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UK tax analysis: Back to *BlackRock* – the Court of Appeal restores order

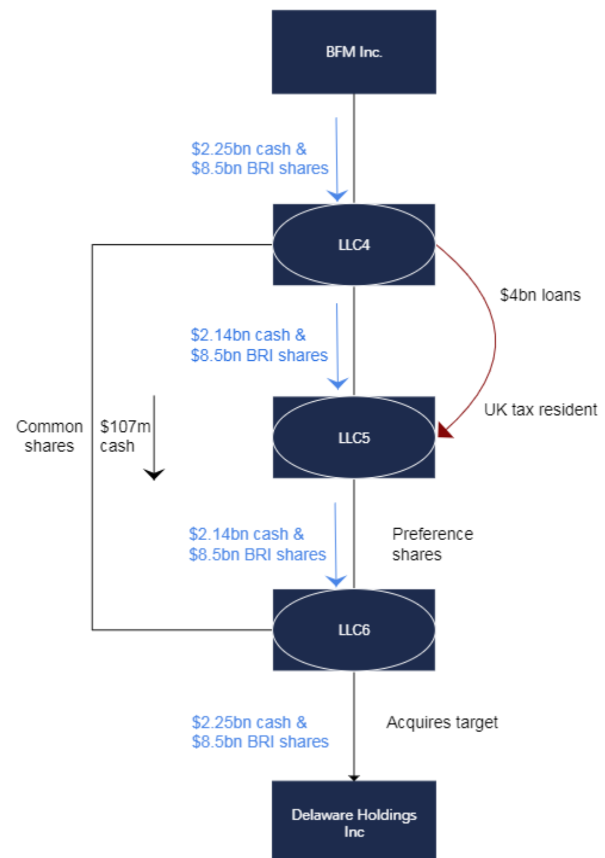
The Court of Appeal decision in *BlackRock* allays the main concerns caused by the lower tier decisions. In the transfer pricing context, it considers whether features not present in the actual transaction can be imported into the hypothetical arm's length transaction to enable a comparison exercise. It also gives clear guidance that the availability of tax relief for interest on a loan does not, without more, mean that the borrower has a tax avoidance purpose in entering into the loan and provides a welcome steer on what may be permissible in conducting a just and reasonable apportionment exercise.

The recent decision of the Court of Appeal (***CA***) in *BlackRock Holdco 5, LLC v HMRC* [2024] EWCA Civ 330 is the latest judicial pronouncement on two issues arising from the BlackRock group's $13.5bn acquisition of the US business of Barclays Global Investors in 2009:

- transfer pricing; and
- the application of the loan relationship unallowable purpose rules (s 441 and 442 CTA 2009).

These issues arose in relation to $4bn of intra-group debt issued by a UK resident Delaware LLC (***LLC5***) which it used to fund the subscription of preference shares in the US resident Delaware LLC bidco (***LLC6***) and in respect of which it claimed interest deductions for UK tax purposes. The common (ordinary) shares in LLC6 were subscribed by a further US resident Delaware LLC (***LLC4***) which was the sole member of LLC5. Thus a 'US-UK-US sandwich' was created, with LLC5 as the filling. The diagram appended to the CA's (and UT's) decision is reproduced above right.

Critically, although as preference shareholder LLC5 was entitled to the vast majority of distributions from LLC6, it was LLC4 (as the holder of common shares in LLC6) which controlled whether any distributions were made by LLC6.



HMRC argued that LLC5's interest deductions should be disallowed in full because the loans would not have been made between parties acting at arm's length or, alternatively, because the loans had an unallowable purpose. This is a case in which the outcome has flipflopped – the FTT found in favour of LLC5 that the interest deductions should not be disallowed on either basis, while the UT found against it on both issues (causing some consternation in the process). With a raft of other cases involving similar challenges to shareholder debt waiting in the wings, the CA decision was eagerly awaited.

Two key issues for the CA to determine were:

1. from a transfer pricing perspective, what can be taken into account in comparing the actual provision with the hypothetical arm's length provision; and
2. on the unallowable purposes front, whether and in what circumstances relevant purposes include unconscious motives.

The CA has provided helpful (and, some might say, overdue) clarity on these issues, which will also be relevant in the transfer pricing context more broadly and in the application of other purpose-based anti-avoidance rules.

Transfer pricing

A brief refresher on the FTT and UT decisions is helpful to contextualise the CA decision on the transfer pricing issue and its significance.

The FTT: importing covenants

There was expert evidence before the FTT that an independent lender would only have been willing to lend the $4bn to LLC5 if certain covenants had been provided by other members of the group to give the lender comfort that distributions would be paid on the preference shares issued by LLC6, enabling LLC5 to service that debt.

No such covenants formed part of the actual fact pattern (since the lender, LLC4, controlled LLC6 and was therefore able to control the flow of funds to LLC5). However, the FTT accepted the evidence of the taxpayer's expert that these covenants were fairly typical and would not have been costly to provide, and effectively imported them into the actual provision. Since the experts had agreed that (subject to the covenants) an independent lender would have lent on the same terms as to pricing as LLC4 actually did, the FTT found in favour of the taxpayer. Accordingly, no disallowance was required under the transfer pricing rules.

The UT: excluding covenants

The UT thought the FTT's approach was impermissible – by importing covenants that were not in fact part of the actual provision, the FTT was not comparing transactions with comparable economically relevant characteristics. The FTT 'compared a different transaction to the actual one'.

The UT agreed with HMRC that s 147(1)(a) TIOPA imposes a 'two party rule', such that only the actual provision agreed between the two parties to the loans could be considered. It also agreed with HMRC that s 152(5) TIOPA (which disregards connected party guarantees for the purposes of the comparison exercise) indicated Parliament's intention that, like guarantees, third-party covenants should only be taken into account in the comparison exercise if they were provided in the actual transaction. The UT therefore disagreed with the FTT that the existence of third-party covenants could be hypothesised.

Viewed in that way, the UT concluded that, because an independent lender would have no comfort that the debt could be serviced, no provision would have been made at arm's length and all of the interest deductions fell to be disallowed on transfer pricing grounds. This is quite a striking conclusion: the UT effectively held that an independent lender would not lend to LLC5, even though it held most of the economic rights to more than $10bn worth of assets.

The UT's decision raised concerns that many intra-group loans could fall foul of the transfer pricing rules because they would not typically include detailed covenants supporting the cash flows needed to service the debt. Compounding the issue, the UT commented that artificially including covenants in intra-group arrangements to get around this problem was potentially open to abuse – giving a sense that the obvious solution to the issue could be viewed unfavourably. This left taxpayers with intra-group lending arrangements potentially stuck between a rock and a hard place.

The UT's focus on the terms agreed between the two parties to the provision and exclusion of any third-party involvement also had the potential for broader ramifications in other contexts.

And so to the CA

The concerns engendered by the UT decision have largely been allayed by the CA in a decision that oozes common sense. The principles elucidated by Falk LJ can be summarised quite simply:

- It is true that the legislation requires a comparison of the provision made or imposed between two persons against the provision that would have been made or imposed between two independent enterprises; and 'two means just that'.
- However, as explained by the Special Commissioners in *DSG Retail Ltd v HMRC* [2009] STC (SCD) 397, the independent enterprises are assumed to have the same characteristics as the actual enterprises.
- Per the OECD transfer pricing guidelines, a comparison between the actual and arm's length transactions requires the economically relevant characteristics of the situations being compared to be sufficiently comparable, or that 'reasonably accurate adjustments' are made to eliminate the effect of any material differences.
- There was a significant difference in the economically relevant characteristics of the actual intra-group lending versus a hypothetical transaction between

independent parties, because the latter gave rise to an economically significant risk (i.e., that the profits from the LLC6 sub-group might be diverted away from the lender) that did not exist in the real world. In the real world, the lender (LLC4) had no need of any of the covenants considered by the experts because, independently of its control of LLC5, it had control of LLC6.

- Importing into the actual transaction the covenants that the FTT had found would typically be provided in an independent scenario fell within the category of making adjustments to eliminate the effect of that difference, 'so rendering the economically relevant characteristics comparable' as between the actual and arm's length provisions.
- It doesn't matter that the imported covenants would be provided by third parties; the 'two means two' mantra cannot be applied without further analysis and the transfer pricing legislation and guidelines contemplate that third parties can be involved in arrangements that give rise to a provision. (Indeed, a provision can involve a series of transactions which don't directly involve both parties to the provision e.g., a provision between A and B can arise where A transacts with C who transacts with B.)

On the basis of this analysis, the CA concluded (as the FTT had) that no adjustments were required to the debt under the transfer pricing rules.

This will be reassuring to taxpayers. From a practical perspective, groups will not need artificially to add detailed covenants into intra-group lending arrangements where the same result is already achieved in practice via the lender's de facto control over the borrower. That must be right; in circumstances where the quantum and pricing of an arm's length debt is agreed to be the same as the actual debt, the control relationship should not of itself mean that the transfer pricing rules can operate to disregard the actual transaction. (Helpfully, though, the CA also noted that there would have been nothing wrong in LLC4 and LLC6 choosing to put artificial debt covenants in place.)

There is a limit, though, to the covenants that can be imported: the CA was careful to note that an intra-group loan to a thinly capitalised borrower cannot be treated as being on arm's length terms simply by hypothesising some form of third-party support that does not exist in the actual transaction.

Unallowable purposes

The CA's decision on the unallowable purposes issue also restores order, after some consternation caused by the FTT and UT decisions.

The FTT: inevitable consequence treated as a purpose

The FTT decision attracted criticism for adopting reasoning from the 'wholly and exclusively' decision in *Mallalieu v Drummond* [1983] 2 AC 861 to 'look beyond the conscious motives of the taxpayer and take account of the inevitable and inextricable consequences of it entering into the loan relationship with LLC4'. As a result, despite having accepted evidence from a director of LLC5 that he had considered whether to proceed with the transaction without taking any UK tax advantage into account, the FTT felt able to infer a tax avoidance main purpose for the loans.

This suggested a very low bar for the main purpose test that would likely be satisfied in any corporate borrowing where interest deductions were anticipated to be available and could not be described as merely incidental. Nonetheless, the FTT concluded that there should be no disallowance under s 442 because the witness evidence indicated that LLC5 would have entered into the loans even if the anticipated tax benefits had fallen away. Accordingly, applying a 'but for' approach to the just and reasonable apportionment question, the FTT concluded that the debits on the loan were entirely attributable to the commercial main purpose.

The UT: purpose of the company's existence treated as purpose for the loans

The UT ruled that the FTT had erred in relying on *Mallalieu* and should have limited itself to following the guidance from the CA's decision in *Travel Document Service v HMRC* [2018] STC 723 (***TDS***), as the only authority on the legislative wording under consideration.

However, this did not help the taxpayer because the FTT was entitled to look beyond the stated motives of LLC5's directors and the evidence was that, absent the UK tax benefits, LLC5 would not have existed at all and the directors of LLC5 were aware of this fact when they approved the loans. As a result, the UT found that there was still a tax main purpose.

Moreover, the UT held that the debits were attributable solely to that tax main purpose because the loans would not have been incurred at all but for the tax purpose and so the correct application of the just and reasonable apportionment rule was to disallow the debits in full. In this respect, the UT ruled that the FTT had wrongly adopted a subjective approach to what was an objective question.

The CA: main purpose

The CA's decision is critical of both the FTT's and the UT's reasoning. The CA agreed with the parties (but not the UT) that it was appropriate to look beyond TDS and it considered the principles in *Mallalieu* in some detail, as well as those in *MacKinlay v Arthur McClelland Moores & Co* [1990] 2 AC 239 and *Vodafone Cellular v Shaw* [1997] STC 734.

The CA succinctly summarises the principles from these cases as follows:

a) Save in 'obvious' cases, ascertaining the object or purpose of something involves an inquiry into the subjective intentions of the relevant actor. (A sensible starting point is to consider 'why' they did it, albeit this will not cover all nuances.)
b) Object or purpose must be distinguished from effect. Effects or consequences, even if inevitable, are not necessarily the same as objects or purposes.
c) Subjective intentions are not limited to conscious motives.
d) Further, motives are not necessarily the same as objects or purposes.
e) 'Some' results or consequences are 'so inevitably and inextricably involved' in an activity that, unless they are merely incidental, they must be a purpose for it.
f) It is for the fact-finding tribunal to determine the object or purpose sought to be achieved, and that question is not answered simply by asking the decision maker.

So far, so sensible: none of these principles are new but they are now at least clearer. Applying these principles, the CA clarified that it cannot be the case that any inevitable consequence can be a purpose and, critically, that it cannot have been Parliament's intention that the inevitable consequence of taking out a loan is to engage the unallowable purpose rules: something more is needed. Moreover, it is unrealistic to suppose that the corporation tax relief afforded for interest expenditure will not form part of ordinary decision-making processes about how to fund a company; indeed it might well be wrong for directors to ignore that consideration in deciding what is in the best interests of the company concerned. This largely removes the concern caused by the FTT's finding on main purpose.

As regards the UT's decision, the CA criticised the UT for not making clear that it is LLC5's purposes for being party to the loans that count; not the purposes for LLC5's existence. Of course, one might impact the other but the different purposes cannot simply be elided. The CA also thought the UT was wrong to discount witness evidence that had been accepted by the FTT and that the UT's (pretty strong) criticisms of the advice given to the board of LLC5 were unjustified. In the CA's view, it was right that the directors were advised to leave any UK tax advantage out of account in assessing the viability of the transaction given that LLC5 itself would obtain no benefit from that tax advantage.

In remaking the decision, the CA considered the purposes of LLC5 from the perspective of its directors and rejected any suggestion that they were acting on instruction. However, it was permissible to look beyond the directors' stated or conscious motives and to take account of the wider context, at least insofar as that was apparent to the directors.

The CA reiterated evidence before the FTT that the directors of LLC5 were not operating in a vacuum: they understood the wider context of the transaction, what the loans were designed to achieve (viz, to take advantage of the UK's 'generous tax regime for interest deductions') and that the 'sole raison d'être' of LLC5 was to enter into the loans to obtain tax advantages for the BlackRock group. Against that background, it 'would be artificial to seek to divorce what occurred at the board meeting from its context'. Accordingly, the CA found that there was a tax main purpose, albeit not for the same reasons as the FTT and UT.

The story does not stop there because the CA also found that there was a commercial main purpose, noting that the board of LLC5 rightly concluded that the transaction was commercially advantageous because the anticipated dividend flow on the preference shares should comfortably exceed the cost of servicing the loans.

The CA: apportionment

Having found both tax and commercial main purposes, the CA (like the FTT and the UT before it) had to tackle the thorny question of a just and reasonable apportionment. The CA confirmed that a just and reasonable apportionment of the debits between tax and other purposes is an objective exercise by reference to the subjective purposes identified by the fact-finding tribunal. The precise mechanism used in any particular case will be fact specific.

Unfortunately for the taxpayer, none of the just and reasonable apportionments proposed by it found favour with the CA. The CA was unimpressed by evidence that the transaction would have gone ahead if the tax relief had been withdrawn at the last moment. Nor did the CA find it helpful to imagine what might have happened had the tax rules changed (because this did not, in fact, occur).

The CA was more sympathetic to the idea that an apportionment based on economic advantage could be appropriate in some cases, so long as that is done objectively rather than subjectively. However, the taxpayer's attempts to apportion by reference to the relative financial significance of the tax relief and commercial advantage were rejected. This may have been because the taxpayer sought to gain credit for the fact that the group at the time assumed (wrongly) that a substantial portion of the interest costs would be disallowed under the worldwide debt cap rules: the CA seemingly thought that an apportionment on this basis re-introduced subjective elements into what should be an objective exercise.

In the end, the CA adopted a 'but for' approach that attributed all of the debits to the tax purpose. The reasoning is brief but turns on the CA's findings that the purpose for which LLC5 was created cannot be divorced from its purpose in entering into the loans and the structure of the transaction was presented as a 'fait accompli' to the directors of LLC5. Against that background, the commercial advantage was in the nature of a by-product and the CA found no principled basis for apportioning any of the debits to it. As Falk LJ put it: 'in the absence of the tax advantage, the decision to enter into the loans would never have been made'.

Where does this leave us?

BlackRock is a case that turns on its facts. The CA was at pains to emphasise that '[i]t does not follow that other debt incurred in connection with a commercial acquisition … would fall foul of the unallowable purpose rule even if the decision to borrow had regard, as it often would, to tax considerations'. Had there been a commercial reason for LLC5's existence, the outcome may well have been different.

We don't yet know if there will be an appeal to the Supreme Court. Even if there isn't, there are other cases still coming through: the appeal of the UT decision in *Kwik-Fit Group Ltd v HMRC* [2022] UKUT 00314 has already been heard by the CA and *JTI Acquisitions Company (2011) Limited v HMRC* [2023] UKUT 00194 is listed before the CA later this year. There are also a number of new cases on transfer pricing and purpose-based rules coming through the tribunals in the next few years which may present more nuanced facts. As such, whilst the CA decision in *BlackRock* has been much anticipated and (by some) will be welcomed as a clearer articulation of the principles to be applied in these areas, it is by no means the last word on the subject.

The CA may have had the last word though on the Commissioners' description in *Mallalieu* of the then Miss Mallalieu as an 'attractive blonde barrister'. Falk LJ's comment that this was 'inappropriate', at least to 21st century eyes, may have been made in passing, but it matters.

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Helen Buchanan

Partner

T +44 20 7716 4884
E helen.buchanan@freshfields.com

Sarah Bond

Partner

T +44 20 7716 4498
E sarah.bond@freshfields.com

freshfields.com

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