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In *JTIAC*, the latest decision on the loan relationships unallowable purpose rule, the FTT finds in favour of HMRC that none of the relevant debits are deductible even though the loan relationship funded the acquisition by a UK company of a target group from a third party. The FTT concludes in the *Beard* case that payments made by a Jersey company out of share premium are dividends of an income, not capital, nature. The Supreme Court finds in favour of HMRC in the *Coal Staff Trustees* case on whether the MOD tax regime (as it existed pre-January 2014) involved any restriction on the free movement of capital and so contravened EU law.

JTIAC: unallowable purpose

In JTI Acquisition Company (2011) Limited v HMRC TC/2019/04496 the First-tier Tribunal (FTT) found in favour of HMRC. A funding structure was put in place 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. It resulted in approximately £40m of non-trade loan relationship interest debits being claimed as group relief. HMRC issued closure notices disallowing the interest debits pursuant to s441 CTA 2009. Around £9m of corporation tax is at stake.

Burden of proof

The FTT emphasised that (despite what the parties had agreed) it is not required to find positively that, if there is a tax avoidance purpose, that purpose was the (or a) main purpose for which JTIAC entered into the transaction in question. Rather, it is for JTIAC to satisfy the FTT that the tax avoidance purpose is not the (or a) main purpose (s442(4)). Whether or not this is the correct interpretation of s442(4) does not matter for the purposes of resolving this case as the FTT also went on to make the same decision if it had to positively determine that obtaining a UK tax advantage was the (or one of) the main purposes.

Tax advantage

The FTT concluded that the loan relationship debits, which were surrendered as group relief to other UK companies resulted in a 'relief from tax' for those companies. This was a tax advantage secured for other group companies as it put those companies in a 'better position' by reducing tax liabilities.

Purpose of securing the tax advantage

The relevant transaction to consider here was the loan relationship between JTIAC and its US parent, JTI. In step 6 of the 9 step plan, JTIAC issued USD 550m loan notes to JTI. The question the FTT asked was what was the purpose for this. In answering this question, the FTT relied more heavily on documentary evidence from the contemporaneous communications of key personnel than on the witness evidence.

The parties agreed that the 'subjective' intentions of the relevant decision makers that resulted in JTIAC entering into the loan relationship had to be ascertained. In the case of a corporate body the decision makers are normally the shareholders/directors of that body but where appropriate the tribunal can look at the intentions of and acts of other members of the group. The evidence led the FTT to conclude that there was no genuine decision making at the UK level, rather the decision makers operated at the JTI level and the ultimate parent, JGI level, both in the US so it was their objective that was relevant. By the time the UK part of the group was presented with the 9 step plan, the decision to implement it had already been taken by the US parent and there was no option but for the UK group to go ahead with the plan, despite reservations from the UK group's accountant that the scheme seems to be done solely for tax planning and may impact the group's low UK risk rating.

The FTT referred to *Brebner* [1967] 2 AC 18 as authority for saying the object of the step which brought into existence the loan relationship is to be found by reference to the overall scheme not the step in isolation. On this basis, the FTT found the object of the directing minds of the US companies for JTIAC entering the loan relationship was securing a UK tax advantage

by generating loan relationship debits for surrender as group relief for the UK members of the group. That object was a tax avoidance purpose and an unallowable purpose.

The reasoning of the FTT is incomplete here. There is no explanation why you would zoom out to take in more steps of the overall scheme than the loan relationship itself but not zoom out to take in the fact that the loan financed the actual acquisition of the target company by JTIAC, an acquisition which was made by the group for commercial reasons.

Was the tax avoidance purpose not the (or a) main purpose?

The non-tax avoidance purposes put forward by the witness were not convincing for the judge and the FTT found that the non-tax advantages suggested were not in fact obtained. The FTT made its view of the taxpayer's witness clear: 'I have found Olsen's evidence to be vague, elusive, lacking in substance, contradictory to the factual matrix, and ultimately unconvincing.' (paragraph 165).

As JTIAC did not meet the burden of proof as regards the negative condition under s442(4), the FTT held the attribution issue did not arise but, in case the FTT was wrong to interpret the test in this way, it then considered the positive case that obtaining the UK tax advantage was the main purpose and concluded that it was. The FTT highlights a lack of genuine commerciality, including the fact that JTIAC's interest payments were 'financed' by reductions in debtor balances and the issue of further loan notes because JTIAC was an empty company without the means to generate income to service the loan. John Gardiner QC's arguments that the loan notes were issued as part of structuring a company's legitimate activities, referring to the Hansard debate on Finance Act 1996 Schedule 9 paragraph 13 (the predecessor to ss441-442), were rejected by the FTT. The FTT considered the scheme exactly the kind of 'artificial, tax-driven arrangements' within the caveat of the ministerial statement as something which Parliament intended to be caught by the unallowable purpose provisions.

The attribution test

The loan relationship debits were wholly attributable to an unallowable purpose pursuant to s441 because the FTT found no other purpose and so no just and reasonable apportionment is required. Even if the FTT had found the tax avoidance purpose was <u>a</u> main purpose rather than <u>the</u> main purpose, in line with *Fidex* the FTT considered the attribution issue would still be determined as wholly attributable to the unallowable purpose: but for the avoidance scheme, there would have been no debit at all. Taking this approach to its natural conclusion, one could equally argue that, but for the loan, there would have been no acquisition but the FTT does not address this.

Unallowable purpose cases are fact specific and the facts of this one did not come out well for the taxpayer with the FTT not finding the witness credible. But the contrast with the FTT decision in *BlackRock* [2020] UKFTT 443 (TC) is interesting. In both cases a US group parent entered into a purchase agreement with a third party for the acquisition of a US business. A Big4 firm was then appointed to do the acquisition structuring and in each case suggested using a UK acquisition vehicle, funded with intra-group debt, as a result of the UK's non-territorial interest deductibility regime (billed by the UK Government in its 2010 Corporate Tax Road Map as a 'competitive advantage'). The only real difference is that whilst JTIAC actually went on to make the third party acquisition, in *BlackRock* that was not possible for a mixture of tax and non-tax reasons and the debt instead funded a preference share investment in a US subsidiary that then made the acquisition. From a policy perspective, it seems odd that the former should trip the unallowable purpose rule when the latter did not.

However, and somewhat sadly for such a key area, it is a case of 'watch this space' with the decision of the Upper Tribunal in *BlackRock* eagerly awaited after the hearing took place in February and with the *Kwik-Fit* case [2021] UKFTT 283 (TC) due to be heard by the Upper Tribunal in September.

***Beard*: characterisation of distributions**

The taxpayer in the case of Alexander Beard v HMRC [2022] UKFTT 00129 (TC) argued that payments he received from a Jersey company (Glencore plc, a Jersey incorporated, Swiss resident member of the FTSE 100) out of share premium were distributions of a capital nature and so subject to capital gains tax rather than income tax in the UK. The FTT (Judge Rachel Short) disagreed and found in favour of HMRC that the payments were dividends of an income nature and so subject to income tax. The taxpayer and HMRC both took on the reverse positions to those argued in the *First Nationwide* case where the taxpayer had argued the payment by a Cayman company out of share premium account was a dividend of an income nature and HMRC argued the dividend was capital in nature and so not within the corporate dividend exemption. The FTT, UT and CA agreed it was a dividend and was income in nature in the hands of the recipient.

The FTT applied the logic of the UT in *First Nationwide* and looked at the mechanism used to make a payment out of share premium in order to conclude that the mechanism was a distribution mechanism and so the payments were dividends. The distributions were paid out of share premium account by the same mechanism

as would be used for paying a dividend out of trading profits.

Jersey law at the relevant time permitted distributions to be made out of share premium under one of two processes: Part 12 (reduction of share capital) or Part 17 (dividends or distributions). It was agreed that if Part 12 had been used the payments would have been a return of capital which would have been treated as a capital dividend.

Judge Rachel Short rejected the taxpayer's argument that share premium has an essential character as capital and that this essential character should be carried through to any payments made out of a share premium account. The FTT concluded that the legal history of Jersey and English law show that the legal character of share premium is not settled. Judge Short described share premium as 'having a chameleon character, taking its colour from the law which is applied to it; it has no intrinsic colour of its own.' This means the only relevant question is how the relevant law (in this case Jersey law) treats share premium. The relevant law was Part 17 which did not define share premium as assimilated to share capital so it must fall into the only other category of funds held by a company available to its shareholders, distributable profit. As such it is available to be paid by a company by way of dividend and the payments were dividends within the meaning of ITTOIA s402.

The FTT then went on to consider whether the dividends were of a capital nature. Following *First Nationwide*, the FTT took a 'form over substance' approach to this question – the character of the payment is determined by the manner in which it is paid out by the company. It is the perspective of the paying company which is relevant. The source of the payment is not determinative, neither are the labels applied by the paying company. It is a very fact specific determination. The FTT concluded that the Part 17 mechanism is one for returning to shareholders funds which are 'distributable' (i.e. funds that are neither nominal share capital nor share capital reserves) and so the payments must be treated for Jersey law and also for English law purposes as of an income and not a capital nature even though they were paid out of a 'capital' account and out of share premium.

It is a relief that the FTT reached the same conclusion as in *First Nationwide* rather than re-introducing uncertainty that HMRC's approach in *First Nationwide* had caused until the Court of Appeal's decision ([2012] STC 1261). Particularly since for income tax purposes there is still a distinction between payments received from UK resident and non-UK resident companies. UK income taxpayers are subject to income tax on any distribution (whether or not capital in nature) from a UK resident company but only on dividends (not of a capital nature) or other income received from a non-UK resident company. Advisers drafting shareholder documents for any of the many London-listed non-UK resident companies are often required to ascertain how a particular payment to UK individual shareholders should be classified.

Coal Staff Trustees: pre-2014 MOD tax regime not incompatible with EU law

The Supreme Court unanimously decided in HMRC's favour the test case of HMRC v Coal Staff Superannuation Scheme Trustees Ltd [2022] UKSC 10 about the tax treatment in the UK of income paid to tax-exempt investors under stock lending agreements.

Although this case is of mostly historic interest, because since 2014 there is no longer any UK withholding tax imposed on manufactured overseas dividends (MODs), there are a number of UK pension funds, life insurance companies, investment funds and charities which have made similar claims and who will be disappointed by the outcome of this case. This disappointment will be all the greater because the Upper Tribunal and Court of Appeal decisions had both been in favour of the taxpayers, although the FTT had found in favour of HMRC.

The issue in this case was whether the MOD tax regime (as it existed pre-January 2014) involved any restriction on the free movement of capital and so contravened EU law. The tax regime at the time subjected payments by the borrower to the stock lender of manufactured overseas dividends to a deduction equivalent to the withholding tax (WHT) that would have applied to actual dividends paid on the non-UK shares. As exempt investors cannot use this WHT credit it was argued there was a disincentive to invest in and lend non-UK shares as compared with UK shares.

The Supreme Court concluded that there was no such restriction. This conclusion was based on market economic analysis that the MOD regime did not have a dissuasive effect upon the lending of overseas shares, as compared with lending of UK shares. The Supreme Court considered the market for stock lending to be highly sophisticated, taking into account the benefits of the arrangement to both borrower and lender. Whereas the MOD itself is intended to put the lender in the same position with regard to net dividend income as if it had continued to own the shares, the lender also receives a lending fee which allows the lender to share in the additional benefits generated by the borrower's use of the lent shares. Applying a 'but for test' the Supreme Court concluded that if there had been no MOD tax regime the investor would not have been sufficiently better off from engagement in stock lending than it was under the MOD regime and so the regime could not be described as restriction on the acquisition of overseas shares as opposed to UK shares.

Even if there were such a restriction, the Supreme Court held that the remedy sought by the trustees (usable tax credits in relation to MOD WHT attributable to stock lending by the trustees) was not proportionate to the wrong suffered as a result of the restriction. The remedy sought by the trustees would have the effect of compensating it for the impact of juridical double taxation (the liability of overseas dividend payments to deduction of tax in the foreign state and then to taxation in the state where they are received) but there is no obligation on a member state to correct for juridical double taxation.

The only remedy which, based on case law, could be said to be 'essential' to restore the equal treatment (if there were any unequal treatment) would be a payment equivalent to the economic value of the possibility that it had been unable to benefit from the financial gains from the dividend arbitrage enjoyed by the borrower. The trustees never sought to claim for such a loss and did not present any evidence to show such a loss has in fact been suffered.

What to look out for:

- The consultation on whether or not the UK should introduce an online sales tax to address the imbalance in the business rates paid by high street retailers as compared with their online counterparts closes on 20 May.
- Comments are requested by 20 May on the OECD's consultation on the regulated financial services exclusion under Amount A of Pillar One.
- Continuing with the OECD's process of releasing consultations on the individual building blocks of Pillar One, a consultation on the tax certainty process is expected in the coming weeks.

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CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com

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