

Test Claimants in the FII GLO

FII-nding a way through the trees

The decision of the High Court in *Test Claimants in the Franked Investment Income GLO* [2008] EWHC 2893 (Ch) comes almost two years after the ECJ's decision in that case. The ECJ had held (C-446/04) that the UK's tax regime for foreign dividends, and the rules which gave rise to substantial surplus ACT for UK multinationals, were in principle contrary to EC law.

HMRC has kept these claims in limbo ever since and this is the first guidance from the domestic courts on how the ECJ decision should be applied in practice. Henderson J's judgment, while in its own way a model of simplicity and clarity, is 149 pages and 450 paragraphs long. And because of the approach to case-management, the judgment handed down on 27 November is essentially a ruling on a series of preliminary issues. He has not drawn those issues together – because he was not asked to do so – into a coherent whole.

Henderson J's decision straddles complex EU non-discrimination issues and also some novel and relatively untested non-tax legal issues relating to High Court remedies. Some of what he says is unquestionably right. Some of what he says is much more contentious. This article attempts to answer in plain English the question that taxpayers with surplus ACT or a D(V) tax charge (that is, a charge on dividends under Case V of Schedule D) have been asking their advisers since the judgment was released: where are we now?

D(V) charge: EU dividends

The starting point here is the decision of the ECJ. The ECJ had held that the UK was permitted in principle to operate a credit system for foreign dividends and an exemption system for domestic dividends. However, this was only insofar as full credit was given for tax paid locally and the tax rate applied to foreign-sourced dividends 'is not higher than the rate

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applied to nationally-sourced dividends' (para 57). On this basis the UK system was discriminatory in respect of portfolio dividends (because it did not give credit for underlying tax, only for withholding tax) and in respect of non-portfolio dividends insofar as a higher rate applied to foreign dividends than domestic dividends.

However, this was all very high-level. It is the UK courts that are required to tie it down to practicalities. Henderson J was asked to make a start on this process for non-portfolio dividends and said that because the *effective* rate of UK corporation tax on domestic profits was in almost all circumstances (and for the test claimants) less than the headline 30% rate charged on foreign dividends, and because the UK tax system did not allow for a reduced overseas effective rate to be passed on, the UK system was discriminatory. The ECJ had not considered this in any detail (the only relevant text was in para 54) but the Advocate-General had done so, finding for the Test Claimants. Henderson J took a very textual analysis of the Opinion and the judgment and concluded that the ECJ had agreed with the view of the Advocate-General. Accordingly, he held that the UK taxation of non-portfolio dividends was contrary to EU law.

Still, because of the nature of the issues put to him, Henderson J was not able to take things any further. He said nothing at all about the impact of this discrimination. There are essentially two possibilities: the first is that the D(V) tax regime is completely disapplied in favour of taxpayers; the second is that it is disapplied only insofar as necessary to reduce the D(V) tax burden to a level

which gives an effective overall tax rate on non-UK-sourced profits which is 'no higher than the rate applied' to UK-sourced profits. This is yet to be resolved.

Henderson J does give clues as to what he might decide: he insisted that the rules on conforming interpretation which played such a significant role in the High Court in *Vodafone 2* [2008] EWHC 1569 are not relevant in this case, but was also prepared to rely on the EC rules on 'effectiveness', concluding that in certain cases they prevented HMRC from insisting on overly detailed evidence to make good EC claims. This suggests that, when asked to do so, Henderson J might well disapply the regime altogether. In other words EU dividends should, in all cases, be exempt from UK tax in the same way that ICTA 1988, s 208 exempts UK dividends. But this is still a question for the future.

D(V) charge: non-EU dividends

Henderson J then turned to claims in respect of non-EU dividends. He said that his decisions above would apply equally to non-EU dividends and profits as they do to EU dividends and profits unless (a) there was a specific reason why the relevant EC Treaty provision (Article 56) should not apply, or (b) the 'grandfathering' protection in Article 57, protecting rules in force before 1 January 1994 from challenge under Article 56 in non-EU situations, blocked the claims.

On (a) he robustly held that the only circumstance in which Article 56 was excluded was where the rule in question was framed in such a way that it could only apply to establishment (for present purposes: group) situations. He then held that the UK

dividend taxation rules apply to all dividend receipts, so Article 56 applies.

With regard to (b) Henderson J was equally robust, but robust in favour of HMRC. There was no debate that the D(V) regime had applied since before the cut-off date, so the only question was whether there had been changes since then which effectively made it new legislation. Henderson J held that the D(V) legislation had not been substantively changed since then, so the D(V) charge was immune from challenge in the context of non-EU-sourced dividend receipts.

D(V) charge: portfolio dividends

Henderson J was asked to consider only non-portfolio dividends, as it was agreed that all claimants in the FII GLO had received dividends from foreign subsidiaries. That said, in the context of EU-sourced foreign dividend income his findings should equally apply, with exemption of such dividends being required, it being remembered that the ECJ's earlier decision made clear that the UK dividend taxation rules as applied to portfolio dividends are clearly in breach of EC law.

With regard to non-EU-sourced foreign dividends the position was simply untouched. It is clear Henderson J considered that Article 57 protects the discriminatory UK rules from challenge in a foreign, non-EU, non-portfolio investment scenario. However, there was no need for him to deal with the obvious point that Article 57 arguably relates only to a 'direct investment', which in this context the ECJ has previously found not to include portfolio investment. If the courts accept that Article 57 does not cover portfolio investment, claims to exempt from UK tax foreign, non-EU-sourced portfolio dividends will have strong grounds for succeeding.

In other words, there are real uncertainties remaining around what the decision means for portfolio investors. It is reasonable to expect that claimants in *CFC and Dividend GLO* will now start agitating for progress in relation to their own fact patterns. There is no immediate sign of this issue being resolved in the *FII GLO*.

Surplus ACT claims

Henderson J also addressed preliminary questions on claims in respect of the ACT regime. ACT was a tax triggered by (and calculated by reference to) payment of a dividend. The sums paid as ACT were then treated as an advance payment of corporation tax and were available to



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reduce the mainstream corporation tax liability due at the end of the year. Under domestic rules a dividend paid by a UK-resident subsidiary attracted ACT and carried a tax credit which meant that no ACT was due on any onward dividend. This credit meant that the dividend was referred to as 'franked investment income'. However, a dividend paid by a non-UK subsidiary carried no tax credit.

The ECJ recognised that ACT was just an advance payment of corporation tax and a peculiarity of the UK system. Accordingly, it held that dividends paid by non-UK subsidiaries on which local corporation tax had been paid should be treated in the same way as dividends paid by UK subsidiaries on which ACT had been paid, and so should also carry the credit. Henderson J approved this and rejected an argument by HMRC that the credit should be restricted by reference to the actual underlying tax paid, holding that that was too complex for the taxpayers to prove. This simplifies the work that taxpayers must do to make out a claim but there is much that he was simply not asked to rule on.

Following *Hoechst C-397/98* it also seems reasonable to assume that claims can still be made for loss of use of cash, even where the surplus ACT was subsequently utilised. Recent ECJ decisions (such as *Lidl C-414/06*) have adopted a less bullish approach to the impact of cash flow disadvantages. But there is nothing here to indicate that that approach has been sufficient to contaminate the clear ECJ decision relating to the ACT regime in *Hoechst* and claims for the cash flow cost of long-standing surplus ACT should remain unimpaired.

The principal issue that Henderson J was asked to deal with was driven by HMRC adopting a very narrow approach to the ECJ's decision. HMRC said that the decision only applied where – in broad terms – the profits were originally generated by the company that paid the dividend to the UK and where the ACT was paid by the UK company that received that non-UK dividend. HMRC had a strong tactical imperative to do so: if this was the correct approach it would slash the value of the claims, by perhaps 90%. Henderson J preferred the taxpayer's argument (that the point in the chain where the non-UK tax or ACT was paid was irrelevant) but as this question was so financially important and had not been squarely put to the ECJ, he felt that the ECJ should be given the opportunity to answer it, so he proposed to make a further reference to the ECJ.

As to claims in respect of non-EU dividends (whereby claimants argue that the foreign, non-EU-sourced dividends should count as FII), Henderson J again made no comment. However, on the basis that the only material change to the ACT regime between 1993 and its abolition in 1999 was the introduction of the FID regime, which mitigated the effect of surplus ACT, it seems very likely that claiming to treat foreign, non-EU-sourced dividends as FII so as to be entitled to a repayment of the ACT suffered stands no greater chance of success than the non-EU D(V) claims.

On the other hand, surplus ACT triggered by dividends from EU mixer companies funded from non-EU profits should be in a different position. Henderson J did not express a clear view here. However, factually what is received in the hands of the UK taxpayer is an EU-sourced dividend. Furthermore, the ECJ has accepted that taxpayers are entitled to arrange their affairs tax efficiently – mixer companies being put in place to manage groups' exposure to double taxation. This would support the position that ACT paid as a result of EU mixer company dividends not constituting FII should be recoverable.

Finally, for claims arising under the FIDs regime itself, Henderson J held that claims could be pursued in respect of non-EU dividends, as the FID regime was a 'new restriction': however, this may only be relevant to claimants in the *FID/Manninen GLO*, as the claimants in FII principally sought to reclaim their loss in having to pay 'enhanced FIDs', which Henderson J said was not a permissible head of claim.

Time limits

The issue of time limits is perhaps the cloudiest of all. Obviously claims can be made going back six years. The real question is whether they can stretch back further. Henderson J lays all of the groundwork for claims to be made for dividends or surplus ACT stretching back to 1973, when the UK first joined the EU. He holds that the *Deutsche Morgan Grenfell* [2006] UKHL 49 mistake of law claims are available. He also strikes down the UK's blocking legislation in Finance Act 2004, s 320 and Finance Act 2007, s 106 without any trouble at all, relying effectively on *Condé Nast/Fleming* [2008] UKHL 2. At this point most taxpayers would assume that the way was clear.

However, in light of a completely separate conclusion buried in Section VI of his judgment, it appears that Henderson J expects these claims to

whether HMRC will actually be able to rely on this. First, this is not a final ruling in HMRC's favour: as he makes clear at [445] he has only ruled that it is available *in principle* and HMRC would have to prove on the facts that it should be available in this case. Second, this decision is actually a significant extension of the current law on change of position in terms of when HMRC can say 'I have spent it' and this extension may well not be legitimate. Third, as in *Sempra Metals*, the EC doctrine of 'effectiveness' could well override this rule of English law and his judgment – if anything – supports the proposition that it should do ([306] to [308] and [442]). Fourth, his decision makes clear that the reason HMRC should have this defence is that 'the money has long ago been spent in the public interest, and everybody assumed in good faith that it had been validly levied' ([344]).

not fully intend to grant). In *Sempra Metals* the House of Lords said that in compensation claims the appropriate rate is the rate that the taxpayer would have borrowed at, and in restitution claims the rate is the rate that HMRC could have borrowed at.

Henderson J made very clear that claims for restitution could be brought but claims for compensation could not (because of a technical EU law reason: HMRC's failure to have correct legislation was not 'sufficiently serious' to trigger compensation claims – see [353] to [404] and [406]). Therefore interest can be awarded on these and other future EU claims on a compound basis but (subject to one technical argument) will be calculated at the rate that HMRC could borrow at. Rates on gilt-edged securities may be a very good starting place.

Conclusion

In summary, Henderson J has answered a great many questions but still left taxpayers some way from settlement. Those already involved in the GLO can proceed with cautious optimism.

Taxpayers seeking to make claims for exemption from D(V) tax on EU dividends should certainly press ahead (through their tax returns if possible). Discussions should be had with Inspectors to explore whether returns can now be agreed. Portfolio investors in receipt of non-EU-sourced dividends continue to have clear grounds to pursue exemption claims.

At least for claims for surplus ACT pursued through the High Court, there remains a substantial prospect that claims can go all the way back to 1973. With the blocking legislation ruled to be illegal, taxpayers who have yet to take action seeking recovery of surplus ACT – or even the cash flow cost on ACT which has now been utilised – may still be in time to do so. The case is also a huge shot in the arm for the pension funds and life assurance companies looking to claim cash tax credits on FIDs.

Let us not forget, though, that there was much that Henderson J was not asked to consider. Further, this is a partial win for both sides in the case and both sides will undoubtedly appeal on the issues where they have not succeeded. The test claimants are not out of the woods just yet.

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fall at the final hurdle. This is because he concludes – tentatively – that a general English law defence known as 'change of position', which HMRC has raised for the first time in this case and did not raise in *Deutsche Morgan Grenfell*, *Sempra Metals* [2007] UKHL 34, or *Condé Nast*, may be very helpful to HMRC. He does not think that it applies across the board but he does think that it applies in relation to the only High Court claims which could take advantage of the extended time-limits: that is to say, the 'mistake of law' claims which were approved in *Deutsche Morgan Grenfell*.

The defence of change of position broadly operates in the following way. In legal terms restitution claims are based on the idea that the defendant has something which the claimant transferred without really *meaning* to do so (say, because it was mistaken). The change of position defence is an argument that the defendant should not be obliged to return that something because he no longer has it: in particular, because he spent the money or dissipated the benefit in reliance on having received it.

Henderson J is clearly of the view that this defence should be available. However, there are four reasons to doubt

Even if that is true for D(V) tax, HMRC will face significant hurdles in proving that for surplus ACT, which was never meant to be a permanent tax in the first place.

In any event, it is important to bear in mind that EU claims in respect of non-EU dividends cannot go back past the early 1990s. Simply: the right to free movement of capital was not directly enforceable prior to that.

Interest charge?

Henderson J did not deal directly with the question of how to calculate interest in any viable claims. This will be a matter of great interest to many claimants, as it will represent a substantial part of their claim. However, the position he will take in due course seems clear, in light of the decision in *Sempra Metals* and Henderson J's approach to the question of remedies.

In *Sempra Metals* the House of Lords confirmed that compound interest is available in EU High Court claims. High Court claims rely on one of two legal remedies: compensation for the taxpayer's loss (a remedy required where HMRC has breached a statutory duty) or reinstatement of HMRC's gain (a remedy required where HMRC has received a benefit that the taxpayer did