Transfer pricing and unallowable purpose: back to BlackRock

In *BlackRock Holdco 5 LLC v HMRC*, despite the Court of Appeal finding in favour of BlackRock Holdco 5 (LLC5) on the transfer pricing issue, its decision that the loan had an unallowable purpose means that LLC5 cannot claim deductions of £654 million (*[2024] EWCA Civ 330*). The judgment serves as a warning about the extent of tax-advantaged structuring of otherwise genuine commercial acquisitions.

Financing the acquisition

In December 2009, the BlackRock Group acquired the worldwide Barclays Global Investors business for about $2.25 billion in cash (the cash) and $8.5 billion in shares of its parent company (the shares).

The US part of the business was acquired by a Delaware limited liability company (LLC), LLC6, which was in turn financed by two other Delaware LLCs, LLC5 and LLC4.

The financing was achieved by a subsidiary of the BlackRock Group's parent company contributing the cash and the shares to LLC4 which, in turn, contributed most of the cash and all of the shares to LLC5 in exchange for shares and loan notes totalling $4 billion (the loans). LLC5 then contributed the cash and the shares that it had received to LLC6 in exchange for preference shares, which gave LLC5 a priority entitlement to distributions.

A small amount of the cash was also contributed by LLC4 directly to LLC6 in exchange for common shares, which gave LLC4 control over LLC6, including as to when distributions would be paid to LLC5 under the preference shares.

Unlike LLC4 and LLC6, LLC5 was controlled and managed in the UK and, therefore, resident in the UK for tax purposes. LLC5 claimed deductions for the interest paid on the loans and those deductions were challenged by HM Revenue & Customs (HMRC).

The transfer pricing issue

The first of HMRC's grounds for refusing the deductions was that the loans would not have been made between parties acting at arm's length, with the result that no deductions could be claimed.

The transfer pricing rules require a comparison between the loans entered into by LLC4 and LLC5 (the actual provision) and the provision that would have been made between two independent parties (the hypothetical provision). The First-tier Tribunal heard expert evidence that an independent lender would have loaned $4 billion to LLC5 but, given the control exerted by LLC4 over any decision of LLC6 to make distributions to LLC5, it would have required additional commercial covenants (*[2020] UKFTT 443 (TC)*). However, on the basis that these covenants would have been given, the First-tier Tribunal concluded that the loans would have been entered into by an independent lender.

HMRC adjusted its position in the Upper Tribunal, arguing that hypothetical third-party covenants cannot be considered under the rules when comparing provisions. The Upper Tribunal agreed, concluding that, as the loans did not actually include such covenants, they would not have been entered into between independent parties (*[2022] UKUT 199 (TCC); www.practicallaw.com/w-036-6556*).

However, the court has reinstated the First-tier Tribunal's decision. The court noted that, although the risks in the actual provision and the hypothetical provision were materially different, adjustments may be made to ensure that those differences are eliminated. The introduction of third-party covenants to the hypothetical provision did exactly that. The court reiterated how broad the concept of an "actual provision" is and stated that the net is therefore intended to be cast very widely.

Significance of the ruling on transfer pricing

Cases on transfer pricing are few and far between, so a Court of Appeal judgment on the application of the arm's length rule will be of interest to taxpayers involved in intra-group lending.

Following the Upper Tribunal decision, there was uncertainty as to whether taxpayers should be entering into formal covenants and security agreements, which are unnecessary in a group context, solely to ensure that their lending mirrored that of an independent lender. HMRC accepted that, in such a case, it would have to take account of those covenants and yet the Upper Tribunal suggested that this was an artificial process that would be very obvious. It was unclear where this left taxpayers that needed to document intra-company loans. They faced the dilemma of whether an unnecessary covenant would be the safest approach or would suggest an attempt to manipulate and abuse the legislation.

The court's more expansive approach suggests that taxpayers can take an arguably more reasonable and less formalistic approach.

Unallowable purpose

HMRC also argued that the loans had an unallowable purpose such that the interest deductions should be disallowed.

The tax deductions under the loans were accepted as comprising a tax advantage and so the dispute centred on whether that was a main (and, therefore, unallowable) purpose and, if so, whether there was also a commercial main purpose, that is, the anticipated profit from the preference shares, to which all or some of the debits could be attributed.

The First-tier Tribunal and the Upper Tribunal found that there were both tax and commercial main purposes. The First-tier Tribunal held that the debits were all attributable to the commercial purpose. The Upper Tribunal found that they were attributable to the tax main purpose.

The court reached the same conclusion as the Upper Tribunal but did so, unusually, by making its own findings of fact.

The First-tier Tribunal had found that the tax advantage was an inevitable and inextricable consequence of the loans, which funded the purchase of the preference shares. However, the court considered that more was needed and found that, however it might be presented, LLC5 became a party to the loans in order to obtain a tax advantage and that its sole function was to enter into the loans in order to obtain tax advantages for the BlackRock Group.

The court further considered that no part of the debits could be apportioned to the commercial purpose because the loans would never have been made in the absence of the tax advantage.

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Significance of the ruling on unallowable purpose

Anti-avoidance provisions are commonplace and a number of recent cases have considered the purpose of the borrowing company alongside the wider arrangement of which it is a part (see, for example, *JTI Acquisitions Company (2011) Limited v HMRC [2023] UKUT 194 (TCC); www.practicallaw.com/w-040-7987*). Although the court in *BlackRock Holdco 5* was clear that the purpose for which a company exists should not be elided with its purpose for entering into the loan relationship, it found that, on the facts, LLC5 had no other function.

The court provided some reassurance that it was the particular facts of the case that had prompted it to conclude that tax was a main purpose; that is, it concerned a UK-resident company in an otherwise US-based acquisition combined with no commercial rationale for LLC5's existence. Nonetheless, acquisitions of this type will often require complex debt-financing structures and deductions for interest payments will inevitably be crucial. Taxpayers will need to be alive to circumstances in which their situation could also cross the line.

The court provided little guidance on how to attribute debits between different purposes, finding that the mechanism to be used was fact specific. However, its approach suggests that no debits will be attributed to a commercial purpose where it cannot be divorced from the tax purpose. The implication is that taxpayers could be required to demonstrate that a loan relationship would have been entered into for its commercial purpose, regardless of any tax advantage.

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