

# UK Tax Round Up

April 2024

**Welcome to April's edition of our UK Tax Round Up. This month has seen a number of interesting decisions covering the application of the transfer pricing rules and the unallowable purpose test to an intragroup financing arrangement, whether interest paid on intragroup loans was "yearly" and the recipient was "beneficially entitled" to it and on the approach that should be taken by the courts in constructing the hypothetical contract required to ascertain whether an individual should be treated as a deemed employee under the IR35 rules among other things.**

## UK Case Law Developments

### UK acquisition loan had an unallowable purpose

In *BlackRock Holdco 5 LLC v HMRC*, the Court of Appeal (CA) considered whether interest paid by a UK resident company on a loan used to acquire a US business should be disallowed applying either or both of transfer pricing principles and the loan relationship unallowable purpose rules. Previous decisions by the First-tier Tribunal (FTT) and Upper Tribunal (UT) had decided that the interest was allowable under both the transfer pricing and unallowable purposes rules (the FTT decision) and that the interest deduction should be denied under both transfer pricing and unallowable purpose (the UT decision). The CA has agreed with the UT's decision that the interest deductions should be disallowed applying the unallowable purpose test but disagreed with the UT on the transfer pricing point.

By way of reminder, the case related to an acquisition structure put in place by the BlackRock group to acquire a US target. The acquisition structure included a number of newly established US resident limited liability companies (LLCs). In addition, and following advice from EY, a UK resident LLC (BlackRock Holdco 5 LLC or BlackRock 5) was introduced into the structure in between its US LLC parent and the acquirer of the US business (another US resident LLC). BlackRock 5 borrowed the acquisition price from its US resident parent and used it to subscribe for preference shares in the US resident LLC that acquired the target. BlackRock 5 was expected to make a profit as a result of the dividends received on the preference shares exceeding the interest expense of the loan. The EY advice had referred to the UK's "generous tax regime for interest deductions" in suggesting that a UK resident company could be added to the structure.

As stated, the case concerned two main issues. First, how the transfer pricing rules should be applied to the interest expense deduction on the intragroup loan notes. Second, how the loan relationship unallowable purpose rule should be applied to it.

On the transfer pricing issue, the UT had agreed with HMRC that the “arm’s length” comparator should be applied on the basis that the intragroup loan did not include group covenants supporting the loan and that an independent enterprise would not have lent to BlackRock 5 on those terms. This decision led to widespread concern that intragroup transactions would have to include additional terms that would be required by an arm’s length party to avoid transfer pricing adjustments even where such terms had been omitted merely for convenience rather than because they could not be provided in an arm’s length transaction (such as, in this case, group company covenants). The CA considered this question by reference to the OECD’s transfer pricing guidelines and, in particular, that they refer to the arm’s length transaction comparator having “economically relevant circumstances” that are “sufficiently comparable” in the sense that any differences either did not have a material effect or could be adjusted for with reasonable accuracy to eliminate their effect. On that basis, the CA stated that the OECD guidelines make clear that incidental benefits which arise from group membership in relation to a loan do not need to be adjusted for when considering whether a third party would lend on the same terms, even if the benefit is substantial. This would include the absence of covenants and contractual rights in an intragroup loan agreement which are inherently unnecessary due to the group structure. The UT had erred in accepting HMRC’s argument that hypothetical covenants should be considered as this was not adjusting the actual characteristics of the parties in question in order to eliminate material difference and would not reflect the economic reality of the risk for a third-party lender where such covenants would be readily provided. This element of the decision will be very welcome to taxpayers entering into intragroup transactions, reversing the requirement to include in such arrangements all terms that would be required by an independent counterparty and affirming the general practice for intragroup and other shareholder loans which are generally drafted without group covenants and protections that a third party lender would require because they are irrelevant for a loan between parties who have a level of control over each other due to the group structure.

The unallowable purpose rule decision by the UT was largely upheld by the CA but on a slightly different basis.

The FTT and, subsequently, the UT had applied the House of Lords' decision in *Mallalieu v Drummond* to hold that the tax advantage obtained by BlackRock 5 was an inevitable and inextricable consequence of, and not merely incidental to, it entering into the loan in order to fund the acquisition. Therefore, it was considered to be a main purpose of BlackRock 5 in entering into the loan. The CA held that the fact that the tax advantage was an inevitable and inextricable consequence did not necessarily mean that it was a purpose and that purposes must be distinguished from the effects of a transaction. The CA stated that the UT should have emphasised the focus of the statutory test on BlackRock 5's purpose for entering into the loan and not the purpose behind its existence since these were separate purposes, although one may impact the other. Applying this approach, however, the CA concluded that BlackRock 5 had entered into the loan relationship for an unallowable purpose as, while it did have a commercial purpose for entering into the loan in order to provide the necessary funding for the acquisition, its entire function in the group was to enter into the loan to obtain a tax advantage and reduce the group's UK tax bill. The use of one UK tax resident LLC in the structure with no commercial rationale other than its ability to claim interest deductions evidenced the main purpose of obtaining that tax advantage. In a short supporting judgement, Nugee LJ referred to BlackRock 5's board minutes which stated that "the Chairman proposed that the Company enter into a series of transactions in accordance with the Project Onyx Closing Step Plan prepared by Ernst & Young LLP". This, he concluded, showed that BlackRock 5's purpose "in entering into the transaction was to take its place in the structure that had been devised to enable the acquisition to take place. But its place in that structure was entirely driven by tax considerations, or, to use the language of the statute, in order to secure a tax advantage for other persons". This was sufficient for it to have a main purpose of securing a tax advantage and that this overriding purpose was sufficient for the "just and reasonable apportionment" of its interest deductions to be that all of the interest was attributed to the unallowable purpose, so none was deductible.

The decision and, in particular, Nugee LJ's short judgement should be taken as a warning that the courts will take a reasonably broad approach to the purposes for which an entity enters into a transaction in structured arrangements such as those in question rather than applying the narrow approach argued by BlackRock that BlackRock 5's purpose was to facilitate the commercial acquisition of the US target.

## **Loans involving Guernsey companies had UK source and interest was “yearly”**

In *Hargreaves Property Holdings Ltd v HMRC*, the CA has upheld the decisions of the FTT and UT that a UK company was not beneficially entitled to interest assigned to it shortly before it was paid and that the interest was “yearly” for the purposes of the UK’s withholding tax rules.

The case involved a group funding arrangement under which loans were made by various trusts and other lenders to the UK resident parent of the group which used the loans to acquire UK property. The UK resident company borrowed sums from two Gibraltar resident family trusts under a Gibraltar law loan agreement. Just less than annually, each existing loan would be repaid using a new loan and the interest receivable under the existing loan would be assigned by the Gibraltar trusts to a UK company for consideration so that the interest was actually paid to the UK company which made a (virtually) matching payment to the Gibraltar trust. The UK borrower argued that it did not have to deduct withholding tax from the interest payment under the exemption to withholding tax deduction in section 933 ITA 2007 as the interest was paid to a UK company which was “beneficially entitled” to it. The borrower also argued that the loans were less than a year in duration and, therefore, the interest paid on them did not qualify as “yearly-interest” for the purposes of section 874 ITA.

The FTT and UT had both held that section 933 ITA did not apply to the payment of interest in this case and that the interest was “yearly” due to the circumstances surrounding the provision, and readvancement, of the loans by the lender group company.

The CA agreed on both counts. It found little difficulty in concluding that the interest was “yearly” given that “the question whether the interest is ‘yearly’ or ‘short’ depends upon a business-like rather than dry legal assessment of [a loan’s] likely duration” and the commercial reality was that the loans made up part of the taxpayer’s long-term capital.

The more interesting aspect of the decision was the conclusion on section 933 ITA and whether the UK company to which the interest was assigned was “beneficially entitled” to the interest. The UT had held that it was not by applying the “international fiscal meaning” of beneficial entitlement that was referred to in the double tax treaty related *Indofoods* case, which requires the recipient to have the full privilege to directly benefit from the interest. The UT had held that, because the UK company was obliged to make a payment virtually equal to the interest received, it was not “beneficially entitled” to the interest. The taxpayer argued that this was the wrong approach, and that section 933 ITA required a UK domestic law approach, rather than an international tax treaty approach, to the term. The CA agreed with that and held that the international meaning was inappropriate and should not have been considered. However, the CA did not restrict itself to a pure legalistic consideration of the term “beneficially entitled” but, rather, applied the general purposive approach to the term in the context of section 933, considering that “beneficially entitled” is not the same as equitable ownership and required, in broad terms, “ownership with benefits”. The CA further stated that, when considering beneficial entitlement in a scheme with a series of steps, it is appropriate to consider the steps both individually and as a whole to determine whether the recipient of the interest is beneficially entitled to it for the purposes of section 933, which is a provision exempting the interest from UK withholding tax on the premise that the interest is subject to UK tax in the hands of the recipient which can benefit from it. Viewed realistically, in the context of the overall transaction, that was not the case here as the UK company could not be said to have benefitted from the rights usually attaching to the receipt of interest.

The taxpayer has also raised the recent decisions of the CA in *Khan v HMRC* and *Good v HMRC* as cases which showed that entitlement to a receipt was not negated by the requirement to make a payment for the amount received. The CA in this case rejected that argument on the basis that those cases were considering different statutory provisions and the requirement is always to apply a realistic view of the facts to a purposive construction of the legislation in question.

The CA's approach to section 933 and the question of beneficial entitlement is interesting in enforcing that, even where what might be considered under UK domestic law to be a legalistic concept is in question, the courts will seek to identify the purpose behind the specific piece of law and apply a realistic view of the facts to the overall arrangement, often disagreeing with narrow interpretations of how the relevant law should apply.

## **Requirement to construct hypothetical contract for IR35 assessment**

In *RALC Consulting Ltd v HMRC*, the UT has considered the process required for a tribunal to assess whether an engagement with a contractor should be treated as deemed employment under Chapters 8 or 10 Part 2 ITEPA 2003 (the so called IR35 rules). The case related to an assessment by HMRC that an IT consultant, Mr Alcock, providing his services through RALC to Accenture and the Department of Work and Pensions (DWP) should be treated as a deemed employee under the IR35 legislation. The FTT had determined that he should not because the fact that he was not obliged to perform work offered to him by Accenture or DWP, and that they were not obliged to offer him work, meant that there was not sufficient "mutuality of obligation" between them and that this would have been reflected in the hypothetical contract between them had Mr Alcock contracted with them directly.

The FTT had considered that the correct way to apply the IR35 rules to the case was to follow the test from *Atholl House Productions Limited v HMRC* and *Ready Mixed Concrete Ltd v Minister of Pensions*, which required the court to assess the actual terms of the contracts, then to consider what the terms would have been for a hypothetical contract made directly between the consultant and the end client and, finally, assess whether the hypothetical contract would have been a contract of employment (or contract of service) or a contract for services.

The UT held that, while the FTT had been correct in its description of the three-stage approach, the FTT had not followed this approach and had not sought to construct the hypothetical contract that would have been entered into between Mr Alcock and Accenture and DWP (the end clients) directly before seeking to apply the employment or self-employment analysis to that contract. Rather, the FTT had considered the actual terms of the contracts between RALC and the end clients and applied those terms directly to make its assessment. Significantly, it concluded that because there was no obligation for the end clients to offer work to RALC or for RALC to agree to perform it in the actual contracts, there would have been no such obligations in the hypothetical contracts between Mr Alcock and the end clients so that there would not have been sufficient “mutuality of obligation” in the hypothetical contract for that direct engagement to have been one of employment. This approach had failed to construct the hypothetical contract and then apply the employment/self-employment assessment to that contract and, in doing that, the FTT had failed to follow its self-instruction on how to make the IR35 assessment. The analysis had been complicated because the actual arrangement involved an “upper-level contract” between the end clients and the agency with which RALC contracted and a “lower-level contract” between RALC and the agency. The FTT had taken the upper-level contract terms into account when assessing the mutuality of obligation aspect of the purported hypothetical contract between Mr Alcock and the end clients.

The UT then further assessed the FTT’s approach to whether the hypothetical contract would have contained terms that meant that there was mutuality of obligation in light of the authorities, including the primary case of *PGMOL v HMRC*. *PGMOL* established that insufficient mutuality of obligation in an overarching contract did not prevent individual engagements entered into pursuant to the overarching contract from having sufficient mutuality of obligation in respect of the work actually undertaken. A single engagement can give rise to a deemed employment contract provided the work offered is done for payment. In this regard, the UT stated that all that is required is mutual work related obligations within a specific engagement, but also that this would only place the engagement “into the employment field”. The engagement could still be one of employment or self-employment, depending on the facts. This highlights what recent cases in this area have shown, that a work engagement is likely to meet the mutuality of obligation part of the *RMC* employment test and that it is likely to be other factors that are determinative of the employment or self-employment question.



The UT has remitted this case back to the FTT with strong direction on the importance of following the three step process for applying the IR35 rules and considering the implications of case law authorities referred to when considering the mutuality of obligations.

## **Payments into remuneration trust scheme taxed under disguised remuneration rules and non deductible**

In *Marlborough DP Limited v HMRC*, the UT held that certain payments made into a remuneration trust by Marlborough DP Ltd (MDPL) and then lent to Dr Thomas, its sole shareholder and director, were taxed as employment income under the disguised remuneration rules in Part 7A ITEPA 2003 and were not deductible for MDPL. The FTT had previously held that the payments were taxable as distributions received by Dr Thomas and were not deductible but that they would have been deductible were they taxable as employment income.

MDPL was a dental company through which Dr Thomas operated his dental practice. It entered into a remuneration trust scheme under which it made payments broadly equal to the profits of MDPL to a trust, and the trust then made loans to Dr Thomas.

HMRC sought to charge Dr Thomas and MDPL to employment taxes on the amounts lent to him and argued that MDPL was not entitled to a deduction for the payments. HMRC appealed against the FTT's decision that the payments should be taxed as distributions rather than as earnings and that, if the payments were taxed as earnings, they would be deductible for MDPL. On the first point, HMRC argued that the loans made to Dr Thomas should be taxed as either earnings from employment under section 62 ITEPA or treated as earnings in connection with employment under Part 7A ITEPA. HMRC also argued that the payments by MDPL to the remuneration trust were not deductible for corporation tax purposes because they were not incurred wholly and exclusively for the purpose of MDPL's trade and had another purpose of obtaining a tax deduction without the payments being subject to income tax.

The UT agreed with the FTT on one point and disagreed on two. The UT agreed that the FTT had correctly applied the general earnings test under section 62 and were correct that it is the employer's purpose in making the payment that should be considered to determine whether the earnings are "from" employment. On the facts, the FTT was correct to determine that the loans were not earnings from employment, given the payments to the trust represented the entire profits of MDPL and Dr Thomas would have otherwise received the profits as a distribution as sole shareholder, and not as remuneration, as was evidenced by past practice.

However, the UT held that the FTT was incorrect in deciding that the disguised remuneration rules in Part 7A did not apply. For the disguised remuneration rules to apply to a payment made by a third party (here the remuneration trust) it must be reasonable to suppose that, in essence, the payment is a means of providing rewards or recognition or loans "in connection with" the relevant individual's employment (or directorship). The FTT had held that the required link to the employment under Part 7A was that the employment must be at least "part of the reason" for the payment. The UT disagreed and held that the "in connection with" has a wider scope (or looser required link to the employment) than the section 62 "from the employment" test. The UT agreed that there must be a relatively strong or direct nexus between the employment relationship and payment as it was not Parliament's intention to catch circumstances where the relationship between the employment and the payment was merely incidental but that the required link was not as strong as the "from" employment test under section 62 or that the employment must be part of the reason, in a causative sense, for the payment.

In seeking to determine whether there was the required connection between the payment and Dr Thomas's employment (or directorship), the UT found that the loans reflected the profits from Dr Thomas's dental practice, that Dr Thomas had authorised the payment to the remuneration trust as the only director of MDPL and that Dr Thomas then received the loan from these profits. On this basis, the UT found that the essence of the arrangement considered as a whole was that the loans were made in connection with Dr Thomas's employment.

The UT then considered the deductibility issue and held, in contrast to the FTT, that the payment to the remuneration trust was not incurred wholly and exclusively for the purposes of MDPL's trade, and on the facts, this was not satisfied. The purpose, as shown by all the evidence, was tax efficiency. As the UT stated, "the intention of MDPL in making the contributions was to empty the company of profit in order to fund a tax-free benefit (i.e. the loans) to Dr Thomas. There was no trading purpose and no benefit to MDPL's trade". Accordingly, the payments were not deductible for corporation tax purposes.

The case highlights the breadth of scope of the disguised remuneration rules in Part 7A and the caution that should be applied in entering into transactions that might be caught by them when assessing whether a payment that is not obviously an earnings payment might still be made "in connection with" the employment, particularly where the recipient has a significant influence over the company making the payment.

### **FTT's ability to "rectify" arrangement to determine tax outcome**

In *Cooke and another v HMRC*, the FTT had to consider whether it had the power to determine the taxpayer's tax liability by reference to terms that it considered would have been rectified by the High Court (HC) had an application for rectification been made.

The case related to the question of whether Mr Cooke was entitled to claim entrepreneurs' relief (ER) in respect of the gain on the disposal of shares he held in a company when the number of shares held was one short of the number for him to hold the 5% of ordinary share capital required to make a claim for ER.

Mr Cooke had agreed to purchase 5% of the shares in a company from the two founder shareholders. It was clear between the parties that the intention was for the acquisition of 5% in order for Mr Cooke to qualify for ER when the shares were eventually disposed of. However, a mistake was made in the spreadsheet that was used to calculate how many shares he should acquire because all numbers in the spreadsheet were rounded to two decimal places. As a result, Mr Cooke had only acquired shares comprising 4.99998% of the share capital of the company. HMRC assessed Mr Cooke on the basis that he did not qualify for ER as he did not hold the requisite 5% shareholding. Mr Cooke appealed on the basis that had proceedings been brought before the HC, the HC would have rectified the documents to increase the appellant's shareholding to the required 5% and, had the documents been so rectified, Mr Cooke would have been treated as owning the required 5% for ER purposes. The FTT held that although it did not have the power to rectify the documents, it did have the power to determine if the HC would have ordered rectification and, if it found that it would have done so, the tax position of the appellant would follow as if such rectification had been made following the authority of *Lobler v HMRC*.

The FTT noted that in order for the HC to agree to rectification it would have to be convinced, on the balance of probabilities, that (i) the parties had a common continuing intention, whether or not amounting in law to an agreement, in respect of the particular matter in the instrument to be rectified, (ii) there was an outward expression of accord, (iii) the intention continued at the time of execution of the instrument sought to be rectified and (iv) by mistake, the instrument did not reflect that common intention.

The FTT held that, based on the evidence about the parties' intentions and the specific importance to Mr Cooke that he acquired 5% of the shares to be able to claim ER on a future sale, the requirements for rectification were met and the HC would have rectified the sale agreement to provide for Mr Cooke to have acquired the one further share that he required.

The other point discussed was that the HC might not order rectification if the only reason for it was to avoid an unwanted tax consequence. On this, the FTT stated that it did not need to wrestle with this issue because, other than Mr Cooke's entitlement to ER, the deemed rectification had a non-fiscal effect of reducing the consideration received by the other shareholders (or one of them) on the sale on the basis that Mr Cooke held one more share and the other shareholders one fewer.

The discussion around rectification is interesting in that the tax position will automatically follow rectification if a tax tribunal finds that the HC would order it, but that the tax tribunal might be concerned that the HC would not order rectification where the effect of it would only be a fiscal benefit and the rights of the parties would not change. Helpfully, in this case, the FTT decided that the very small non tax consequence of the rectification (one share in nearly 246,000) was sufficient to allow it to decide that the HC would have granted rectification.

The case also highlights the importance, when dealing with share acquisitions and any specific holding required to achieve desired tax consequences of checking that spreadsheets are calibrated properly to ensure the share percentages are accurate and correct, as even 0.00002% below the required shareholding percentage may be sufficient for HMRC to deny the taxpayer the intended tax consequence.

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