ICTA 1988, s.349(3)(a) (unamended) – "Payable in the UK" – Whether interest on a loan made by a UK bank remained so payable notwithstanding assignment of accrued interest debt to a company resident abroad, to which interest was subsequently paid

THE SPECIAL COMMISSIONERS

APPLETREE GROUP
MISTLETOE LTD - Appellants
- and -
FRANCIS FLOOD - Respondent

Special Commissioner: MR B M F O'BRIEN

Sitting in Belfast on 2 September 2002

Ivan Carruthers of Ernst & Young, Chartered Accountants, for the Appellant

Terry Mallan, Inspector of Taxes for Inland Revenue, for the Respondents

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ANONYMIZED DECISION

1. This appeal by Mistletoe Ltd ("Mistletoe") is against an assessment made under paragraph 4(2) of Schedule 16 to the Income and Corporation Taxes Act 1988. The assessment was made because Mistletoe had not deducted and accounted for income tax when it made a payment of interest in November 1995. It is common ground that the conditions for such deduction, laid down in s.349(2) of that Act, are satisfied : the sole question is whether the obligation to deduct tax in accordance with that subsection is negatived by subsection (3) – and, in particular, by head (a) therein – to which subsection (2) is expressly subject.

2. Mistletoe is a wholly-owned subsidiary of Appletree Ltd ("Appletree") and, together with another such subsidiary, formed part of the Appletree Group. The Group traded as property developers in Northern Ireland. It appears that its operations were to a large extent funded by loans made by the Northern Bank; and the combination of falling property prices in Northern Ireland and high interest rates which were features of the 1970s and 1980s resulted in the Group becoming insolvent. In 1984 the Northern Bank (as the principal creditor) took over the Group.

3. Interest on the bank loans continued to accrue. However, at the end of 1989, the Northern Bank appears to have written off the capital element – certainly that of Mistletoe's total debt – and from 31 December 1989 no further interest was charged. The Group's debt thus became fixed : it amounted in total to some

£11m, of which Mistletoe's share was £5,303,958 (all of which represented bank interest).

4. On 5 June 1990 the Northern Bank sold the shares in Appletree (which of course carried its subsidiaries with it) to another property development company in Northern Ireland. The price paid must, I think, have represented not so much the intrinsic value of the Group – its balance sheets were negative – as the value to the purchaser of the Group's losses for tax purposes, which had been enhanced by the bank interest charges up to the end of the previous year. I am not concerned with that. However, on the same day, the Northern Bank assigned all the Group's interest debts to a company resident in the Channel Islands, Aberne Ltd. The consideration paid by Aberne Ltd was nominal (£10,000). That assignment is crucial to this case, having regard to the location of the assignee, the substituted creditor.

5. Mistletoe's bank interest debt continued to be interest-free following the assignment, so any subsequent payment by Mistletoe to Aberne Ltd would be wholly in respect of interest which had accrued during the period when it was due to the Northern Bank.

6. The Group's insolvency appears not to have interrupted its trading. I have before me Mistletoe's accounts for the year ended 30 April 1996; and while the balance sheet shows liabilities exceeding assets by more than £3m, the profit and loss account for the year shows a profit of a little over £500,000.

7. During that accounting year, on 21 November 1995, Mistletoe paid Aberne Ltd £500,000 in part repayment of its assigned interest debt. The payment was made by telegraphic transfer from Mistletoe's bank account in Belfast to Aberne Ltd's in St Helier, Jersey; and it was made without deduction of tax. If the Crown's view of the matter is correct, £125,000 should have been deducted (and accounted for). That is the amount of the tax charged by the assessment under appeal.

8. Section 349(2) and (3), so far as material, were as follows in 1995:

> "(2) Subject to subsection (3) below … where any yearly interest of money … is paid –
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> (a) … by a company; or
>
> . (b) by any person to another person whose usual place of abode is outside the United Kingdom,
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> the person by or through whom the payment is made shall, on making the payment, deduct out of it a sum representing the amount of income tax thereon for the year in which the payment is made.
>
> (3) Subsection (2) above does not apply –
>
> (a) to interest payable in the United Kingdom on an advance from a bank carrying on a bona fide banking business in the United Kingdom."

As already indicated, Mistletoe accepts that its £500,000 payment prima facie falls within subsection (2). For his part, the Inspector accepts that the Northern

Bank's assignment was a true assignment, and that the interest which Mistletoe was liable to pay remained "interest payable … on an advance from a bank" as described in subsection (3) notwithstanding the change in the ownership of the debt. (There was no new loan made by Aberne Ltd to Mistletoe, enabling Mistletoe to discharge its liability to the Northern Bank.) What is in dispute is whether the interest remained "payable in the United Kingdom".

9. Mistletoe was represented by Mr Ivan Carruthers, a Chartered Accountant and Tax partner in Ernst & Young, Belfast. His primary contention was founded on the Revenue's acceptance of the proposition that an assignment does not affect the description of the advance. If, notwithstanding assignment, "an advance from a bank carrying on a bona fide banking business in the United Kingdom" retains that character throughout its existence, and if the interest on that advance was "payable in the United Kingdom" when it became payable (as is undoubtedly the case here), then it is logical, he submitted, to regard the interest as continuing to have that quality. Mr Carruthers emphasised that the word used is "payable", and does not import actual payment : so that, in his submission, the interest was still "payable" in the United Kingdom in 1995, although it was actually paid in Jersey. In this connexion, he drew attention to the re-casting of subsection (3)(a) which occurred in 1996 (after the payment in the present case). The provision now reads:

> "(a) to interest payable on an advance from a bank, if at the time when the interest is paid the person beneficially entitled to the interest is within the charge to corporation tax as regards the interest".

This version closely directs attention to the time of actual payment as the time at which the condition must be satisfied.

10. Secondly, Mr Carruthers drew my attention to passages in the Revenue's own internal instructions which, in his view, supported his argument that the interest retained its United Kingdom payability. He acknowledged that such manuals do not have the force of law, but they do represent the official view on the issue at the relevant time. I propose to deal with this point quite shortly. The cited passages particularly relate to the issue of the status of the advance. In my view it is highly unsafe to draw inferences from what is stated in documents of this kind as to the position in relation to circumstances not expressly covered. The particular circumstance in this case – an assignment out of the jurisdiction – is not mentioned.

11. The Inspector, Mr Mullen contended –

> (i) Subsection (3)(a) – in its 1995 form – contains two separate requirements. One is concerned with the entity which made the advance, the source of the income. That is a matter of history and the answer cannot change while the advance continues in being. The second is concerned with the place of due payment of interest on the advance. That is different, because of the periodical nature of interest. The due place of payment can change during the period of the advance's existence – by agreement between the parties or (as in the present case) as the result of an assignment to a non-resident, absent agreement preserving the previous place of payment.

(ii) The subsection does not itself specify the date by reference to which the "payable in the United Kingdom" requirement has to be met, and a historical date cannot be read in. Subsection (2), however, clearly states the date when the question falls to be answered : the date when a payment is made. An ordinary and natural construction of subsection (3)(a) would point to that same date.

(iii) The 1996 Finance Act effected a change only of form, not of substance. The new subsection (3)(a) is simply more explicit. The change was made necessary by the expansion that year of the definition of "bank" to include, inter alia, European institutions. In addition, the old form no longer fitted comfortably with developing practices of United Kingdom banks in their international business.

12. In my judgment the Inspector is right, and for the reasons he gave. I see no necessity in logic to construe "payable in the United Kingdom" as "payable in the United Kingdom when the advance was made (or when the interest first became due)" just because the source of the interest has not altered since that date. The truth is that the date of payment is the relevant date for both requirements : but the nature of one is such that the answer to the question is the same at that date as it has been throughout the period since the advance, while the nature of the other is such that it may not be. And is not in the present case.

13. Furthermore, the Revenue's construction seems to me to accord with subsection (3)(a)'s evident rationale. As I understand it, interest paid in the United Kingdom to United Kingdom banks is brought into their corporation tax computations as part of their Sch D, Case I profits. It seems obvious that subsection (2) should be disapplied in those circumstances, to avoid duplication of charge. Disapplication is not called for if the interest is not within the corporation tax net : as where the interest is payable (and ex hypothesi has been paid) abroad to a foreign resident. "Payable in the United Kingdom" and "if … the person beneficially entitled to the interest is within the change to corporation tax as respects the interest" (the 1996 version) essentially look in the same direction.

14. I accordingly confirm the assessment.

B M F O'BRIEN

SPECIAL COMMISSIONER

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