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TAX AND THE CITY

The Court of Appeal in *BlackRock* decides in favour of the taxpayer on transfer pricing, but HMRC wins on unallowable purpose. In *Hargreaves Property*, the Court of Appeal decides the interest on short but recurring loans is yearly interest and subject to withholding tax but takes a broader view of beneficial entitlement than the Upper Tribunal. HMRC updates its stamp taxes on shares guidance on the meaning of capital-raising arrangements and its capital gains guidance on share exchange clearances. The OECD publishes its promised consolidated version of the commentary on the GloBE model rules incorporating the three sets of administrative guidance released by the end of 2023.

BlackRock: transfer pricing and unallowable purpose

In *BlackRock Holdco 5, LLC v HMRC* [2024] EWCA Civ 330, the Court of Appeal had to consider whether loan relationship debits were restricted by the application of the transfer pricing rules in TIOPA 2010, Part 4, or under the unallowable purpose rule in the CTA 2009, section 441. The loan relationship came about as part of the funding structure for the acquisition of a US business by a US group. BlackRock Holdco 5, LLC (LLC 5), was a Delaware incorporated but UK tax resident LLC interposed in the structure in order to get interest deductions in the UK which could be group relieved to UK group companies. The financing structure involved LLC 5 effectively borrowing $4bn from its US resident parent company, LLC 4, to acquire preference shares in another US resident company, LLC 6. LLC 6 used the proceeds from the preference share subscription to acquire the US business of Barclays Global Investors. LLC 4 owned most of the common stock in LLC6 and controlled it (having 90% of the vote directly and 10% indirectly via LLC 5).

Transfer pricing

LLC 5 won on the transfer pricing point. The issue was whether LLC 5 would have been able to borrow if the borrowing had been from a third party, rather than a group company. The key risk for a lender to LLC5 was the fact that LLC5 had no control over the dividend flow. This was not a risk for LLC4, the actual lender, because it had control of LLC 6 and therefore did control the dividend flow. The OECD Transfer Pricing Guidelines anticipate that when comparing the actual situation with the arm's length situation, adjustments may be necessary to eliminate material differences in order to achieve comparability. There was disagreement between the taxpayer and HMRC as to the extent of these adjustments. HMRC argued that the hypothetical arm's length loan cannot take into account covenants from third parties which did not, in fact, exist.

The Upper Tribunal (UT) had said the transfer pricing rules do not permit third party covenants to be hypothesised where they are not present and concluded that a third party lender would not have lent to LLC 5. The Court of Appeal held this was an error of law and remade the decision by dismissing HMRC's challenge to the conclusion reached by the FTT. The Court of Appeal's analysis was that there are risks that third parties (specifically the LLC 6 subgroup) may take actions in the hypothetical scenario that might prejudice the performance of the loans. Such risks do not exist for the parties in the actual transaction and so hypothesised covenants are necessary in the hypothetical transaction to bring the risks into line and allow effective comparison.

Lady Justice Falk hinted, however, that HMRC might have won on transfer pricing had it run a different argument looking at whether, if LLC 5 did not have control of the preference share dividend tap and was independent of the person who did, LLC 5 would have been prepared to borrow. It is not the first time Lady Justice Falk has dropped such a hint. Sitting in the UT in *Altrad v HMRC* [2022] UKUT 185, Judge Falk, as she then was, while acknowledging it is not the role of judges to come up with alternative arguments on which to decide the case, hinted that a different *Ramsay* argument might have succeeded. HMRC took the hint and there has since been a successful procedural application to the Court of Appeal for HMRC to appeal running a different *Ramsay* argument with the substantive hearing scheduled for mid-May.

Unallowable purpose

The Court of Appeal agreed with the findings of the FTT that there was both a commercial main purpose and a tax advantage (unallowable) main purpose. The question was then how to attribute the loan relationship debits on a just

and reasonable basis between the commercial and unallowable purposes. On the facts of the case, the Court of Appeal decided that there was no basis for apportionment of any debits to the commercial main purpose, so all the debits were allocated to the unallowable purpose and disallowed.

The taxpayer had suggested various allocation methods including one based on the comparative value of the commercial advantage (i.e. the margin of profit LLC 5 made on the difference between dividends received and interest paid on the loan) as weighed against the value of the tax advantage. But Lady Justice Falk described the commercial advantage to LLC 5 as more in the nature of a by-product (as had the UT too) and concluded that there was no principled basis to identify any debits being attributable to the commercial purpose.

Finding a commercial main purpose but not allocating any debits to it seems inconsistent. If securing the commercial advantage is significant enough to be a main commercial purpose, shouldn't there be some debits attributed to it? And if the commercial advantage is a mere by-product, is seeking it really a main purpose? It would have been simpler (and more intellectually satisfying) to conclude that investing in the preference shares was not a main purpose of the loan relationship, in which case all debits would be allocated to the unallowable purpose in any event.

Given that there was a finding of fact in the FTT that there was a commercial main purpose, though, the more convincing reason for there being no attribution to the commercial purpose is the application of the but-for test. The Court of Appeal concluded that in the absence of the tax advantage, the decision to enter into the loans would never have been made.

Obviously, unallowable purpose cases are fact-specific but a general point which will be helpful to other taxpayers is the Court of Appeal's recognition that borrowing decisions are driven by tax reliefs but that it is not enough to constitute an unallowable purpose that getting a tax relief is an inevitable and inextricable consequence of entering into a loan. As Lady Justice Falk explained: 'it cannot have been Parliament's intention that the inevitable consequence of taking out a loan should engage the unallowable purpose rules, subject only to consideration of whether the value of the tax relief is sufficient to make it a 'main' purpose. Something more is needed'.

What's next for unallowable purpose cases?

The Court of Appeal's decision in *BlackRock* was released on 11 April just in time to be taken into account in *Kwik-Fit and others v HMRC* [2024] EWCA Civ 434, the judgment for which was handed down on 3 May. Lady Justice Falk also gave the lead judgment in *Kwik-Fit* and reiterated some of the points she made *BlackRock*. It remains to be seen if Lady Justice Falk will also be sitting for the Court of Appeal hearing in *JTI* in May and whether the fact pattern of JTI (the loan in that case was used to fund a direct acquisition by a UK company) will make any difference to the unallowable purpose analysis.

Hargreaves Property: 'beneficial entitlement' to interest and 'yearly interest'

In *Hargreaves Property Holdings Limited v HMRC* [2024] EWCA Civ 365, the Court of Appeal had to decide whether interest withholding tax (of around £2.8 million in aggregate) should have been deducted on loan interest payments. A simplified version of the facts is that Hargreaves Property Holdings Limited (Hargreaves), the UK-resident parent of a group which derived the entirety of its revenue from investing in UK real estate, attempted to restructure the group's loan finance so as to receive tax deductions for the interest but escape UK taxation on it. A Guernsey company to whom Hargreaves paid interest assigned the interest to Houmet, a UK incorporated and tax resident company, in return for a payment from Houmet for the assignment. Some of the loans had a duration of less than a year but were routinely replaced by further loans from the same lenders.

The taxpayer lost its appeal to the FTT, then to the Upper Tribunal and has now lost before the Court of Appeal. The taxpayer ran two arguments before the Court of Appeal. The first was that, to the extent that the interest had been paid to a UK company, it was exempt from withholding tax under section 933 of the Income Tax Act 2007. The second was that the interest on loans of a duration of less than a year, but which were routinely replaced by further loans from the same lenders, was not 'yearly interest' within Income Tax Act 2007, section 874.

Beneficial entitlement to interest

The Court of Appeal agreed that the FTT and UT correctly concluded that Houmet was not beneficially entitled to the interest assigned to it and the FTT (Judge Tony Beare) was right to say that the concept of beneficial entitlement in section 933 should not be interpreted in accordance with the *Indofood* approach because the provision is in domestic tax legislation and the court was not concerned with an 'international fiscal meaning'. Most importantly for other taxpayers, though, is that the Court of Appeal did not endorse the suggestion (in paragraph 28 of the UT's decision) that mere payment on by a recipient to an entity outside the UK may be enough to disapply section 933. This aspect of the UT's decision had caused concern about whether a UK lender is beneficially entitled to the interest if it uses any of it to make a payment (for example of fund management fees) to a non-UK entity. The Court of Appeal reassuringly states that the fact that expenses may offset part, or even the whole, of the income will not, by itself, disapply section 933.

So what does beneficially entitled to interest mean? It is still a slippery concept, even after the Court of Appeal's careful review of the UK domestic case law. For example, the principle that Lady Justice Falk derives from the UT in the *Bupa* case [2014] UKUT 262 seems too circular to provide much guidance: '[beneficial entitlement] can be construed as 'entitlement with benefits'. If the person in question would, in truth, have none of the benefits that entitlement would ordinarily bring, they will not be beneficially entitled.'

On the facts of this case, however, Hargreaves lost because it failed to discharge the burden of proof to show that Houmet retained any benefit.

Yearly interest

On the question of yearly interest, unsurprisingly, the Court of Appeal concluded the FTT and UT applied the correct legal approach to the question of yearly interest. The loans were in the nature of long-term funding, were regarded by the lenders as an investment, formed part of the capital of the business and could not be viewed in isolation as short term advances.

Recent HMRC manuals updates: CGT and stamp taxes

Capital-raising arrangements

The 1.5% charge on transfers to depositary receipt and clearances services does not apply to 'exempt capital-raising arrangements' and 'exempt capital-raising instruments'. A transfer of chargeable securities is an exempt capital-raising transfer if the transfer is in the course of capital-raising arrangements. The manual guidance in STSM053100 on the meaning of capital-raising arrangements has helpfully been expanded to list three circumstances which will not prevent an issue of chargeable securities from being capital-raising. These are where: non-cash consideration is provided (for example in the form of assets), no consideration is provided (for example, bonus issues) or consideration is directly received from a third party such as a subsidiary of the issuing company.

HMRC's updated guidance on share exchange clearances

New pages CG52632 and CG52633 have been added to HMRC's Capital Gains Manual on clearance applications for share exchanges. HMRC will not provide clearance under TCGA 1992, section 138 where 'a degree of avoidance of a charge is disclosed in or is apparent from an application and where based on the information provided HMRC cannot be satisfied that avoidance is not a main purpose or one of the main purposes'. This emphasises the importance of making sure the application for clearance provides sufficient evidence that tax avoidance is not a main purpose. On the question of what is tax avoidance, the new guidance refers to the Court of Appeal's decision in *Euromoney* (*Delinian Ltd v HMRC* [2023] EWCA Civ 1281) for confirmation that non-payment of tax that would otherwise be due, rather than deferral of tax that will eventually be charged, is tax avoidance for the purposes of the share exchange and company reconstruction rule (CG52632).

The new guidance also explains the bona fide commercial reasons part of the test. HMRC will not provide clearance to arrangements that seek to avoid a criminal, civil or regulatory risk or liability because HMRC consider that the 'bona fide commercial reasons' test expressly requires genuine, 'good faith' commercial reasons for undertaking the exchange or scheme of reconstruction (CG52633).

Pillar two: global minimum tax rules: consolidated OCED commentary

Anyone struggling to marry together the OECD commentary on the global minimum tax model rules with the various tranches of administrative guidance will be pleased that the OECD has published its promised consolidated version which incorporates the three sets of administrative guidance released before the end of December 2023. The bad news is that a further two sets of administrative guidance are expected so the period of having one place to find OECD guidance will be short lived - until the next consolidated version!

What to look out for:

- The Court of Appeal is scheduled to hear the appeal in *Altrad Services Limited v HMRC* (a disclosed arrangement intended to deliver capital allowances in respect of 'magical' expenditure) on 14 or 15 May.
- The Court of Appeal is scheduled to hear the appeal in *JTI Acquisitions Company v HMRC* (unallowable purpose) on 15 May.
- The Mutual Societies (Transfers of Business) (Tax) (Amendment) Regulations 2024 come into force on 15 May 2024. These regulations amend the current rules for transfers of business by building societies to reflect changes made in 2017 to transfers of trade and the use of losses. This includes greater flexibility for the offset of post-1 April 2017 trade losses, subject to some restrictions in the first 5 years after the transfer of business. The amendments apply retrospectively to transfers of business by building societies occurring from 1 January 2023. The final regulations are unchanged from the version published for consultation from 31 January 2024 to 28 February 2024.
- 29 May is the closing date for the consultation on raising the standards in the tax advice market.

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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

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

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