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“Unallowable purpose” following Blackrock, JTI and Kwik-Fit – is the law now settled?

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UK tax legislation now includes numerous anti-avoidance tests which rely on the classic “unallowable purpose” or “main purpose” formulation. We have seen the courts consider these in a wide range of circumstances. Many of these cases considered the rules included in the loan relationship regime but these decisions have application to many other targeted anti-avoidance rules of this type. There have been a number of recent court decisions that might suggest the position is becoming clearer; we discuss here whether that is in fact the case.

The legal test

To summarise the loan relationship rule itself, the rule is that UK tax relief will be denied in respect of financing costs to the extent that it is attributable to an “unallowable purpose”; this includes where one of the main purposes of a transaction is securing a UK tax advantage.

Recently, we have had the benefit of several cases which have provided us with more clarity on the courts’ view on these provisions in the context of financing transactions: BlackRock HoldCo 5 LLC, JTI Acquisition Company (2011) Ltd, and Kwik-Fit Group Ltd v HMRC.

The Supreme Court has recently refused permission to appeal in all three of these cases. This means that the cases are now final, and we now have to apply the lessons from them. We have already seen this in the very recent First-tier Tribunal (FTT) judgement in Syngenta Holdings Ltd (for which see below).

What were these cases about?

In summary, BlackRock group headquartered in the US acquired a US business using a funding structure that involved a UK company specifically incorporated for the purpose. A US Delaware LLC which had “checked the box” and so was disregarded for US tax purpose made a loan in cash and BlackRock shares to the UK entity. The UK entity claimed interest relief for its financing costs.

In JTI, a slightly different funding structure was put in place also for the acquisition of a US company by a US-headed group, using a UK acquisition vehicle with debt pushed down to the UK from the US.

Kwit-Fit had a quite different fact pattern. Following its acquisition by an overseas company, it undertook a restructuring of its intra-group debt. Prior to the reorganisation, one of the group’s UK companies had built up a substantial amount of non-trading loan relationship deficits that were effectively “stranded” which meant they could only be gradually used up as the company received interest payments. The group decided to increase very substantially the rate of interest charged by the UK company to other group companies; this increased its profits, allowing it to access those losses. A transfer pricing study concluded that this increased rate was actually an arm’s length rate of interest, and this was not disputed.

The Court of Appeal has now had its opportunity to address several of the key issues in these cases, and to try and clear up some points of debate on purpose tests more generally, with the release of these three decisions.

The recent FTT decision in Syngenta is another loan relationship unallowable purpose case. In this decision a UK holding company acquired the entire share capital in another UK group holding company from its Dutch parent company. This sale was funded by a mixture of a loan from its parent and an issue of shares effectively pushing additional debt down into the UK and reducing the group’s taxable profits in future years. The case centred on whether the documentary and witness evidence demonstrated that the transaction was tax driven when looked at from the perspective of the group as a whole.

A substantial amount of attention was given to witness statements given by the participants and the case emphasises the importance of this type of evidence when looking at purpose-based tests. It also shows that counsel for HMRC may well look to cross examine witnesses at length and the court may look to the outcome of that in making its decision.

So where have we landed after these cases?

The most important point flowing from these decisions is that they are all based on what the evidence showed about the facts and circumstances of the cases, when viewed against the statutory language of the “unallowable purpose” test and its role within the loan relationships legislation. The Syngenta decision is a good example of the way in which particular evidence demonstrating a primary tax driver for a transaction can itself drive a court’s decision-making process.

Whilst it is difficult to generalise as each case turns on its own facts, some of the other principles that can be found in the cases are as follows.

- In looking at the facts and the circumstances, while the statutory test asks you to determine what the purpose of the loan is, you need to look at the wider context in which the board took its decision. It is for the FTT as the fact-finding tribunal to determine the object or purpose sought to be achieved, and that question is not answered simply by asking the decision maker.

- A tribunal determining whether a company had a “tax avoidance purpose” was not required to adopt a “tunnel-visioned” approach that looked solely at how the company was proposing to use the money it was borrowing.

- The various decisions do not mean the rule will apply in all circumstances though. The existence of interest relief as a result of the loan is a factor that boards are allowed to – and indeed should - take into account.

- This point was made specifically by Lady Justice Falk in Blackrock when she explained that “Something more is needed.” i.e. that since it is inevitable that entering into a loan relationship could give rise to tax relief it cannot have been Parliament’s intention that the unallowable purpose rule apply in all those situations.

- Save in obvious cases, ascertaining the object or purpose of something involves an inquiry into the subjective intentions of the relevant actor. A simple starting point in ascertaining a person's purpose for doing something is to consider “why” they did it. While the Court recognised that this will not cover all the nuances – and in particular the potential distinction between purpose and motives– it is a sensible starting point.

- The “but for” approach i.e. asking what would have happened “but for” the tax main purposes was viewed by the Court of Appeal as a helpful check. In other words, what would have happened had there not been a tax advantage available? In one sense this might seem obvious, but it provides a useful guide to taxpayers considering their own decision-making process or those who are beginning a dialogue with HMRC regarding a transaction that has completed.

- Object or purpose has to be distinguished from effect. In all but obvious cases it is necessary to “look into the mind” of a taxpayer. That said, “object” must be distinguished from the effects or consequences of a transaction which, even if inevitable, are not necessarily the same as objects or purposes.

  Having said that, subjective intentions do not seem to be limited to conscious motives. Further, motives are not necessarily the same as objects or purposes. Some results or consequences can be so inevitably and inextricably involved in an activity that, unless they were merely incidental, they had to be a purpose for it.

  The purpose or purposes of being a party to a loan relationship cannot simply be elided with the purpose for which the relevant entity exists. In both Blackrock and JTI, this was the rationale for the insertion of the UK entity. The sole reason for their existence was to enter into the loans to obtain tax advantages for the group.

- There are a number of factors that were relevant in these cases:

  - Why was the UK chosen as the location for the borrower, when otherwise there was no or limited nexus to the UK.

  - Whether key decision takers were presented with a “done deal”? If the UK is to be chosen, it would make sense for this to happen before the transaction is set in stone. Involving them early will not necessarily solve the issue but it could make it easier.

  - What is the rationale for the underlying transaction? As both JTI and BlackRock demonstrate, the fact that there is an acquisition from a third party is not enough. However, Syngenta does demonstrate some of the difficulties with internal group reorganisations, which are in essence so-called debt push-downs. That is not to say all internal group reorganisations can be challenged; many do have commercial purposes.

  - What has driven the economics of the transaction? The fact that there was to be an expected return from the financing (i.e. a margin left in the borrower) or the values used were such that the acquisition was not a “bad investment” may not be enough.

  - Who is driving the project? Is it driven by the tax group or is the tax group implementing the overall (commercial) aims of the wider business? The latter is clearly more helpful in demonstrating the relative priority of the tax objectives.

  - While it is clear that you look at the object rather than the effect of the transaction, what is the net effect of the transaction in UK tax terms and how important was that effect in the decision-making process? In Syngenta, one of the drivers could have been said to be that the UK group had exhausted its supply of UK tax losses. On the other hand, in BlackRock, the fact that the board of the UK entity would have gone ahead regardless of the potential interest relief was held not to be a defence.

Just and reasonable apportionment

The loan relationships rules provide that, where there are mixed main tax and commercial purposes, it is necessary to determine a just and reasonable apportionment between those purposes. The statutory test requires the identification and disallowance of “so much of” any debit that is “attributable” to the unallowable purpose. The Court of Appeal has found that a just and reasonable apportionment should be measured by reference to the relevant purposes. Those purposes are identified objectively, by reference to the subjective purposes of the decision makers using the approach identified by the Courts in these cases. The framework for the apportionment is to take the purposes that have been

identified by the fact-finding tribunal, taking into account all the relevant facts and circumstances of the case. As to the precise mechanism by which this is done, the legislation is not prescriptive. The answer to that question will inevitably be fact-specific.

Where are we now?

While the Court of Appeal has indicated its views in these loan relationship cases on the guiding principles that the lower courts (and HMRC) should follow in looking at the specific rule in question, these cases are unlikely to be the last word on the subject. It is clear from them that there is no clear line; each case has to be looked at on its own facts, having regard to the purpose of the particular legislative test. It is true that all these cases have involved victories for HMRC, but they are all decisions based on the evidence placed in front of the courts. A different set of facts may well have resulted in a different answer. While the Supreme Court has decided at this time not to have the last word, they may still have to look at the issue in the future.

The UK domestic tax legislation has over 300 different variants of the “main purpose” test, each of which is drafted slightly differently and should be construed differently depending on the mischief it is intended to prevent and its place within the wider framework of the legislation to which it relates. There are also now “main purpose” tests in many international double taxation treaties, where courts may take a different interpretive approach based on the “international fiscal meaning” of the term; the most recent UK Upper Tribunal case marked a victory for the taxpayer (Burlington Loan Management DAC v HMRC). Accordingly, this story is likely to be far from over and these cases on loan relationships may come to be seen as only forming part of a much wider body of case law on similar provisions.

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