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JTIAC reaches the Upper Tribunal

Onward, through the Slough of Despond, but for which purpose?

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Analysis

JTIAC reaches the Upper Tribunal: onward, through the Slough of Despond, but for which purpose?

Speed read

Three observations can be made from the Upper Tribunal's judgment in *JTIAC*, in which the UT rejected the taxpayer's argument that the existence of a genuine commercial purpose precluded the operation of the unallowable purpose rule. First, while it is clearly right that the FTT must view evidence critically, it is questionable how far the FTT should go – and whether, in the instant case, the FTT's construction of JTIAC's purpose was too 'aggressive'. Second, if the UT's decision ultimately stands, HMRC are likely to have widened the scope of the unallowable purpose rule by inferring that a 'group purpose' constitutes a 'main purpose'. Third, even in light of HMRC's recently revised guidance, it remains difficult to determine where HMRC draws the line between what is acceptable and what is not – and, more generally, HMRC appears to be being given space to 'legislate by guidance' using criteria devoid of any statutory basis.

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Those advising the taxpayer in the case of *JTI Acquisitions Company (2011) Ltd v HMRC* [2023] UKUT 194 (TCC) may be forgiven for feeling that, like John Bunyan's hero Christian in *The Pilgrim's Progress*, they are sinking in the mire weighed down by 'fears, and doubts, and discouraging apprehensions'– and, therefore, for dreaming of succour in the shape of the tax law equivalent of the surface mining equipment in which the taxpayer group specialises.

The brief facts are that JTIAC was incorporated as a bid vehicle to acquire a genuinely valuable non-UK resident company as part of an arrangement, involving the use of a Cayman company to side step the anti-arbitrage rules (which preceded the hybrid and other mismatch legislation), intended to enable group relief to be accessed using debits accruing from arm's length interest paid by JTIAC.

Out of eight grounds of appeal, the taxpayer succeeded on only one ground and that made no difference to the outcome.

The key question of construction before the Upper Tribunal (UT) was whether the unallowable purpose test in CTA 2009 ss 441–442 asks:

- 'what was the purpose of entering into that loan relationship by the appellant?'; or
- 'why was the appellant, rather than someone else, party of the loan relationship?'

The UT rejected the 'over compartmentalised and narrow interpretation' put forward by counsel for the taxpayer in support of the first question. The UT concluded that a tribunal should look at all the facts and circumstances in identifying a company's main purpose, there is no rule that, as a matter of law, the unallowable test is inapplicable to arm's length finance costs for a commercial acquisition and that the use to which a borrowing is put is relevant but not determinative. This approach to statutory construction more or less doomed each of the challenges made on behalf of the taxpayer to the First-tier Tribunal's (FTT's) finding of fact. The taxpayer's sole success was to convince the UT that the FTT's rationalisation, undertaken on the FTT's own initiative, of the proposition that the identification of a main purpose precluded the need to undertake a 'just and reasonable' apportionment to an unallowable purpose was 'difficult to follow' and had fallen into error.

So, what are the practical takeaways from this decision?

Three observations come particularly to mind: the first relates to the importance of evidence and how that evidence is approached by the FTT and the second and third relate to how this decision sits against the backdrop provided by HMRC's revised 9 May 2023 guidance ('May 2023 guidance') on the unallowable purpose rule.

> Where 'purpose' is at stake, the lodestar should surely be the House of Lord's confirmation in *IRC v Brebner* that purpose is a subjective matter [and so] evidence as to directors' actual thought processes should be the primary focus of a FTT's investigation ... A tribunal that loses sight of this should be treated as having gone astray

No genuine decision making

Firstly, the FTT's finding that there was no genuine decision making at the UK level, coupled with its decision to largely disregard oral evidence given by Mr Olsen, one of the taxpayer's directors and the group's CFO, was of critical importance.

It is perhaps not entirely surprising that the taxpayer struggled before the high bar necessary to convince the UT that it was not open to the FTT to find the facts that it did, or that the FTT had acted unfairly in rejecting Mr Olsen's evidence despite that evidence not having been challenged before the tribunal.

However, given how critical a FTT's role is when identifying (one might almost say 'constructing' after the event) what is deemed to have been the purpose of an entity which is (in effect) a legal fiction, it is perhaps worth stepping back a little to consider what the approach should be to assessing such important (and colourable) evidence.

An interesting, albeit subtle, difference in emphasis between the argument seemingly made by Elizabeth Wilson KC for HMRC before the UT in *JTIAC* and the May 2023 guidance (now in HMRC's *Corporate Finance Manual* at CFM38000 onwards) is that the May 2023 guidance refers simply to *Gestmin* [2013] EWHC 3560

(Comm) and another case (*Kimathi* [2018] EWHC 2066 (QB)), whereas the UT's decision refers also to the Court of Appeal's judgment in *Kogan* [2019] EWCA Civ 1645. *Kogan* concerned relatively informally documented interactions between individuals – and, as such, does not offer much direct assistance in a corporation tax context. However, where *Kogan* is useful is in the Court of Appeal's unanimous view that *Gestmin* is not to be taken as laying down any general principle for the assessment of evidence – thereby hinting at the importance of a context-sensitive approach.

When transposed to a corporation tax context, the question *Kogan* begs, which the UT in *JTIAC* does not appear to have engaged closely with, is precisely what approach to the assessment of evidence is appropriate when considering alleged tax avoidance not involving fraud or tax evasion?

While it is clearly right that the FTT must view evidence critically, how far should it go?

The feeling that the FTT in *JTIAC* may have trodden too heavily (with feet (*pedes*) of lead (*plumbeos*), rather than feathers (*plumeos*), as the great lawyer pope Boniface VIII might have put it) may be illustrated through comparison with a recent case concerning residence: *Development Securities plc*. *Development Securities* had a somewhat bruising passage to a divided Court of Appeal; *Development Securities*' relevance here, it is suggested, stems from the fact that locating 'central management and control' raises similar evidential challenges in seeking to elucidate the mental processes and role of directors (for example, identifying whether they submit to group 'influence' or 'instruction') as a tribunal tends to encounter in an unallowable purpose case.

The FTT in *Development Securities* [2017] UKFTT 565 (TC), in a decision that Newey LJ would subsequently praise as 'very full and conscientious' ([2020] EWCA Civ 1705, para 15), picked its way through extensive findings of fact made following a ten-day trial including oral evidence, taking a much more nuanced approach than the FTT took after a three-day trial in *JTIAC*. However, Nugee LJ observed ([2020] EWCA Civ 1705, para 101) of the FTT's findings that it would represent a 'significant departure' if a local board of directors of a company had actually met, had understood what they were being asked to do, had understood why they were being asked to do it, had decided it was lawful, had reviewed for itself the transactional documents, had been found not to have acted mindlessly, but was nevertheless been found not to have exercised centralised management and control. Nugee LJ's 'considerable reservations' as to such a line of reasoning led him to suggest an alternative way of rationalising the FTT's conclusion with respect to how central management and control had been exercised. Residence and purpose are, of course, different issues but there is, it is suggested, an echo between the unease that underlies Nugee LJ's admonitory comments with respect to the FTT's seeming willingness in *Development Securities* to disregard the actions of directors as established (in part) from oral evidence and the approach taken by the First-tier in *JTIAC*. As in *Development Services*, so in *JTIAC*, there would appear to be room for the Court of Appeal to take a very close look at how the FTT approached the evidence before it and precisely what it did with that evidence.

Where 'purpose' is at stake, the lodestar should surely be the House of Lord's confirmation in *IRC v Brebner* [1967] 43 TC 705 that purpose is a subjective matter. As the test is subjective it seems that, while allowing as Newey LJ did in *Travel Document Service & Ladbroke Group International v HMRC* [2018] STC 723 (at paras 44–47) for the drawing of 'inescapable inference', evidence as to directors' actual thought processes should be the primary focus of a FTT's investigation. (In *HMRC v Black Rock HoldCo 5 LLC* [2022] UKUT 199 (TCC), at para 166, the UT explicitly lent into Newey LJ's openness to the drawing of such an inference.) A tribunal that loses sight of this should be treated as having gone astray.

In the context of *JTIAC*, was the FTT's construction of JTIAC's purpose too 'aggressive'? Without being present at the hearing it is impossible to say with any confidence, which is of course why *Edwards v Bairstow* [1956] AC 14 sets the bar so high for findings of fact to be set aside.

The wider question though, in the context of tax planning of this type, is whether the correct measure of scepticism is as high as it would be if tax evasion were alleged? And, if (as it is suggested is appropriate) the answer is 'no', how ready should the FTT be to arch an eyebrow when seeking to identify a company's subjective purpose?

Group purpose

Secondly, if the UT's decision ultimately stands, HMRC are likely to have succeeded in making it easier to open the door wider than in the past, generally, tended to be thought appropriate, to an inference that a 'group purpose' constitutes a 'main purpose'.

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A difficult line to draw

Thirdly, as is inevitable with guidance cast in the form of (heavily caveated) examples, it is far from easy to read the runes as to where HMRC would like to draw the line between what is acceptable and what is not.

The example in the May 2003 guidance of conduct that may be acceptable, and which seems particularly apposite (indeed to be modelled around *JTAIC*), is example 4 (which HMRC regard as likely not to involve an unallowable purpose) at CFM38190. In example 4, it is specified that there is no cross-border double dipping of interest relief and we are told that the holding company's personnel are in a position to actively contribute to the success of the target's business by exchanging technical operation expertise and experience to their mutual benefit. To this one might respond that there is no statutory basis either (as the UT recognised in *JTIAC*) for taking into account the tax treatment in another jurisdiction or for requiring the active participation of UK employees in the success of a corporate acquisition.

If the tribunals are, as the UT did in *JTIAC*, to reject a taxpayer's argument that the existence of a genuine commercial purpose precludes the operation of the unallowable purpose rule while also observing in a somewhat slippery ellipse that 'nothing turned on the fact that the transactions were structured in order to avoid

a US tax charge, but that fact did provide the context for understanding the wider arrangements which had given rise to the appellant's existence', it is important that HMRC should not be allowed to 'read in' to the legislation either a warrant to use the unallowable purpose rule to act as a global tax policeman or anything else for which there is no evidence of Parliamentary intention (such as the sort of a requirement, envisaged by example 4 in the May 2023 guidance, for a borrower to have employees engaged in operational activities (rather than directors merely discharging the responsibilities one would normally expect for an essentially passive holding company)).

The underlying impetus behind the financial secretary to the Treasury's *Hansard* statement in 1996 when the unallowable purpose rule was introduced is that it is inherent in the statutory test that there is uncertainty as to the range of situations in which the unallowable purpose rule should in practice apply.

It would not be a good outcome for UK PLC if activist FTTs were to 'move the needle' against taxpayers by making too ready use of tools developed by the judiciary to sift evidence provided by fraudsters and, in the resulting vacuum created by the way the legislation has been framed, HMRC were to be given space to 'legislate by guidance' using criteria devoid of any statutory basis

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Final thoughts

Although a spell imprisoned in Bedford County goal for breaching the Conventicles Act of 1664 is said to have inspired John Bunyan (rather than concern about the obscurities of a Finance Act), it is to be hoped that the taxpayer, taking inspiration from John Bunyan's pilgrim, will persevere and that the Court of Appeal will, whether by means of endorsing a more balanced approach to statutory construction or providing some more nuanced guidance on the approach to evidence in tax cases such as this, find a better way to approach the application of the unallowable purpose rule. ■

This commentary was first published in Lexis+.

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Our pick

JTI Acquisitions Company (2011) Ltd v HMRC
No error by FTT in applying unallowable purpose rules

In *JTI Acquisitions Company (2011) Ltd v HMRC* [2023] UKUT 194 (TCC) (7 August), the Upper Tribunal (UT) dismissed the taxpayer's appeal against the First-tier Tribunal (FTT) decision that the unallowable purpose rules applied such that all of the loan relationship debits in respect of the interest paid should be denied.

The taxpayer, a UK company and part of a US-headquartered multinational group, sought to apply debits in respect of the arm's length interest it paid on an intra-group US $550m loan (which was used to part-fund the acquisition of another US-based corporate group).

HMRC had denied the debits on the basis of the unallowable purpose rules in CTA 2009 s 441 and s 442). Where the rules apply, the deduction of loan interest by the loan debtor that would otherwise arise, is denied, but only insofar as it is attributable to the unallowable purpose on a just and reasonable basis.

The FTT agreed with HMRC that the unallowable purpose rules applied and that all of the loan relationship debits in respect of the interest paid should be denied. (For more on the FTT's decision, see '*JTI Acquisition*: the FTT casts a wide net on unallowable purpose' (Oliver Marre), *Tax Journal*, 25 May 2022.)

The taxpayer advanced eight grounds of appeal against the FTT's decision to the UT, with the appeal largely turning on the proper statutory approach to be taken when considering the purpose for which the taxpayer was a party to the loan.

The taxpayer argued that borrowing at arm's length for a commercial acquisition should not result in the unallowable purpose rules applying. However, HMRC submitted that all circumstances, including corporate group structuring, should be considered to determine purpose, and whether the rules applied.

The UT was required to consider the correct interpretation of the provisions, and whether the correct analysis encompassed looking at why the particular company, as opposed to another company, was a party to the loan relationship, or whether the approach was restricted to considering the purpose for which the company was a party in the sense of the reason why the particular company entered into the borrowing. The contrast for the UT to consider was essentially between the questions 'what was the purpose of entering into that loan relationship by the taxpayer?' on the one hand, and 'why was the taxpayer a party to the loan relationship as opposed to someone else?' on the other.

The UT stated that it considered HMRC's less restrictive statutory interpretation, which permitted consideration of all the facts and circumstances, was the better interpretation and one which better reflected parliament's intentions. Having confirmed the FTT's decision as to purpose, the UT turned to the FTT's decision as to attribution. While the UT did accept that the FTT had made errors in relation to interpreting the provision on related transactions and on attribution, it did not consider either of those to be material, and therefore dismissed the taxpayer's appeal.

Why it matters: This latest UT decision, together with the FTT decision that it upholds, add to the increasing list of essential reading when considering whether and how best to establish a UK-based holding company where the acquisition of a target company is, at least partly, debt-funded.

The UT's interpretation of the legislative provisions, which allows for all the facts and circumstances to be considered in the analysis of a company's purpose in being a party to the loan relationship, accords with the approach taken by the UT in *BlackRock Holdco 5 LLC v HMRC* [2022] UKUT 199 (TCC).

The approach of looking at all the facts and the whole of the evidence is also reflected in the UT's summary of the various propositions relevant to ascertainment of a person's purpose under the unallowable purpose provisions in *Kwik-Fit Group Ltd v HMRC* [2022] UKUT 314 (TCC).

It is also worth noting that, since the FTT decision, HMRC has updated its unallowable purpose guidance, found in HMRC's *Corporate Finance Manual* at CFM38100–CFM38200. (For more information, see 'New HMRC guidance on "unallowable purpose"' (Paul Freeman & Angela Savin), *Tax Journal*, 16 May 2023.)

In an article published in this week's journal ('*JTIAC* reaches the Upper Tribunal: onward, through the Slough of Despond, but for which purpose?', see page 14), Gerald Montagu, partner at Gide Loyrette Nouel, wrote that three observations came to mind from the UT's judgment in *JTAIC*: 'the first relates to the importance of evidence and how that evidence is approached by the FTT and the second and third relate to how this decision sits against the backdrop provided by HMRC's revised guidance on the unallowable purpose rule.'

'While it is clearly right that the FTT must view evidence critically, how far should it go?' Montagu asked. 'In the context of *JTIAC*, was the FTT's construction of JTIAC's purpose too "aggressive"? Without being present at the hearing it is impossible to say with any confidence, which is of course why *Edwards v Bairstow* sets the bar so high for findings of fact to be set aside.'

'Evidence as to directors' actual thought processes should be the primary focus of a FTT's investigation', Montagu said, adding: 'A tribunal that loses sight of this should be treated as having gone astray.

'Secondly, if the UT's decision ultimately stands, HMRC is likely to have succeeded in making it easier to open the door wider than in the past, generally, tended to be thought appropriate, to an inference that a "group purpose" constitutes a "main purpose".

'Thirdly, as is inevitable with guidance cast in the form of (heavily caveated) examples, it is far from easy to read the runes as to where HMRC would like to draw the line between what is acceptable and what is not,' Montagu wrote.

'It would not be a good outcome for UK PLC if activist FTTs were to "move the needle" against taxpayers by making too ready use of tools developed by the judiciary to sift evidence provided by fraudsters and, in the resulting vacuum created by the way the legislation has been framed, HMRC were to be given space to "legislate by guidance" using criteria devoid of any statutory basis,' Montagu concluded.