10 May 2019

Global Tax Alert

UK First-tier tribunal rules financing structure's main purpose was a tax advantage; interest expense deduction disallowed

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Executive summary

The First-tier Tribunal (FTT) has found in favor of *HM Revenue & Customs* (HMRC) in relation to whether a loan issued by a United Kingdom (UK) company (Oxford Instruments UK 2013 Ltd) had a main purpose of achieving a UK tax advantage, and determined that all interest expense should be disallowed for Corporation Tax purposes to the UK company.

While the decision in this case was based on a specific set of facts involving a UK parented Group financing its United States (US) operations, the findings of the case may have broad application and impact for any UK financing arrangements.

Companies should consider the application of this case to existing and historic UK financing structures, and specifically to any structures that are currently under enquiry from HMRC.

Detailed discussion

Overview

The case involved a specific financing structure with which a UK parented Group debt funded its US operations, with a subsequent loan advance between the US Group and a disregarded UK subsidiary held by the US for the purchase of preference shares in the US group.

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The intention was to secure a deduction in the US Group in relation to the finance expense paid to the parent, with no incremental tax in the UK as a result of the interest expense in the UK subsidiary being group relieved against the interest income in the parent (with the return on the preference shares being exempt from tax in the UK).

Decision

The FTT determined that while the overall purpose of the "Scheme" was to secure a US tax deduction, the UK company issuing the loan had a main purpose of achieving a UK tax advantage and therefore all interest expense arising on this loan was not deductible for UK corporation tax purposes.

The FTT concluded that the final step of the Scheme, being the issue of a promissory note by a UK company and associated subscription for preference shares in the US group, was not required to achieve the US objectives of the Scheme.

This final step would not have been implemented if it would not have given rise to the UK tax advantage – interest expense in the UK subsidiary offset against the interest income arising in the UK from the preceding steps.

As such, the FTT concluded that the sole purpose of Oxford Instruments UK 2013 Ltd entering into the final step of the Scheme, the issue of the loan note in exchange for preference shares to the US, was to ensure that the overall Scheme would give rise to no incremental net taxable income in the UK by virtue of creating debits in relation to the interest expenditure.

Next steps for case

The taxpayer may seek permission to appeal the decision to the Upper Tribunal. Such an appeal will need to argue that there was an error of law in the decision (though this can include an unreasonable finding of facts). It should be noted that there were detailed facts set out as part of the judgment in this case which may impact the decision to appeal.

Decisions of the FTT do not generally create a binding legal precedent; however, they can be influential in other decisions of the courts and tribunals. Furthermore, the decisions of the FTT are often cited by HMRC and taxpayers in support of their contentions in disputes.

Key points from case

The FTT held that the key question was whether the borrower had obtained a tax advantage, and that by having the ability to offset the interest expenditure against other interest income, the UK had obtained such an advantage. The fact that the scheme, viewed in its entirety, was "flat" from a UK tax perspective did not undermine this conclusion.

Groups cannot simply rely on the fact that the refinancing results in no net increase in UK debt in considering the unallowable purpose provisions.

The Group's purpose for the Scheme was to debt fund the US and this was achieved in steps prior to the UK borrower issuing the debt. The issue of debt by the UK borrower was to secure the UK tax advantage and absent the UK tax advantage this step would not have been entered into.

The FTT noted that while the UK borrower obtained a commercial return on the borrowing, as the funds were used to acquire preference shares which resulted in an economic profit for the UK borrower, this was part of the means for justifying the overall transaction or perhaps part of the mechanism to achieve it and not the purpose for entering into the borrowing.

The decision emphasized that it is solely the purpose of the borrower company that is relevant.

The FTT also noted that if the company could show that it had one or more commercial main purposes which did not involve a tax advantage, in addition to the tax advantage purpose, there would be no need to apportion any of the interest debits to the unallowable tax advantage purpose.

The Group had previously obtained clearance from HMRC under the anti-arbitrage provisions (the precursors to the UK hybrid and other mismatch provisions). The court said that if HMRC had been intending at the time to challenge the structure on the basis that the unallowable purpose rule applied, it would have been misleading to provide clearance. However, the court decided that HMRC did not have the intention at the time and had subsequently changed their view on the application of the unallowable purpose rule to this structure.

Implications

Taxpayers with financing structures involving a UK borrower should consider the implications of this case, both in relation to ongoing enquiries and historic positions.

As noted above, the existence of an arbitrage clearance was not sufficient to protect the taxpayer from a challenge under the unallowable purpose rules.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United Kingdom), London

- James Taylor jtaylor3@uk.ey.com
- Claire Hooper chooper@uk.ey.com
- Fiona Thomson fthomson@uk.ey.com
- Amy Smith asmith11@uk.ey.com
- Richard Milnes, *Financial Services* rmilnes@uk.ey.com
- Tom Passingham, *Financial Services* tpassingham@uk.ey.com

Ernst & Young LLP (United States), UK Tax Desk, New York

- Matthew Williams matthew.williams1@ey.com
- Jo Smith jo.smith2@ey.com
- Pamela Collie pamela.collie1@ey.com

Ernst & Young LLP (United States), UK Tax Desk, San Jose

- Graham Nattrass graham.nattrass@ey.com

Ernst & Young LLP (United States), FSO Tax Desk, New York

- Michael Bolan michael.bolan@ey.com

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EYG no. 002249-19Gbl

1508-1600216 NY
ED None

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