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The UK tax authority's approach to purpose-based enquiries

*The UK tax authority, HM Revenue & Customs (**HMRC**), recently published (substantially) revised guidance on the unallowable purpose rules that helpfully confirms a number of technical points emerging from recent case law. It also gives an indication of HMRC's practical approach to these enquiries, including its focus on contemporaneous documentary evidence. The guidance and accompanying examples illustrate a number of factors that HMRC considers relevant to whether or not the borrowing company has a tax purpose, such as whether the arrangements are UK base erosive, are the result of complex structuring, or include shareholder debt. This will also be of relevance to corporate groups considering other purpose-based anti-avoidance rules.*

Following a raft of recent UK case law, HMRC has updated its guidance on the loan relationship unallowable purpose rule in ss 441 and 442 CTA 2009. If a loan relationship of a company has an unallowable purpose, s 441 applies to prevent a company from bringing into account so much of any debits in respect of that relationship as on a just and reasonable apportionment are attributable to the unallowable purpose. The meaning of 'unallowable purpose' is given in s 442 as (put simply) a main purpose for which the company is party to the loan relationship of securing a UK tax advantage for the company or any other person.

The newly updated guidance represents a substantial revision to the previous version. Broadly, it covers:

- HMRC's views on how the technical requirements of the unallowable purpose rule should be interpreted – for example, whose purposes are relevant, how to establish what is a 'main' purpose and the meaning of 'tax advantage'; and
- how HMRC approaches unallowable purpose enquiries, including the factors that HMRC considers to be relevant in assessing whether there is a main purpose of tax avoidance, which is illustrated with a number of (surprisingly nuanced) examples.

The technical guidance (in HMRC's *Corporate Finance Manual* at CFM38110 onwards) helpfully confirms points emerging from recent case law (many of which were outlined in our previous article '[How to handle unallowable purposes enquiries]'). As a result, there are no major surprises, although HMRC acknowledges the case law in this area is still developing.

The practical guidance (at CFM38170 onwards) is more interesting, for what it says (and does not say) about HMRC's approach to purpose-based enquiries and the situations which HMRC would 'normally' regard as involving (or not involving) a tax avoidance purpose. These will be of relevance to corporate groups considering the application of s 441 as well as a range of other purpose-based anti-avoidance rules. In particular, corporate groups may need to consider how the positions they are taking correspond to or differ from HMRC's position as expressed in the guidance in order to assess whether any disclosure is required under the uncertain tax treatment regime.

Technical guidance

Whose purposes?

The guidance recognises the significance of the directors' views in assessing a company's purposes and that it would be rare for directors to cede de facto control of the company or to be acting as mere puppets. However, in HMRC's experience, where the loan relationship is part of wider arrangements, directors will typically have knowledge of the group purposes for those wider arrangements and will take those group purposes into account.

These principles will also apply in the context of other purpose tests; the guidance expressly refers to case law on whether expenditure was incurred wholly and exclusively for the purposes of a company's trade, but the principles will apply equally to other anti-avoidance rules which require an assessment of a company's subjective purposes.

What is a main purpose?

Importantly, the guidance acknowledges that tax will be taken into account as a factor for companies and groups putting finance arrangements in place – that (on its own) is not enough to invoke the unallowable purpose rules. It also acknowledges the 'choice principle' – i.e., per *IRC v Brebner* [1967] 43 TC 705, if a taxpayer chooses the option for carrying out a commercial transaction which minimises the UK tax payable, that does not necessarily mean that the taxpayer has a main purpose of obtaining a UK tax advantage. This is drawn out further in the examples (discussed below) in the context of choosing between debt and equity finance, which is rightly identified as a difficult area.

It is notable though that the guidance highlights the Court of Appeal decision in *HMRC v Lloyds TSB Equipment Leasing (No. 1) Limited* [2014] EWCA Civ 1062 to make the point that, even if each transaction forming part of a wider set of arrangements has a commercial purpose, it could still be the case that the taxpayer's choice in structuring the arrangements was such that tax was a main object (or purpose).

Mention is also made of the comments of the Court of Appeal in *Travel Document Service & Ladbroke Group International v HMRC* [2018] EWCA Civ 549 regarding the absolute and comparative size of the tax advantage – which in that case, being large, created an 'inescapable inference' that securing the tax advantage had become a main purpose. Conversely, no mention is made of the Upper Tribunal's conclusion in *HMRC v Euromoney Institutional Investor PLC* [2022] UKUT 205 (TCC) (currently on appeal to the Court of Appeal) where the relatively small size of the tax advantage compared to the overall commercial transaction pointed in the other direction.

To what extent can purposes be inferred?

The Upper Tribunal in *HMRC v BlackRock Holdco 5, LLC* [2022] UKUT 00199 (TCC) rejected HMRC's argument (which had found favour before the First-tier Tribunal) that, based on the reasoning of the House of Lords in *Mallalieu v Drummond (Inspector of Taxes)* [1983] 2 AC 861, a purpose can be inferred simply because it is an inevitable and inextricable consequence of the borrowing. Since the guidance continues to refer to the *Mallalieu* case, one might infer that HMRC is continuing to argue this point.

The substantive content of the guidance is more nuanced, though: it simply notes that the consequences or effects of a transaction are likely to be relevant factors to be taken into account as part of an assessment of all the relevant circumstances, but are not determinative, in establishing the purposes of a company.

Just and reasonable apportionment

The guidance acknowledges that this is a particular area which is under discussion in cases that are currently being litigated, including *BlackRock* and *Kwik-Fit Group Ltd & others v HMRC* [2022] UKUT 314 (TCC). It also flags that some of these cases have been held to involve loans with mixed purposes, and so the question of whether debits should be subject to partial apportionment between those purposes is being considered. In the meantime, the guidance helpfully emphasises that the legislative test confers a 'wide latitude in judgment' and that, while the test should not be glossed or reformulated, there are a range of possible approaches which may be used to make or test a proposed apportionment in mixed purpose cases.

Hansard report

Statements made by the Economic Secretary to the Treasury about the scope of the unallowable purpose rules when were they first debated in Parliament have been the subject of much correspondence in s 441 enquiries. These statements were reproduced in full in the previous version of the guidance, together with HMRC's interpretation of them. Taxpayers have taken reassurance from these statements that ss 441-442 should not prevent companies from getting tax relief for legitimate financing arrangements; however, HMRC has often referred to the comment that the rules might apply if the financing were structured in an 'artificial' way when challenging acquisition debt under s 441.

HMRC stands its ground on this, viewing its previous summary of the statements as consistent with its current view of the law. The revised guidance therefore continues to set out the statements in full, and reiterates HMRC's previous interpretation of them, being that ss 441 and 442:

- will normally apply where UK branches of overseas companies borrow for overseas activities outside the UK tax net;
- will not normally apply where a company borrows to acquire shares in companies, whether in the UK or overseas, or to pay dividends, provided the borrowings are not structured in an artificial way; and
- will not normally apply where a company choosing between different ways of arranging its commercial affairs chooses the course that gives a favourable outcome, provided that tax avoidance is not one of the main objects of the arrangements.

Practical guidance

Approach to enquiries

The description of HMRC's approach to unallowable purpose enquiries reflects what we are seeing in practice. The approach is iterative and evidence-led: HMRC wants to establish 'the full factual context' to understand and test the taxpayer's asserted commercial purposes for the borrowing.

The guidance is clear that contemporaneous documentary evidence will be key. However, the list of contemporaneous documents that HMRC considers it 'reasonable to expect' to see makes some potentially unrealistic assumptions about the documents that will actually be produced and retained in the context of a fast-moving or multi-faceted transaction. That said, taxpayers will welcome the recognition by HMRC that some points may be so obvious that they are not consciously considered or documented, and also that tax department emails might naturally be expected to be tax-focussed. Critically, HMRC acknowledges that the relative importance of purposes should not be assessed with hindsight and that purposes may change over time.

By contrast, evidence of the stated intentions of those involved in contemporaneous decision-making is viewed as 'helpful but not determinative'. On this point, the guidance highlights case law suggesting that a tribunal might similarly prefer contemporaneous documentary evidence to witness evidence. However, it is important to recognise that the case law on this point (while not quoted in the guidance) also confirms that witness evidence still has value, in subjecting the documentary record to critical scrutiny and gauging the motivations of a witness.

Factors HMRC considers relevant to an assessment of tax purpose

The examples (at CFM38190) of situations where HMRC considers that the unallowable purpose rules would or would not normally apply are deliberately nuanced, rather than extreme cases at one end of the spectrum or the other. (Indeed, anyone who has been following the case law in this area is likely to recognise a few of the fact patterns as corresponding to those in decided cases.) Consequently, despite numerous qualifications and caveats, they do provide some practical assistance for taxpayers in working out what HMRC would consider falls within or outside the scope of s 441.

While the guidance does not include any analysis explaining the basis for the conclusions reached in relation to each example, care has clearly been taken in crafting the assumed facts of each case. Read together with the guidance on factors relevant to assessing evidence of a main tax avoidance purpose (at CFM38170), it is possible to draw out some key themes running through HMRC's approach.

Focus on the net UK tax benefit and net global tax benefit

An important point for HMRC is assessing the net UK tax benefit, and the net global (UK and non-UK) tax benefit, arising from the arrangements. This goes beyond looking simply at whether there is a UK tax advantage and focuses more on whether there is UK base erosion – that is, situations where the borrowing creates UK deductions with no or limited corresponding pick-up in the lending jurisdiction.

It is apparent from the examples that there are very few 'net global tax benefit' (or base erosive) cases where HMRC would accept that s 441 would not normally apply. The only exception is Example 3, in which funding for a UK commercial opportunity is provided in the form of debt rather than equity, and is borrowed from a non-resident sister company in a low-tax jurisdiction or with existing tax losses, rather than the non-resident parent. The assumed facts indicate that the commercial (non-tax) reasons for each option are finely balanced, with tax being the deciding factor. It therefore appears HMRC would view this outcome as a straightforward exercise of the 'choice principle'.

Use of the borrowed funds

The technical guidance notes that the use to which the loan or the borrowed funds are put is relevant but not determinative when assessing the company's purpose.

HMRC's practical application of this principle is to ask whether the borrowed funds are being used for activities or investments that do not themselves generate UK tax. This in part seems to be testing the commercial nexus between the debt funding and the UK – accordingly, where the debt funding for the acquisition of shares in a non-UK company has been routed via a UK subsidiary and where there is no obvious commercial nexus to the UK, as in Example 11, HMRC's view is that s 441 would normally apply.

It's notable in this context that several of the examples assume a fact pattern involving the use of the funds borrowed for a 'UK commercial opportunity'. These are all examples in which HMRC considers that s 441 would not normally apply. A 'UK commercial opportunity' is defined as an acquisition of (non-share) assets made by a company with a 'profitable UK operating business, which is fully taxable in the UK'. This suggests that HMRC is generally comfortable with debt funding of asset acquisitions by UK trading companies, but less comfortable with debt funding of share acquisitions by UK holding companies. If that's right, this is not easy to square with the commentary in the Hansard report.

There is also little in the way of acknowledgement that the UK has held itself out as an attractive holding company regime and has specifically enacted reliefs and exemptions to encourage international groups to establish UK holding companies. That said, Example 10 does at least acknowledge that the unallowable purpose rules will not normally apply where an investment manager uses profit participating loans to fund an intermediate asset holding company meeting the test to be a qualifying asset holding company (***QAHC***), even if that company would not have been located in the UK absent the QAHC regime. This conclusion is unsurprising given the UK has been actively promoting the QAHC regime in recent years. What is not clear is whether the same view would be taken in relation to other reliefs and exemptions designed to encourage inward investment or discourage corporate emigrations.

Shareholder debt

A further distinction drawn is between external debt and shareholder debt. It appears that shareholder debt is unlikely to be regarded by HMRC as acceptable, despite the express assumption that all debt is on arm's length terms, unless there are good reasons for routing it through the UK (as in Example 4, which involves the acquisition by a UK operating company of shares in another operating company which is expected to benefit that existing UK business).

Conversely, external debt is generally regarded as acceptable, even where it is being used to fund investments in assets which are expected to attract capital allowances, such that no or minimal UK tax is likely to be paid immediately (as in Examples 5 and 6). And Example 8 confirms that external borrowing to pay a dividend (or repurchase or redeem share capital) will generally be acceptable if this is to meet market expectations on returns.

Complex structuring

Picking up on one of the points made by the Economic Secretary to the Treasury, a key question for HMRC is whether the arrangements are more complex as a result of structuring to achieve the tax advantage. Put another way, would the arrangements have happened, or happened in a different way, 'but for' the tax advantage? HMRC will be keen to understand the answer to this question and the reasons for additional complexity being introduced if that appears to be the result of tax advice. HMRC will also look at how much attention was paid to securing the tax advantages (and may take as a proxy for that the relative magnitude of the fees paid for tax advice).

Basic tax advice seems to be acceptable (e.g., removing limited recourse features from start-up financing for a UK commercial opportunity, as in Example 9). But HMRC will want to test transactions that are unnecessarily or overly structured unless there are clear (non-UK tax) reasons driving the structuring. HMRC says that it will look at the choices made and alternatives considered. A particular area of focus is where identification of the commercial benefits appears to follow on from identification of tax benefits.

Where next?

The case law on the application of purpose-based tests is still developing in a number of areas, as the guidance acknowledges – several of the cases referred to in the guidance are currently under appeal and so it may well require updating in the near future.

As regards s 441 enquiries, the introduction of the corporate interest restriction (***CIR***) for periods of account starting from 1 April 2017 onwards means the impact of s 441 applying is significantly reduced in many cases. The CIR applies a formulaic (rather than purpose-based) rule to disallow debits where the UK debt is excessive compared with the group debt and, as a result, UK groups are much less likely to get deductions for shareholder debt. We might therefore expect the large number of current s 441 enquiries to tail off in the coming years. This is acknowledged in the guidance at CFM38165: if the impact of CIR is such that the debits would in any event be disallowed, HMRC may not enquire into the potential application of s 441 – although if circumstances change and debits disallowed by the CIR are reactivated, the prospect of a s 441 enquiry may be raised at that stage.

But there are plenty of other purpose-based anti-avoidance rules in the tax code (for example, other targeted anti-avoidance rules, the 'wholly and exclusively' test for the deduction of expenditure and the 'principal purpose test' that now appears in a number of double tax treaties) and we are seeing an increasing number of challenges being raised under those. This guidance will provide a useful indication of the situations that HMRC is likely to challenge and of its approach to enquiries in those cases.

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