HMRC’s revised ‘unallowable purpose’ guidance – a purposive spring clean?

On 9 May 2023, HMRC, with very little fanfare, revised its guidance on the unallowable purpose rule in the loan relationships regime and added a significant amount of new commentary. Gerald Montagu, Counsel at Gide, Loyrette Nouel, considers what has been added and, perhaps just as importantly, why.

On 9 May 2023, HMRC, with very little fanfare, refreshed its guidance on the application of the ‘unallowable purpose’ rule in the loan relationships regime (found in sections 441–442 of the Corporation Tax Act 2009) and grafted-on a significant amount of new commentary. This can be found in HMRC’s Corporate Finance Manual at CFM38100 to CFM38200.

The new guidance has clearly been framed with some care and seems to reflect both the importance which HMRC attaches to the unallowable purpose rule, and a recognition of the practical difficulties it poses for both taxpayers and HMRC. As any taxpayer who has been on the receiving end of an unallowable purpose enquiry is likely to be painfully aware, the process is extremely resource-intensive and the new guidance repeatedly acknowledges the very fact-sensitive nature of the test. (This is especially evident from HMRC's ‘practical approach’ to unallowable purpose enquiries, set out at CFM38200).

But, why now?

HMRC’s new guidance openly acknowledges that it addresses questions that are still before the courts. Bearing in mind how many years HMRC's guidance has remained unchanged, this begs some interesting questions as to quite why HMRC decided to publish this in May 2023. Notwithstanding that the auguries seem to suggest that much of the ongoing litigation to which HMRC alludes appears to be going somewhat in HMRC's favour (eg HMRC v BlackRock HoldCo 5 LLC [2022] UKUT 199 (TCC) and JTI Acquisition Company (2011) Ltd v HMRC [2022] UKFTT 166 (TC)), HMRC generally tends not to issue revised guidance until litigation has been resolved and, at the very least, this new guidance will need to be reissued when the courts have given their final verdict on these proceedings.

Does HMRC’s new guidance presage a battening-down of the hatches in anticipation of a plan to enhance compliance activity? In this context, could HMRC's intention be to help shepherd disclosures into the net cast by the uncertain tax treatment rules introduced by Schedule 17 to the Finance Act 2022? In other words, might new guidance seek to make it more challenging to conclude that a decision not to apply the unallowable purpose rule is not in conflict with HMRC's ‘known position’ (as to which see HMRC’s Uncertain Tax Treatments by Large Businesses Manual at UTT13200)?

Alternatively, given that the new examples included within the guidance run to 25 pages of A4, and are preceded by four A4 pages of health warnings and assumptions (including the injunction that these examples should not serve as a ‘starting point’ for an HMRC team), could the new guidance represent a plank in building a case to persuade Ministers of the need for more fundamental reform? Could this depend, in part, on the outcome of the ongoing proceedings?

The Deterrent Effect

What seems fairly clear is that the issue of the new guidance appears to represent a change of tack of sorts by HMRC. HMRC's previous longstanding unwillingness to update the guidance had caused that guidance to become woefully out of date and encouraged the view that HMRC seemed to prefer opacity, with that lack of transparency serving as a form of deterrence in and of itself.

The new guidance at least sets out, a little more transparently, HMRC's view as to how HMRC would like this legislation to be applied. The deterrence purpose is spelt out more explicitly than before (and perhaps slightly sanctimoniously?) for finance directors and heads of tax: if a company is treated as having potentially strayed onto the unallowable purpose grass, HMRC will not issue a closure notice lightly. 'Of course, in issuing the closure notice HMRC will need to obtain sufficient information to arrive at an informed and sustainable conclusion' (CFM38160).

'Complex'

One area (rightly) described as 'complex' is the apportionment of debits (or foreign exchange credits) to an allowable purpose. Here, HMRC states: 'whilst case law decisions which are final so far have resulted in all or nothing apportionments in relation to the debits challenged, there are cases under litigation at the time of writing where it has been held that there are mixed purposes for the loan relationships and the question of whether the debits in question should be subject to partial apportionment is being considered' (CFM38150).

Purpose

The new guidance on how to identify a 'purpose' (CFM38135) and with respect to 'whose purpose' matters (CFM38125) will have wider application beyond the unallowable purpose rule.

Although not revelatory (nor remotely exhaustive) and, in relation to questions such as the existence of a 'group' purpose (as alluded to further below) where the guidance seemingly reflects what HMRC would like the law to be rather than what, pending the outcome of live cases, the new guidance necessarily is, the guidance is generally constructive.

It is helpful, for example, that HMRC recognises explicitly that: 'It is a natural consequence of using debt financing that tax deductions will generally be available in respect of the interest costs, which means that tax advantages will be secured…. Determining whether or not it is a main purpose to secure a tax advantage may be difficult in the context of financing in some situations.'

Helpful, also, is recognition of authority stretching to Brebner that 'purpose' is a subjective matter, and that the existence of a tax benefit does not automatically render securing that benefit a main purpose.

As to 'whose' purpose is important, HMRC indicates that in its 'experience' this is the purpose of the directors which will, often, take account of 'group purposes' and that is only in 'rare' cases that directors act as 'puppets' (of shareholders or any other interested party).

Tax Advantage

With respect to what constitutes a 'tax advantage', Kwik-Fit Group Ltd v HMRC [2022] UKUT 314 (TCC) is advanced as a case being litigated 'which supports' the view, expressed by Lord Justice Parker in IRC v Trustees of the Sema Group Pension Scheme [2003] EWCA Civ 1857, that the term covers 'every situation in which the position of the taxpayer vis-à-vis the Revenue is improved in consequence of the particular transaction or transactions' (CFM38140).

Unallowable Purpose

In assessing whether securing a tax advantage is the main purpose or one of the main purposes, the new guidance indicates that HMRC will consider, in particular, the following factors (CFM38170):

- the size of the tax advantages, absolute or in comparison to the size of commercial (excluding UK tax) benefits

- the existence, or lack, of net UK tax benefits in wholly UK or cross-border financing arrangements

• the existence, or lack, of net global tax benefits in cross-border financing arrangements

• whether or not the arrangements would have happened, or would have happened in a different way, had the potential for the tax advantage never existed or had ceased to exist in the course of developing the arrangements, ie ‘but for the tax advantage’

• whether the borrowing funds activities or investments which are not expected to generate UK tax, either immediately or at all

Application in Practice

New examples (CFM38190) indicate that HMRC takes the view that if ‘an amount borrowed is intended to, and does, fund a business investment straightforwardly linked to the UK, where in particular the UK’s involvement generates a material net group commercial (non-tax) benefit’ HMRC will not normally expect there to be an unallowable purpose. In ten examples there is a choice between debt and equity funding, debt funding is chosen and the unallowable purpose rule is ‘unlikely’ to be engaged. A further seven examples, of which one relates to mutual trading, one to a borrowing for the purpose of lending to a director , one to an impairment loss on an interest free loan made for non-business reasons to an unconnected company, three relate to cross-border financings and one relates to financing with a UK group, illustrate fact patterns where HMRC will normally start from the presumption that there is an unallowable purpose.

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