Proskauer

UK Tax Round Up

August 2023

Welcome to August's edition of our UK Tax Round Up. This month has seen two interesting decisions from the Upper Tribunal, the first on the loan relationship unallowable purpose test and the second on the meaning of "exceptional circumstances" for the statutory residence test.

UK Case Law Developments

UK loan to buy US business had unallowable purpose

In *JTI Acquisitions Company (2011) Ltd v HMRC,* the Upper Tribunal (UT) has upheld the First-tier Tribunal's (FTT's) decision that no deduction was allowed for interest payments on a loan made to JTI Acquisitions Company (2011) Ltd (JTI) because it was party to the loan for an unallowable purpose under sections 441 and 442 CTA 2009. This decision follows the UT's decisions in the recent *BlackRock* and *Kwik-Fit* cases and is the latest of a number of cases in which HMRC has challenged interest deductions on unallowable purpose grounds.

The case involved the establishment by a US headquartered group of JTI for the purpose of acquiring another US company. The US group was headed by Joy Global Inc (JGI). JGI had entered into a purchase agreement to acquire LeTourneau Technologies Inc (the Target) for $10.1 billion on terms that allowed JGI to nominate a different group purchaser. Following what was referred to as the “9 step plan”, proposed by Deloitte after JGI had entered into the purchase agreement, JGI borrowed $500 million from a third-party bank on commercial terms. JGI’s direct subsidiary (USSub) then established JTI as a UK incorporated and tax resident company. JGI contributed $550 million to USSub as an equity contribution and lent it $550 million on interest bearing terms. USSub lent $550 million to JTI on similar terms and lent the additional $550 million on non-interest bearing terms. JTI elected to be treated as a disregarded entity for U.S. tax purposes. JTI used the $1.1 billion to acquire the Target. USSub also established a Cayman Islands incorporated and tax resident company (CayCo) as a subsidiary to which it contributed the $550 million interest bearing loan receivable (now owed by JTI to CayCo). CayCo also elected to be treated as a disregarded entity for US tax purposes. CayCo was included in the overall structure to avoid the application of the UK’s anti arbitrage rules in force at the time that would otherwise have disallowed JTI’s interest payable on its loan from USSub using an exemption in the rules for interest paid to companies that were not subject to tax by reason of their residence. The loan from USSub to JTI was agreed by HMRC to be on arm’s length terms and was the subject of an advance thin capitalisation agreement between JTI and HMRC.

The overall arrangement was intended to generate an interest deduction for JTI which it could group relieve to other UK companies in the JGI group with the interest paid by JTI to CayCo not being recognised for US tax purposes because JTI and CayCo were disregarded and with JGI generating a US tax deduction on the interest that it paid to the third-party bank on its $500 million loan.

The FTT had agreed with HMRC that the loan relationship unallowable purpose rule in sections 441 and 442 CTA 2009 applied to JTI's $550 million loan and that all of the interest payable on it should be disallowed. Section 441 applies where a loan relationship of a company has an unallowable purpose. Section 442 states that a loan relationship has an unallowable purpose if "the purposes for which the company is party to the loan relationship include a purpose which is not among the business or commercial purposes of the company". It then states that if a "tax avoidance purpose" is one of the purposes for which the company is party to the loan relationship then that purpose is only among the business or commercial purposes of the company if it is not the main purpose or one of the main purposes for which the company is party to the loan relationship.

JTI had two UK directors and a third director, Mr Olsen, who was the CFO of JGI and a US resident. JTI was established on 8 June 2011 following the presentation by Deloitte to JGI of the "9 step plan" on 2 June and a memo on 6 June from JGI's group VP of Tax to Joy UK's (the existing UK business of the group) CFO stating that "With the acquisition of LeTourneau we have identified an acquisition structure that will provide Joy UK with some fairly substantial prospective tax savings [through the receipt of group relief from JTI]".

The decision as to whether JTI had an unallowable purpose in being party to the loan from USSub (and then CayCo) made by the FTT rested, broadly, on the test that should be properly applied in determining the purpose for which JTI was party to the loan. The appeal also brought into question the extent to which the FTT had been entitled, as a matter of law, to disregard much of Mr Olsen's testimony as to JTI's purpose in deciding that JTI did have an unallowable purpose because he had not been cross examined on his evidence.

JTI argued that in assessing JTI's purpose(s) in being party to the loan it must be taken as a given under the terms of sections 441 and 442 that JTI is the company and that it is party to the loan relationship. The question is then only what its purpose is in being party to the loan. In addition, it argued that where a loan was used to make a commercial acquisition the loan was necessarily outside the scope of section 441. These are, of course, really the same point made in two different ways.

The UT rejected this argument (as had the FTT) on the basis that section 441 was "drafted in expansive terms, … to prevent tax avoidance by the use of loan relationships, as more specifically described therein. It seems to us that it would defeat Parliament's intention if an over compartmentalised and narrow interpretation, such as that advocated by [JTI] were to be adopted. There seems no reason why, on the words of the statute, such a restrictive meaning should be given to what are, after all, ordinary English words" and further stated that the natural reading of the terms of section 442 simply invited the question "why are you [JTI] a party to the loan?". The UT described the different approach put forward by JTI and by HMRC as being the difference between asking "what was the purpose of entering into that loan relationship by [JTI]?" subsequent to accepting JTI as the party as opposed to asking the broader question of "why was [JTI] a party to loan relationship as opposed to someone else?". The UT decided that the latter was a correct question to ask in the relevant circumstances when determining the purposes for which the relevant company was party to a loan relationship and that in assessing the company's purpose(s) one should look at the wide range of facts and circumstances surrounding it becoming and being a party to the relevant loan.

The evidence before the FTT and the UT involved Mr Olsen's oral evidence setting out a number of commercial reasons for JTI being added to the group as the purchaser of the Target and also documentary evidence surrounding Deloitte's presentation of the 9-step plan and JGI's response to it and communication to JTI about its benefits. The FTT had discounted much of Mr Olsen's evidence and stated that it preferred to rely on the documentary evidence when assessing JTI's purpose in being party to its loan, applying the broad approach to JTI's purpose(s) discussed above. It had also determined that JTI's board of directors had not taken a "genuine" decision when resolving to enter into the overall transaction, borrow the money and acquire the Target. One of the grounds for JTI's appeal against the FTT's decision was that the FTT had not cross-examined Mr Olsen on his evidence and so was not entitled to discount it. On this, however, the UT determined that the FTT had simply weighed up the probative value of Mr Olsen's evidence against that of the contemporaneous documentary evidence setting out the tax motivations for the establishment of JTI and its use as the purchaser of the Target. The UT also stated that the FTT's use of the word "genuine" did not mean that the JTI board decision was not valid for company law purposes but simply that the original decision to implement the 9 step plan had been taken by JTI and that JTI had no real role on following that decision, This is, of course, a different question to whether the JTI board had, for instance, taken a valid decision in the UK for the purposes of its tax residence (not considered in this case) and, rather, goes to what JTI's purpose was and whether its decision to enter into the commercial transaction of acquiring the Target overrode the tax motivated decision of JGI (attributed to JTI) to establish JTI and use it as the borrower in order to generate a group relievable interest deduction for the group.

Given the commentary that there has been around this seeming broadening of (or validation of a broad approach to) the circumstances to which the unallowable purpose test can be applied, the decision might well be appealed, but the clear discussion does highlight that, when entering into tax motivated transactions, the taxpayer should be wary of relying on narrow commercial reasons to defeat any "main purpose" tax avoidance test and also that internal documentary discussion of the wide rationale for transactions is likely to become material in any dispute even when the internal discussion is about why the tax drivers for a transaction should be played down.

What are "exceptional circumstances" for being in the UK?

In *A Taxpayer v HMRC,* the UT allowed HMRC's appeal against the decision of the FTT that the taxpayer in question did not have "exceptional circumstances" for being in the UK for a number of days in the tax year 2015-16 for the purposes of the statutory residence test (SRT) in Schedule 45 to FA 2013 when her reason for being in the UK was to care for her sister who was suffering a crisis linked to her alcoholism and depression and to care for her sister's children.

The taxpayer in question had left the UK on 4 April 2015. Subsequent to that her husband had transferred some shares to her and she had received an £8 million dividend. Because 2015-16 was her first year of non-UK residence she could only be in the UK for 45 days to avoid retaining her UK tax residence. It was accepted that she had been in the UK for 50 days in the tax year, so that she would only avoid retaining her UK residence if she could show that for at least five of those days she met the test in paragraph 22(4) Schedule 45 that she "would not [have been] present in the UK at the end of [a given] day but for exceptional circumstances beyond [her] control that prevent[ed] [her] from leaving the UK and that she intend[ed] to leave the UK as soon as those circumstances permit[ted]". Examples of circumstances that might be "exceptional" (as set out in paragraph 22(5)) are "national or local emergencies, such as war, civil unrest or natural disasters, and a sudden or life threatening illness or injury". These are, as stated, only examples of what might be exceptional circumstances.

The taxpayer had visited the UK in December 2015 and February 2016 to, among other things, visit her non-identical twin sister who had suffered from alcoholism and depression for a number of years and had two children, aged 13 and 11, for whom she was the primary carer. The visit in December 2015 was from 18 to 20 December and resulted in two days stayed in the UK for the purposes of the SRT. The taxpayer acknowledged that she had already been in the UK for 44 days before this visit so, to avoid retaining her UK residence, those days would have to be "exceptional circumstances". Similarly for the visit from 15 to 19 February 2016. Both trips were made by private jet available to the taxpayer so, in principle, she could leave the UK at any time. Subsequent to these visits, in April and July 2016, the sister was admitted to an NHS hospital and then to a residential mental health hospital to be treated for severe alcohol and drug misuse and she made a number of suicide attempts.

The taxpayer's evidence as to her visits in December 2015 and February 2016 was described by the FTT as "defensive and vague" and it was noted that, although she knew that she needed to rely on the exceptional circumstances derogation in the SRT she did not keep any contemporaneous record as to why she was in the UK and exactly what she did while there. There was evidence that she had, for instance, gone shopping while she was in the UK. The taxpayer's argument was that the risk that her sister would commit suicide constituted "exceptional circumstances" and she was prevented from leaving the UK until her sister was "in a place of safety". The FTT rejected this argument on the basis that mental health crisis was not "exceptional" and that the taxpayer's evidence on what she actually did while in the UK and what she did to expedite the possibility that she could leave was not compelling. The FTT was not convinced that the taxpayer "came to and remained in the UK in December 2015 and February 2016 because her twin sister had threatened to commit suicide".

The taxpayer also argued that, in addition to the possibility that her sister would attempt suicide, her sister "was unable to care for her minor dependent children" and she was "unable to leave the UK and forced to stay until such time as her sister [was] in a place of safety and appropriate care arranged for her children". The FTT accepted the taxpayer's evidence that, on arriving at her sister's house, she found the children unkempt and in need of care that the sister could not provide and that she was the only person that could look after them notwithstanding that after the visit in December 2015 she put in place no arrangements relating to her sister or her children. The FTT determined that the term "prevent" in paragraph 22(4) "can encompass all manner of inhibitions – physical, moral, conscientious or legal". The FTT also concluded that, although the requirement to look after her sister was not an "exceptional circumstance" because alcoholism and depression were not themselves uncommon or exceptional, the additional requirement (or moral obligation) to look after her sister's minor children elevated the reason for her stay to being an exceptional circumstance, stating "moral obligations and obligations of conscience – including those arising by virtue of a close family relationship – can qualify as exceptional circumstances and those obligations may be strong enough to prevent a taxpayer leaving the UK".

The UT has now overturned the FTT's decision on this ground on the basis that the exceptional circumstance test is an objective one and its scope is coloured by the examples given in paragraph 22(5). So, the exceptional circumstances must objectively prevent the relevant individual from leaving the UK. That was not the case for a "moral obligation" which did not "prevent" the taxpayer from leaving.

The other point noted by the UT is that it is for the taxpayer to prove, on the balance of probabilities, that the exception circumstance test is met for every day in question. So, in order for a tribunal to accept that the exceptional circumstance requirement is satisfied, the taxpayer must provide reasonable evidence on the point for each day that is being assessed. The UT decided that the taxpayer had not provided sufficient evidence to the FTT for it to properly conclude that the test had been satisfied on each day.

The case shows clearly how strict an approach should be taken to determining whether there is an exceptional circumstance which prevents an individual from leaving the UK and how carefully a taxpayer should objectively assess their circumstances if they are thinking about trying to rely on the exceptional circumstances derogation to avoid becoming UK resident, particularly if, as here, there is a considerable amount of tax at stake.

Other UK Tax Developments

Reintroduction of the 1.5% "season ticket" stamp duty and SDRT charge?

There has been considerable discussion recently as to whether the government intends to retain the current suspension of the 1.5% stamp duty and stamp duty reserve tax (SDRT) charge which arises under sections 67, 70, 93 and 96 FA 1986 when a UK company issues shares or transfers shares into a clearance system or to a depositary receipt issuer. The government announced its suspension of this so called "season ticket" charge in 2009 as a result of various ECJ cases that held that the charge was contrary to the EU Capital Duties Directive (the Directive). The implementation of the Retained EU Law (Revocation and Reform) Act will remove much EU law from the UK statute book from 1 January 2024, including the requirement for the UK to apply the Directive.

The 1.5% “season ticket” charge was introduced when shares are issued or transferred to a clearance system or are put into depositary receipt form because of the impracticality of collecting stamp duty or SDRT at the normal 0.5% rate on future transfers.

Under the Directive, EU Member States are not permitted to levy tax on the raising of capital (so, on the issue of shares and the transfer of shares in relation to capital raising). As a result of the relevant ECJ decisions on this issue, HMRC suspended application of sections 67, 70, 93 and 96 FA 1986, although the provisions have not been repealed. The question has arisen as to whether, once large swathes of EU law are removed from the UK statute book next January, HMRC will reverse this suspension and seek to levy the 1.5% charge on the issue or transfer of UK company shares to clearance services or depositary receipt systems, with people arguing that this would be harmful to UK capital raising and the UK capital markets.

To date HMRC has not made any comment on this point. In the current consultation on modernising stamp taxes on shares, HMRC has simply stated that the consultation “does not include the 1.5% charge. If modernisation is taken forward then the 1.5% charge will be dealt with separately”.

So, we wait to see whether the government will make any statement on this prior to next January and/or whether the season ticket charge will be abolished as many would like to see.

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