TC02530

Appeal number: TC/2011/9844

INCOME TAX – overseas property purchase using borrowed funds – whether an "offset mortgage" – whether interest income on escrow account chargeable under Part 4 ITTOIA 2005 – whether relieved under Part 8 ITTOIA 2005 – Appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Mr NEIL COXON **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE PETER KEMPSTER
MRS RAYNA DEAN FCA

Sitting in public at Stoke-on-Trent on 23 January 2013

Mr Lyn Hill (Elite Consultancy) for the Appellant

Mr Phillip Jones (HMRC Appeals Unit) for the Respondents

DECISION

Background

1. In February 2007 Mr Coxon and his wife entered into a contract to purchase a residential property ("the Property") in Cyprus "off plan" – that is, the Property was not then constructed but the vendor developer undertook to construct and deliver the Property. To fund the purchase Mr Coxon paid a substantial deposit and for the balance entered into a loan agreement ("the Loan Agreement") with Alpha Bank Cyprus Limited, whereby he borrowed 553,000 Swiss Francs. The Property purchase price was in Cypriot Pounds, so Alpha Bank immediately swapped the Swiss Francs into Cypriot Pounds and placed those Cypriot Pounds into a deposit account ("the Escrow Account") in the names of Mr & Mrs Coxon. The Escrow Account converted into Euros when Cyprus entered the Eurozone in January 2008. All the relevant documentation was executed by a Cypriot lawyer acting under a power of attorney conferred by Mr Coxon. The plan was that funds would be released to the developer against certificates of value as the development proceeded. In fact, although the Property has never progressed beyond a shell and the developer appears now to be insolvent (having mortgaged the site for its own borrowings), most of the contents of the Escrow Account have already been passed to the developer. Mr Coxon – along with other dissatisfied purchasers – is in litigation in the Cyprus courts with both the developer and Alpha Bank. Mr Coxon accepts that, with the benefit of hindsight, his grasp of the financial details was not complete – for example, the Loan Agreement gave him a 25 year Swiss Franc liability that was unhedged. When the true state of affairs became apparent Mr Coxon refused to keep up repayments on the Loan Agreement, which Alpha Bank treated as an event of default and terminated the Loan Agreement in January 2012, also enforcing its charge over the Escrow Account (conferred under the terms of the Loan Agreement).

2. In 2011 the Respondents ("HMRC") opened an enquiry into Mr Coxon's tax affairs, prompted by information received that Mr Coxon had not returned certain deposit interest income. The dispute that comes before this Tribunal concerns the interest that was credited to the Escrow Account in the tax years 2007-08 to 2009-10. HMRC have issued discovery assessments to tax half of that interest on Mr Coxon. Mrs Coxon is in a similar position, HMRC regarding half the interest to belong to each spouse. The detailed arguments of the parties are set out below but in essence HMRC maintain that half of the interest credited to the Escrow Account is taxable income of Mr Coxon, while Mr Coxon argues that as he has never received any of the funds in the Escrow Account he cannot be liable to tax on those sums.

Relevant Statutory Provisions

3. Sections 368 to 371 Income Tax (Trading & Other Income) Act 2005 ("ITTOIA") provide, so far as relevant:

> "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 United Kingdom. …
>
> 369 **Charge to tax on interest**

(1) Income tax is charged on interest. …

370 **Income charged**

(1) Tax is charged under this Chapter on the full amount of the interest arising in the tax year.

(2) Subsection (1) is subject to Part 8 (foreign income: special rules).

371 **Person liable**

The person liable for any tax charged under this Chapter is the person receiving or entitled to the interest."

4. Sections 829 and 841 ITTOIA provide, so far as relevant:

"829 **Overview of Part 8**

This Part provides for—…

(*c*) relief where a person is prevented from transferring income to the United Kingdom (see Chapter 4).

841 **Unremittable income: introduction**

(1) This Chapter applies if—

(*a*) a person is liable for income tax on income arising in a territory outside the United Kingdom, and

(*b*) the income is unremittable.

(2) For the purposes of this Chapter, income is unremittable if conditions A and B are met.

(3) Condition A is that the income cannot be transferred to the United Kingdom by the person who is liable for income tax in respect of the income because of—

(*a*) the laws of the territory where the income arises, …

(4) Condition B is that the person who is liable for income tax in respect of the income has not realised it outside that territory for an amount in sterling or in another currency which the person is not prevented from transferring to the United Kingdom. …"

Evidence

5. Mr Coxon and his wife gave oral evidence as to the factual background to the dispute, none of which was challenged by HMRC. Mrs Sue Dougal, an Inspector in HMRC's Offshore Unit, confirmed she was aware of a number of other taxpayers who were in an identical or very similar position to Mr & Mrs Coxon, and thus the Tribunal's decision in this appeal may have wider relevance beyond Mr Coxon's affairs.

6. We have considered the following documents.

(1) A booklet prepared by Alpha Bank entitled "Alpha Bank Mortgage – How It Works", which states:

"*The Mortgage*

The Alpha Bank loan facility works much the same as an 'Offset Mortgage' you can get from UK High Street banks.

You will have a Cypriot Pound (CYP£) credit account this will be used to purchase your property. As of January 2008 this will change to Euro as Cyprus officially entered the Euro Zone. The official conversion rate is 0.585274 Euros to the Cypriot Pound.

The second account will be the Swiss Franc (CHF) debit account. This is the mortgage that you will repay.

Both of the above accounts will be charged / gain interest at the same rate. When you receive your statements from Alpha Bank you will receive two; one in CHF, the other in CYP / EUR. Attached is copies of the statements, they include notes to explain the bank charges that are added to the loan. These statements are sent out annually."

(2) The Loan Agreement, which includes as clause 13:

"The Bank is entitled to consider that all accounts in the Debtor's name with any branch of the Bank including any accounts in foreign currency, constitute a single combined current account all debit and credit balances offsetting each other and the benefit of the guarantees or any other securities held by the Bank or any branch of the Bank particularly earmarked to each item of this current account shall remain assigned to secure the debit balance, if any, of all monies owed by the Debtor hereunder."

(3) Bank statements for the Escrow Account, which show several credit items "Credit interest – INTEREST [date]" and, on the same dates, debit entries "Tax - INTEREST [date]" – the latter being 10% Cypriot withholding tax at source.

(4) An extract from an explanation of the Escrow Account provided to Mr Coxon by Alpha Bank, apparently in connection with HMRC's enquiries:

"The deposit escrow account was opened in Euro so that the proceeds from the loan account, which was denominated in a different currency, would be transferred in Euro and thus ensure that the client would not incur any exchange rate difference to enable him to meet his property purchase obligation which was in Euro.

The escrow account was necessary as the purchased property was not completed at the time of purchase and the payments for the purchase were taking place over a period of time.

During this period (until the completion of the property) the escrow account earned interest which was wholly used to offset part of the interest charged on the loan account."

Taxpayer's Submissions

7. Mr Hill for Mr Coxon submitted three alternative grounds of appeal against the discovery assessments.

8. *First: Mr Coxon has never received nor derived any benefit from the interest, and thus is not taxable thereon.*

(1) It was clear that Mr Coxon never had access to the funds in the Escrow Account and, sadly, was unlikely ever to have any benefit from those funds. Control over and access to the funds was confined to Alpha Bank and the developer. It could not be said that Mr Coxon was "the person receiving or entitled to the interest" as required by s 371.

(2) HMRC's own guidance in its Manuals at SAIM2400 supported this view. After commenting on the case of *Dunmore v McGowan* [1978] STC 217 the Manual states, "But if there is no way in which the person can benefit from interest accruing to an account – in other words, if they have no entitlement to the interest – they are not chargeable".

(3) The decision in *Dunmore* had been restricted by that in *Girvan v Orange Personal Communication Services Ltd* [1998] STC 567.

9. *Second: The Escrow Account was part of a Cypriot-style offset mortgage and accordingly there is no taxable interest income.*

(1) The Escrow Account was merely one part of an offset mortgage arrangement. If matters had progressed as expected then no right to the interest on the Escrow Account would have accrued to Mr Coxon; it would all have been offset against the sums due under the Loan Agreement.

(2) This was apparent from the description of the accounts in the mortgage brochure (see paragraph 6(1) above). Also, from clause 13 of the Loan Agreement (see paragraph 6(2) above).

10. *Third: The interest is not taxable pursuant to the foreign income special rules in Part 8 ITTOIA.*

(1) It was clear that the interest on the Escrow Account would never be received by Mr Coxon. It was frozen in Cyprus because of the operation of the Loan Agreement and the relevant laws in Cyprus. It was a legal impossibility to remit the interest. Accordingly, it was unremittable foreign income under the laws of the territory where it arose. Relief was thus available under Part 8 of ITTOIA.

(2) It was accepted that a claim under Part 8 may be out of time but leave would be pursued to have a late claim admitted.

HMRC's Submissions

11. Mr Jones for HMRC submitted as follows.

12. While HMRC were sympathetic to the unfortunate financial predicament that has befallen Mr Coxon, the legal position was clear and the interest income had been correctly assessed on Mr Coxon under Part 4 ITTOIA.

13. It was clear from the bank statements that interest was credited to the Escrow Account regularly over three years. The Escrow Account was in the joint names of Mr & Mrs Coxon. Cypriot tax had been deducted at source from the interest credited. *Dunmore* was clear authority that when interest entered the account it did give a benefit to the account holder, even where it was charged as a security for other liabilities (there, a business guarantee). That would be the case even if the bank subsequently failed and so the funds were irrecoverable by the account holder – that was confirmed in *Dunmore* itself. The interest was in the account and was over and above the original deposit in that account, and applied to the benefit of the account holder. Mr Coxon was joint legal owner of the Escrow Account (with his wife) and the interest was received by him and available to him to be spent.

14. The Escrow Account and the borrowings under the Loan Agreement were two separate and distinct accounts. There was no offset mortgage and the interest on the Escrow Account arose in its own right. The monies in the Escrow Account were not offset against the Loan Agreement liability so as to cause no deposit interest to be earned.

15. In relation to Part 8 ITTOIA, there was no evidence of any relevant laws in Cyprus that would make the interest unremittable. Also, a formal claim was required and HMRC had no record of a claim, which would now be out of time – s 842(5) refers.

Consideration and Conclusions

16. We consider in turn the three grounds of appeal advanced.

17. *First: Mr Coxon has never received nor derived any benefit from the interest, and thus is not taxable thereon.* The Tribunal sympathises with Mr Coxon concerning his unfortunate financial predicament. However, we do not accept that the fact that he has lost a large amount of money in relation to the Property must relieve him of any tax liability on interest credited to the Escrow Account. We derive considerable assistance from the Court of Appeal decision in *Dunmore* where Stamp LJ stated (at 219-220):

> "First of all, may I say this, that it appears to me that the doctrine that 'receivability without receipt is nothing' is a doctrine which can be pressed too far.
>
> …
>
> Just as the £28,000 deposited with the bank was a debt due by the bank to the taxpayer subject to any claims that might arise under the guarantee, so on the interest being credited to the deposit account did the interest acquire the same characteristics. The interest was received or 'got' when it was credited to the deposit account, an account of money which was at all times owed by the bank to the taxpayer, albeit charged in support of the guarantee.
>
> Counsel for the taxpayer submitted that the taxpayer would only receive the interest credited to the account if the bank turned out to be

> solvent. In my view this confuses payment with receipt in the sense in which that word is used in the relevant parts of the Income Tax Acts. The interest which is credited to my deposit account is received by me at the date when it is so credited, notwithstanding that it may not be paid to me until a future date, and it is just as much mine whether it is or is not paid to me.
>
> Counsel for the taxpayer also repeated the submissions made in the court below, that the bank became a trustee of the 'funds' (I put the word in inverted commas, it was the word used by counsel for the taxpayer) in which the taxpayer had only a contingent interest. Counsel for the taxpayer when asked what was the property of which the bank was a trustee submitted that the property consisted of what he called the totality of the accounts. I confess I found difficulty in appreciating the meaning of that expression but, however that may be, I am satisfied that the relationship between the bank and the taxpayer never became anything but the relationship of banker and customer.
>
> Alternatively, it is said that the bank exercised control over what counsel for the taxpayer called the 'fund'. Again I confess I do not understand or appreciate that conception. There was no fund except a sum of money which historically had been deposited with the bank and for which the bank became liable (in one way or another either by discharging the amount due on the guarantee or by repayment to the taxpayer) to repay. I can see no fiduciary element in the transaction at all."

We consider that this disposes of the first ground of appeal. The fact that the Escrow Account – including the interest added to that account - has been charged by the bank, and retained under the security arrangements, does not affect the taxability of the interest income on the account holder. We do not agree that the position is changed by the decision in *Girvan v Orange Personal Communication Services Ltd* – there "no interest was credited to any account in the name of [the taxpayer]" – see Neuberger J, at 585 (and also the summary of facts at 582).

18. *Second: The Escrow Account was part of a Cypriot-style offset mortgage and accordingly there is no taxable interest income.* Although the brochure prepared by Alpha Bank (quoted at paragraph 6(1) above) likens the loan arrangements to a UK offset mortgage, the structure actually adopted was different. For an offset arrangement to have the desired tax effect requires that debit and credit balances owed to and from the bank are offset, with interest being charged or paid by reference to the net balance. It is not sufficient that interest is calculated separately on the debit and credit balances and then the two interest amounts are offset. In the former case the contract between customer and bank determines that only one amount of interest is due (usually from customer to bank). In the latter, there is both interest income and interest expense for the customer, albeit the amounts may be directly or indirectly netted against each other in the books of the bank. We conclude that the contract between Mr Coxon and Alpha Bank was in the latter category. There is one point in favour of Mr Coxon and two against him. In his favour is clause 13 of the Loan Agreement which does refer to offset of balances, but we conclude that clause is seeking chiefly to cover the security position of the lending bank in the event of default, rather than stipulating that interest is calculated only on net balances. Against

him are first, the fact that interest was calculated and actually credited to the Escrow Account without any reference to the funds due under the Loan Agreement; and second, that Cypriot withholding tax was deducted by the bank from the full amount of interest credited. We conclude that the explanation of the workings of the Escrow Account given by Alpha Bank (quoted at paragraph 6(4) above) is correct – interest expense and income were both present and "the escrow account earned interest which was wholly used to offset part of the interest charged on the loan account." That is not sufficient to achieve the result sought by Mr Coxon.

19. *Third: The interest is not taxable pursuant to the foreign income special rules in Part 8 ITTOIA.* We do not consider that s 841(3)(a) assists Mr Coxon. We consider that provision applies to overseas legislation such as foreign exchange control restrictions, or blocked funds accounts arising from trading boycott sanctions. It is not sufficient to cover an inability to transfer funds to the UK because of a contractual provision restricting one party's ability to deal with those funds (here, the bank's security charge over the Escrow Account). Mr Hill made reference to Cypriot banking laws but, at least in the absence of further detail, we conclude that a contractual restriction, albeit one legally enforceable under Cypriot law, is insufficient to bring s 841(3)(a) into play.

20. Accordingly, we find against Mr Coxon on all three grounds of appeal.

Other matters

21. During the hearing passing reference was made of Mr & Mrs Coxon's intention to use the property as a holiday let. We did explore with Mr Hill the possibility of treating interest on the loan as a business expense deductible from the interest income but, given that the property has never been built let alone available for letting, that raises problems over abortive expenditure and we merely record here that the point was raised by the Tribunal but no conclusion reached.

22. No penalties were in the appeal before us but we record our view that, given the explanation of the "offset" workings of the accounts provided to him by Alpha Bank (see paragraph 6(1) above), we would not consider Mr Coxon to have been careless in omitting the interest income from his tax returns. That view is *obiter* but may be of assistance to HMRC if the point arises subsequently.

Decision

23. For the reasons set out at paragraphs 17 - 20 above, the appeal is DISMISSED.

24. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

PETER KEMPSTER
TRIBUNAL JUDGE

RELEASE DATE: 8 February 2013