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UK tax analysis: How to handle 'unallowable purposes' enquiries

The UK tax code is littered with unallowable purposes rules but the loan relationship unallowable purposes rules seem to be particularly in vogue as HMRC (the UK tax authority) tackles what it perceives to be artificial (mainly intragroup) financing structures.

Unallowable purposes enquiries are fact-heavy and can be difficult to resolve, and the case law is still developing. The authorities to date have established that one must look to the subjective purposes of the company (usually represented by the directors) and the significance attached to those purposes to determine whether a loan relationship has an unallowable purpose.

However, contentious questions remain around how tax and non-tax purposes are tested, the extent to which tax purposes can be inferred and the application of the unallowable purposes rules to commercial transactions. Particular care should be taken with intragroup borrowing and borrowing that might be said to be artificial or structured with tax in mind.

Legislation

The loan relationship unallowable purposes rules are contained in ss 441 and 442 of the Corporation Tax Act 2009 (***CTA 2009***). Section 441 applies if a loan relationship of a company has an unallowable purpose. Where it applies, the company is prevented from bringing into account so much of any debits in respect of that relationship as on a just and reasonable apportionment are attributable to the unallowable purpose.

Section 442 sets out what an unallowable purpose is. A loan relationship of a company has an unallowable purpose if the purposes for which the company is party to the relationship or any related transactions include a purpose which is not amongst the business or other commercial purposes of the company. A tax avoidance purpose (which is a purpose of securing a UK tax advantage for the company or any other person) will only be regarded as a business or commercial purpose if it is not the main or one of the main purposes for which the company is party to the loan relationship or related transaction. So, put simply, a main purpose of securing a UK tax advantage will constitute an unallowable purpose.

It follows that there are two key questions to be considered here:

- Does the loan relationship in question have an unallowable purpose?; and
- If it does, what is the just and reasonable apportionment of debits to that unallowable purpose?

Generally accepted propositions

There are a number of different propositions of law which are relevant for the purposes of answering these two questions. Most of these have been fairly well established by the case law and should therefore be largely uncontroversial.

Whose purposes?

'Purposes' in the context of s 441 means the subjective purposes of the company (confirmed by the Court of Appeal in *Travel Document Service & Ladbroke Group International v HMRC* [2018] STC 723). That is, the actual reason(s) that the company has decided to become a party to the loan relationship or enter into a related transaction; not what someone might think those reasons are when looking at the objective evidence.

The purposes of the company must generally be divined from the purposes of the directors of the company, and what was in their minds at the relevant time. However, that is not always the case: for example, if the shareholders have usurped control of the company, the relevant purposes would be the purposes of the shareholders. And, where the directors are acting under instruction, it may be appropriate to consider the purposes of those instructing or advising the directors. An extreme example is *Iliffe News and Media Ltd and others v HMRC* [2012] UKFTT

696, where the First-tier Tribunal (***FTT***) took account of the subjective intentions of the company's advisers in circumstances where the witnesses were not able to explain certain aspects of the transaction. In a similar vein, the FTT in the more recent case of *JTI Acquisition Company (2011) Ltd v HMRC* [2022] UKFTT 166 took into account the purposes of the US parent on the basis that no genuine decision making took place at the UK level.

Particular difficulties in assessing whose purpose matters can arise where the loan relationship being tested is a deemed loan relationship. In *Travel Document Service*, TDS held shares that became a deemed loan relationship when TDS entered into a total return swap that resulted in its return being economically equivalent to interest. The Court of Appeal held that it was TDS' purposes in holding the shares that mattered, but that decision turned on the deeming rule in play. It remains an open question whose purposes should be tested in other situations involving deemed loan relationships, including those involving partnerships.

When are purposes tested?

Section 441 is a continuing test which requires the purposes to be tested for each accounting period during which the company is party to the loan relationship in question. In many cases, the relevant purposes will not have changed over the life of the loan relationship so can be tested at inception. However, purposes can change over time. For example, where an existing loan relationship is later employed as part of a tax avoidance scheme, as in *Fidex Ltd v HMRC* [2016] STC 1920, the tax avoidance purpose may result in deductions being disallowed from that point. It may also be necessary to retest the original purposes on a refinancing of existing loan relationships, as held by the FTT in *Kwik-Fit Group Ltd & others v HMRC* [2021] UKFTT 283 (and confirmed by the Upper Tribunal (***UT***) on appeal).

What is a main purpose?

A 'main' purpose is an important purpose which is of significance to the taxpayer. This too is a subjective test (per *Versteegh Ltd and others v HMRC* [2013] UKFTT 642), so the relevant individuals (i.e. the directors or those controlling or instructing the directors) must be identified to test what was considered significant to them in the context of all the reasons for entering into the transaction.

Strictly, the main purpose test is only relevant to tax avoidance purposes but in practice it tends to be considered in the round to assess the relative importance of different purposes. In some cases, attempts have been made to quantify the benefits of different purposes but this is an area fraught with difficulty – tax purposes can generally be quantified easily enough but non-tax purposes are often harder to quantify. Nonetheless, the UT in *HMRC v Euromoney Institutional Investor PLC* [2022] UKUT 205 (TCC) concluded that it was relevant, in assessing the subjective purposes of the company in that case in the context of a similarly framed main purpose test, to take into account the relative size of the tax advantage compared to the overall commercial transaction.

More contentious points

How are purposes tested?

Board minutes and board resolutions will often be the starting point for evidencing purpose, although HMRC has historically challenged their usefulness and, following the UT decision in *HMRC v BlackRock Holdco 5, LLC* [2022] UKUT 199 (TCC), it may be necessary to look beyond the stated motives or intentions of the directors to consider their broader understanding. Witness evidence is therefore important but will rarely be determinative on its own.

In general, the FTT places more weight on contemporaneous documents than witness evidence (as in *JTI*, where the FTT found material aspects of the witness' testimony to be 'given with the legal issues in mind'). For this reason, unallowable purposes enquiries tend to involve a significant evidence-gathering phase. This is a common pressure point (as the case management decision in *Syngenta Holdings Ltd v HMRC* [2021] UKFTT 0236 demonstrates) because document requests can be onerous and expensive to comply with. There may also be a debate about the correct interpretation of contemporaneous documents or the weight that should be attached to certain emails, particularly if the directors were not party to those emails.

What are the commercial purposes?

Another common pressure point is identifying and evidencing the commercial purposes and determining whether they are:

- actual purposes;
- the right kind of purposes, that is to say purposes of the company in being party to the loan relationship or entering into the related transaction; and
- main purposes.

Non-UK tax purposes are treated as commercial purposes because, unlike the anti-hybrids rules, s 441 does not police overseas tax planning.

Sequencing can be important here. The FTT in *Oxford Instruments UK 2013 Ltd v HMRC* [2019] UKFTT 254 (TC) disregarded commercial purposes of the arrangement as a whole because they had already been fulfilled before the company became party to the loan relationship. Identifying the point by which the company's commercial purposes have been fulfilled has been a focus area for HMRC following this decision.

The *Oxford Instruments* decision also highlights the narrowness of the s 441 tests in looking to the purposes of

the company becoming party to the loan relationship or entering into the related transaction, rather than the purposes of the arrangements as a whole. In practice, however, a tribunal will generally want to consider the purposes in the round by reference to the wider commercial context, even if (as in *Oxford Instruments* and, more recently, *BlackRock* and *JTI*) that commercial context is not sufficient to save the taxpayer. It is notable that HMRC successfully advocated for a broader approach in *BlackRock*, that examined 'all the circumstances' when deciding the taxpayer's purposes in entering into the loans, including the group's purpose for inserting the taxpayer into the structure.

To what extent can purposes be inferred?

The tribunal's willingness to infer an (unconscious) tax avoidance main purpose despite clear and contrary witness evidence was one of the more striking aspects of the FTT decision in *BlackRock Holdco 5 LLC v HMRC* [2020] UKFTT 443 (TC). The FTT, adopting the reasoning of the House of Lords in *Mallalieu v Drummond (Inspector of Taxes)* [1983] 2 AC 861, concluded that, although the company had decided to borrow for commercial reasons, it was an inevitable and inextricable consequence of the borrowing that the company would obtain a tax deduction and, as that consequence was not merely incidental, it must be taken to be a main purpose.

This aspect of the FTT decision in *BlackRock* was overturned by the UT, which held that a purpose should not be inferred simply because it is an inevitable and inextricable consequence of the borrowing. The UT nonetheless found there was an unallowable purpose on the evidence (considering it relevant that the UK taxpayer would not have existed at all in the absence of the UK tax benefits, a factor that also influenced the FTT in *JTI*). The UT's decision was arguably more in line with the earlier FTT decision in *Versteegh* and has been followed in the recent FTT decision in *Burlington Loan Management DAC v HMRC* [2022] UKFTT 290 (TC) concerning a double tax treaty principal purpose rule formulated as a main purpose test.

The case law in this area highlights the difficulty tribunals face unpicking the relationship between purposes and consequences, and the extent to which purposes can be inferred or found as facts in the face of contrary witness evidence.

Are comparator transactions relevant?

Comparator transactions are potentially relevant at several different stages of the legislative analysis.

First, in identifying whether there is a tax advantage: the concept of an advantage implicitly includes a comparison with an alternative, less favourable tax result (per *AH Field (Holdings) Ltd v HMRC* [2012] UKFTT 104 (TC)). However, as 'tax advantage' is defined in CTA 2010 s 1139 to include a relief from tax, the tribunals tend to skip over this part of the analysis, with little discussion of relevant comparators. The taxpayer in *Kwik-Fit Group Ltd and others v HMRC* [2022] UKUT 314 (TCC) argued before the UT that no tax advantage arose because its position vis-à-vis HMRC was not improved as a result of undertaking the transaction (it had no tax liability either before or after, as a result of having and then using carried forward non-trading loan relationship deficits). However, the UT held that s 1139 did not require one to demonstrate whether less tax was ultimately payable, just whether relief from tax was actually given. In other words, the UT did not think any comparison was required. Comparators may also be relevant in determining purposes. If, for example, a transaction is restructured following receipt of tax advice to achieve a better tax result than the simple comparator transaction that could have been done, HMRC may argue that this is indicative of a tax purpose. If the purported commercial purpose would have been achieved without taking an additional tax-motivated step then fulfilling that commercial purpose without taking that step may be an appropriate comparator (per *Oxford Instruments*). And a tribunal might determine purpose by comparing the desired tax saving with the position had no loan relationship been entered into at all (per *JTI*).

Perhaps most importantly, though, comparators can be relevant in relation to the just and reasonable apportionment analysis because the latest line of case law suggests that, if the taxpayer would have become party to the loan relationship regardless of the tax advantage, then none of the debits are attributable to the unallowable purpose. In other words, the disallowance should be limited to the debits that would not have arisen 'but for' the tax advantage. This is another controversial point which was considered by the UT in *BlackRock* and to some extent also in *Kwik-Fit*. The current judicial consensus seems to be that 'but for' tests can be helpful but are no substitute for the words of the legislation. The UT in *Kwik-Fit* usefully confirmed that the legislation indicates there may be more than one just and reasonable apportionment, and also that the attribution exercise requires an objective assessment of the facts and circumstances having regard to the subjective purposes of the taxpayer in being party to the relevant loan (which are the possible sources in contention for the attribution of debits). However, it's disappointing that 25 years after enactment of the loan relationship unallowable purposes rule, there remains precious little judicial guidance on how to approach a just and reasonable apportionment where there are both commercial and tax purposes.

Can s 441 apply to commercial transactions?

A further contentious point is the extent to which s 441 applies to commercial transactions, such as acquisition finance. HMRC guidance (in its Corporate Finance Manual

at CFM38160) cites comments of the economic secretary to the Treasury that appeared in *Hansard* when the unallowable purposes rule went through the report stage of the parliamentary process, before becoming enacted legislation. These comments (reproduced in full at CFM38170) indicated that the rules were generally not intended to catch acquisition debt and taxpayers and advisers have historically taken significant comfort from these statements.

However, these comments also indicated that the rules might apply if the financing were structured in an 'artificial' way and it is this aspect that is often referred to by HMRC when challenging acquisition debt under s 441. In particular, HMRC has focused on steps being inserted following tax advice and on features HMRC views as artificial, such as interest-free loans or hybrid entities and instruments.

Relevance of clearances

A clearance confirming the non-application of the anti-hybrids rules (or their predecessor, the anti-arbitrage rules), and thereby confirming the applicable purpose test is not satisfied, may not provide any defence here. Whilst the FTT in *Oxford Instruments* was sympathetic that the taxpayer in that case had received an HMRC clearance that the anti-arbitrage rules were not in point, that was not an answer to the s 441 challenge as the purpose test is different. The taxpayer's position might have been stronger had HMRC given comfort on s 441 but that would be a matter for judicial review.

Practical advice

Anticipating challenges

Despite suggestions to the contrary, it is clear that a tax main purpose will not exist in relation to every UK borrowing simply by virtue of the fact that the directors are aware in general terms that interest is likely to be tax deductible. As the economic secretary to the Treasury put it back in 1996:

'*Companies that enter into schemes with the primary aim of avoiding tax will inevitably be aware of that. The transactions we are aiming at are not ones which companies stumble into inadvertently. As one top tax adviser said recently, companies will know when they are into serious tax avoidance; apart from anything else, they are likely to be paying fat fees for clever tax advice and there will commonly be wads of documentation.*'

Unfortunately, the case law since then suggests that the bar may now be set some way below 'serious tax avoidance' and that ordinary tax planning around commercial transactions may be challenged. Particular care should be taken with intragroup borrowing and borrowing that might be said to be artificial or structured with tax in mind, especially if the 'before' versus 'after' picture shows a reduction in UK tax as that is likely to pique HMRC's attention. This puts tax directors in a difficult position: they are not doing their job if they have not considered the tax consequences of a significant lending arrangement; but if the potential tax benefits have been quantified and communicated to the company directors, this may be taken as evidence of a tax main purpose. Instructing directors to ignore tax advantages when considering whether to enter into loans and to document their commercial purposes may sound like good practice but (as in *BlackRock*) can backfire if that instruction appears contrived.

Engaging with the evidence

Where an unallowable purposes enquiry is opened, HMRC will almost always want to gather evidence before discussing the technical arguments, considering possible settlements or embarking on litigation. This can be a frustrating part of the process for taxpayers but it is generally an unavoidable one, so it pays to engage with HMRC to identify the relevant evidence and understand the common ground and differences in view. If the dispute reaches litigation, far more time will be spent by the FTT in considering the evidence than the legal arguments, and the burden of proof will generally sit with the taxpayer. (This too has been a contentious point in unallowable purposes cases; in particular, the FTT in *JTI* suggested that, if there was evidence of a tax avoidance purpose, it was for the taxpayer then to prove that the tax avoidance purpose was not a main purpose, which seemingly requires the taxpayer to prove a negative – albeit *JTI* is currently under appeal.)

With this in mind, it's obviously important that taxpayers get on top of the evidence early on in an enquiry and identify any weaknesses or gaps. HMRC will test the evidence carefully, including against any information obtained from third parties or other tax authorities and against the early rounds of correspondence. In extreme cases, taxpayers could find themselves subject to discovery assessments or even allegations of fraud where HMRC feels that they have misrepresented the facts. As ever, it's important that taxpayers and advisers test the facts carefully and present them as fairly as they can. And taxpayers should expect HMRC to do the same.

Managing parallel lines of enquiry

Unallowable purposes enquiries commonly sit alongside other enquiries, for example transfer pricing or thin capitalisation enquiries or enquiries relating to other anti-avoidance provisions, such as the anti-arbitrage and anti-hybrids rules. There may also be interactions with the corporate interest restriction.

It may seem illogical to engage with transfer pricing enquiries where HMRC is separately seeking to disallow all of the debits using the unallowable purposes rules. But even though managing the parallel workstreams can be tricky, the enquiry will be more protracted if they are dealt

with in turn rather than simultaneously. And, if the matter reaches litigation, it is perfectly possible that more than one issue will be considered by the tribunal. *BlackRock* is an example in point. At the UT level, the decision actually turned on the transfer pricing rather than the s441 analysis, although the UT found against the taxpayer on both points.

What's next?

The law in this area is still evolving; there have been a raft of recent cases, with more in the pipeline. That will inevitably add further nuances to the existing guidance on how to establish whether a loan relationship has an unallowable purpose and (it is to be hoped) on how to undertake a just and reasonable apportionment of debits between purposes.

Ultimately, though, each case will turn on its facts. Any taxpayers anticipating or facing an unallowable purposes enquiry would therefore be well-advised to be led by the evidence and to ensure that the evidence fairly reflects the decision-making process.

This article was originally published in Tax Journal on 17 February 2023.

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