SLAUGHTER AND MAY/

CLIENT BRIEFING

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TAX AND THE CITY REVIEW

The Upper Tribunal in *JTI Acquisitions* dismisses the taxpayer's appeal, agreeing with the First-tier Tribunal's conclusions on the application of the unallowable purpose rule whilst identifying some non-material errors in its approach. In *Hotel La Tour* the Upper Tribunal dismisses HMRC's appeal, agreeing with the FTT that VAT incurred on advisers' fees in relation to a share sale was recoverable as the share sale had the purpose of raising funds for the holding company's taxable general activity. The latest HMRC Report and Accounts show a record £814 billion tax revenues were raised in 2022-23 but customer service performance is below HMRC's targets and historical performance levels.

JTI Acquisitions: scope of the loan relationships unallowable purpose test

The Upper Tribunal (UT) in *JTI Acquisitions Company (2011) Limited v HMRC* [2023] UK 194 (TCC) took a similar approach to the unallowable purpose rule (CTA 2010, sections 441 and 442) as it did in both *BlackRock Holdco 5 LLC* [2022] UKUT 199 (TCC) and *Kwik-Fit* [2022] UKUT 314 (TCC).

In brief, a funding structure was put in place by Joy Global, a US-headed group, for the acquisition of another US-headed group, using a UK acquisition vehicle (JTI) with debt pushed down to JTI 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 CTA 2009, s441. Around £9m of corporation tax is at stake. The First-tier Tribunal (FTT) held 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 taxpayer put up a good fight, appealing against the FTT's decision on eight grounds, but the UT dismissed the appeal. It did find in favour of the taxpayer on two of the grounds (misinterpretations by the FTT of the meaning of 'related transactions' and on when attribution is required) but these were not material as they had not affected the outcome of the FTT's decision.

In essence, the taxpayer argued that the rule was only concerned with the purpose for which the taxpayer had borrowed the money it did and that commercial asset purchases bought with borrowing at arm's length were simply outside its scope. The rule was not concerned with why the taxpayer was borrowing rather than someone else. However, the UT held the words of the statute should be given their ordinary English meaning and that they were simply asking 'why are you a party to the loan relationship?' and that naturally included considering why that company in particular was party to the loan relationship rather than someone else. The correct approach is to look at 'all the facts and the whole of the evidence', which would include the taxpayer's role in the acquisition structure. That is not to say that group purpose or the purpose of another company is determinative. It is still the taxpayer's purpose which is relevant but group purpose, and in particular the awareness or understanding of a director of the taxpayer of that purpose, can be a relevant factor in determining the taxpayer's purposes.

So this case reiterates that whilst it is the company's own subjective purposes (expressed primarily through its directors) that matter, the group's perspective is also relevant as 'it informs the determination of the particular taxpayer company's purpose'.

Lack of evidence of commercial purpose

A key argument of the taxpayer was that where a company borrows at arm's length to make a commercial acquisition, no question of unallowable purpose can arise. The UT emphasised that it is not enough to show a commercial basis and arm's length borrowing to close off an unallowable purpose challenge. The UT pointed to the Court of Appeal's judgment in *Travel Document Service and another v HMRC* [2018] EWCA Civ 549 and the UT's decision in *Kwik-Fit Group Ltd and others v HMRC* [2022] UKUT 314 as examples of case law showing that even with both of these factors, unallowable purpose can come into play.

A key fact or circumstance in this case was the existence of artificial tax driven arrangements (a nine-step plan) intended to structure and finance the acquisition which was clear from the documentary evidence. The taxpayer had been unable to convince the FTT or UT that there were

any commercial reasons for the acquisition being made by the UK company, JTI, and so the unallowable purpose of obtaining loan relationship debits was found to be the main purpose for which JTI was a party to the loan relationship. In the words of the UT at paragraph 99 'the acquisition of LTT was "parked" in the UK not for commercial reasons, but in order to obtain loan relationship debits'. It did not help the taxpayer that the evidence of Mike Olsen, Executive Vice President, Treasurer and Group CFO was found by the FTT to be 'vague, elusive, lacking in substance, contradictory to the factual matrix, and ultimately unconvincing'. The documentary evidence was accordingly given more weight than the witness testimony and this was fatal to the taxpayer.

In another case, however, the debt funding of an acquisition by a UK company may not fall within the unallowable purpose rule, for example if it can be shown that there are commercial reasons for the particular UK company, rather than another company in the group, to make the acquisition.

Just and reasonable attribution

One welcome aspect of the decision is that it shows that the FTT incorrectly interpreted the legislation about when just and reasonable attribution is required. The FTT's reasoning, described by the UT as 'difficult to follow' led to the conclusion that where the tax avoidance purpose was the main purpose, then just and reasonable attribution was not necessary and none of the debits could be deductible. The UT found the FTT had misinterpreted the legislation here. The implication of the unallowable purpose being the main or one of the main purposes is that there may be other purposes and there is no reason in principle why there should not be an attribution between the unallowable purpose and those other purposes. This error of the FTT had not been material, however, as the FTT had gone on to conduct the attribution in case they were wrong that no attribution was required. The question of attribution was a matter of evaluation and the UT concluded that the FTT was entitled to reach the conclusion that none of the debits were attributable to an allowable purpose.

'Related transactions'

Another clarification by the UT concerned the meaning of 'related transactions'. The FTT misinterpreted this term giving it a generic meaning rather than applying the specific definition in section 304. However, the upshot of this error was that the FTT considered all the facts and circumstances (including the transactions in the nine-step plan) in ascertaining the purpose. The UT held this approach was required anyway under correct legal principles regardless of the interpretation of 'related transactions' because all the facts and circumstances surrounding the loan relationship, and not just the transaction which was the loan relationship, must be considered. Accordingly, the misinterpretation had not had a material effect on the FTT's decision.

Where next?

Although we have moved on from the wholly unsatisfactory position of the FTT in *BlackRock Holdco 5 LLC* that a company borrowing with only a subjective main commercial purpose can nonetheless be deemed to have a main purpose of obtaining a tax advantage (because a large interest deduction is an inevitable consequence of taking on a significant loan) and has to rely on a just and reasonable apportionment to avoid a disallowance, we have not necessarily moved that far.

The UT explored with HMRC's counsel how the rules would apply to 'the familiar situation' where a corporate group, having decided to make an acquisition for entirely commercial reasons, chose to fund the acquisition using debt on the basis that loan interest was deductible. In the UT's own words 'It would, on the face of it, seem remarkable if such a legitimate debt vs equity comparison meant that the acquisition debt fell foul of the unallowable purpose rules'. To which the answer was that whilst the company would have a purpose of securing a tax advantage, 'it would be open to the tribunal to consider that securing the tax advantage of deduction, although a purpose was not a *main* purpose.'

Not entirely reassuring for taxpayers, particularly since this is essentially Example 1 from HMRC's updated unallowable purpose guidance (CFM38190) and their view, without giving any reasoning, is that the rule would not normally apply. Which falls someway short of it being remarkable if it did.

In Spring 2024, the Court of Appeal is scheduled to hear the appeals in the unallowable purpose cases of *BlackRock Holdco 5 LLC* and *Kwik-Fit* so it will be interesting to see what it makes of all of this.

***Hotel La Tour Ltd:* input tax recovery in fund-raising transaction**

Another case where purpose was centre-stage is *HMRC v Hotel La Tour Ltd* [2023] UKUT 178 (TCC). The UT upheld the FTT's decision that input tax was recoverable on professional fees incurred by a holding company, HLT, on the sales of shares in a subsidiary. The purpose of the share sale was to raise capital for the building of a new hotel as part of HLT's downstream taxable activity and the FTT found as fact that the sale proceeds had been spent accordingly. The UT agreed with the FTT's application of the approach to input tax recovery adopted by the CJEU in *SKF* (Case C-29/08) as interpreted by the Supreme Court in *Frank A Smart* [2019] UKSC 39. Although the general position is that an exempt transaction breaks the chain between a supply and the taxable person's taxable economic activities, *SKF* made it clear that this 'chain breaking' effect is not applicable to a fund-raising transaction and the UT disagreed with HMRC's arguments to the contrary.

This case is good news for input tax recovery on services used for fund-raising transactions. Whether those fund-raising transactions are exempt (such as, in this case, a share sale by a holding company which provided

management services to its subsidiary, therefore carrying on an economic activity) or outside the scope of VAT (such as where a holding company which did not provide management services to its subsidiary sold shares in the subsidiary), if three conditions are met, the input tax on the services should be immediately recoverable. First, the purpose of the fund-raising must be to fund the taxpayer's economic activity. Second, the funds raised are later used for taxable supplies. Third, the costs of the services are cost components of downstream activities which are taxable. The third condition means that the right to deduct will be lost if the cost of the services is incorporated into the price of the shares sold in the initial transaction but, as the UT acknowledges, it would be very unusual to see the costs of the professional fees being reflected in the price paid for the shares in a standard sale agreement.

HMRC's Annual Report and Accounts 2022 to 2023

The latest HMRC annual report and accounts shows record tax revenues of £814 billion for 2022-23, reflecting the freezing of tax bands and thresholds and the impact of inflation on taxable goods, profits and services. The tax gap (the difference between the amount of tax that should, in theory, be paid to HMRC and what is actually collected) has reduced in the long-term from 7.5% of total theoretical tax liabilities in 2005 to 2006, to 4.8% (£35.8 billion) in 2021 to 2022. The estimated yield from HMRC's tax compliance activities in 2022-23 was £34 billion. Although this was a 10% increase compared with 2021-22 it is £2 billion below HMRC's target. The report explains compliance yield is affected by interventions in previous years and the effects of reduced compliance activity during the pandemic are reflected in HMRC's 2022-23 performance.

The Tax Assurance Commissioner's Report (starting on page 121) always makes for interesting reading for advisers as it includes statistics on HMRC's success rate in tax appeals before the various tribunals and courts. This year's report shows HMRC has an impressive 100% success rate before the Supreme Court (in the six cases determined in 2022-23) up from just 50% (in the four cases determined in 2021-22). The success rate before the Upper Tribunal has, however, come down to 73% from 78% the previous year. Although there were approximately 39,500 appeals in progress on 31 March 2023, 34,000 of these are appeals to the FTT stood over, generally whilst a decision in a related lead case is awaited.

It is not all good news for HMRC, however. HMRC's customer service performance was well below its expected service standards in 2022-23 and the report notes that HMRC's existing resources are insufficient to meet the forecast demand for phone and post services at the standard it expects. An increased demand for HMRC's services has coincided with a reduction of 834 (5%) customer service staff in 2022-23 as HMRC faced its own spending pressures. HMRC strives to modernise and digitise as part of the tax administration strategy, and taxpayers are encouraged to use digital services where they can, but the report notes it will take time to make this transition and HMRC needs to improve how it services current demand in the meantime. On the plus side, the HMRC app was rated 4.8 on the Apple app store!

A simpler tax system would reduce the compliance burden for taxpayers and ease the pressure on HMRC but there is no quick way to achieve this. Jim Harra, First Permanent Secretary and Chief Executive, comments that 'We know the tax system can be complex. Following the closure of the Office of Tax Simplification we will make simplifying the tax system integral to our approach to developing tax policy. Simplification is now very much part of our core day to day work.'

What to look out for:

- **The closing date for responses to the oil and gas fiscal regime review: call for evidence is 11 September.**
- **12 September is the closing date for comments on the draft guidance on the multinational top-up tax and domestic top-up tax.**
- **12 September is also the date for comments on the draft legislation published on L-Day.**
- **26 September is the closing date for the consultation on draft regulations specifying which assets are to be treated as structural assets of an insurance company's long-term business. As income and gains from structural assets are excluded from trading profits, it is important that there is certainty about the meaning of structural assets. The regulations are expected to be made in the Autumn with effect for accounting periods beginning on or after 1 January 2024.**
- **A revised version of the OECD commentary on the GloBE model rules is expected to be published later this year to reflect the administrative guidance released subsequent to the publication of the initial commentary.**

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