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UK Tax Round Up

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June 2024

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Welcome to June's edition of the UK Tax Round Up. This month features the latest Court of Appeal decision in a trilogy of recent cases regarding the loan relationship "unallowable purpose" test, an Upper Tribunal decision regarding the application of the old "abuse" provision in the Ireland/UK double tax treaty and further development in the line of recent IR35 decisions.

UK Case Law Developments

Court of Appeal applies "unallowable purpose" to deny interest payment deductions on intragroup loans

In *JTI Acquisitions Company (2011) Ltd v HMRC*, the Court of Appeal (CA) affirmed previous decisions by the First- tier Tribunal (FTT) and Upper Tribunal (UT) in finding that interest deductions were not allowed for interest payments on an intragroup loan to JTI Acquisitions Company (2011) Ltd (JTI) because the loan had an unallowable purpose under sections 441 and 442 CTA 2009. We previously covered the UT's decision in our August 2023 Round Up.

By way of reminder, the case revolved around the incorporation of JTI as a UK subsidiary of a US headquartered group established to acquire a US company (the Target) for $10.1 billion. The terms of the deal allowed the parent company of the US group (JGI) to nominate a different group purchaser to acquire the Target and it was decided, following advice from Deloitte in what was referred to as the "9 Step Plan", that JTI would be incorporated to purchase the Target. In order to fund the acquisition, a US subsidiary of JGI borrowed money from JGI and then lent $550 million to JTI for which JTI issued interest-bearing notes. The loan to JTI from its US parent was agreed by HMRC to be on arm's length terms and was the subject of an advance thin capitalisation agreement between JTI and HMRC. Notwithstanding this agreement, HMRC was of the view that the main reason that JTI was inserted into the group structure was to generate an interest deduction for JTI which it could group relieve to other UK companies in the JGI group. The arrangements also had a US tax advantage because JTI elected to be treated as a tax transparent entity for US tax purposes which resulted in JTI's US parent not being treated as receiving any interest payments from JTI.

As outlined above, the loan relationship debits recognised by JTI in respect of the loan from its US parent are the subject matter of this case. The FTT had agreed with HMRC that the loan relationship unallowable purpose rule applied to the loan to JTI and that all of the interest payable on that loan should be disallowed. In concluding that the main purpose of the arrangement between JTI and its US parent was to obtain a tax advantage, the FTT placed considerable weight on the 9 Step Plan. The UT dismissed JTI's first argument that, when assessing JTI's purpose in being party to the loan, it must be accepted as a given under the terms of sections 441 and 442 CTA 2009 that JTI is the company and that it is party to the loan relationship and that, therefore, the only question that needs to be considered is what is its purpose in being party to the loan. JTI had argued that this purpose was the purely commercial one of funding its acquisition of the Target and that the interest cost was just then a natural consequence of the funding. In reaching its decision, the UT had considered the wider approach supported by other cases (prominently *BlackRock* and *Kwik-Fit*) and concluded that when considering the company's purpose it is appropriate to look at the wide range of facts and circumstances surrounding it becoming, as well as being, a party to the relevant loan. The UT had dismissed another of JTI's grounds for appeal which centred on the fact that the FTT had discounted oral evidence for the inclusion of JTI in the group from one of its directors (Mr Olsen who was the CFO of JGI) and preferred the documentary evidence on this question, being the 9 Step Plan and JGI's communication regarding the benefits of incorporating and using JTI. The UT had also rejected the argument that the FTT had made an error when it found that JTI's board did not make a "genuine" decision when determining whether or not JTI should enter into the transaction.

In assessing the appeal, the CA noted that there were three main issues to be considered: (a) was there an unallowable purpose, (b) was there a commercial purpose, and (c) was an apportionment appropriate between any unallowable and any commercial purpose?

a) Was there an unallowable purpose?

JTI put forward the argument that the FTT had asked itself the wrong question when it focused on why JTI was the group entity chosen to acquire the Target instead of why JTI borrowed the funds. In considering this argument, the CA focused on six main principles derived from the CA's recent decision in the *BlackRock* case:

- even where a company entering into a loan relationship was brought into being to further a wider scheme, the company's purposes in becoming a party to the relationship are not necessarily those for which it was created or those of the wider scheme;

- on the other hand, the context and, in particular, the purposes of the wider scheme which the company was intended to advance may, depending on the facts, be relevant to the company's purposes in entering into the loan relationship;

- the company will have a "tax avoidance purpose" within the meaning of section 442 CTA 2009 if it is seeking to play its part in a scheme which, to the knowledge of the company's relevant decision makers, was designed to secure a UK tax advantage;

- if it can be said that the company wishes to go along with such a scheme whatever its purposes might be, it may well be that the company has an unallowable purpose regardless of whether it appreciates that the scheme was designed to secure a tax advantage. It may suffice that those promoting the scheme have that intention;

- the fact that the decision makers consider that entering into the loan relationship is in the company's interests for other reasons does not preclude them from having a "tax advantage purpose"; and

- a Tribunal determining whether a company had a “tax avoidance purpose” is not required to adopt a “tunnel-visioned” approach looking simply at how the company was proposing to use the money it was borrowing.

The CA determined that, while the FTT’s focus should be on the intention of the taxpayer’s decision makers, it was entitled to look at the reason for the existence of JTI as part of the wider group arrangements if that was relevant to inform those intentions. The CA said that it was evident that the members of the JGI board were aware that there was a UK tax advantage to be gained by JTI borrowing the funds and being the purchasing entity, noting that *“*not only were all [JTI’s] directors alive to what was expected of [JTI], and why” but that one of the directors (Mr Olsen) was a “contributing architect” to the plan and, therefore, it was evident that there was a “tax avoidance purpose” for JTI being a party to the loan in question.

b) Was there a commercial purpose?

The FTT found that there was no bona fide commercial purpose for JTI being party to the loan relationship. The UT hadn’t challenged this finding on the basis that it did not consider that there was any evidence that the FTT had made an error of law in coming to this conclusion. Similarly, the CA agreed that the UT was correct in its approach and said there was not a sufficient basis to challenge the FTT’s finding, commenting that the FTT was “not required to adopt a “tunnel-visioned” approach looking simply at how the company was proposing to use the loan”.

c) Just and reasonable apportionment

Finally, the CA had to consider whether the FTT had made an apportionment on a just and reasonable basis when it disallowed the entirety of the interest. The FTT had determined that the transaction had no commercial purpose and was satisfied that the only purpose for issuing the loan notes was to secure a UK tax advantage and, therefore, concluded that no apportionment was necessary. The FTT had noted that even if the tax advantage was not the main purpose for the transaction it would still have attributed the entire amount to the unallowable purpose. In dismissing the appeal in full, the CA was satisfied that but for the opportunity to secure the tax advantage there would have been no loan relationship and no debit and, consequently, it considered that the FTT was entitled to attribute the entire debit to the unallowable purpose and that no other apportionment was necessary.

This decision is the third recent CA ruling on corporate interest deductions which has found for HMRC and follows the most recent *BlackRock* judgment in applying a relatively broad group purpose to the existence of the UK company as, and its purposes in being, a borrower as well as the UK company’s narrower use of the funds that it borrows. It remains to be seen whether this or the recent *BlackRock* decisions will be appealed to the Supreme Court but taxpayers should carefully consider any interest deduction claims based on the particular facts that apply, particularly where a UK company is used as part of the acquisition of a non-UK company and in light of HMRC’s updated guidance on the application of the unallowable purpose rule.

Upper Tribunal finds main purpose of assigning debt claim was not treaty abuse

In *Burlington Loan Management DAC v HMRC*, the UT dismissed an appeal from HMRC against the FTT’s decision that the assignment of a debt claim to Burlington Loan Management DAC (Burlington), an Irish resident company, did not have the main purpose of taking advantage of the interest withholding tax article in the UK/Ireland double tax treaty (the Treaty). The FTT’s decision was previously covered in our September 2022 UK Tax Round Up, which also summarises the factual background.

By way of summary, the case involved the assignment in 2018 of a £142m debt claim payable in association with the administration of a UK tax resident company (the Assignment) by a Cayman tax resident company (SAAD Investments Company Limited (SICL)) to Burlington. The principal amount of the debt claim had been settled and so Burlington only acquired the right to receive future payments of yearly interest (amounting to approximately £90.7 million) which would, in the absence of any available exemption, have been subject to UK withholding tax (UK WHT). No such exemption was available if the interest had been paid to SICL. The consideration paid by Burlington for the interest receivable was less than £90.7 million and it was accepted that Burlington took into account the fact that SICL would have received the interest subject to UK WHT at 20% while Burlington expected to be able to reclaim the UK WHT among other factors when it set its purchase price. Following payment of the interest subject to UK WHT, Burlington claimed that it was entitled to be repaid the WHT applying Article 12(1) of the Treaty, which provides that interest derived and beneficially owned by a resident of Ireland or the UK, as applicable, is taxable only in that state (i.e. Ireland in this case).

At the time Burlington submitted the repayment claim, Article 12(1) was subject to an anti-abuse measure in Article 12(5) which applied if "it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment". Had the Assignment not occurred, SICL would have been subject to UK WHT at a rate of 20% as no exemption would have been available to it. HMRC refused Burlington's repayment claim on the basis that Article 12(5) applied because Burlington and SICL were splitting the benefit of the potential UK WHT relief and, therefore, the Assignment had taken place with a main purpose of allowing Burlington to take advantage of the Treaty. The FTT disagreed with HMRC that Article 12(5) applied and noted that while the pricing reflected the expectation that Burlington would not be subject to UK WHT, it was not the main purpose of the assignment which had a number of other, commercial purposes and, on that basis, Burlington was entitled to the rebate.

HMRC appealed the FTT decision on a number of grounds including that the FTT had made errors both on the law and on the factual evidence presented, although the approach to the general interpretation of the Treaty was common ground between the parties. The UT, when considering the appeal, stated that the correct starting point is to assume that Burlington, as an Irish tax resident company and beneficial owner of the interest should only be subject to tax on the interest in Ireland, and then to ask whether there was an abusive arrangement which fell within Article 12(5). HMRC argued that the FTT had incorrectly approached the analysis of SICL's purpose as it misconstrued Article 12(5) of the Treaty when it found that a transferor of an interest-bearing debt only has a main purpose of "taking advantage" of Article 12(1) if the transferor has knowledge that the purchaser is entitled to the benefit of Article 12(1) specifically, and that it would not be sufficient for the transferor to be aware that the purchaser is entitled to some UK WHT exemption. The UT, in dismissing this ground of the appeal, concluded that this could not be the correct interpretation as, if HMRC's submission was correct, Article 12(5) would apply whether or not the transferor actually knew the basis on which UK WHT would not apply to the purchaser and the UT was not convinced that this was consistent with the object or purpose of Article 12 generally.

HMRC also argued that the FTT made an error when it failed to conclude that the sole economic basis for the actual (compared to a hypothetical) transaction entered into by Burlington was the "UK WHT arbitrage resulting from Burlington's reliance on Article 12(1) [of the Treaty]" and that the 20% difference between the value of the debt claim to Burlington and to SICL was the economic basis of the Assignment. The UT dismissed this argument on the basis that it was appropriate for the FTT to take into account the fact that other potential purchasers that would not have needed to rely on the Treaty to have been entitled to an exemption from UK WHT. The UT emphasised that the FTT was right to focus on the subjective question of whether SICL's or Burlington's subjective purpose in entering into the Assignment constituted an "abuse".

HMRC also made several challenges to what it said were errors of law made by FTT in determining both Burlington's and SICL's purpose in entering into the Assignment. HMRC argued that the ability for Burlington to make a profit on the Assignment was based solely on it being able to obtain the exemption under the Treaty and that this went to the purpose of the transaction. The UT agreed that the FTT's determination showed that the FTT knew that the only way that Burlington could realise a profit was through its entitlement to the exemption from UK WHT under the Treaty, but the UT held that this did not mean that Burlington was seeking to abuse the Treaty. Instead, the UT considered that this merely showed that Burlington was expecting the Treaty to apply to the Assignment (which it was entitled to do) and concluded that the FTT's core finding that it could not find anything abusive in the manner in which Burlington attempted to rely on the Treaty had not been reached on a flawed basis. Accordingly, the UT dismissed this ground of the appeal.

Finally, the UT also dismissed HMRC's assertion that no reasonable tribunal could have come to the same decision as the FTT in its judgment.

While the UT also rejected Burlington's submission that Article 12(5) of the Treaty can only apply where there are "artificial" steps or arrangements, it does provide comfort to taxpayers that when considering a taxpayer's purpose for entering into a transaction a multifactorial approach should be used. Although the availability of treaty relief may be a factor for a transaction or its terms it does not automatically mean that it is considered to be a main purpose of the transaction or to constitute an "abuse" of the relevant treaty.

Upper Tribunal sets aside FTT decision in IR35 case

In *Basic Broadcasting Limited v HMRC*, the UT has allowed HMRC's appeal setting aside the FTT's decision which found that the hypothetical contracts that would have existed between Mr Chiles, a well-known television and radio presenter, and the BBC and ITV would have been contracts for services and not contracts of employment. This case is the latest in a string of IR35 cases involving broadcasters over the last few years and highlights that IR35 not only that is heavily fact specific but that it is very difficult to assess how the courts are likely to approach the self employment vs employment question. The UT has not held that IR35 did apply to the arrangements between Basic Broadcasting Ltd (BBL) and ITV and the BBC but has remitted it to the FTT for the FTT to reconsider its decision.

The case involved the analysis of the provision of services by Mr Chiles to ITV and the BBC through his personal service company, Basic Broadcasting Limited (BBL), between 2012 and 2017. HMRC issued determinations to BBL for the relevant tax years and sought to recover £1.7 million of income tax and national insurance contributions on the basis that Mr Chiles' arrangements with ITV and the BBC were contracts of services (employment) rather than contracts for services (self employment). BBL was successful in its appeal against the determinations before the FTT and HMRC appealed that decision to the UT.

As with all IR35 cases, the UT confirmed that, when determining whether or not the IR35 rules apply, the court is required to carry out a three stage analysis. The first two stages of the analysis involve assessing the actual contractual arrangements between the personal service company and the client and the relevant circumstances in which the individual worked and then determining what the terms of the "hypothetical contract" between the client and the individual providing the services through their personal service company would have been had there been such a direct contract in place to govern the terms of the engagement. Having determined the terms of that hypothetical contract, the court is then required to consider whether the hypothetical contract would be a contract of service (employment) or a contract for services (self employment). The employment or self employment test (the so called *Ready*

Mixed Concrete or *RMC* test) itself requires an analysis of (a) the level of control the client has over the individual's work, (b) the mutuality of obligation between the individual providing the services and the client providing work and paying for it and, if there is sufficient control and mutuality of obligation to mean that there might be an employer/employee relationship, (c) an assessment of whether the other provisions of the contract are consistent with it being a contract of service (rather than a contract for services).

In Mr Chiles' case, the FTT found that the contracts contained sufficient mutuality of obligation and control and these findings were not challenged in BBL's appeal. It then found, however, that Mr Chiles demonstrated that he was in business on his own account (the third limb of the *RMC* test) and that his arrangements with ITV and the BBC under the hypothetical contracts would have fallen within that existing business. Accordingly, and applying the approach taken by the UT in the *Atholl House* case, the FTT held that IR35 did not apply as a result of the "other provisions" of the hypothetical contacts being consistent with a contract for services rather than a contract of service. In appealing this decision, the first argument that HMRC put forward was that the FTT erred in law when considering this third limb of the *RMC* test and that it did not put the relevant terms of the "hypothetical contracts", rather than an overall view of Mr Chiles' past working practices, at the centre of its analysis. HMRC submitted that whether an individual was generally in business on his or her own account should not be the central element of the FTT's evaluation, and instead the main focus should be on the terms of the hypothetical contract and then the extent to which the individual's general working practices were relevant to the arrangements under the hypothetical contract without any presumption that the arrangement in question would simply make up part of the individual's other or historic business activities.

This point had recently been considered by the CA in the *Atholl House* case and the CA had decided that the UT in that case was wrong to presume that the fact that the individual in question had a history of carrying out similar engagements as part of her self-employed business meant that the engagements in question should be considered to also be undertaken as part of that business. In this case, the UT focused on the importance of the *Atholl House* CA decision as HMRC submitted that the FTT had made the same errors when considering Mr Chiles' case as those that had been found to have been made by the UT in *Atholl House*. In Mr Chiles' case, the UT was satisfied that the FTT began by determining that the appropriate level and nature of control existed and agreed that there was a prima facie assumption of employment between Mr Chiles and the BBC/ITV prior to considering the final stage of the *RMC* test. However, when considering how the FTT approached that final stage, the UT held that the FTT had also accepted that the fact of Mr Chiles' history of conducting his activities as part of a business on his own account without scrutinising carefully enough the terms of and circumstances surrounding the hypothetical contract. On that basis the UT allowed the appeal and remitted the case back to the FTT for its reconsideration.

Despite the UT finding with HMRC on the first ground, it did go on to consider the second ground of HMRC's appeal which centred on the submission that the FTT had failed to take into account certain matters which were relevant to the third limb of the *RMC* test, being the extent to which matters that were or were not known or reasonably known by the BBC/ITV could be taken into account when considering the circumstances around the hypothetical contract and the extent to which Mr Chiles' past working practices should be taken into account in determining how the relevant arrangement should be characterised (what was referred to in the judgment as the Knowledge Issue). The Knowledge Issue had not been raised before the FTT in the initial hearing, and so was the subject of objection by BBL on the basis that it said it would be procedurally unfair to permit the new argument at the UT appeal. The FTT had deferred to the UT to determine whether or not it was appropriate to hear evidence on this argument when granting permission for HMRC to appeal its original decision. When allowing the appeal, the UT noted that the Knowledge Issue was relevant because of the new *Atholl House* CA decision that had been delivered between the FTT and UT decisions in Mr Chiles' case and agreed that, on balance, HMRC should be permitted to raise this new argument. While this ground of appeal was successful the UT noted that no blame for failing to consider the Knowledge Issue lay with the FTT or either party, but that as the law regarding this area has developed it was an important point and, therefore, agreed that it was necessary to hear that argument in light of the *Atholl House* CA decision.

The case will now be remitted to the FTT with the direction from the UT that the FTT should reconsider its decision using the guidance from the *Atholl House* CA decision.

Although this case was first heard in 2019, the recent prevalence of IR35 cases before the FTT highlights not only HMRC's continued focus on this area but also quite how difficult it is to predict how any particular case will be decided and exactly what the important points in any particular case are likely to be that will sway the decision one way or another.