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Allocation issues: Transfer pricing and tax avoidance: just and reasonable solutions?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Monday, November 16th, 2020

When the UK introduced its diverted profits tax, I was telephoned by a lawyer at the US Treasury. He wanted to know whether the "just and reasonable" apportionment of profits, in certain circumstances where DPT applied, was a new development? What did it mean?

I was reminded of that discussion this week as a result of two very recent judgements in the UK where the just and reasonable apportionment principle was engaged.

Oil and gas ring-fenced profits

In *Total E&P North Sea UK Ltd v HMRC* [2020] EWCA Civ 1419,the English Court of Appeal considered the application of a just and reasonable apportionment of profit in relation to oil related trading activities. For UK Corporation Tax purposes, these profits are ring-fenced from other trading profits and subject to a supplementary tax charge. The rate of the supplementary charge was increased part way through the taxpayer's accounting period. The issue turned on whether the total profits for that period should be apportioned on a time basis, or on the basis of separate profit calculations for each part of the period, before and after the rate increase.

The difference was significant because of Capital Allowances (tax depreciation) related to capital expenditure incurred in the earlier part of the period and also shutdown of the oil facilities in the North Sea as a result of storm damage and scheduled shutdown, which limited oil production in the later part of the period.

The Court of Appeal held that treating each part as if they were two separate accounting periods, and allocating income, expenditure and allowances to the periods accordingly was just and reasonable. Similarly, the Capital Allowances, which could be claimed in later actual accounting periods than when the expenditure was incurred, could be treated similarly for notionally separate periods.

Just and reasonable apportionment and tax avoidance

BlackRock Holdco 5 LLC v HMRC [2020] UKFTT 443 (TC), concerned the purchase of a United States resident company by another US resident company from a UK resident seller. A UK resident company was interposed between the US purchaser and the US target company. The UK company issued debt instruments (loan notes) to the US purchaser as part of the financing arrangement. HMRC challenged the deduction of interest expense on the loan notes on two bases. Firstly, the

loan notes were not on arm's length terms. Secondly, the purpose, or one of the main purposes, of the loan notes was tax avoidance. HMRC argued that both arguments meant that no interest expense was deductible.

Transfer pricing

HMRC argued that the loan would not have been made at all, had the parties been independent enterprises. The transfer pricing element turned on expert evidence provided by the parties. The experts agreed that it would have been possible for the borrower to execute a $4 billion debt transaction with an independent enterprise at similar interest rates to the actual transaction, but subject to different terms and conditions that independent lenders would have required to manage the credit risks appropriately. The key difference between them appeared to be that HMRC's expert considered that some form of guarantee would have been necessary. The taxpayer's expert considered that no formal guarantee was necessary because of the implicit support of the parent company.

The judge preferred the view of the taxpayer's expert, concluding that the loan would have been made between independent enterprises, albeit subject to additional covenants. A finding that the loan would have been made, would, in effect mean that only the rate of interest would be subject to adjustment to reflect the additional covenants. It appeared that both parties took an all or nothing approach.

Tax avoidance

The First-tier Tribunal (UK tax court of first instance) found that one of the main purposes was to secure a tax advantage (deduction of the interest expense) which amounted to avoidance within the specific anti- avoidance provisions relating to loan relationships (unallowable purpose in Corporation Taxes Act 2009, s 441 and 442). That legislation prohibits deduction of interest and other financing cost to the extent that it is, on a just and reasonable apportionment, attributable to the unallowable purpose.

The Tribunal found that there was a commercial purpose in making the loan. The judge accepted the taxpayer's evidence that the parties would have entered into the loans, even if there was no tax advantage. He concluded that the tax advantage purpose did not increase the interest expense. As a result, on a just and reasonable basis, all the interest expense was to be apportioned to the commercial main purpose, rather than the main tax avoidance main purpose.

What is just and reasonable?

The First-tier Tribunal did not attempt to address this. A quick review of the considerable UK case law where the principle is engaged, seems to show that courts tend to similarly apply the principle rather than analyse it. The Court of Appeal in the *Total* case identified indicators of reasonableness, including the fact that method was closely aligned to the method used for management accounting and reporting purposes and was not a contrived. It was applied consistently to both income and expenditure, which did not always work in the taxpayer's favour. It was also consistent with the statutory context of the ring fence for oil trades and capital allowances. HMRC's main concern with the justness of the result was that it led to all profits allocated to the earlier, lower tax period.

The amounts of money involved alone suggest that HMRC will seek to appeal both decisions.

A general principle of law

The principle is not limited to UK tax law (see for example, in the United States, Steve N. Isser, *Just and Reasonable: The Cornerstone of Energy Regulation*). Isser suggests a Roman law origin. Under Roman law, and off sale required the price to be genuine (*verum*). This requires an intention that the price be paid and that it should not be merely derisory. In such cases the transaction is not a sale but a gift. In addition, in some cases it must be reasonable (*justum*). Thus a vendor who received less than half the fair price might recover what he had sold, returning the money or require payment of the fair price (RW Lee, *Elements of Roman law* 4th Ed, pp 311 citing Justinian's Digest). These concepts suggest that the arm's-length principle is deeply rooted in fundamental legal principle.

Does the same concept apply to anti-avoidance doctrine or rules? The UK unallowable purpose test for debt finance expressly requires a just and reasonable apportionment. The latest iteration of anti-avoidance rules expressed in the OECD's PPT and the EU ATAD article 6 GAAR simply state that the treaty benefit should be denied (PPT) or the arrangements disregarded (ATAD GAAR). If a just and reasonable approach is a principle of more general application, that would suggest that treaty benefits would be denied to the extent identified with the tax avoidance purpose of the arrangements. Similarly, arrangements would be disregarded for purposes of the ATAD GAAR to the extent that they are associated with the tax avoidance purpose.

Critics of such an approach would no doubt pointed to the uncertainty inherent in concepts as vague as just and reasonable. Given the uncertainty that has always existed in anti-abuse doctrine and rules, this may not make it more so.Outcomes may be better. All views on this are invited.

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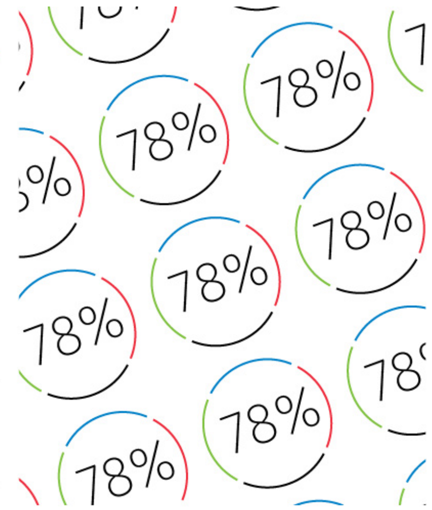

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