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HMRC v BlackRock Holdco 5 LLC: transfer pricing and unallowable purpose

The Upper Tribunal (UT) decision in *HMRC v BlackRock Holdco 5 LLC*[1] is of particular interest as a rare instance of a case involving the application of the UK's transfer pricing legislation as well as being the first UT case on how to apply the just and reasonable apportionment provision in the loan relationships unallowable purpose rule.

At heart, the facts of the case are relatively straightforward. BlackRock Inc entered into an agreement to buy the worldwide business of Barclays Global Investors (BGI) for a mixture of cash and BlackRock shares. After taking tax advice from EY, BlackRock decided to make the acquisition of BGI US via a new US incorporated, but UK tax resident, company LLC5. However, due to concerns around, inter alia, the application of the UK's CFC rules, instead of making the acquisition of BGI US directly, LLC5 acquired preference shares in LLC6 carrying 10 per cent of the voting rights and 99 per cent of the economic rights in LLC6 (the "prefs"). LLC6 was a new US incorporated non-UK resident company controlled by LLC5's parent, LLC4 (another non-UK resident company), via a holding of common shares. LLC5 acquired circa $2.2 billion

[1] *HMRC v BlackRock Holdco 5 LLC (BlackRock (UT))* [2022] UKUT 199 (TCC); [2022] S.T.C. 1490.

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in cash and 37.5 million BlackRock shares in consideration for issuing circa $4 billion of loan notes (the loans) and some ordinary shares. LLC5 used the cash and BlackRock shares to subscribe for the prefs and LLC6 used the cash and shares to pay for the acquisition of BGI US. So LLC5 raised nearly $11 billion (in the form of cash and BlackRock shares) through issuing $4 billion of debt and the balance in ordinary shares and which it invested in the prefs, giving it an indirect economic interest in BGI US without control.

HMRC disallowed all of the loan relationship debits arising to LLC5 in respect of the loans either because they were all attributable to an unallowable purpose within the meaning of section 441 of the Corporation Tax Act 2009 (CTA 2009) or under the transfer pricing rules because the loans differed from the provisions that would have been made at arm's length. The taxpayer successfully appealed both the transfer pricing issue and the unallowable purpose issue before the First-tier Tribunal (FTT).

The transfer pricing issue

Before the FTT, both the taxpayer's expert and HMRC's expert effectively agreed that an independent lender would have lent $4 billion to LLC5 on the same terms if they had been provided with a suitable covenant package to secure the dividend flow on the prefs. This covenant package would have included covenants given by BGI, LLC4 and LLC6 as well as LLC5 itself. Where the experts differed was whether or not those covenants would have been given to a third party lender. The FTT held that they would have been and that the taxpayer therefore succeeded in its appeal on the transfer pricing issue on the basis that the actual transaction, being the loans, did not confer any tax advantage when compared with the hypothetical arm's length transaction, being the same loans but with the covenant package.

Before the UT HMRC changed tack, as the UT noted, and argued not that the covenant package would not have been forthcoming at arm's length but that, even if it would have been, it was impermissible to take it into account. Section 147(1)(a) of the Taxation (International and Other Provisions) Act 2010 (TIOPA) refers to the "provision…made or imposed as between any two persons…by means of a transaction or series of transactions" meaning the provision between the borrower (LLC5) and the lender (LLC4). The hypothetical arm's length transaction has to be comparable to the actual transaction in terms of its economically relevant characteristics and, as such, it cannot take into account covenants from third parties such as LLC4, LLC6 and BGI that were not provided in the actual transaction.

The UT agreed and allowed HMRC's appeal on the transfer pricing point. They did not accept the taxpayer's argument that the provision of the covenant package was akin to a third party service; the covenants went to the economically relevant characteristics and could not be taken into account in the hypothetical transaction. The taxpayer also sought to argue that section 152(5) TIOPA, which provides for any guarantee provided by a related company not to be taken into account in considering the hypothetical arm's length transaction, showed the legislation specifically contemplating third-party involvement in the hypothetical transaction. Not so, said the UT. This actually demonstrates that Parliament considered that third-party guarantees did affect the substance of the loan transaction and should therefore be left out of account.

The UT also noted that it was "unclear why Parliament only chose to rule out guarantees",[2] and not covenants, and also that the consequence of all of this was that "LLC5 would not have been challenged if it had gone through the rather artificial exercise in the actual transaction of having covenants in place with LLC4 and LLC6 and BGI".[3] Indeed they also noted that this was potentially open to abuse and could be used unscrupulously.

Analysis of the transfer pricing issue

The writer is not sure that it is unclear why Parliament only chose to rule out guarantees nor that there is any possibility of using covenants for abuse as a result.

The definition of guarantee for these purposes in section 154(4) TIOPA is very wide and includes any arrangement or understanding, whether formal or informal, whereby the lender has a reasonable expectation that in the event of a default by the borrower the lender will be paid out of the asset of one or more other companies. It is clearly driving at the situation where a borrowing is supported, explicitly or implicitly, by the assets of a company other than the borrower. It would include, for example, any form of covenant to pay the lender, or put the borrower in funds to pay the lender, on default.

But that is not what the hypothetical covenant package in this case would have been there for. It would have been there to ensure that the assets of LLC5, being the prefs, were worth what they should have been and therefore could support the borrowing. As it was recorded by the FTT:

> "The preference shares carried an expectation that [LLC5] should receive over USD700m annually in income which would have given it a sizeable debt capacity. The main issue was that the flow of value from BGI US to LLC6 and then to [LLC5] via the preference shares was paid at the discretion of LLC4. Whilst a lender would probably be unlikely to accept this position, it should have been possible for BGI US, and LLC6—with the explicit consent of LLC4—to effectively ratify the legal and financial position to which [LLC5] was entitled."[4]

The real issue in this case is the fact that the non-arm's length transaction seems to have been LLC5's subscription for the prefs. If LLC4, LLC5 and LLC6 had been transacting at arm's length, LLC5 would surely have insisted on ensuring it had the ability to secure the dividend flow on the prefs itself without needing to rely on LLC4. It would have entered into a shareholders' agreement with LLC4 whereby LLC4 would have agreed to exercise its control over LLC6 and BGI to ensure the expected dividends would be paid up and to restrict any transactions that could devalue the prefs. Had they done so, LLC5 could surely have supported the borrowing without needing any third-party covenants.

To assume the ratification (to use the FTT's word) of LLC5's financial position is clearly to put it in a different economic position than it was actually in, by assuming its expected, but unsecured, dividend flow on the prefs was in fact secured and fundamentally changes its borrowing

[2] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [70].
[3] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [72].
[4] *BlackRock Holdco 5 LLC v HMRC (BlackRock (FTT))* [2020] UKFTT 443 (TC); [2021] S.F.T.D. 267 at [78].

capacity. However, viewed thus, it is clearly not objectionable that if the parties had actually done that that it would have been taken into account in determining the hypothetical arm's length transaction. Indeed it seems a bit of a stretch to describe actually doing so as artificial. Presumably LLC5's advisers thought it clear that the substantial shareholdings exemption would apply to any future disposal of the prefs such that they were not too concerned with chargeable gains basis in the prefs. The fact that such basis is generally limited, on a share issue, to the lower of the subscription price paid and the market value of the shares issued by virtue of section 17 of the Taxation of Chargeable Gains Act 1992 is one reason you would generally expect a group to go through that exercise.

Viewed thus, the UT's conclusion that covenants from LLC4 in particular cannot be taken into account in the hypothetical transaction is unsurprising. What is perhaps more surprising is its conclusion that the UT should itself remake the decision on the basis that all of the debits should be disallowed under the transfer pricing rules, rather than remitting the decision back to the FTT.

That seems to rest on the UT's conclusion at [76] of its decision that, having decided that an independent lender would not have made a $4 billion loan to LLC5 without covenants in place, the FTT "should itself have determined that there was no comparable arm's length transaction"[5] and that no provision would have been made as between independent enterprises. It is the UT's conclusion that the FTT should have found that no provision would have been made as between independent enterprises that allows it to remake the decision on the basis of full disallowance, the arm's length provision being simply no loan. But the writer cannot see how that conclusion logically follows.

How does the conclusion that an independent lender would not have lent $4 billion to LLC5 on the same terms without the covenants (which is what the FTT found at [103] of its decision) lead to the conclusion no provision would have been made as between independent enterprises?

Having concluded that the parties would not have entered into the same loans on the same terms and in the same amounts if they had been independent enterprises in the negative, the question the FTT went on to consider, with the help of expert evidence, was would they, as independent enterprises, have entered into the loans at all, and if so, in what amounts, at what rate(s) of interest, and on what other terms? Then, because the experts effectively agreed the loans could have been made on the same terms with the covenants, the focus shifted to whether the covenants would be given. But surely the next step, once the UT has concluded that the covenants cannot be taken into account, is to answer that question with that in mind. Would LLC4 and LLC5, as independent enterprises, have entered into the loans at all, and if so, in what amounts, at what rate(s) of interest, and on what other terms, but without being able to take third party covenants into account?

The writer does not really see the support in either judgment for the UT's conclusion that the answer was simply no. LLC5 effectively paid nearly $11 billion for the prefs (in the form of cash and the BlackRock shares). It had no liabilities. Is the UT saying that no independent lender would have lent it anything at all? Perhaps that is the case but it seems somewhat surprising that that was not remitted back to the FTT to determine as a finding of fact given that the FTT had

[5] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [76].

already noted that "a lender would probably be unlikely to accept"[6] making the actual loans to LLC5, implying one might lend something if the risk were reduced (lower amount) or the reward (interest rate) increased and the fact that the FTT never really got to the bottom of the suggestion by taxpayer's counsel that some of the perceived gaps in shareholder protection that the covenant package was to fill might in any event be covered by provisions of Delaware law.

The unallowable purpose issue

The taxpayer had also won the unallowable purpose issue before the FTT. Here the test was whether the main purpose, or one of the main purposes, for which LLC5 was party to the loans was to secure a tax advantage for itself or any other person.

Before the FTT it was accepted as common ground that the deduction of loan relationship debits in respect of interest was a tax advantage. It was also common ground that it was the subjective purpose of LLC5 that had to be considered in order to determine whether securing a tax advantage was the "main purpose" or "one of the main purposes" for which it was party to the loans.

The FTT also held, following the Court of Appeal in *Travel Document Service v HMRC*[7] (*TDS*), that "main" meant more than "more than trivial", it had a connotation of importance. More controversially, the FTT also found support in the case law on the wholly and exclusively for the purposes of the trade deductibility test, in particular *Mallalieu v Drummond (Inspector of Taxes)*[8] (*Mallalieu*), for looking beyond a "taxpayer's conscious motives" and taking into account the "inevitable and inextricable consequences" of its actions. Consequently although the FTT appeared to accept the witness evidence that the directors took the decision to enter into the loans without taking account of any UK tax advantage, it went on to hold that, as securing a tax advantage was an inevitable and inextricable consequence of entering into the loans, it was a purpose and an important one at that and therefore main.

However, as the FTT accepted that LLC5 also entered into the loans in furtherance of its commercial business of making investments, and that was clearly important too, it also had a main commercial purpose. It was therefore necessary to apportion the debits between the unallowable purpose and the commercial purpose on a just and reasonable basis. The FTT purported to do this by applying the (obiter) approach adopted by Judge Beare in *Oxford Instruments UK 2013 Ltd v HMRC*[9] (*Oxford Instruments*) and held that as the witness evidence was that LLC5 would have entered into the loans even if there had been no tax advantage in doings so, the tax advantage purpose had not increased the debits arising to the taxpayer and, as such, they should all be apportioned to the commercial purpose.

This gave both the taxpayer and HMRC something to argue about before the UT. The taxpayer argued that the FTT erred in finding that it had an unallowable purpose given its finding that it did not have a conscious motive of obtaining a tax advantage. This was "super-para 13", an abandoned 2007 proposal to extend the unallowable purpose rule to situations where a loan which did not have a tax purpose was part of wider arrangements which did, by the backdoor.

[6] *BlackRock (FTT)* [2020] UKFTT 443 (TC) at [78].
[7] *Travel Document Service v HMRC* [2018] EWCA Civ 549; [2018] S.T.C. 723.
[8] *Mallalieu v Drummond (Inspector of Taxes)* [1983] S.T.C. 665; [1983] 2 A.C. 861 HL.
[9] *Oxford Instruments UK 2013 Ltd v HMRC (Oxford Instruments)* [2019] UKFTT 254 (TC).

The FTT should have stuck to applying the principles laid out in *TDS*, the only authority on these provisions, and erred in taking into account the "inevitable and inextricable consequences"[10] of the loans.

The UT found that the FTT had misapplied *Mallalieu* but did not think that there was a material error in its finding that LLC5 had an unallowable purpose. Although it was LLC5's actual subjective purpose that was relevant, the FTT was entitled to look beyond the directors' stated intentions to determine this. Particularly where, as here, the directors had been specifically told to put any tax advantage out of their minds in considering the transaction. The UT thought there was "ample evidence"[11] to support the finding that securing a tax advantage was a main purpose of the creation of LLC5 "and thereafter, its intention and purpose in entering into the Loans".[12]

Similarly, the UT also considered there was sufficient evidence to support the finding that LLC5 also had a main commercial purpose, which HMRC had challenged.

Which brought the UT to just and reasonable apportionment. HMRC argued, and the UT agreed, that the FTT had misapplied *Oxford Instruments*. If it had been applying *Oxford Instruments*, the FTT would have asked if the debits would have existed at all if the benefit of the tax relief had never existed. To which the answer was no. There would have been no loans and no LLC5 without the tax benefit. The test is an objective one and the FTT was wrong to apply a subjective test simply asking whether the transaction would still have proceeded if the tax benefit had been withdrawn at the last minute. Consequently, in the UT's view, all of the debits should have been attributed to the unallowable purpose not the commercial purpose.

Analysis of the unallowable purpose issue

When the loan relationships unallowable purpose rule was first introduced, in 1996, it created a great deal of uncertainty which the then Economic Secretary sought to address in comments recorded in *Hansard* (28 March 1996) and still reproduced in HMRC's published guidance today (CFM38170). The general theme of the comments was reassurance that companies choosing a more tax efficient route to achieve their commercial outcomes would not trigger the rule and that it was aimed at egregious tax avoidance schemes only:

> "Companies that enter into schemes with the primary aim of avoiding tax will inevitably be aware of that. The transactions we are aiming at are not ones which companies stumble into inadvertently. As one top tax adviser said recently, companies will know when they are into serious tax avoidance; apart from anything else, they are likely to be paying fat fees for clever tax advice and there will commonly be wads of documentation."[13]

That did not sit easily with the approach of the FTT, in particular in looking beyond the conscious motives of the taxpayer to the inevitable and inextricable consequences of its actions.

[10] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [161].
[11] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [167].
[12] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [167].
[13] HMRC, Internal Manual, *Corporate Finance Manual* (16 April 2016), CFM38170, "Loan relationships: tax avoidance: unallowable purpose: application: Hansard report", *https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm38170* [Accessed 13 October 2022].

If an interest deduction is always a tax advantage,[14] given that an interest deduction should always be an inevitable and inextricable consequences of entering into an interest bearing loan, that implied that any company taking on any borrowing necessarily had a purpose of obtaining a tax advantage, whether consciously or not. Further, "important" here must, if it is to be capable of application where the taxpayer does not have a conscious tax purpose, relate to size. So the implication from the FTT's decision was that any company taking out a large loan necessarily had a main purpose of obtaining a tax advantage and only received its tax deduction because the debits would, on a just and reasonable basis, be wholly attributable to its conscious commercial purpose.

That seemed clearly wrong and the UT's correction of that approach is welcome. It is the taxpayer's actual subjective purpose, and only the taxpayer's actual subjective purpose, which is relevant. What may yet give the taxpayer something to go after on a further appeal is whose purpose is relevant here. On the evidence, a lot of the tax planning predated LLC5 coming into existence. However, the UT had tried to address that by looking at the extent to which LLC5 and its directors became aware of the planning after it had come into existence and adopted the group's purposes as its own subjective ones.

On just and reasonable apportionment, the writer always felt there was something odd about the FTT's conclusion that you could have a main purpose of obtaining a tax advantage, in the form of debits for the interest on the loans, yet apportion none of those debits to the main purpose of obtaining them. That seemed to be a way of fixing the problem the FTT created for itself when it found the taxpayer had an unconscious purpose.

But the UT's decision suffers the same problem in reverse. It is also quite odd to find the taxpayer was party to the loans for a main commercial purpose, yet apportion none of the debits to it. Is it really an important (main) purpose if you cannot attribute any debits to it?

That potentially seems to be the issue here. The UT is very clear that the commercial purpose was a mere "by-product or consequence" of the tax purpose: "The commercial purpose of LLC5 and the Loans would not have occurred but for the tax purpose".[15] In *Oxford Instruments* the taxpayer issued a $140 million promissory note carrying a 5.5 per cent coupon to invest in $140 million preference shares carrying an 8.1 per cent coupon, thereby generating a spread for the taxpayer. Judge Beare found that the sole purpose for which the taxpayer was party to the note was to secure a tax advantage, in the form of the deduction for the interest on the note. The deduction was needed to offset interest income arising elsewhere in the structure. He found that:

> "as a matter of the subjective intentions of the directors of the Appellant, obtaining the spread did not itself constitute a self-standing purpose in its own right. Instead, it was merely an inevitable known consequence of their resolving to enter into the transactions whereby their tax advantage purpose could be secured".[16]

[14] Accepted as common ground by the parties in *BlackRock* but potentially open to debate if you follow the "Wilberforce comparator" school of thinking, following the reasoning of Lord Wilberforce in *IRC v Parker* 43 T.C. 396; [1966] A.C. 141 HL.
[15] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [194].
[16] *Oxford Instruments* [2019] UKFTT 254 (TC) at [105(17)].

The writer cannot help but feel that, given a freehand, the UT would similarly have concluded that investing in the prefs was not a self-standing purpose in its own right for LLC5 either and that LLC5 was party to the loans only for an unallowable purpose. Which would have avoided any need to make a just and reasonable apportionment and the odd conclusion that all of the debits are attributable to one main purpose and none to the other main purpose.

However, as the finding that LLC5 did have a main commercial purpose was a finding of fact by the FTT, it was not open to the UT simply to take a different view from the FTT on the evidence found. As the UT itself put it:

> "the question before us when exercising an "error of law" jurisdiction is not whether we would have made the same decision as the FTT…The test is whether the FTT's factual findings or evaluative judgment were within a reasonable range of conclusions that a properly directed tribunal could have made on the evidence available to it".[17]

Chicken or egg

Having found for HMRC on the transfer pricing issue, the UT noted that that rendered the unallowable purpose issue immaterial to the outcome of the appeal. This does not mean that the transfer pricing rules fall to be applied before the loan relationships unallowable purpose rule just that, with HMRC having won on the transfer pricing issue, it would not matter to the overall outcome of the appeal whether or not the taxpayer won on unallowable purpose.

The profits and losses of LLC5 only fall to be calculated as if the arm's length provision had been made or imposed instead of the actual provision (i.e. the loans) if "the actual provision confers a potential advantage in relation to United Kingdom taxation" on LLC5 (section 147(2)(b) TIOPA). Under section 155(2) TIOPA an actual provision confers a potential advantage if "disregarding this Part [i.e. the transfer pricing rules]" the effect of imposing the actual provision instead of the arm's length provision is to reduce the profits or increase the losses of the taxpayer.

Consequently, because the UT found against the taxpayer on the unallowable purpose issue, it must be the case that all of the debits were, in fact, disallowed by the unallowable purpose rule. The loans would not have conferred a "potential advantage" because, ignoring the transfer pricing rules, all of the debits would still have been disallowed under the unallowable purpose rule. So the transfer pricing rules do not apply.

If, however, the taxpayer had won on the unallowable purpose issue, the loans would have conferred a potential advantage and the debits would instead have been disallowed by the application of the transfer pricing rules.

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[17] *BlackRock (UT)* [2022] UKUT 199 (TCC) at [136].

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