SLAUGHTER AND MAY/

**Tax News Podcast**

**Special Episode: Unallowable Purpose Rule in the UK's Loan Relationships Regime**

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| **Tanja Velling** | Hello. I'm Tanja Velling, co-host of Slaughter and May's regular Tax News podcast, and I'm delighted to welcome you to this special edition about a tax rule that could impact M&A financing structures, intra-group reorganisations and many other things.<br><br>Here, I am, of course, talking about the unallowable purpose rule in the loan relationships regime, and this podcast is going to discuss the developments in three important cases – the Court of Appeal decided all three of them this year – they are *BlackRock*, *Kwik-Fit* and *JTI*, and I am joined by two of our tax partners, Dominic Robertson and Charles Osborne.<br><br>Dominic, Charles, before we get started, do you quickly want to introduce yourselves? |
| **Dominic Robertson** | Yes, of course. Thank you, Tanja. I'm Dominic Robertson one of the tax partners at the firm and one of our co-heads of Tax Disputes.<br><br>We've seen a lot of questions from clients in relation to the unallowable purpose rule over the last few years, both taking account of disputes where people are asked about this, but also people looking at how they structure acquisitions and whether that's affected by these rules and the cases we're talking about today. |
| **Charles Osborne** | And I'm Charles Osborne another one of the tax partners at the firm. |
| **Tanja Velling** | So, Charles do you want to take us through how the unallowable purpose rule works? |
| **Charles Osborne** | Sure. As will come as no surprise, under our legislation, companies get to deduct interest payments when calculating their overall corporation tax profits. The unallowable purpose rule in section 441 turns off a company's ability to do that where it holds the loan in question for a main tax avoidance purpose and the deductions are attributable to that tax avoidance purpose. |
| **Tanja Velling** | And what can we learn from the cases about when a court or tribunal is likely to find that there is a main tax avoidance purpose? |
| **Charles Osborne** | One of the important things to realise here is that, traditionally, all sorts of structuring was thought to be fine for the purpose of this rule and people used to structure deals and acquisitions of companies such that they had loans going into the UK, allowing them to get significant deductions and use those in their wider UK group, and that was traditionally thought to be totally fine – until even a few years ago.<br><br>The rules now are being interpreted by the courts slightly differently. A quite standard structure would be that a US group looking to acquire a business, either in the US |

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| | itself or the UK or elsewhere, interposes a UK company as a BidCo into which it places some debt. If the purpose behind putting that UK company in place and the loan into the UK company is to get significant tax deductions that can then be surrendered around the UK group, the courts are now looking at the facts involved in that decision and often interpreting those in such a way to say that there is a main purpose of getting those tax deductions and disallowing, therefore, those tax deductions under this rule. |
| **Tanja Velling** | And those are of course almost the facts exactly in *BlackRock* and *JTI* where, in both cases, we had a US group acquiring a US target and then, interposed in the acquisition structure, there was a UK tax resident company. In *JTI,* it was also a UK-incorporated company which directly made the acquisition whereas, in *BlackRock*, it was a US LLC (UK tax resident) which sat above BidCo and got the majority of the economic benefit from the acquired group and BidCo, but it didn't have control. And so, some people had thought that, actually, in *JTI*, the facts (in a way) were better than in *BlackRock* because you had a direct acquisition, but still the court found against the taxpayer. What can that tell us? |
| **Dominic Robertson** | I think what this tells us is that, historically, a lot of advisers would have said this rule operates as a subjective test (and that is still the case after these cases) and it's looking at the subjective purpose of the company which borrows the money.<br><br>And so, a lot of advisers, historically, would have looked at a case like *JTI* and said: well, if you look at that company, the new company, as a given, you say: well, that company now exists, you ask subjectively why did it borrow the money? You would say: well, it has a commercial main purpose of doing so which is to acquire the target company and that you don't take account of the broader circumstances around the creation of the company and the structuring that had been put in place by the wider group.<br><br>That's clearly no longer the case. It's still right, after these cases, that this is a subjective test and it's a test which looks at the purpose of the borrower. But the way that that is then described in the cases is the sort of reasoning which sometimes gives lawyers a bad name because you are told that it's a subjective test, you're told it's the purpose of the borrower, but then you are told that that purpose can include looking at the purposes of other entities, and it's not determined simply by asking the decision-makers what their purpose was. In one sense, that must be right: it can't be the case here that you simply ask the directors: did you have a main purpose of getting interest deductions? No; case closed. But what you have now got is a rule where there is the ability to look more broadly than the company itself, but the precise boundaries of that remain still slightly unclear. |
| **Tanja Velling** | So then, once you've established that there is a main tax avoidance purpose, as Charles has explained, interest deductions would be disallowed to the extent they are attributable to that purpose. How does this attribution work – especially when there is also a commercial reason for the borrowing? Can you save some deductions by apportioning them to the commercial purpose? |

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| **Dominic Robertson** | So, you've got three slightly different decisions in each of these cases.<br><br>In *BlackRock*, you have a decision that the company had both a tax avoidance purpose (getting the deductions) and a commercial purpose (acquiring the company).<br><br>*JTI,* which superficially looks like a very similar case: decision of the First-tier Tribunal was that there was no commercial purpose for the company in borrowing the money and that was upheld at the Court of Appeal. So, in that case, apportionment becomes very easy. There is no commercial purpose, so 100 per cent. of the interest deductions are disallowed.<br><br>In *BlackRock*, you had two purposes: you had the tax avoidance purpose of getting the deductions; commercial purpose of buying the shares. What the courts endorsed is what they've called a "but-for" causation test which says: in attributing the debits between the different purposes, you ask yourself: what would the deductions have been but-for your tax avoidance main purpose? And in *BlackRock*, what they then said was: well, but-for that purpose, this company would never have existed. It was clear from the broader email evidence from the group that this was created to achieve a debt push-down into the UK, and therefore, but-for the tax purpose, there would have been no interest deductions. Therefore, you allocate 100 per cent. of the interest expense to the bad purpose, zero per cent. to the good purpose.<br><br>I'm not sure that's always an easy test to apply, this but-for test, because you could see an argument (in fact, an argument made in *JTI*, ultimately irrelevant) that you would say: well, there are two things which are but-for causes of the deduction, one is the tax avoidance purpose, but the other is the commercial transaction which is buying the shares.<br><br>*Kwik-Fit* is a bit different to the other two cases.<br><br>*Kwik-Fit* was a transaction where you had a series of pre-existing loans where the creditor side was moved to companies in the group that had carried-forward losses and could shelter interest with those carried-forward losses. The interest rate on those loans that were moved was then significantly increased. So, you were using the carried-forward losses more quickly. And, as part of the transaction, a couple of new loans were created.<br><br>In that case they held, as regards the new loans, that they only had a tax avoidance main purpose and, therefore, 100 per cent. of the interest deductions were disallowed, subject to one point I'll come back to. In the case of the existing loans, they clearly had an existing commercial purpose; they had been advanced for good commercial reasons, historically. What the court held there is: well, the excess interest deductions, so the interest expense attributable to the rise in interest rates, had a bad purpose. The existing interest deductions were not tainted by the unallowable purpose and continued to be deductible. |

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| | The other point on *Kwik-Fit*, which I actually just think is really weird as an outcome, is the court said: well, once you have actually used up all the carried-forward losses in the creditor company, at that point, your bad purpose for the loan disappears and 100 per cent. of the interest deductions at whatever interest rate you're charging are attributable to your commercial purpose not your unallowable purpose. It's a fair outcome, I think, for the taxpayer, but it is a slightly surprising outcome technically when you say: well, the loan, if it continued in existence and it only had a tax avoidance purpose historically, why does that suddenly get cured once the creditor uses up its carried-forward losses? |
| **Tanja Velling** | Obviously, with apportionment as well as the determination of the purpose to start with, one key factor would be the evidence. Dominic, you've already mentioned that you've had clients who came to you in respect of disputes in relation to the unallowable purpose rule. And so, can you or Charles take us through what happens in a dispute scenario? |
| **Charles Osborne** | A dispute here is the same in many ways as a dispute with HMRC in any other area.<br><br>An enquiry is opened as usual or HMRC ask informal questions. At that stage, the process is an information gathering exercise, and as people will be familiar from other dispute areas, these days HMRC are no longer happy to take evidence that is superficial and just look at things like the board minutes of the company as evidence of someone's intention.<br><br>They are now interested in gathering far more detailed evidence including emails of people involved to look at their subjective intentions, various slide decks, anything that was sort of put together in the process of actually implementing the structure. So, the information gathering exercise and the process of interacting with HMRC at the beginning is now far more involved and detailed than it was before, and of course, people might be tempted to not play ball and provide evidence, especially seeing that some of that is an incredibly involved process, but HMRC do have a wide range of powers to compel people to provide evidence and they will use that, if people don't play ball.<br><br>So, I think, generally speaking, in our experience, it's far better to actually co-operate and be helpful in the process of dealing with HMRC. |
| **Dominic Robertson** | Yeah, and if you are looking at the subjective purpose of the decision-makers, and very often you are looking at this for transactions which happened several years ago, HMRC understandably will want to look at contemporaneous documents and not just formal documents like board papers, but actually informal communications.<br><br>So, one of HMRC's favourite cases at the minute is a case called *Credit Suisse v Gestmin* which basically says (slightly over-exaggerating) that witness evidence is worthless because they say: well, witnesses inevitably have difficulty recalling precisely what happened a long time ago and, therefore, you should pay much more attention to documentary evidence from the time, in particular emails, instant |

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| | messages, etc. because they can shed real light on what's actually happening behind the scenes.<br><br>And certainly if you look at *BlackRock* itself, it always seemed to me one of the most unhelpful facts for BlackRock is that, shortly after the third-party acquisition was signed and before the UK company came onto the scene, you had an email from the head of tax at the taxpayer saying, where can we do debt push-downs, followed shortly afterwards by a proposal to bring a UK company into the acquisition structure. It's very difficult then to say: well, we were not doing this to achieve a debt push-down, i.e., to get interest deductions into the UK. So, HMRC very much want to see email evidence.<br><br>The scope of those requests at the moment is a real challenge. We are seeing a couple of trends in this.<br><br>• One is HMRC are defaulting to sending people formal information notices, so-called Schedule 36 notices, rather than proceeding through informal information requests and only using Schedule 36 notices if taxpayers don't play ball. Largely, I think that is so that they have a sanction if something is not disclosed (deliberately or inadvertently) because they can then say: well, we served you this notice, you had to comply – you haven't, here's a penalty.<br><br>• And the scope of what is requested in those notices is, at the moment, very wide. So, HMRC will simply say: please provide all emails involving very large numbers of people which relate to the transaction over potentially several years. That can be hundreds of thousands, if not, millions of emails. |
| **Charles Osborne** | And of course, some people might be tempted to comply on the literal terms of the notice because dumping HMRC with a huge amount of emails is going to be difficult for HMRC. Taxpayers need to be aware there are a couple of issues with that as well.<br><br>• One, taxpayers will generally, depending on where they are based, have obligations to actually strip out certain types of emails because they have private and confidential information from the employees involved.<br><br>• And of course, they might want to be aware of their privilege rights over some of the emails and not hand over emails that would otherwise be privileged.<br><br>• The obvious other point that taxpayers should really think about before handing over emails is: it's probably helpful for them to understand what's in the emails before they hand them over. |
| **Dominic Robertson** | I think one other point just on the temptation to data dump every email from the people's inboxes. I fear, in addition to the points that you've just made Charles, if you did that HMRC would also say: well, you have actually provided us with a whole load of irrelevant material. |

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| **Charles Osborne** | And you and I have actually seen an enquiry where, after the initial request when HMRC were told about the number of emails that fit the criteria they were asking for, they were absolutely horrified by the idea. So, there has to be hopefully a sensible discussion at some point. |
| **Dominic Robertson** | You can have that dialogue with HMRC. It's very helpful to be able to give them that sense of the scale of the request and the scale of the material they may have to wade through.<br><br>If you get a formal information notice, you are able to appeal that to HMRC, and it's generally a very good idea to do that – not with a view to saying: well, we are immediately going to head off to the tax tribunal and litigate the breadth of this information notice, but simply to give you that forum to discuss and narrow the issues rather than being told: well, you're just stuck with it, you've got a notice and you now have to comply. |
| **Tanja Velling** | So, if I was to summarise, the key message here, from a taxpayer's perspective, is to get a handle on the evidence at an early stage, know what is on your system, know what HMRC might want and to engage with HMRC to, where possible, narrow down overly broad information requests.<br><br>But then, say the enquiry progresses and you get to a point where the case is going to go to court. We know the First-tier Tribunal is the fact-finding tribunal in the UK's tax court system and it's very difficult to overturn any factual findings and conclusions drawn by the First-tier Tribunal. What does that mean for taxpayers? |
| **Dominic Robertson** | There was a case which gets cited in almost every Upper Tribunal appeal now: a case called *Fage* which says the First-tier Tribunal hearing is "the first and last night of the show" and that's I think a slight exaggeration, but on points of fact it is clearly right.<br><br>It's crucial that you devote a lot of effort and resource to putting your case forward as strongly as possible at the First-tier Tribunal stage. If you have adverse findings against you at that stage on the facts, it is in practice going to be very difficult to overturn that on an appeal, unless you can identify some obvious error of law. |
| **Charles Osborne** | And we can see that in the unallowable purpose cases currently. In the *JTI* case, in particular, the Court of Appeal engaged with this question at some length about the findings of the First-tier Tribunal and it seems clear from what they are saying that, to some extent, they are slightly surprised by the findings of the FTT, but they were reluctant to overturn them despite pointing out that, you know, there were some slightly strange conclusions around the fact that there was no commercial purpose to the loan. So, it's a perfect example especially in this type of case of where you really do need to make sure that you get your facts out as strongly as you can in the FTT hearing. |

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| **Dominic Robertson** | Both in the terms of the documents but also in terms of the witness evidence at the FTT. I think one of the points which hurt JTI is that, certainly reading the First-tier Tribunal judgment, the tribunal judge was not impressed by the lead witness for the taxpayer and the reasons which he gave for the structure and the acquisition and that then very much plays into these superficially odd findings that there is no commercial purpose to a loan to buy 100 per cent. of a very valuable company. |
| **Tanja Velling** | We've now considered what HMRC might expect to see during an enquiry and points around the fact-finding instance in the judicial process. But perhaps we should go back to an earlier stage for a moment. What should I be thinking about when putting in place a funding structure? |
| **Charles Osborne** | It's the flip side to everything we've already talked through. Taxpayers need to be aware that people's emails will be relevant if an enquiry is opened.<br><br>And so, the people engaged in this process of actually implementing a structure, of putting in place the loan, the directors of the various companies, the tax function of the various companies – what they say in their emails is going to be fair game in front of the tribunal. So, people need to be very clear about that.<br><br>And I think there's also a question as to what people should think about at board level when implementing these structures because, of course, what is clear from the cases is that, as Dominic said earlier, it is the subjective intention of, or purpose of, the taxpayer borrower company. Now, that means that, instinctively and initially, the court will look at what the directors of that company were considering when they were entering into the borrowing, and that means more than just the board minutes at the time. But it does mean that the board minutes are relevant, and what was discussed at the relevant board meetings is very important, and one question that I think we do get asked from time to time is: does that mean actually it's better for the board to simply not discuss tax purposes and tax benefits involved in taking out a borrowing? Because, of course, if they don't discuss this and it's not in their mind or they are never told about it, how can they have a tax purpose?<br><br>That's just not right, unfortunately, based on how the courts have interpreted this. As Dominic said, you do look at the wider context of why the borrowing is being entered into which does involve looking beyond the taxpayer company and so, if you simply don't discuss it and the board just enter into it because that's part of a wider plan for the group, that won't save you as the taxpayer here.<br><br>So, I think actually it's more important that people do address tax benefits of entering into the loan. There will always be a tax benefit, arguably, in the sense that you will get deductions if you do the right thing and you're not prevented from taking them under these rules. The more important point is that the borrowing is being entered into not because of a tax avoidance main purpose but because of a commercial purpose that outweighs that. |

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| **Tanja Velling** | What does this mean now for when you're planning an acquisition? Can you still use a UK BidCo? |
| **Charles Osborne** | As the cases are clear, and in some ways rather unhelpfully, whether the rule applies or not is totally down to the facts. You are looking at the subjective purpose of entering into the borrowing and the wider context of that. That does not necessarily mean that you cannot use a UK acquisition vehicle with some debt in it in order to acquire a company, but the broader context is going to be crucial. It does feel like a situation, where a new BidCo in the UK is incorporated and debt is pushed down into that vehicle in order to acquire a non-UK business with no real other purpose other than getting tax deductions in the UK, will no longer be a viable route, if you expect to get those tax deductions. I think that's clear from the cases. |
| **Dominic Robertson** | Yeah, I think if you look at *BlackRock* in particular, Lady Justice Falk is at pains in that judgment (para 171) to try to limit the impact of *BlackRock* on what you might call more ordinary acquisition structures. So, she expressly says this is fact-specific. If you look at *BlackRock* compared to other acquisition structures, what she sees as the big differences are:<br><br>• Well, firstly you've added a debt-funded UK company into what is otherwise an entirely US ownership chain: US parent, US company signed the third-party purchase agreement, US target business, but UK company ended up in the middle of the chain. There was no rationale in that case for inserting the UK company as a BidCo; looking on a group-wide basis there was no rationale for that company other than tax.<br><br>• And then *BlackRock* (but not *JTI*), I think, was also then helped by the fact that they then did an awful lot of structuring to ensure that the UK purchaser acquired the economics of the target, but not voting control, which looks like another bell and whistle, which gets you into difficulty.<br><br>If you have a situation where you have a foreign business looking to acquire a UK target or a private equity business looking to acquire a UK target and they set that up using a UK BidCo and they put an arm's-length amount of debt into UK BidCo to help fund the acquisition, it seems to me that that is very, very different.<br><br>Clearly, all the points that Charles and I have made around unhelpful email evidence and board papers still need to be borne in mind, but you are in a very different position, if you say: well, we are buying a UK target group. Lots of people, if it's a completely UK structure already (UK purchaser buying UK target) they would probably debt fund that somewhere; that's very different to saying: well, we are just going to insert a UK company for no purpose other than tax. |
| **Charles Osborne** | I think the structures that are going to become really difficult to work out which side of the line you are on, though, are where you are acquiring a non-UK business, but you might have some sort of broader purpose for choosing to have UK BidCos and HoldCos in the stack of companies used to acquire that business. So, for example, if actually you have a strong presence in the UK and you have traditionally used UK |

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| | BidCos to buy companies in Europe because your EMEA headquarters is based in the UK, whether that is a problem or not under these rules is going to be incredibly difficult and come down to the specific facts. But I can see that's going to be the slightly uncomfortable situation as opposed to the extreme ends where you have totally, artificially inserted a UK company with no other connection to the UK to acquire a non-UK business. |
| **Tanja Velling** | I think, we are probably reaching the end of the podcast. So, Dominic, do you want to summarise the three most important points to take away? |
| **Dominic Robertson** | For me, the three most important points here:<br><br>• One, although the unallowable purpose rule remains a subjective test, that does not mean you look at the company, the borrower, in a vacuum; you have to have regard to the wider purposes of the group.<br><br>• Two, the case law does not mean, as some of the more alarmist commentary suggests, that actually you never get UK deductions for acquisitions. We think, as we've discussed in this podcast, we think there are lots of situations where you would still get UK interest deductions for a share acquisition. It very much depends on the facts, and the facts in *BlackRock* and *JTI* are at the slightly more extreme end of the spectrum.<br><br>• And thirdly, a point which I think everybody always makes about the unallowable purpose rules: because it is a fact-specific test, getting the right evidence in place to support your purpose at the time, thinking about what at the time you can put together as a pack of information you can immediately show HMRC, if they ask about the transaction in due course, is important. But also bearing in mind when you get to an enquiry that you will need to run the information gathering and disclosure process very thoughtfully and very efficiently to make sure that that does not overwhelm the taxpayer organisation or indeed HMRC. |
| **Tanja Velling** | Well, thank you, Dominic, and thank you, Charles. And thank you for listening. I hope you enjoyed this discussion as much as I did and if you would like to discuss the unallowable purpose rule or the cases and what they mean for your business, please do contact Dominic, Charles or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May tax department can be found on the European Tax blog, www.europeantax.blog. You can also follow us on X: @Slaughter and May Tax, and remember to subscribe for our regular Tax News show. The next episode will be out soon. |