‘Unallowable purpose’ taboos broken (JTI Acquisition Company (2011) Ltd v HMRC)

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Tax analysis: Gerald Montagu, Counsel at Gide, Loyrette Nouel considers JTI Acquisition, a decision which is likely to prove controversial and cause considerable disquiet since the First-tier Tax Tribunal (FTT) has agreed with HMRC’s challenge to long-accepted taboos (such as that borrowing to finance a corporate acquisition is not an unallowable purpose), notwithstanding counsel for the appellant’s remonstrance that the approach advocated by HMRC was ‘unprecedented’ and such as to render this case the first of its kind.

JTI Acquisition v HMRC [2022] (published on the Pump Court Tax Chambers website)

What are the practical implications of this case?

Since the introduction in 1996 of the rule (now found in sections 441–442 of the Corporation Tax Act 2009 (CTA 2009)) that relief is denied for debits where a company is party to a loan relationship for an ‘unallowable purpose’, it has been understood that HMRC generally accepts that:

- borrowing to finance a corporate acquisition is not an unallowable purpose
- the surrender via group relief, by a non-trading holding company, of a non-trading deficit generated by interest payable on such a borrowing does not taint the holding company’s purpose in relation to that borrowing, and
- the unallowable purpose rule is concerned only with the avoidance of UK tax

In a consultation launched in October 2021, the Department for Business, Energy and Industrial Strategy (BEIS), HM Treasury (HMT) and HMRC, all declared that:

> ‘The UK is a leading destination for investment and business…The UK has a highly competitive corporate tax system.’

This case suggests that HMRC is rather less committed to that prospectus than HM Treasury and BEIS. The implication of this case is that, if a multinational group makes a debt funded acquisition of a company in the UK, intending to use the benefit associated with arm’s length financing costs (approved by HMRC by means of an advanced thin capitalisation pricing arrangement) to shelter UK taxable profits arising to other members of the group, HMRC’s view may be that the unallowable purpose rule can cause interest relief to be disallowed.

The FTT was clearly influenced by the fact that the interest relief was ‘double dipped’ in the US and that the arrangement was structured in such a way as not to fall foul of the anti-arbitrage rules (which preceded the hybrid and other mismatches regime) or withholding tax, and also by the fact that the borrower was incorporated as a UK company for the purposes of the ‘scheme’.

The approach adopted by HMRC’s counsel appears to run contrary to the spirit of guidance at CFM38180 which states that ‘double dipping’ should not engage the unallowable purpose rule provided that the structure does not have a ‘non-commercial feature’ and/or relief might be available more than once in the UK in respect of the true economic cost of the borrowing.

HMRC’s position also suggests that the reassurance to the effect that ‘the economic value of [a] new company as an asset and its capacity to generate future profits for the group would be likely to offset any tax benefit’, and as such not be offensive in the context of the restriction on brought forward reliefs introduced initially for the banking sector and then more widely in 2015 (CTA 2010, Pts 14A and 14B), should be treated with considerable caution.

The main decision, and any appeal, should therefore be required reading when considering establishing a holding company in the UK where the acquisition of a target company is at least partly debt funded.

It is also worth noting that in a separate application to the judge (*JTI v HMRC and EY as a third party* [2021] UKFTT 446 (TC)), a firm of accountants, EY, who were not involved in the proceedings sought disclosure of the parties' pleadings, skeleton arguments and post-hearing written submissions; securing disclosure of redacted skeleton arguments. For litigators, the main decision and the disclosure decision, when read together, demonstrate, unsurprisingly, that disclosing many thousands (17,000!) unindexed and unsorted documents will irritate HMRC without dissuading HMRC from pursuing a case and also open the door further for third parties to obtain access to skeleton arguments.

What was the background?

JTI Acquisition Company (2011) Ltd (JTIC) was established as a member of a US headquartered group, specialising in the design and manufacture of mining equipment, to acquire a corporation, LeTourneau Technologies Inc (Longhorn), incorporated under the laws of Texas, for $1.1bn; Longhorn was similarly engaged in the design and manufacture of extractive equipment. On 13 May 2011, an agreement was entered into by the ultimate parent of the group (Joy Inc) to acquire Longhorn and the benefit of that agreement was assigned to JTIC, and the agreement was completed, on 22 June 2011.

JTIC's funding consisted of $50m of share capital, an interest free loan of $500m and $550m loan notes (Notes) carrying a 3.5% coupon issued on 21 June 2011 to an intermediate parent company. That intermediate parent company financed its subscription for the Notes using the proceeds of a borrowing made by Joy Inc from a third-party bank.

On 8 August 2011, the group company to which the Notes had been issued sought the transfer of the Notes to another group company incorporated in the Cayman Islands and, on 28 September 2011, JTIC approved the listing of the Notes on the Channel Islands Stock Exchange.

A check-the-box election was made for US federal income tax purposes in relation to JTIC.

What did the tribunal decide?

The FTT confirmed, following Mr Justice Beare's decision in *Oxford Instruments* [2019] UKFTT 254 (TCC), that the burden of proof that JTIC's purpose was not unallowable rested with JTIC.

The FTT then held that:

- JTIC secured, by virtue of the scheme under which JTIC was incorporated and issued the Notes, a tax advantage by being party to the Notes in that the loan relationship debits resulted in a relief from tax for other UK group companies by means of group relief
- the directing minds, by reference to which JTIC's purpose was to be determined, were not confined to the intentions of JTIC's directors but to the 'minds' of Joy—and, on the facts, there was no genuine decision at the JTIC level
- the 'strategic reasons' that 'purported to be the business and commercial purposes' for JTIC being party to the Notes did not obtain
- securing the UK tax advantage was the main purpose for which JTIC was party to the Notes. The submission by JTIC's counsel that it was 'clearly nonsense' to apply CTA 2009, s 441 as the Notes were issued 'as part of structuring a company's legitimate activities' was dismissed with 'no difficulty' on the basis that the scheme constituted 'artificial, tax driven arrangements' of the type the Minister had referred to (Hansard, 28 March 1996) when the unallowable purpose rule was enacted, and
- the entirety of the debits were, following *Fidex v HMRC* ([2016] EWCA Civ 385), attributable to the unallowable purpose

In the separate hearing on the disclosure point, the FTT held, following the Supreme Court's decision in *Cape Intermediate Holdings Ltd v Dring* [2019] UKSC 38, that there had been an effective hearing of the appeal (notwithstanding that a dispositive decision had yet to be made) and that the third party accountants had an entitlement to redacted skeleton arguments (but that ordering disclosure of post-hearing written submissions would not be proportionate and practical); it is worth noting that the debate in relation to disclosure has subsequently been taken forward in *Cider of Sweden Ltd v HMRC (Ernst & Young LLP (Third Party))*

[2022] UKFTT 76 (TC), for which see News Analysis: FTT denies third party access to documents before substantial judicial involvement in appeal (Cider of Sweden v HMRC and EY as third party).

Case details

- Court: First-tier Tribunal (Tax Chamber)
- Judge: Judge Heidi Poon
- Date of judgments: 19 April 2022 and 25 June 2021

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