Analysis

FII group litigation ruling on tax on foreign sourced dividends

Speed read

The Court of Appeal handed down its judgment in *The Test Claimants in the FII Group Litigation v HMRC* on 24 November 2016, finding largely in favour of the taxpayers. The method of computing double tax relief on EU sourced dividends for the period from 1973 to 1999 therefore remains as established by Henderson J. HMRC again raised its various 'restitutionary' defences as to why it should not have to repay the unlawful tax, but these were rejected. The court notably allowed the claimants' cross-appeal regarding the date of discovery, extending the date from which the six-year limitation period began to run from 2001 to 12 December 2006 and bringing all claims in the GLO within time.

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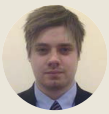

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On 24 November 2016, the Court of Appeal delivered its judgment in the franked investment income (FII) group litigation (see *Test Claimants in the FII Group Litigation v HMRC* [2016] EWCA Civ 1180, reported in *Tax Journal*, 2 December 2016). This determines HMRC's appeal and the claimants' cross-appeal against Henderson J's judgment of 18 December 2014. It is the latest development in the long-running litigation, which has generated decisions at every level of the UK courts and no fewer than three references to what is now the CJEU.

The background to the case is the hybrid system of taxation operated by the UK until 1999 of exemption for domestic dividends and imputation (granting credits for foreign tax) for foreign dividends. That system required the payment of advance corporation tax (ACT) at the corporate level to be set against corporation tax, with a corresponding credit to the shareholders to be set against income tax.

Prior to the High Court hearing, the claimants had already established that various aspects of this regime were contrary to EU law and that they were entitled in principle to restitution of the unlawfully levied tax. This was true in relation both to corporation tax charged on foreign sourced dividends under Schedule D Case V of ICTA 1988 (DV tax) and to ACT.

Henderson J's judgment therefore focused on quantifying the claims and the availability of certain defences to HMRC.

The High Court's judgment took the form of 29 separate issues, 19 of which were appealed to the Court of Appeal. The Court of Appeal determined 17 of the 19 issues in the claimants' favour, largely for the reasons already given by Henderson J. The claimants' case had also been strengthened in a number of respects since the High Court's judgment, as a result of the Court of Appeal's decision in *Prudential Assurance Company Ltd v HMRC* [2016] EWCA Civ 376 (*Prudential CA*), which considered some of the same issues in the context of portfolio holdings.

This Court of Appeal has not merely relied on that earlier judgment, but has actively reconsidered the same points and come to the same decisions. Between them, these judgments now establish the methodology for computing claims for double tax relief and the recovery of ACT for holdings both above and below 10%.

The one adverse change to the High Court's judgment which has any impact on value is only relevant to the circumstance of a UK company in receipt of EU dividend income, and which then paid ACT on dividends to a foreign parent. In circumstances where the foreign parent was entitled to an abated half tax credit for the ACT paid, the Court of Appeal has held, contrary to Henderson J, that credit must be given against the ACT reclaim for the half credit received. This produces a minor reduction in the value of such ACT claims.

Date of discovery

In one significant way, the claimants have substantially improved their position over the High Court judgment. This concerns the time limit for issuing High Court claims. High Court claims must be issued within six years of payment of the tax concerned. For claims in mistake, however, that six year period does not commence until the claimant discovered, or could with reasonable diligence have discovered, that the tax had been paid by mistake (the tax in reality not being due). Henderson J had set that date at 8 March 2001, the date of the *Hoechst* judgment [2001] Ch 620. This put claims issued after 8 March 2007 out of time, which affected seven of the claims in the GLO.

Following the Supreme Court's logic in *DMG v HMRC* [2006] UKHL 49, the Court of Appeal held that, in the case of a point of law being disputed in current litigation, the true state of the law is not 'discoverable' until the point has been authoritatively resolved by a final court. For the claimants, this was not until the CJEU's decision in the first *FII* reference (Case C-446/04) on 12 December 2006. This had the effect of ensuring that all claims within the GLO were in time.

Restitutionary defences

Having determined the amount of the unlawful tax, the court went on to consider various 'restitutionary' defences put forward by HMRC. These were various arguments to the effect that it was not required to repay any (or virtually any) tax, even where it had been unlawfully levied.

Set-off against unlawful tax (issue 17)

This concerned the extent to which HMRC could deduct credits given to shareholders from the amounts of unlawful ACT to be repaid.

The High Court had previously held that this was not allowed because, inter alia, there was insufficient connection between the credits and the unlawful tax, as they were the subject of independent statutory provisions. The Court of Appeal dismissed HMRC's appeal but disagreed with Henderson J's reasoning; it was not necessary that HMRC be 'a mere channel for the transfer of money from companies to their shareholders'. The real issue, it said, was that on a proper construction, the credits were not dependent on payment of the unlawful tax at all.

Change of position (issues 19 and 20)

HMRC argued that it should not have to repay the unlawful tax because it had changed its position by irretrievably spending those receipts.

Whilst this argument was available in principle, HMRC had not successfully proved it on the facts. It had to show that expenditure would not have been incurred had the overpayments not been received; it was, however, 'miles away from demonstrating that to be the case'. Critically, there was a 'fatal absence of evidence of how *any* ACT (utilised or not) was taken into account in government forecasts'. The same was true in relation to the relatively modest overpayments of corporation tax on DV income.

Actual benefit (issues 22 and 23)

HMRC argued that it was only required to repay the unlawful tax to the extent of the 'actual benefit' that it received from it. This, it argued, was much less than the objective time value of the cash, because it had been largely spent on current public expenditure (as opposed to reducing borrowing or on capital expenditure), which was of no value.

The Court of Appeal overturned the judge's conclusion that this defence was not open to HMRC as a matter of English domestic law. However, the court then agreed with the judge that in any case the defence had not been made out on the facts. The government was not to be regarded as an involuntary recipient of the tax. It was well able to choose how to spend the overpayments and whether or not to repay borrowing; as such, it was required to repay the objective use value of the money, accepted to be compound interest at the government borrowing rate.

Remedies under EU law (issues 18, 21 and 24)

Having rejected each of HMRC's arguments to reduce the amounts repayable as a matter of English law, the court considered that the same arguments were, in any event, precluded as a matter of EU law.

Next steps

At the time of writing, the Court of Appeal has yet to decide whether to grant HMRC permission to appeal to the Supreme Court. It is likely that it will at least receive permission to appeal the question of whether interest is to be paid on a compound or simple basis, in order to protect its position should the Supreme Court overturn the Court of Appeal's judgment in *Littlewoods Retail Ltd v HMRC* [2015] EWCA Civ 515. If the Court of Appeal refuses HMRC's application, the next stage will likely be for it to seek permission directly from the Supreme Court, with a decision expected usually in about four months from the judgment.

The Court of Appeal's decision marks a significant step in this mammoth litigation, a major contribution to the English law of restitution and a positive result for the claimants and other multinationals with claims enrolled in the GLO. Whether the end is now in sight or whether there will be a second trip to the Supreme Court, however, still remains to be seen. The table (right) sets out each of the issues of the FII case and their status. ■

The author's firm acted for the claimants in this case.

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- Cases: *The test claimants in the Franked Investment Income group litigation v HMRC* (30.11.16)
- *Prudential Assurance*: foreign dividend income and EU law (Simon Whitehead & Philippe Freund, 11.5.16)
- High Court judgment in FII: compensating for unlawful tax (Simon Whitehead, 15.1.15)

The status of the FII issues at stake

Issue		Answer	Status
1	DTR credit on DV income	Credit for the higher of tax actually paid or the foreign nominal rate (FNR). FNR credit is only available for EU/EEA sourced income	Court of Appeal (CA) upheld High Court
2 & 3(a)	Which FNR?	The FNR of the profit source with a blended DTR credit for mixed source dividends (ICTA 1988 s 801)	CA upheld High Court
3(b)	Exempt capital gains	FNR credit extends to such exemptions	CA upheld High Court
3(c)	Belgian Coordination Centres	FNR credit is limited to the actual tax base	Not appealed to CA
3(d)	German silent partnerships	No ACT credit or additional credit against DV income available	CA upheld High Court
3(e)	UK sourced profits of another EU company	The same credit is available as under [1]	CA upheld High Court
4(a)	Computation of DV income	Grossed up by actual tax paid (i.e. not grossed up at the FNR)	Not appealed to CA
4(b)	Withholding tax (WHT)	Credit for WHT is in addition to credit for ULT	CA upheld High Court
5	ACT credit for foreign tax on DV income	Credit for the higher of tax actually paid or the FNR capped at the ACT rate	CA upheld High Court
6	WHT credit against ACT	Credit for foreign tax against ACT is inclusive of WHT	CA upheld High Court
7	Nature of the credit for foreign tax against ACT	An ICTA 1988 s 231 credit calculated in accordance with [5] & [6]	CA upheld High Court
8	Which FNR to credit against ACT?	Same answer as for DV tax	It was agreed that the same would follow as for DV tax
9	Linking of foreign tax credits with ACT paid higher in the corporate hierarchy	EU income created FII computed in accordance with the answers above. The credits passed with group income as if FII	CA upheld High Court
10	Foreign income dividends (FIDs)	ACT on FIDs was always unlawful	CA upheld High Court
11	Attribution of ACT utilised within a mixed pool of lawful and unlawful ACT	A pro rata approach applies	Decided in Prudential CA
12	Carried back FII	Pro rata between lawful and unlawful ACT	Decided in Prudential CA
13	Attributing EU FII to quarterly ACT payments	If dates of receipt are not known, pro rata	Not appealed to CA
14	ACT credit for EU branch profits?	No	Not appealed to CA
15	Parent treaty credits	Must be offset against ACT claimed	CA overturned judge
16 & 29	Quantification	The method of computing claims applying the above answers has been agreed	Agreed
17	Shareholder credits	HMRC was not 'disenriched' by the payment of shareholder credits, as such credit had to be given by the payment of foreign tax	CA upheld High Court for different reasons
19 & 20	Change of position	HMRC can argue that it changed its position by using the unlawfully collected tax against public expenditure as a matter of English law, but it failed to prove it as a matter of fact	CA upheld High Court
22 & 23	Actual benefit	HMRC can argue that the value of the tax unlawfully collected was less than its objective value as a matter of English law, but it failed to prove it as a matter of fact	CA overturned High Court on the issue of English law but came to the same answer on the facts
18, 21 & 24	Are these restitutionary defences precluded by EU law?	Yes	CA upheld High Court
25 & 26(a)	Simple or compound interest	Compound	On the period to utilisation of ACT, this is agreed. Decided for subsequent periods in Littlewoods CA
26(b)	Interest rate	Moving average of 10 year gilts	Agreed
27 & 28	Time limits	Six years from 12 December 2006	CA overturned High Court