-residence, and in the case of a company, place of business. The International Tax Handbook provides at para 1103:

An important factor in determining the source of interest is the residence of the debtor. 'Residence' does not, however, necessarily mean tax residence, rather it means where the [debtor] company has a business presence and can be sued for the debt. If it has more than one such presence then the source will normally be where, under the contract, the company is primarily required to pay the interest and repay the principal. It is, therefore, possible for a UK resident to pay interest which has an overseas source if a borrowing is made and interest is paid by an overseas branch. Likewise it is possible for a UK branch of a non-resident company to pay

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The Inland Revenue position in that case is outlined in Tax Bulletin 9 of November 1993 [RI 58]."

UK source interest.

The SAI Manual makes the same point for interest paid by companies:

**9095. Yearly interest: UK source: Companies**

*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.<sup>41</sup> 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.

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.

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.

*The impact of modern private international law*

The background law (that is, private international law) has moved on considerably since the date of the situs cases which underlie the HMRC view, such as *New York Life Insurance* decided in 1924. Jurisdiction is now largely governed by international conventions, under which it is only very approximately correct to say that residence of the debtor is the test of jurisdiction, (even though in many cases the end result be the same.) In short, it is not the case that the residence or place of business of the debtor is the place the debt will be enforced.<sup>42</sup> Do we continue to apply the historic residence tests? or do we say interest arises where the debt is enforceable, ignoring the place that the debtor resides?

The author of the SAI Manual is aware of the problem, but does not know the answer:

**EU rules**

If the debtor is resident within the EU, the Council Regulation (EC) 44/2001 on Jurisdiction and

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41 “Residence” is being used here in a non-standard way, but it does not matter.

42 In *Bank of Greece* the debt was enforceable in the UK but the interest was not UK source.

the Recognition and Enforcement of Judgments in Civil and Commercial matters, [“the Judgments Regulation”] and the 1968 ‘Brussels Convention’,<sup>43</sup> may have an impact on the general rule described above.

Different rules apply for individuals, corporations, and trusts.

The usual rule is that where an individual is domiciled in a contracting state, then they should be sued in the courts of that state (Article 2 of the Regulation/Convention).<sup>44</sup> Domicile is defined according to the rules of that contracting state but for these purposes only, it is, in the UK, linked to the individual’s residence. Under these rules an individual is domiciled in England for example if he is resident there and the nature and circumstances of his residence indicate that he has a substantial connection with England.<sup>45</sup> So an individual resident in England would in general terms only be sued in the courts in that country. However this is a complex area and there are exceptions. For example it may be argued that:

- [1] the case does not fall within the Regulation;
- [2] another convention or international agreement gives jurisdiction to another state’s courts
- [3] proceedings have already begun in another state’s courts; or
- [4] it has been agreed under Article 22 of the Brussels Convention<sup>46</sup> that the courts of a particular state have exclusive jurisdiction.

Point [4] is fairly common, as the parties may agree any jurisdiction which suits them. What happens then? HMRC will not say (I expect they do not know):

In any case in which it is argued that a UK resident debtor can be sued in a Member State in precedence to the UK courts please refer the case to CT&VAT (Financial and Insurance Team).

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43 [Author’s footnote] The Judgments Regulation applies in the Member States of the European Union. It supersedes the 1968 Brussels Convention except for some territories which fall within the scope of the Convention and which are excluded from the Regulation pursuant to Article 299 of the Treaty.

44 [Author’s footnote] Article 2 of the Judgments Regulation 44/2001, provides: "Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State."

45 [Author’s footnote] Article 59 of the Judgments Regulation provides:  
"1. In order to determine whether a party is domiciled in the Member State whose courts are seised of a matter, the court shall apply its internal law.  
2. If a party is not domiciled in the Member State whose courts are seised of the matter, then, in order to determine whether the party is domiciled in another Member State, the court shall apply the law of that Member State.

In England, s.41(3) Civil Jurisdiction and Judgments Act 1982 provides:

"... an individual is domiciled in a particular part of the United Kingdom if and only if—

- (a) he is resident in that part; and
- (b) the nature and circumstances of his residence indicate that he has a substantial connection with that part.

46 I think the reference should be Article 23 Council Regulation (EC) No 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, which provides:

“1. If the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction...”

The SAI Manual then turns to consider the impact of the modern law on debts owed by companies:

### **Companies within the EU**

Under both the EU Regulation and 1968 Convention, domicile is the main ground of jurisdiction and will, at first sight, determine the rules for the recoverability of debts. EU regulation 44/2001 provides for a definition of domicile for corporations so that the company is domiciled where it has its statutory seat (in the UK its registered office), central administration or its principal place of business.<sup>47</sup> However it is important to note that a corporation is not domiciled in a country for these purposes merely because it does business there. If an EU based company carries on business in a country in which it is not domiciled you have to consider the terms of the loan agreement to determine the situation of the debt. For example, if a company which has its principal place of business in the UK also carries on business in another Member state, where the interest and loan are payable in that other Member state and that member state's courts have jurisdiction then the interest will be non-UK source. For branches of EU companies the position is as described above for branches generally.<sup>48</sup>

Just as for the IHT/private international situs rules, it is suggested that the better approach is to pay no regard to modern conflicts law in determining the source of interest, even if the place where the debt is enforceable is not the place where the debtor resides.

### *Interest from securities*

FB EN 2008 makes a useful comment:<sup>49</sup>

77. ... Securities are "foreign" where income from them (in practice, interest) would be relevant foreign income. This would include, for example, a security issued in registered form by a non UK company, which maintains the register of note-holders outside the UK.

The rule that the source of interest on registered bonds of a foreign company is the location of the register seems a sensible rule and is consistent with *Bank of Greece*.

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47 Article 60 Judgments Regulation provides:

"1. For the purposes of this Regulation, a company or other legal person or association of natural or legal persons is domiciled at the place where it has its:

- (a) statutory seat, or
- (b) central administration, or
- (c) principal place of business.

2. For the purposes of the United Kingdom and Ireland "statutory seat" means the registered office or, where there is no such office anywhere, the place of incorporation or, where there is no such place anywhere, the place under the law of which the formation took place."

48 Article 5(5) Judgments Regulation provides:

A person domiciled in a Member State may, in another Member State, be sued:

... 5. as regards a dispute arising out of the operations of a branch, agency or other establishment, in the courts for the place in which the branch, agency or other establishment is situated;"

49 The comment is made in relation to the AIS remittance basis, but the point made here relating to the source of interest has a more general application.

## Source of interest: conclusion

There are two rival solutions to the question of where is the source of interest: the place of credit test and the balance all the factors approach. It is submitted that the courts ought to adopt the place of credit test, ie 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 (at least in Hong Kong) and alone provides a reasonable element of certainty. The English courts are not bound to follow it, however.

The rival balance of all the factors approach is supported by *Spotless* and (current) HMRC practice, though 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 law would ever be clear. If (contrary to that 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.

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 (e.g. 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.

(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.

### *Commentary*

HMRC correctly say:

The current tests in UK law of whether, for the purposes of deduction of tax, payment of interest is made from a UK source are unclear and cause confusion.<sup>50</sup>

The test in the OECD Model Treaty is superior to both the place of credit test and the balance all the factors approach.<sup>51</sup> A HMRC consultation document in 2003 proposed this sensible reform

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50 “Income tax: Meaning of UK Source for Payments of Interest and Royalties” Consultation document 10 December 2003, para 1.1.

51 Article 11(5) OECD Model Treaty provides:  
“Interest shall be deemed to arise in a Contracting State when the payer is a resident [i.e. treaty-resident] of that State. Where, however the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on

but the proposal was quietly dropped.

## DISCLOSURE AND COMPLIANCE

### Levels of disclosure

Taxpayers disclosure may be classified by various standards:

“**Minimum disclosure**” – the minimum required by statute.

“**Above-minimum disclosure**” meeting some higher standard above that minimum. This is a (deliberately) loose expression since (in the absence of context) a variety of standards might be applied. One particular standard (discussed below) I call “**Veltema-disclosure**” but there can be other standards.

“**Full disclosure**” (in the absence of context) is not an apt expression, and I prefer to avoid it, because one cannot disclose *everything*: that is not practical. Indeed even to try would swamp HMRC with information so they could not identify what is relevant. HMRC are themselves aware of this. SP 1/06 provides:

9. A taxpayer can further restrict the opportunity for discovery [assessments] by providing enough information for an HMRC officer to realise within the enquiry period that the self-assessment is insufficient. However taxpayers are encouraged to submit the minimum necessary to make disclosure of an insufficiency. The Veltema judgement does not require the provision of enough information to quantify the effect on the assessment. Information will not be treated as being made available where the total amount supplied is so extensive that an officer ‘could not have been reasonably expected to be aware’ of the significance of particular information and the officer’s attention has not been drawn to it by the taxpayer or taxpayer’s representative.

### Advantages of above-minimum disclosure

Above-minimum disclosure is only voluntary. Everyone who is responsible for completing tax returns has to ask questions and decide on the answers. If an answer is reached, there is in general no obligation to disclose this process of reasoning to HMRC. Failure to do so does not render answers in the return (even if they turn out to be wrong) to be dishonest or negligent errors. The CIOT agree:

In the preparation of a tax return, there is no duty to provide more information to the tax authorities than the return requires simply because some pieces of information known to the member might support a different tax treatment from that which the member, after due

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which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.”

consideration of all the information available to him, honestly considers to be the tax treatment.<sup>52</sup>

The fact that there is a possibility that the courts might disagree with an adviser's view does not in itself require any disclosure.

Voluntary disclosure may be desirable for any one or more of the following reasons:

- (1) It may curtail HMRC's enquiry period.
- (2) It may facilitate good relations with HMRC.
- (3) It may help avoid later allegations of bad faith, which might later arise if the view taken turns out to be in error, and tax is due:
  - (a) Allegations of dishonesty (based on a suspicion that the taxpayer might be relying on HMRC not finding out the facts).
  - (b) Allegations of neglect.
  - (c) Allegations of no reasonable excuse.

### **Voluntary disclosure to curtail enquiry period**

The advantage of voluntary disclosure is that HMRC cannot (after the one-year period has passed) make any further enquiries into the return. If a taxpayer wants security that the matter is closed after one year, therefore, it would be necessary to disclose relevant facts. I refer to disclosure which meets the requirements of s.29(5) TMA as "***Veltema*-disclosure.**"

Taxpayer are entitled to weigh up the advantages of *Veltema*-disclosure (curtailing the enquiry period) against the disadvantages (possible costs).

### **Above-minimum disclosure for sake of good relations with HMRC**

CIOT Professional Conduct in Relation to Taxation<sup>53</sup> provides:

"It may be in the client's best interest to furnish more information than he is strictly required to do because this is likely to lead to a more reasonable approach by the tax authorities, thereby saving money and time in the long run ..."

The CIOT are tentative (note the *may*) and the validity of the point is not easy to assess: it may vary from client to client<sup>54</sup> and from time to time.

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52 The Professional Conduct in Relation to Taxation, 2004, para 3.10 accessible [www.tax.org.uk](http://www.tax.org.uk)  
The Keith Committee recommended that taxpayers' doubts should be disclosed to HMRC but the recommendation was rightly rejected as impractical: see Committee on Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.6 and HMRC consultation papers "The Inland Revenue and the Taxpayer" and "Keith: Further Proposals" (1988).

53 Para 3.10, accessible [www.tax.org.uk](http://www.tax.org.uk)

54 The trade-off may be different for large businesses who have a specific "client relationship manager", where HMRC expressly offer the carrot of "far fewer interventions" in return for behaviour which meets the HMRC low risk criteria; and, conversely, the stick of "more intensive scrutiny" for "high risk customers": see HMRC Approach to Compliance Risk Management for Large Business, March 2007, accessible

It seems to me that the only tangible incentive for above-minimum disclosure is to curtail the enquiry period, and obtaining “a more reasonable approach by the tax authorities” is uncertain, unquantifiable, unenforceable and ultimately chimerical. But those who deal directly with HMRC on a daily basis will be in a better position than I am to form a view on this issue, and this is (understandably) an attitude that HMRC wish to encourage.<sup>55</sup>

This debate should be seen in the context of a broader policy debate of the correct relationship between the Revenue and the taxpayer. The traditional view has been that this relationship should be characterised by adherence to rules (substantive tax rules and procedural rules such as courtesy, honesty and efficiency) and it is at heart adversarial. The interests of HMRC and taxpayer are distinct.

A rival (and more recent) view that the relationship should be a mutual one, taxpayer and state working together in harmony to achieve a common goal, to ascertain the right amount of tax, something defined partly in rules and partly in a more insubstantial spirit of the rules (of which one suspects HMRC consider themselves the final arbitrator.) This raises factual questions of whether HMRC and taxpayers actually regard this as their relationship, and the political and moral questions of whether they should do so, or the extent to which they should do so, are important questions but they lie beyond the scope of this lecture.

### **Above-minimum disclosure to avoid allegations of bad faith**

Disclosure may be sensible to help avoid allegations of bad faith, which might later arise if the view taken turns out to be in error, and tax is due: allegations of dishonesty, neglect or lack of “reasonable excuse”

### **Self-assessment tax return: minimum disclosure**

A tax return is a series of questions, and the statutory duty of taxpayers (and advisers) is simply to answer them. The answers should be honest and non-negligent. That is, one cannot necessarily avoid errors, but any errors in the return should be honest and non-negligent.

The question must be decided in the light of the position as it was at the relevant time without the benefit of hindsight. The fact that a view later turns out to be mistaken does not show that it was negligent to form that view. An allegation of neglect is a serious one and it should not be lightly made. I stress these points because HMRC ignore them and allege neglect as a matter of course, whenever neglect is necessary to justify out of time assessments.<sup>56</sup>

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*[www.hmrc.gov.uk/budget2007/large-business-riskman.pdf](http://www.hmrc.gov.uk/budget2007/large-business-riskman.pdf).*

55 See comments on the “enhanced relationship” in the OECD Study into the Role of Tax Intermediaries, 2008, [www.oecd.org/dataoecd/28/34/39882938.pdf](http://www.oecd.org/dataoecd/28/34/39882938.pdf) and the OECD’s “Engaging with High Net Worth Individuals on Tax Compliance” (May 2009); [www.oecd.org/dataoecd/5/25/42798312.pdf](http://www.oecd.org/dataoecd/5/25/42798312.pdf).

56 See eg International Manual:  
“**268520. Assessing time limits** [February 2008]  
... If we come to the reasonable conclusion that there is a PE, or that the company is resident in the UK, prima facie there has been negligent conduct in the failure to notify.”

Depending on which statutory provision is in point, it may be necessary to ascertain:

- (1) whether the taxpayer is guilty of neglect; or
- (2) whether the taxpayer's agent is guilty of neglect.

*The standard of care: taxpayers*

A taxpayer who is not an expert in taxation must leave technical tax issues to his professional advisers. When tax law is complicated a properly represented taxpayer cannot be expected to identify his advisers mistakes. So where there are technical errors of law, the issue is normally whether the taxpayer's professional advisers have been guilty of neglect. HMRC agree (if grudgingly):

A taxpayer who

- [1] goes to an ostensibly competent professional adviser,
  - [2] provides a full and accurate account of the facts,
  - [3] checks that advice to the limit of his or her ability and competence,
  - [4] and then follows the agent's advice (or signs the return prepared on that basis)
- has not been negligent. He or she has taken reasonable care. If it turns out that the agent has made a careless error in giving the advice or in preparing the tax return the taxpayer who has taken reasonable care will not be penalised.<sup>57</sup>

An interesting question is what the taxpayer should do if his advisers disagree. A safe course then (if the amounts involved make this reasonable) is to seek the advice of counsel, or more senior counsel, or a QC, but what is to be done if two tax QCs disagree or if the amounts do not justify that expense? It is suggested that the correct course is as follows:

- (1) The individual must ask himself whether one view or the other is obviously or glaringly wrong. However it is not to be expected that this will often provide a solution.
- (2) Subject to that, the individual can in principle follow whichever view suits him, provided that the person whose advice is adopted is suitably experienced, has seen the contrary advice and maintains his view. Then (even if the practitioner whose view is adopted turns out to be wrong) any error is non-negligent and a reasonable-excuse error.

*The standard of care: tax practitioners*

The question then is what reasonable tax practitioners should do in advising or completing a tax return for a client. The standard of care is that to be expected of a reasonable practitioner.

A solicitor or accountant is entitled to rely on advice given by an appropriate expert counsel (provided it is not obviously or glaringly wrong). A person who acts in this way is not negligent. This rule applies in the completion of a tax return.

What should a practitioner do if the law is so unclear that he is unable to form a view? Common examples include residence and the source of interest: in many cases the only honest answer to

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<sup>57</sup> "Modernising Powers, Deterrents and Safeguards: Working with Tax Agents" 22 April 2009, accessible [www.hmrc.gov.uk/budget2009/tax-agent-6440.pdf](http://www.hmrc.gov.uk/budget2009/tax-agent-6440.pdf)

the question of how a court would decide is “I don’t know” or “toss a coin”. In such cases the proper course is to complete the tax return on whichever view best suits the client.

A trickier question is where professional views differ between view A and view B, the practitioner prefers view A, but view B suits the client. It is suggested the practitioner can advise the client to fill in his return on view B. Take, for example, the old chestnut problem of GWR and trusts. In my view there is no IHT charge on the death of a deemed domiciled individual who has a GWR in an excluded property trusts. Some practitioners (I think, a minority) take the view that there is a charge. Should they really advise their clients to complete the return on that basis? I would have thought not. If that were wrong, then the best advice one could give would be to change advisers, which can hardly be right.

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