[2018] UKUT 0152 (TCC)

Appeal number: UT/2016/0191

INCOME TAX – pension fund lending overseas shares under stock lending arrangements – ICTA 1988, Sch 23A – manufactured overseas dividends ("MODs") representative of dividends on overseas shares – whether a difference in UK tax treatment between MODs and manufactured dividends representative of dividends on UK shares was a restriction on movement of capital – Art 56 EC Treaty; Art 63 TFEU – whether restriction justified by an overriding reason in the public interest – prevention of tax avoidance – balanced allocation of taxing powers – fiscal cohesion – remedy

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

COAL STAFF SUPERANNUATION SCHEME TRUSTEES LIMITED — **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Respondents**

TRIBUNAL: MR JUSTICE MORGAN
JUDGE ROGER BERNER

Sitting in public at The Royal Courts of Justice, The Rolls Building, Fetter Lane, London EC4 on 13 and 14 February 2018

Malcolm Gammie QC and James Rivett, instructed by Pinsent Masons LLP, for the Appellant

Rupert Baldry QC and Oliver Conolly, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. This is the appeal of the appellant, the Coal Staff Superannuation Scheme Trustees Limited ("the Trustee") against the decision of the First-tier Tribunal ("FTT") (Judge Jonathan Cannan and Mrs Helen Myerscough) released on 27 June 2016 (and published under the reference [2016] UKFTT 0450 (TC)) by which the FTT dismissed the Trustee's appeal against the refusal by HMRC of the Trustee's claims for payment of "relevant withholding tax" in respect of manufactured overseas dividends received by the Trustee pursuant to certain stock lending transactions in the years 2002-03 to 2007-08. The Trustee appeals with permission of Judge Cannan.

2. The aggregate amount of the Trustee's claims is £8,827,316. A number of other UK pension funds, life insurance companies, investment funds and charities have made similar claims. We understand that there are parallel proceedings in the High Court which have been stayed pending the outcome of these proceedings. This case is therefore regarded as a test case.

The basis for the Trustee's claims

3. By way of introduction, we set out a brief summary of the basis of the Trustee's claims.

4. The Trustee is an institutional investor which is as such a long-term holder of shares issued by UK resident companies ("UK Shares") and shares issued by non-UK resident companies ("Overseas Shares"). The Overseas Shares include shares in companies that are established both in the European Union ("EU") and in third countries.

5. For a number of years, the Trustee has used its investment portfolio as a means of entering into stock lending transactions. Stock lending is an integral feature of properly functioning securities markets and is one of the means by which market liquidity in terms of the securities traded is maintained. It is frequently used by large institutional investors, such as the Trustee, as a means of generating an additional income on their securities portfolios through the charging of a fee to the Borrower for each loan transaction. These are wholly commercial transactions entered into on ordinary market terms and in the ordinary course of market operations. It was common ground that the Trustee's stock lending programme did not have any tax avoidance purpose.

6. We shall consider the mechanics of stock lending and its UK tax treatment in more detail below, but in summary under the contractual terms of the relevant stock loans the Borrower was obliged to provide the Trustee, as Lender, with a payment equivalent to dividends paid on the relevant shares during the stock lending period. Under the UK tax regime, such payments are known as "manufactured dividends" ("MDs") when the underlying securities are UK Shares and as "manufactured overseas dividends" ("MODs") when those securities are Overseas Shares. At the end of the term of each relevant stock loan, the Borrower was obliged to return to the

custodian bank (as agent for the Lender) either the same or equivalent shares, and the Borrower was entitled to the return of an amount equivalent to the collateral it had provided.

7. In broad terms, under the legislation as it then stood, so far as the Borrower is concerned, the MDs are treated for UK tax purposes as if they were dividends on the underlying UK Shares. There is accordingly no UK withholding tax on those amounts, and the Trustee, as an exempt fund, suffered no UK tax on the MDs it received in the relevant period in respect of the UK Shares. By contrast, in the case of MODs, the gross amount of the dividends paid on the underlying Overseas Shares is subjected to a deduction of relevant withholding tax at source ("the MOD withholding tax"), and the MOD is treated as an overseas dividend of the gross amount but paid after withholding on account of overseas tax of the amount of the MOD withholding tax deducted.

8. The Trustee's case is that the difference in treatment as between MDs paid in respect of the lending of UK Shares and MODs paid in respect of the lending of Overseas Shares, which arose solely as a result of the exercise by the UK of its taxing competence, discriminated against and was liable to discourage investment in Overseas Shares. In consequence, submits the Trustee, the MOD withholding tax constituted a restriction of movement of capital under EU law which infringed the Trustee's rights and which was prohibited by Article 56 of the Treaty Establishing the European Community ("the EC Treaty") and for later periods Article 63 of the Treaty on the Functioning of the European Union ("TFEU").

Stock lending: the contractual position

9. We start by examining the nature of a stock lending transaction in Overseas Shares. Such transactions are subject to a market standard Overseas Securities Lending Agreement, although that is typically modified in certain respects by an Appendix. The agreements we had before us were in a standard form, but in each case were subject to an amending Appendix.

10. With one exception, all the agreements we had were entered into in periods which pre-dated the relevant periods of the Trustee's claims. However, the parties agreed that all of the agreements were representative of the contractual terms that applied to the stock lending of overseas securities at the relevant time. Both Mr Gammie and Mr Baldry made submissions by reference to an agreement dated 23 December 1998 between The Chase Manhattan Bank (London branch), which we infer was at that time acting as agent for the Trustee, as Lender, and an unnamed counterparty as Borrower, and it is that agreement that we will take as representative.

11. In considering the nature of a stock lending transaction, it is important, we consider, to appreciate that the expression of the process as one of lending and borrowing, with accompanying collateral by way of security, is essentially one of market practice. That reflects the underlying economics of the transaction. The agreement respects that economic substance, but the legal mechanisms by which it is achieved are different. That can be seen clearly from clause 1(C):

> "Notwithstanding the use of expressions such as 'borrow', 'lend', 'Collateral', 'Margin', 'redeliver' etc. which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, title to Securities 'borrowed' or 'lent' and 'Collateral' provided in accordance with this Agreement shall pass from one Party to another as provided for in this Agreement, the Party obtaining such title being obliged to redeliver Equivalent Securities or Equivalent Collateral as the case may be."

12. Although amended so as to refer simply to a recital that the parties might enter into stock lending transactions from time to time "subject to any Inland Revenue provisions then in force", in its standard form, Recital 1 of the agreement contemplates that the Borrower will be enabled to fulfil contracts to sell the relevant securities or to lend them on to others for that purpose. This reflects the rationale of stock lending, to which we referred above, as a means of providing market liquidity. Although the terminology of loan transactions is employed, the provision of that liquidity entails more than simple lending; it is necessary that the Borrower obtains full title to the securities in order that such title will pass to other market participants.

13. The passing of title to the securities is provided for by Clause 4. Under that clause the parties are obliged to procure that all right, title and interest in the securities borrowed passes to the Borrower, subject to further terms and conditions of the agreement and in accordance with "the Rules". Those Rules are defined as including the rules of the Stock Exchange, and the provisions with regard to tax contained in regulations and Inland Revenue guidance notes and associated procedures. The same title provisions apply with respect to the Equivalent Securities which a Borrower is obliged to redeliver to the Lender, and to both the Collateral provided by the Borrower to the Lender and the Equivalent Collateral which is redelivered by the Lender to the Borrower. The redelivery obligations are confined to those equivalent assets; there is expressly no obligation on any party to return or redeliver any of the assets acquired under the agreement.

14. Although title to the securities which are the subject of the stock loan vests in the Borrower, the agreement reflects the economic substance of a loan transaction in a number of ways. Most material are the provisions for the payment of MODs. The Borrower is obliged to make a payment to the lender of an amount which represents any dividend that has been paid in relation to the securities. That obligation arises whether or not the Borrower has received the dividend. In fact, in most cases, given the nature of stock lending, and its purpose, the Borrower will have transferred full title to the securities, including the right to the actual dividend, to a third party, and the ultimate owner of the securities (and the dividend) at the material time may be a person deriving title through a number of market transactions.

15. The MOD which, unless a lesser amount is agreed to be paid, is expressed to be payable by the Borrower to the Lender is the amount of the net dividend on the securities (which will be the amount after deduction by the issuer, for example of any applicable dividend withholding tax) grossed up by the addition of "an amount equivalent to any deduction, withholding or payment on account of tax made by the relevant issuer (or on its behalf) in respect of the [dividend] together with an amount

equal to any other tax credit associated with such [dividend] …" As an alternative, such grossing-up is not required if the Borrower is able to provide to the Lender a tax voucher which enables the Lender to claim from the relevant tax authority any repayment of tax or benefit of a tax credit to which the Lender would have been entitled but for the stock loan.

16. It can be seen therefore, that although the legal effect of a stock lending transaction is that the Lender is divested of all rights and title to the securities, including the right to receive a dividend on the securities, the economic effect is that the Lender is given a compensatory entitlement to a payment which is equivalent to the dividend, together with rights to tax repayment or tax credit where applicable, but otherwise with the benefit of grossing-up for amounts deducted or withheld, or applicable tax credits. In economic terms, the Borrower is intended to be placed in broadly the same position as regards the benefit of dividends as if it had retained the securities in its own beneficial ownership.

17. The payment obligation of the Borrower to the Lender in respect of the MOD is subject to any requirement of the Borrower to account for UK withholding tax. The Borrower is obliged to pay the amount of the MOD less amounts equal to such withholding tax, and the Borrower must also, if requested to do so, supply a tax voucher to the Lender in respect of the UK tax deducted.

18. The economic equivalence to a lending transaction is also reflected in other provisions of the agreement. Thus, there are provisions which enable the Lender, despite having transferred all title to the securities, to give instructions in certain circumstances (where the Borrower is holding securities of the same description as those lent) for the exercise of voting rights attached to those securities. Further, the requirement to redeliver Equivalent Securities extends, subject in some cases to notice having been given by the Lender or a relevant payment having been made, to securities into which the original securities have been converted, subdivided or consolidated, to a sum of money equivalent to the proceeds of any redemption, to the consideration received in the case of a takeover, and to the original securities plus any bonus or rights issue securities allotted in that respect.

Stock lending: the UK tax position

19. The relevant statutory provisions for the years 2002-03 to 2006-07 are those contained in s 736A of and Schedule 23A of the Income and Corporation Taxes Act 1988 ("ICTA"). The provisions of Schedule 23A applied to certain cases where under a contract or other arrangements for the transfer of shares or other securities a person is required to pay to the other party an amount representative of a dividend or payment of interest on the securities (s 736A ICTA).

20. The provisions of s 736A and Schedule 23A ICTA were re-written as part of the tax law rewrite project and are contained within Chapter 9 of Part 15 of the Income Tax Act 2007 with effect for years after 2006-07. There is no material difference between the two sets of provisions. The parties referred exclusively to the ICTA provisions, and we shall do likewise. For ease of reference we set out the material

parts of those provisions (as they applied for the year 2005-06; nothing turns on the period chosen by way of illustration) in Appendix 1 to this decision.

21. Schedule 23A ICTA made separate provision in respect of manufactured dividends on UK Shares (the "MDs") and manufactured dividends on Overseas 5 Shares (the "MODs").

Treatment of MDs

22. Paragraph 2 of Schedule 23A applied wherever under a contract or other arrangements for the transfer of UK Shares, one of the parties (a "dividend manufacturer") was required to pay to the other an amount (the MD) which was 10 representative of a dividend on the UK Shares. In the case of the recipient, the MD is in all cases treated as a dividend on the UK Shares in question (para 2(2), (3)).

23. At all material times, the UK exempted pension funds from income tax on their investment income, including dividend income from both UK Shares and Overseas Shares held as investments for the purpose of a registered pension scheme (see s 15 186(1)(a) of the Finance Act 2004 ("FA 2004")). Accordingly, the effect of the UK regime in relation to MDs received by the Trustee in respect of UK Shares was that such MDs were not subject to any charge to UK income tax or deduction of tax at source.

Treatment of MODs

20 24. Paragraph 4 of Schedule 23A applied wherever under a contract or other arrangements for the transfer of Overseas Shares, one of the parties (an "overseas dividend manufacturer") was required to pay to the other an amount (the MOD) which was representative of a dividend on the Overseas Shares.

25. In those circumstances, except in a case where the overseas dividend 25 manufacturer was not a UK resident and the MOD was not paid by him in the course of a trade carried on through a branch or agency in the UK, the scheme of paragraph 4 was to treat the gross amount of the MOD as an annual payment within s 349 ICTA, but modified so that the amount to be deducted from that gross amount on account of income tax is an amount equal to the "relevant withholding tax" on that gross amount 30 (para 4(2)).

26. Two expressions need to be understood to explain the mechanics of paragraph 4(2). The first is the concept of the gross amount of the MOD. That is defined in paragraph 4(5) as an amount equal to the gross amount of the overseas dividend represented by the MOD, and the gross amount of the overseas dividend is the net 35 amount of the actual overseas dividend with the addition of the amount of overseas tax actually deducted and the amount of any overseas tax credit. This looks therefore to the actual gross overseas dividend. So, if the beneficial owner of the Overseas Shares that were the subject of the stock loan received a dividend of 85 on which foreign withholding tax of 15 had been deducted at source, the gross overseas 40 dividend would be 100.

27. The second expression is "relevant withholding tax". That is not synonymous with the actual foreign withholding tax. Instead, in relation to the gross amount of the MOD, it means an amount of tax representative of:

(a) the amount (if any) that would have been deducted by way of overseas tax from an overseas dividend on the Overseas Shares of the same gross amount as the MOD; and

(b) the amount (if any) of the overseas tax credit in respect of such an overseas dividend.

28. The rates of relevant withholding tax were prescribed by regulation 3 of the Income Tax (Manufactured Overseas Dividends) Regulations 1993 ("the MOD Regulations"). By that regulation, in the period 1 November 2003 to 30 September 2007, the rate was the rate (or, if more than one, the highest rate) at which the overseas withholding tax would have been payable on an overseas dividend paid in respect of the same kind of Overseas Shares as those represented by the MOD on the same date as the MOD (and on any overseas tax credit related to such a dividend) to a hypothetical person who was:

(a) resident in the UK and not carrying on a trade outside the UK through a branch or agency (or permanent establishment);

(b) subject to tax under UK law; and

(c) not subject to a special relationship with any person as respects any commercial or financial dealings.

29. Thus, if it is assumed that a dividend on such Overseas Shares to such a hypothetical UK recipient would have suffered foreign withholding tax at the rate of 15%, the "relevant withholding tax" falling to be deducted at source by the overseas dividend manufacturer on a gross dividend (calculated as above) of 100 would be 15. The amount paid to the Lender would then be 85.

30. It can thus be seen that, although expressed as a deduction of relevant withholding tax, paragraph 4 in fact simply imposes a liability to account for income tax on the MOD manufacturer. That liability is calculated by reference to a notional amount, namely the gross overseas dividend, although there will have been no necessary receipt of such a dividend by any UK resident. There is, in particular, no relationship with, and thus no statutory deduction as such of tax from, the amount actually paid by the Borrower to the Lender which is representative of the overseas dividend. It is the overseas dividend manufacturer, in other words the Borrower, which is liable to pay the tax so calculated to HMRC, or such amount as may be due after set off (see below): regulation 11 of the MOD Regulations. So far as the Lender is concerned, however, as we have described above, the amount that would otherwise be due to the Lender under the stock lending agreement, that is the grossed-up amount of the overseas dividend, or some lesser amount that might be agreed, is contractually reduced by an amount equal to the relevant withholding tax.

31. For periods after 30 September 2007, the provisions of the MOD Regulations were amended so as to change the way in which the rate of the MOD withholding tax

was calculated. Essentially, the rate was to be ascertained in certain cases on the assumption that the overseas dividend represented by the MOD had been paid to a hypothetical person having the same attributes as the Lender. Those circumstances included the case where the recipient of the MOD was a registered pension scheme. The rate of the relevant withholding tax was calculated by reference to an assumed foreign dividend on the Overseas Shares paid to such a recipient.

32. Mr Gammie told us that the practical effect of this change in 2007 was to increase the amount of MOD withholding tax on the MODs received by it on its lending of certain Overseas Shares for periods after 30 September 2007. By way of example, we were told that prior to 30 September 2007 the Trustee suffered MOD withholding tax at 15% in respect of MODs representing dividends on shares in German companies that were loaned, whereas for periods after that date and until the abolition of MOD withholding tax (by the Finance Act 2013 with effect from 1 January 2014) the rate increased to 21.1%.

33. We should refer, if only in passing, to the fact that in the case of an overseas dividend manufacturer who is not resident in the UK and who pays the MOD otherwise than in the course of a trade carried on in the UK through a branch or agency, there is no requirement on that person to deduct MOD withholding tax. In that case, paragraph 4(3) imposes an obligation on a UK resident recipient to account for an amount of tax equal to the MOD withholding tax that would have been payable under paragraph 4(2) if the overseas dividend manufacturer had been resident in the UK. Although the legislation does not use the term, this is referred to as the "reverse charge". We make that reference only in passing because we were told that the reverse charge is not relevant to the stock lending transactions which are the subject of this appeal.

34. In circumstances outside the reverse charge, the relevant withholding tax, at the rate ascertained in the way we have explained, is required to be deducted by the payer of the MOD from the gross amount of the MOD. It is an amount of UK income tax. However, it is not treated as an amount of UK income tax so far as the recipient of the MOD is concerned. Instead, by paragraph 4(4) of Schedule 23A ICTA, the MOD is treated in relation to the recipient as if it were an overseas dividend of an amount equal to the gross amount of the MOD, but paid after the withholding from it, on account of overseas tax, of the amount of the MOD withholding tax deducted.

35. The effect of the regime for a recipient was that the recipient received an amount of a MOD which equalled the gross amount of the actual overseas dividend less the deduction of the MOD withholding tax. The MOD withholding tax was deemed to be overseas tax withheld from an overseas dividend of that gross amount. Double taxation relief was in principle available in respect of that deemed overseas tax. However, by s 796 ICTA, a tax credit in respect of that deemed overseas tax was available only to the extent that the recipient had a UK tax liability for the year of assessment in question. Because the Trustee was exempt from tax on its investment income (s 186 FA 2004), no relief was available for the deemed overseas tax. Nor, because the MOD was deemed to be an overseas dividend and not UK income, and the MOD withholding tax was treated as an amount of overseas tax withheld instead

of as an amount on account of income tax, was the Trustee able to obtain repayment of the MOD withholding tax by reason of its tax-exempt status.

Set off in the overseas dividend manufacturer

36. In all the transactions that are the subject of this appeal, the Overseas Shares were lent to an approved UK intermediary (or "AUKI"). Such intermediaries were entitled (by regulation 9 of the MOD Regulations and subject to regulation 10) to set off tax suffered on certain real overseas dividends and MODs received against the MOD withholding tax that the AUKI was liable to pay under paragraph 4(2) of Schedule 23A ICTA.

37. The entitlement to set off depended on the application of two sets of rules. First, provided for by regulation 10 of the MOD Regulations, were the rules which provided for the matching of particular dividend receipts (or MODs) relating to particular shares with the outgoing MODs which were representative of those dividends (or MODs). That matching was, however, confined to amounts received and paid in the same chargeable period (the accounting period for corporation tax: reg 2A(1)(a)). Regulation 10 provided identification rules under which real overseas dividends and MODs received were matched with their equivalent MODs paid for the purpose of identifying overseas dividends and MODs which were effectively passing through the market. The intention was that tax credits attached to such overseas dividends or MODs should similarly flow through to the final beneficiary.

38. Where as a result of the matching process receipts which were net of tax were matched with payments under deduction of tax, those matched receipts and payments were included in a "sub-pool" under regulation 9 so that the total amount of overseas withholding tax suffered on the matched dividends could be set against the total amount of the AUKI's liability to account for the tax it had deducted (regulation 9(3), (4)). Where an AUKI matched an incoming overseas dividend with an outgoing MOD, the AUKI was not permitted to claim double tax relief in relation to the tax on the overseas dividends: regulation 9(4A). We accept that the logic of this provision was that the AUKI would have effectively used the overseas tax credit against its own liability to account for MOD withholding tax. The overseas dividend manufacturer would not in those circumstances obtain double tax relief, but such relief would be available (subject to the usual rules and restrictions) to the ultimate recipient of the MOD.

39. Where there was no matching under regulation 10, the AUKI was entitled under regulation 9 to set off against the charge to the MOD withholding tax the following amounts: (a) overseas tax in respect of overseas dividends or MODs received by it; (b) MOD withholding tax on MODs received by the AUKI; (c) reverse charge amounts paid on MODs received by the AUKI; and (d) similar reverse charge amounts paid under regulation 4(3) of the MOD Regulations (which are not relevant to this appeal). To the extent of the set off, the AUKI was not entitled to double tax relief for the overseas tax on the dividends or MODs that it received: regulation 9(4C). However, where after set off there was an excess of overseas tax over the MOD withholding tax, that excess was available for double tax relief: regulation 9(5).

40. The effect of these provisions is that where the MOD withholding tax on a MOD was set off against overseas tax by the AUKI, the AUKI could not claim double tax relief for that overseas tax. Where it was not so set off, the AUKI could claim double tax relief. The Lender was also entitled, by virtue of paragraph 4(4) of Schedule 23A ICTA, to claim double tax relief as applicable to it. But in those circumstances, there was no double counting, as the AUKI would have accounted for the MOD withholding tax (and not set it off); that counteracted any benefit the AUKI received from claiming double tax relief.

41. We set out at Appendix 2, by way of illustration, examples of offsetting by an AUKI under regulation 9 of the MOD Regulations, which are derived from the Guidance Notes on Manufactured Payments on Overseas Securities published by the Inland Revenue in December 2003. Those examples illustrate, first, that the offset is by reference to overseas dividends and MODs generally; there is (subject to regulation 10) no necessary matching between the actual overseas dividend (which may never be received by the Borrower) and the MOD which represents that dividend; secondly that double tax relief for the AUKI by way of credit for foreign tax was exhausted to the extent that it was offset against the MOD withholding tax (and not available to offset other tax liabilities of the Borrower); and thirdly that to the extent the MOD withholding tax was not offset it was payable by the AUKI under regulation 9(6) of the MOD Regulations.

42. In summary, the ultimate recipient of a MOD (the Lender) was always entitled to credit by way of double taxation relief for the amount of deemed overseas tax represented by the MOD withholding tax, subject to the normal rules. In the case of the Trustee, the application of those normal rules, by s 796 ICTA, had the consequence that the Trustee, which was exempt from tax under s 186 FA 2004, was unable to obtain relief or credit for the MOD withholding tax. The overseas dividend manufacturer (the AUKI) was either able to offset credit for overseas tax against MOD withholding tax which it was liable to pay, or to the extent it did not offset was entitled to claim double tax relief by way of credit for that overseas tax.

Freedom of movement of capital

43. Article 56 of the EC Treaty, which applied from 1 January 1994 to 30 November 2009, provided as follows:

> "Chapter 4
>
> CAPITAL AND PAYMENTS
>
> Article 56
>
> 1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
>
> 2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

44. With effect from 1 December 2009, Article 56 was superseded by Article 63 of the TFEU, which is couched in identical terms. We shall refer in terms principally to the TFEU provisions, but in doing so we include the corresponding provisions of the former EC Treaty.

45. It will be noted that, unlike the other fundamental EU freedoms, the freedom of movement of capital applies equally to third country movements. There is accordingly no distinction in this case between stock loans of EU shares and stock loans of shares in companies outside the EU.

46. We should add that, although Article 58 of the EC Treaty (Article 65 TFEU) provides for a limited derogation from Article 56 (Article 63 TFEU) in respect of national tax law provisions which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested, that is subject to such measures not constituting a means of arbitrary discrimination or a disguised restriction on the free movement of capital. It was common ground that, to the extent that the UK's tax treatment of MODs was a restriction on such free movement, neither Article 58 of the EC Treaty nor Article 65 of the TFEU would prevent it from being prohibited.

47. It is also common ground that the acquisition of Overseas Shares by the Trustee is a movement of capital within the scope of Article 63 of the TFEU. That was a finding of the FTT, at [110], that HMRC does not seek to challenge. HMRC did, however, take issue with the FTT's further finding, at [112], that the acquisition, disposal and re-acquisition of Overseas Shares under the terms of a stock lending agreement would themselves be movements of capital.

48. In view of the common ground, it may not be necessary for us to resolve that issue. However, we consider that the FTT was plainly right. It is not necessary for it to be argued, as Mr Gammie did, that stock lending is as "indissociable" from share ownership as the Court of Justice of the European Union ("the Court of Justice") found the payment of dividends to be in *Staatssecretaris van Financiën v Verkooijen* (Case 35/98) [2002] STC 654, at [29]. As the FTT recognised, the legal mechanisms of stock lending itself amount to capital movements. There is no distinction based on any perceived difference between the right to a dividend, which is part of the bundle of rights comprising a share, and a right to lend shares; there is no loan as such, but there are transfers of legal and beneficial ownership which are themselves movements of capital.

49. It is convenient to refer to *Verkooijen*, at [32], for the established proposition, which has been repeated in many of the judgments of the Court of Justice, that although direct taxation falls within the competence of the Member States, the Member States must nonetheless exercise their competence consistently with Community law. That includes exercise of that competence so as not to constitute an unlawful restriction on the movement of capital.

50. Article 63 of the TFEU prohibits any legislative measure which tends to dissuade or hinder investors resident in the Member State in question from investing

their capital in companies in another Member State. That includes making investment in domestic entities more attractive than investment in overseas entities, including both the acquisition of such investments and the maintenance of holdings in overseas entities, and a provision which "constitutes an obstacle" to the raising of capital (see, for example, *Verkooijen*, at [34] – [36]). It also includes any provision which is "liable to discourage" the exercise of a right to the free movement of capital (*Bouanich v Directeur des services fisceaux de la Drome* (Case C-375/12) [2014] All ER (D) 197 (Mar), at [43] – [44]).

51. It is not necessary to establish that the relevant national provision has actually had the effect of leading persons or companies resident in the Member State in question to refrain from acquiring or holding the investments in overseas entities. It is sufficient that the provision be capable of restricting the exercise of the relevant freedom. That appears from *Test Claimants in the Thin Cap Group Litigation v Inland Revenue Commissioners* (Case C-524/04) [2007] STC 906, a case concerning the freedom of establishment, but which in this respect is equally applicable to the freedom of movement of capital. It is also the case that once something is identified as a restriction, it is prohibited even if of limited scope or minor importance (see, for example, *de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* (Case C-9/02) [2005] STC 1722, at [43] – a case also concerning freedom of establishment)

52. In identifying in the context of a holding of shares whether a given measure has a dissuasive effect, or makes the acquisition of a holding in an overseas company less attractive than a holding in a resident company, the approach of the Court of Justice is to consider whether the system treats the holding of such Overseas Shares less favourably than a holding of shares in a resident company (see, for example, *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners* (Case C-446/04) [2007] STC 326 ("*FII ECJ 1*"), at [145] – [154]). Where those situations are objectively comparable, and in the absence of any objective justification, that difference in treatment will be an infringement of Article 63 of the TFEU.

53. In *FII ECJ 1* itself, it was held that the different treatment of a shareholder who received ordinary dividends from a UK resident company, and was entitled to a tax credit, and a shareholder who received dividends which had their origin in foreign-sourced dividends, and which were treated as foreign income dividends (FIDs), and was not entitled to a tax credit but was treated as having received income which had been taxed at the lower rate, was one element which led to the UK's FID regime being a restriction on the freedom of movement of capital (*FII ECJ 1*, at [148], [173]). It was also held that the FID regime, which distinguished between UK dividends received on which advance corporation tax (ACT) had been paid and foreign dividends on which no ACT had been paid, led in practice to a company receiving foreign dividends being less favourably treated than a company receiving UK dividends. The Court rejected an argument by the UK government that a company receiving foreign-sourced dividends was not in an objectively comparable situation to that of a company receiving nationally-sourced dividends (*FII ECJ 1*, at [86] – [87], [152]).

54. In *FII ECJ 1*, the Court was responding to claims made by UK companies in receipt of foreign dividends which had elected to be taxed under the FID regime. The more recent case of *Trustees of the BT Pension Scheme v Revenue and Customs Commissioners* (Case C-628/15) [2017] STC 2075 concerned the position of UK-resident shareholders in receipt of FIDs from UK resident companies. The Court confirmed, at [36], that the absence of a tax credit for shareholders not subject to income tax in respect of dividends had the effect of discouraging those shareholders from investing in UK companies which received dividends from companies resident outside the UK, and favouring investments in UK resident companies receiving dividends from other companies resident in the UK.

55. The UK government argued in *BT Pension Scheme* that the trustees could not rely on Article 63 of the TFEU to obtain entitlement to a tax credit on the FIDs received on the ground that their investment of capital in UK resident companies subject to the FIDs regime did not involve a movement of capital. The Court rejected that argument. Although the Court acknowledged, at [39] – [40], that the scope of the freedom of movement of capital was confined to situations related to trade between Member States, and does not apply to situations which are confined in all respects within a Member State, it found, at [42], that:

> "… the unfavourable tax treatment of certain shareholders receiving dividends treated as FIDs, namely the absence of the tax credit … is precisely due to the fact that those dividends have their origin in the profits that the distributing company has received from a non-UK-resident company, whereas in the case of dividends which have their origin in the profits received from a UK-resident company, those recipient shareholders would have been entitled to such a tax credit, all other things being equal."

56. In the absence of any justification for the restriction (the Court found there was none), Article 63 of the TFEU conferred rights on a shareholder receiving dividends treated as FIDs (*BT Pension Scheme*, at [44]).

The FTT's decision on the restriction issue

57. Having reviewed the case law of the Court of Justice on the legal test to be applied in determining whether or not a provision of national law comprises a restriction on the right of freedom of movement of capital, the FTT summarised the position at [52] by saying, in an effective echo of what Advocate General Kokott had said at [28] of her opinion in *Proceedings brought by Manninen* (Case C-319/02) [2004] STC 1444:

> "It can be seen therefore that a restriction is something which makes a cross-border movement of capital more difficult or less attractive, or is liable to deter or dissuade cross-border investments."

58. The FTT's decision on the restriction issue derived from the question it identified at [116] and the way in which it answered that question. The FTT said:

> "The real question therefore is whether a pension fund would be dissuaded from purchasing or retaining foreign shares in favour of UK shares because of the MOD regime. The answer to that question it seems to us is 'no'. The reason it might be dissuaded is not because of the MOD regime but because income from overseas shares suffers a withholding tax for which the UK does not give credit to pension funds, whether that income arises in respect of actual dividends or manufactured dividends."

59. The FTT noted, at [117], the uncontroversial point that, as part of the UK's system for relieving double taxation, credit for foreign withholding tax was available only to the extent that the recipient had a UK tax liability against which it could offset the credit, and that such a regime was not contrary to EU law. That reflected both the judgment of the Court of Justice and the opinion of the Advocate General in *Kerckhaert and Morres v Belgian State* (Case C-513/04) [2007] STC 1349, to which the FTT had referred at [30] – [35]. The UK did not tax either UK source dividends or foreign dividends. The absence of a credit for foreign withholding tax in the case of a recipient who had no tax liability was not a restriction on the freedom of movement of capital as any adverse consequences resulted from the exercise in parallel by two Member States of their fiscal sovereignty (*Kerckhaert and Morres*, judgment, at [20]).

60. The FTT then considered the rationale for the regime for manufactured dividends, both as regards MDs and MODs, stating at [118] that it was "directed towards ensuring that the recipient was taxed in the same way as if it had received the underlying dividend". That meant, in the case of MODs, that it was necessary to "get the credit for foreign withholding tax to the shareholder in a way which would restrict relief for that withholding tax by reference to the tax liability of the shareholder in the UK".

61. Having referred to various submissions of the parties, the FTT summarised its conclusions at [127] – [129] in the following way:

> "[127] In considering these submissions we return to the movement of capital which is relied on in the present case, that is the acquisition of foreign shares. The restriction relied on by Mr Gammie was that the MOD regime would dissuade persons resident in the UK from acquiring foreign shares. It is helpful, we consider, to analyse that a little further. It is said that a UK resident investor such as the Fund would be dissuaded from purchasing foreign shares in favour of purchasing UK shares because if it entered into stock lending arrangements then the manufactured dividends would be exempt whereas MODs would be taxable. That analysis focuses solely on the MOD and ignores the underlying tax treatment of dividends from such shares. We cannot see that an investor such as the Fund would be dissuaded from acquiring foreign shares because the MOD was taxable. It would know that the dividend itself from a foreign shareholding would be taxable. In other words it would be in no better or worse position than it would have been if it had not lent the shares. The MOD regime therefore would not dissuade the Fund from lending foreign shares. Nor would it dissuade the Fund from acquiring or

> retaining foreign shares. The only factor which might dissuade the Fund from purchasing foreign shares is that the dividends from foreign shares are subject to a withholding tax for which it could not obtain credit because its investment income as a whole was exempt from UK income tax.
>
> [128] We agree that if one simply looked at the MOD regime in isolation, regardless of the underlying tax treatment of dividends, then it might appear that it would dissuade acquisition of foreign shares. A pension fund might consider that it would be disadvantaged if it invested in foreign shares because stock lending transactions in foreign shares resulted in a withholding tax on the MOD levied by the UK whereas identical transactions in UK shares resulted in a manufactured dividend which was exempt from UK tax.
>
> [129] However it is not appropriate in our view to take such a narrow approach. The MOD regime simply reflects the taxation treatment of the underlying dividends. It is one aspect of a regime which seeks to equate manufactured dividends from UK and overseas shares with the tax treatment of actual dividends. Looked at in that context it seems clear to us that it does not amount to a restriction on the acquisition of foreign shares. Even if a pension fund was intending to purchase shares specifically with a view to entering into stock lending transactions, it would not be dissuaded by the MOD aspect of the regime from purchasing foreign shares. It might consider that UK shares would be a better prospect because the manufactured dividends were exempt. The reason for that is not because of the MOD regime. It is because the underlying dividend paid by the overseas company is subject to a withholding tax and the UK has chosen not to give the benefit of any credit for that withholding tax to an exempt pension fund."

62. On that basis, the FTT decided, at [130], that the MOD regime did not involve any restriction on the movement of capital.

Restriction on movement of capital: Discussion

63. We have reached a different view from that taken by the FTT. In our judgment, for the reasons given below, the MOD regime did constitute a restriction on the movement of capital.

64. The starting point, in our view, is that, in contrast to the position that was applied by the UK to MDs, which represented UK dividends, the UK applied domestic taxation to MODs in such a manner that precluded the recovery by the Trustee of that tax, which amounted therefore to a cost, in terms of UK taxation, to the Trustee of undertaking stock lending using Overseas Shares. No such cost would arise in the case of stock lending using UK Shares.

65. A close analysis of the MOD regime confirms this to be the case. Although it is a necessary condition for the application of the regime that an amount (the MOD) representative of a dividend on the Overseas Shares is to be paid, the UK tax charge is unrelated to the actual amount of the MOD. It is also unrelated to the actual amount of overseas tax that might have been deducted by the overseas company paying the

dividend. Instead, first, the relevant withholding tax is calculated on the basis of a hypothetical receipt in the UK of a dividend on the Overseas Shares and the gross amount of the actual overseas dividend (whether or not received by the Borrower), and secondly, whatever the amount of the MOD itself, the Lender is treated as having received an overseas dividend equal to that gross amount, less the relevant withholding tax, the tax having been deducted being treated not as UK income tax, but as overseas tax.

66. The corresponding provisions for MDs on UK equities adopt a different approach. There is in that case no notional amount of the dividend. It is the actual MD that is treated as a dividend, in the case of the Borrower as a dividend paid by him, and in the case of the Lender as a dividend on the UK Shares in question. There is, in contrast to the position on MODs, no UK withholding tax on such deemed dividends nor any requirement on the part of the Borrower to account for UK tax with respect to such a dividend.

67. That, in our judgment, amounts to a relevant difference in treatment such as to amount to a restriction on the movement of capital. It is a difference that is predicated entirely on whether the shares employed in a stock lending transaction are Overseas Shares or UK Shares. The use of Overseas Shares results in those transactions being treated less favourably than objectively comparable transactions involving UK Shares. We accept, in this regard, Mr Gammie's submission that an investment in Overseas Shares that are used for stock lending is directly and objectively comparable to an investment in UK Shares that are used for the same purpose; they are the same form of transaction entered into for the same aim or with the same purpose in mind, both from the Trustee's perspective and from a market perspective. The difference in treatment is sufficient, on the basis of the authorities of the Court of Justice, to amount to a dissuasive effect so far as the acquisition of Overseas Shares, and the continued retention of such shares, as opposed to UK Shares, is concerned. That difference in treatment is apt, in our view, to make investment in domestic entities more attractive than investment in overseas entities.

68. The FTT took the view, at [127], that a UK resident investor such as the pension fund, would not be dissuaded from purchasing Overseas Shares by the MOD regime. It reasoned that the fund would know that an actual dividend from a foreign shareholding would be taxable, by which the FTT was referring to the application of the foreign withholding tax and the inability of an exempt fund to obtain any credit or repayment in respect of such foreign tax. On this basis, the FTT took the view that, because the fund would be in no better or worse position than if it had not entered into the stock lending transactions, the MOD regime could not have a dissuasive effect.

69. We disagree with the FTT's analysis. First, we accept Mr Gammie's submission that the FTT erred in analysing the restriction issue by comparing the treatment of MODs to the tax treatment of the receipt of actual dividends paid on Overseas Shares, and secondly by making that comparison by reference to the taxation of actual dividends on the Overseas Shares in the overseas state, rather than focusing on the differences in UK taxation.

70. Mr Baldry submitted that the comparison drawn by the FTT was the correct one. As regards the comparison with the treatment of actual dividends on the Overseas Shares, he referred to the purpose of the stock lending agreement being to compensate the Lender for the loss of the dividend. The tax treatment of MODs was designed to ensure that the Lender would be in the same position (net of tax) after lending the shares and receiving a MOD as it would have been had it received the dividend itself. That made it clearly appropriate for the comparison to be between the taxation of the real overseas dividend and the MOD.

71. As regards the comparison having regard to the source state taxation, and not simply the UK tax position, Mr Baldry pointed to the fact that the MOD withholding tax was designed to replicate the real overseas withholding tax and to be offset in the hands of an AUKI against real overseas withholding tax. In attempting to determine whether a Lender would, in the real world, be dissuaded from acquiring Overseas Shares by the MODs regime, it is necessary, Mr Baldry argued, to look at their real-world position pre- and post-lending transaction, taking both overseas and UK taxes into account.

72. We do not accept those submissions. The correct comparison, in our judgment, is between the UK tax treatment of MDs and the UK tax treatment of MODs. That comparison, as we have concluded above, does reveal a difference in treatment such as to amount to a restriction. It is true that, consistently with the economic rationale of stock lending, and the making of payments of manufactured dividends that represent the actual dividends, the UK regime was aimed at replicating the same tax effect for the Lender as would have applied on an actual receipt of the dividend on the relevant Overseas Shares. But although restrictions on freedom of movement of capital which result inevitably from the exercise by different states of their sovereign domestic taxing rights are not prohibited, that is not the case where the disadvantageous tax treatment results from the application of the rules of a single jurisdiction (see the opinion of the Advocate General (Geelhoed) in *Test Claimants in Class IV of the ACT Group Litigation v Inland Revenue Commissioners* (Case C-374/04) [2007] STC 404, at [32] – [55]; and *Kerckhaert and Morres*, AG opinion, at [17] and [18]).

73. In seeking to support the approach taken by the FTT, Mr Baldry referred us to *Kerckhaert and Morres* and in particular to the observations of the Advocate General (Geelhoed), at [26] of his opinion, concerning the need to have regard to the economic context as a whole. In *Kerckhaert and Morres*, the taxpayers were Belgian residents who were subject to tax in Belgium on their worldwide income, including dividend income. They received dividends from a French company on which there was an imputation credit (the *avoir fiscal*). Those dividends, including the credit, were subject to French withholding tax at 15%. Belgium subjected all dividends, both domestic and foreign, to a blanket tax of 25%. The question before the Court of Justice was whether the application of that rate, without taking into account the 15% withholding tax, was a prohibited restriction on the movement of capital.

74. Having referred to the need, for there to be such a prohibited restriction, for the disadvantageous tax treatment not to result purely from disparities or division of tax

jurisdiction between two or more Member States' tax systems (AG opinion, at [18]), the Advocate General turned to consider whether the exercise by Belgium of its worldwide home state jurisdiction discriminated between foreign-source and domestic income. That included whether the Belgian tax system had a discriminatory effect in fact, or whether those rules restricted free movement of capital in a way that went beyond the restrictions resulting inevitably from the fact that tax systems are national (AG opinion, at [22]).

75. The Advocate General rejected the taxpayers' argument that the overall tax burden on French tax dividends was, by virtue of the fact that those dividends suffered French withholding tax at 15%, in fact greater than that placed on Belgian-source dividends, even though both were subject to the same flat-rate tax in Belgium of 25%. The Advocate General pointed out, however, that by reason of the application of the *avoir fiscal*, the taxpayers were in fact better off in net terms if they received a French dividend that if they had received an equivalent Belgian dividend (to which no equivalent tax credit attached). By focusing on the headline rates of tax, rather than the application of those rates to the actual circumstances, the taxpayers had presented a distorted picture. It was in that context that the Advocate General said (at [26]):

> "It is clear … that Belgian residents receiving French-source dividends are not worse off in comparison to those receiving Belgian-source dividends; on the contrary, the combined effect of the French and Belgian tax systems means that overall they are better off. There can therefore be no question of discrimination or restriction within the meaning of art 56 EC. Rather, the present case is a good illustration of the dangers which may arise, in considering whether a member state's legislation complies with the Treaty free movement provisions, when examining the situation of an individual economic operator in the framework of just one state's legislation, or just one facet of this legislation. Such an approach risks failing to capture the reality of the economic context in which that operator is acting, and the overall balance arrived at between home state and source state in dividing tax jurisdiction (see my opinion in *Test Claimants in Class IV of the ACT Group Litigation* [2007] STC 404, para 72)."

76. The Advocate General went on to find that, even if the French *avoir fiscal* was ignored, so that there would have resulted juridical double taxation, in France and in Belgium, of the French dividends, in the circumstances of the blanket rate of Belgian tax applicable, without discrimination, to foreign and domestic dividends alike, the Belgian provisions would not have constituted a prohibited restriction. The fact that Belgium had chosen not to relieve that juridical double taxation would not of itself have been contrary to Article 56 of the EC Treaty (*Kerckhaert and Morres*, AG opinion, at [36]).

77. The Court adopted this latter principled approach. At [20], it said that in the circumstances of the case the adverse consequences which might arise from the application of an income tax system such as the Belgian system in issue resulted from the exercise in parallel by two Member States of their fiscal sovereignty. The domestic Belgian law did not make any distinction between dividends from Belgian

companies and those established in another Member State, but applied the same uniform rate of tax. Consequently, the Belgian legislation was not precluded by Article 56 of the EC Treaty (judgment, at [17], [24]).

78. We accept that any analysis of a domestic tax system must have regard to all the relevant circumstances, which will include the relevant economic context. However, we do not consider that regard to the economic context can have the consequence of treating a difference in tax treatment which arises solely from the laws of one jurisdiction as if it were instead attributable to the exercise by more than one jurisdiction of their respective sovereign taxing rights. In this case, in contrast to the position in *Kerckhaert and Morres*, the only jurisdiction seeking to tax the MODs was the UK. The fact that the MOD was representative of an overseas dividend does not permit the system of taxation by another state of such dividend (which, by definition, is not received by the Lender) to be taken into account in recharacterising the transaction as one which arises inevitably from the operation of more than one national system. No such inevitability can be said to arise in this case.

79. A similar contrast was identified by the Court of Justice in *Bouanich*. That case concerned whether certain French legislation, which applied a "tax shield" entitling a taxpayer to reimbursement of tax levied above a certain threshold, was a restriction on the movement of capital because it failed to take full account of foreign withholding tax on Swedish dividends. It was argued, by both the French and UK governments, that this was merely a disadvantage arising from the parallel exercise of tax jurisdiction by Sweden and France, and that free movement of capital did not require a Member State to prevent juridical double taxation resulting from a bilateral agreement (the France-Sweden double tax treaty), where the two Member States have the right to tax the income.

80. That argument was rejected by the Court. It distinguished *Kerckhaert and Morres* on the basis that in that case the national legislation at issue did not make any distinction between dividends from shares in companies established in the territory of the Member State concerned and dividends from companies established in other Member States. The dividends were subject to the same uniform rate of tax and the adverse consequences accordingly arose from the exercise in parallel by two Member States of their tax jurisdiction. In *Bouanich*, by contrast, whereas the granting of a credit under the double tax treaty for the Swedish withholding tax was part of the parallel tax jurisdiction (and was in order to prevent juridical double taxation), the French tax shield concerned only France's tax jurisdiction and was unrelated to the parallel exercise of tax jurisdiction (*Bouanich*, at [37] – [42]).

81. Mr Gammie referred to *Cadbury Schweppes plc and another v Inland Revenue Commissioners* (Case C-196/04) [2006] STC 1908 in support of his argument that the overall economic position of the taxpayer does not preclude a finding that a domestic regime (in that case the UK's controlled foreign companies ("CFC") regime) is a restriction on a fundamental freedom. The comparison sought to be made in *Cadbury Schweppes* was between the UK tax payable under the CFC rules and the UK tax that would have been paid on the assumption that the Irish subsidiaries of the UK parent (on whose profits the CFC charge had been levied in the UK parent) were established

in the UK. Even though in those terms the taxpayer was no worse off, the fact that it was the UK resident parent company that was taxed on the profits of the subsidiaries sufficed to amount to a disadvantage.

82. No such comparison can be made in this case. On any basis, the Trustee suffers a disadvantageous burden of UK tax on a MOD. That is the case whether the position of the Trustee receiving a MOD is compared to its receipt of an MD, or if it is compared (although we do not consider such a comparison can properly be made) with the assumed receipt of the foreign dividend itself. The overseas tax on the foreign dividend cannot be taken into account to justify the imposition of a similar (if not always corresponding) amount of UK tax on a MOD. That UK tax arises solely by reason of the operation of the UK's own domestic system and as in *Bouanich* is unrelated to any relief for juridical double taxation or the parallel exercise by different Member States of tax jurisdiction.

83. Nor, for similar reasons, can reliance be placed by Mr Baldry on any set off in the AUKI, designed to produce a neutral position so far as the AUKI was concerned in relation to its obligation to account for the MOD withholding tax and its own credits for foreign tax. Even if, on the materials available to us, we could have been satisfied that such a neutral position could be assumed, the tax position of another party, the AUKI, can have no bearing on whether the Trustee was subjected to less favourable tax treatment by its use in a stock lending transaction of Overseas Shares as compared with UK Shares. For the reasons we have explained, the Trustee plainly was placed in a less favourable position, and that amounted to a disadvantage and disincentive to the acquiring and holding of Overseas Shares, and accordingly to a restriction on the movement of capital.

84. In our judgment, in basing its conclusion on an assessment that the pension fund, by engaging in stock lending of Overseas Shares under the MOD regime, was in no better or worse position than it would have been had it not engaged in such transactions but had merely held the Overseas Shares and received the dividends on those shares, the FTT erred in law. It was wrong to make the comparison between the treatment of MODs and the different receipt of the foreign dividends themselves, and it was wrong in any event to consider that whether a difference in treatment was a restriction on a fundamental freedom could be determined by asking the question whether the person affected was in a better, worse or neutral position.

85. The question of economic equivalence has in this context been addressed by the Court of Justice, not in considering the threshold question whether there is a restriction, but in examining whether a restriction may be justified by some corresponding advantage. The Court has made it clear that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages (*Verkooijen*, at [61], and cases cited there). If, as the Court has consistently stated, a restriction cannot be justified on the basis of a corresponding advantage, it is clear that the existence of such an advantage cannot prevent a difference in treatment from being a restriction at all. On that basis, even if (contrary to our view) it were correct to compare the receipt of a MOD with the receipt of the foreign dividend itself, mere neutrality of treatment or the fact that the taxpayer may

be in no better or worse position by that comparison, cannot prevent a difference in treatment from being a restriction.

Justification

86. A restriction on the movement of capital will be prohibited by Article 63 of the TFEU, except to the extent it may be justified. Although the FTT had found that the MOD regime did not involve any restriction on the movement of capital, it went on to make findings on the issue of justification, in case it was wrong on the question of restriction.

87. We have found that the FTT was wrong on the restriction question. It is therefore necessary for us to address the justification issue.

88. A difference in treatment which would otherwise constitute a restriction of a fundamental freedom under EU law is permissible only if it is justified by an overriding reason in the public interest (see, for example, *Finanzamt Linz v Bundesfinanzgericht, Ausentelle Linz* (C-66/14) [2015] All ER (D) 58 (Oct)). In order to be so justified, the difference in treatment must not go beyond what is necessary to achieve that objective (*X Holding BV v Staatssecretaris van Financien* (C-337/08) [2010] STC 941).

89. The FTT found that, if the MOD regime did involve a restriction on the movement of capital, it was justified for each of two reasons. The first was that it was justified by a combination of the prevention of tax avoidance and the preservation of a balanced allocation of taxing rights (FTT, at [140]). The second was that it was justified in terms of the fiscal cohesion of the UK tax system (FTT, at [145]).

Prevention of tax avoidance and balanced allocation of taxing powers

90. There can be no doubt that, in appropriate circumstances, a combination of an objective of ensuring the balanced allocation of taxing powers between Member States together with the prevention of tax avoidance can constitute a justification for a restriction. The significance of such a combination is that it broadens the scope of the arrangements which the national measures may, with justification, seek to counter with the objective of preventing tax avoidance. In such a case, those arrangements need not be confined to wholly artificial arrangements designed to circumvent the legislation of the Member State concerned.

91. The case of *Proceedings brought by Oy AA* (Case C-231/05) [2008] STC 991 concerned Finnish legislation under which, in certain cases, a national subsidiary was entitled to a tax deduction from its taxable business income on an intra-group financial transfer to a parent company. The financial transfer was added to the taxable income of the parent company. The legislation applied only to Finnish resident companies. On the question whether such a system was precluded by freedom of establishment, the Court of Justice observed, at [43], that such a difference in treatment did amount to a restriction on the freedom of establishment, but held that

such a restriction was justified by a combination of the balanced allocation of taxing powers and the need to prevent tax avoidance.

92. The Court first considered whether the Finnish legislation was needed to safeguard the balanced allocation of taxing powers. It held, at [56], that if a cross-border transfer, such as the intra-group financial transfer at issue in *Oy AA*, were to be deductible from the taxable income of the transferor, that would result in groups of companies being allowed to choose freely the Member State in which the profits of the subsidiary were to be taxed. That would undermine the system of the allocation of the power to tax between Member States because, according to the choice made by the group of companies, the Member State of the subsidiary would be forced to renounce its right to tax the subsidiary's profits in favour, possibly, of the Member State of the parent company.

93. Moving to the question of the prevention of tax avoidance, the Court acknowledged, at [58], the possibility of transfer of income, by means of purely artificial arrangements, with a view to profits being taxed in Member States applying lower rates of taxation. By restricting the application of the Finnish legislation to establishments in the same Member State, the Finnish system, although not targeted against such practices, was able to prevent them. The Court thus held (at [60]):

> "Having regard to the combination of those two factors, concerning the need to safeguard the balanced allocation of the power to tax between the member states and the need to prevent tax avoidance, this court therefore finds that a system, such as that at issue in the main proceedings, which grants a subsidiary the right to deduct a financial transfer in favour of its parent from its taxable income only where the parent and the subsidiary both have their principal establishment in the same member state, pursues legitimate objectives compatible with the Treaty and justified by overriding reasons in the public interest, and is appropriate to ensuring the attainment of those objectives."

94. The Court returned to the theme of the combination of the two factors when considering whether the system went beyond what was necessary to attain all the objectives pursued. It said:

> "62. It should be noted at the outset that the objectives of safeguarding the balanced allocation of the power to impose taxes between member states and the prevention of tax avoidance are linked. Conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to those activities and jeopardise a balanced allocation between member states of the power to impose taxes (see the *Cadbury Schweppes* case (paras 55, 56) and the *Test Claimants in the Thin Cap Group Litigation* case (paras 74, 75)).
>
> 63. Even if the legislation at issue in the main proceedings is not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with

> the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as a whole."

5 95. *Oy AA* was followed in that respect by the Court of Justice in *Société de Gestion Industrielle SA v État Belge* (Case C-311/08) [2010] 2 CMLR 1017 ("*SGI*"). *SGI* concerned Belgian transfer pricing legislation which applied to the grant by an undertaking established in Belgium of "unusual or gratuitous advantages" to non-resident companies with which the Belgian undertaking had a relationship of 10 interdependence. The question was whether that legislation was compatible with the freedom of establishment and freedom of movement of capital, given that it did not apply where advantages had been granted to another resident company and which were taken into account in the computation of that company's taxable income.

96. Following *Oy AA*, the Court held, first, at [63], that to permit resident 15 companies to transfer their profits in the form of unusual or gratuitous advantages to connected companies established in other Member States may well undermine the balanced allocation of the power to impose taxes between the Member States. It would effectively transfer the right to tax from the Member State of the parent company to the Member State of the recipient company. The legislation in question, 20 by providing that the resident company was to be taxed in respect of such an advantage granted to a company established in another Member State, permitted the Belgian Sate to exercise its tax jurisdiction in relation to activities carried out in its territory (*SGI*, at [64]).

97. The Court in *SGI* also followed *Oy AA* in respect of national legislation that was 25 not specifically designed to combat purely artificial arrangements, but which could be regarded as justified by the objective of preventing tax avoidance when taken together with that of preserving the balanced allocation of the power to impose taxes between Member States (*SGI*, at [66]). The Court referred, at [67], to the risk that, by means of artificial arrangements, income transfers could be organised to secure taxation at 30 lower, or nil, rates in other Member States. It was concluded by the Court, at [68], that the legislation at issue was able to prevent such practices.

98. The Court went on to consider the question of proportionality. It noted, at [71], that:

> "National legislation which provides for a consideration of objective 35 and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax 40 avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that 45 there may have been for that transaction (see, to that effect, *Test*

> *Claimants in the Thin Cap Group Litigation*, paragraph 82, and order in Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation* [2008] ECR I-2875, paragraph 84)."

99. More recently, in *Masco Denmark ApS and another company v Skatteministeriet* (2016) (C-593/14), ECLI:EU:C:2016:984, the Court of Justice considered the compatibility of Danish thin capitalisation legislation with the freedom of establishment. The Danish rules prohibited thinly-capitalised subsidiaries from deducting certain interest expense. The corollary in Denmark was that the interest income received by the Danish parent company was exempt from taxation. However, that exemption did not apply if the subsidiary was established in another Member State and was in that Member State also prohibited from deducting interest expense.

100. The Court held, at [28], that since the difference in treatment resulted solely from the Danish rules, it was a restriction and was permissible only if it related to situations that were not objectively comparable or if it were justified by an overriding reason in the public interest. Denmark submitted that the difference in treatment was justified both by the need to ensure a balanced allocation of taxation powers between Member States and by the need to prevent tax avoidance (*Masco*, at [34]).

101. On the question of the balanced allocation of taxing powers, the Court concluded, at [38]:

> "In the present case, it must be held that legislation of a Member State, such as that at issue in the main proceedings, which limits the tax exemption in question solely to interest paid by a resident subsidiary appropriately ensures a balanced allocation of the power to impose taxes between the Member States concerned. By allowing a resident company which has granted a loan to a subsidiary resident in another Member State to deduct all interest paid by its subsidiary where that subsidiary is not entitled to deduct that interest expenditure under the thin capitalisation rules of that other Member State, the Member State in which the parent company is resident would be foregoing, on the basis of the choice made by companies having relationships of interdependence, its right to tax the interest income received by the parent company depending on the rules on thin capitalisation adopted by the Member State of residence of the subsidiary, which is what the legislation at issue in the main proceedings seeks to avoid."

102. The Court then went on, before considering any question of justification on the ground of preventing tax avoidance, to examine whether the Danish legislation went beyond what was necessary in order to attain the objective of ensuring a balanced allocation of taxing rights. It found, at [43], that the granting by the Member State in which the parent company was resident of a tax exemption to that parent company for interest paid by that subsidiary limited to the amount the subsidiary was not entitled to deduct under that Member State's legislation would not call into question the balanced allocation of taxing powers, and would be a measure less restrictive of the freedom of establishment than the Danish legislation at issue.

103. It was only at that stage that the Court considered the objective of preventing tax avoidance as a possible justification. It did not refer to *Oy AA* or *SGI*. The Court said:

> "44. As regards the objective of preventing tax avoidance, it should be noted that, in order for an argument based on that justification to succeed, the specific objective of that measure must be to prevent wholly artificial arrangements which do not bear any relation to economic reality and which are designed to avoid payment of the tax normally due on the profits generated by activities carried out on national territory (see, to that effect, judgment of 17 December 2015, *Timac Agro Deutschland*, C-388/14, EU:C:2015:829, paragraph 42 and the case-law cited).
>
> 45. In that regard, it should be noted that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent Danish tax legislation, from attracting tax benefits; rather, it generally excludes all resident companies which have granted, for whatever reason, a loan to a thinly capitalised subsidiary resident in another Member State from attracting the relevant tax benefits (see, by analogy, judgment of 12 December 2002, *Lankhorst-Hohorst*, C-324/00, EU:C:2002:749, paragraph 37 and the case-law cited).
>
> 46. Furthermore, it seems clear from the file before the Court that the loans granted by Damixa were intended to finance the main portion of the deficit of Damixa Armaturen, which was in major financial difficulties at the material time, and therefore, a priori, those losses did not appear to constitute a wholly artificial arrangement entered into for tax reasons alone."

104. By way of summary, we conclude that, although there are circumstances where a restriction may be justified by a combination of the objective of ensuring the balanced allocation of taxing rights between Member States together with the prevention of tax avoidance, and the consequence of such a combination is that the relevant national rule may be held to be justified and proportionate even if not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, those circumstances can only arise where the restriction can be justified on the basis of the balanced allocation of taxing powers alone, and where such a restriction is proportionate to the aims pursued. Where it is either not justified by reference to such balanced allocation or if justified is nonetheless disproportionate to those aims, a restriction can be justified by reference to the prevention of tax avoidance only if the specific objective of that measure is to prevent wholly artificial arrangements which do not bear any relation to economic reality and which are designed to avoid payment of the tax normally due on the profits generated by activities carried out on national territory.

Balanced allocation of taxing powers

105. The cases in which the Court of Justice has held that a restriction is justified by reference to the preservation of a balanced allocation of taxing powers have been limited in their scope. In broad terms they have been confined to those where the result of the restriction being prohibited would be to enable the relevant taxpayers effectively to choose in which Member State to be taxed (*Oy AA*, at [56], *SGI*, at [67] and *Masco*, at [38]). That, it has been held, would undermine the system of the allocation of the power to tax between Member States.

106. Mr Baldry relied on the fact that the UK has decided, in relation to underlying dividends, to grant a credit for foreign tax to recipients of real overseas dividends who have taxable income. Exempt entities are unable to utilise such a credit in the absence of UK taxable income. The purpose, he submitted, of the MODs regime is to preserve the position that exists with regard to underlying dividends, and to mirror this position with regard to manufactured dividends. He argued that if it did not preserve this position, it would follow that the UK would be compelled by EU law to make payments of tax credits to the Trustee in respect of manufactured but not real dividends. It would thereby be forced to adopt a decidedly unbalanced allocation of its taxing powers, as manufactured dividends, by definition, represent real dividends.

107. We do not agree with Mr Baldry. It is telling, we consider, that his submission refers nowhere to the foreign tax treatment of the foreign dividends themselves or any foreign taxation of the manufactured dividends. In describing the allocation of taxing powers, Mr Baldry focuses solely on the matter of UK taxation. The reason he must do so is because the tax at issue, the MOD withholding tax, is solely a domestic matter for the UK. It does not depend on any element of foreign taxation. The Member State of source of the foreign dividend itself will operate its own system of taxation of the dividend. That may include a withholding tax, subject to the application of any applicable double tax treaty, depending on the position of the ultimate beneficial owner of the dividend, who may not be a UK resident. Although the UK rules require a grossing up of the overseas dividend, that grossing up is always to the amount of the dividend before deduction of foreign withholding tax (plus any foreign tax credit). The rate of the MOD withholding tax is, as Mr Gammie submitted, entirely a matter of UK domestic law, albeit that it is computed by reference to a hypothetical charge to foreign withholding tax on an assumed dividend received by a UK resident.

108. Mr Baldry submitted that the FTT had been correct, at [140], to hold that the MODs regime:

> "… preserves the UK's decision to exempt pension funds from income tax but to restrict that exemption in the case of foreign withholding taxes. In the absence of a system such as the MOD regime the UK would be unable to maintain the effectiveness of that decision."

109. We disagree. First, the question is not about the effectiveness of the UK's policy to restrict the exemption from UK income tax for pension funds. It is about the balanced allocation of taxing powers between Member States (and third countries in the case of freedom of movement of capital). Secondly, we reject Mr Baldry's

submission that if the UK were compelled to give a payable credit for foreign withholding tax to exempt taxpayers in relation to manufactured but not real dividends, that would clearly be by reference to the rate of foreign withholding tax and would not be a purely internal matter. A domestic tax does not become other than a purely internal matter merely by reason of being calculated by reference to a rate of foreign tax on a hypothetical dividend that is merely deemed to have been received in the UK by an assumed UK resident with particular attributes.

110. Our conclusion is that the MODs regime cannot be justified by reference to the need to preserve a balanced allocation of taxing powers between the UK and any other Member State. No question of proportionality arises.

Prevention of tax avoidance

111. As we have concluded above, in the absence of any justification on the basis of the balanced allocation of taxing powers, the restriction can only be justified on the basis of the prevention of tax avoidance if the specific objective of that measure is to prevent wholly artificial arrangements which do not bear any relation to economic reality and which are designed to avoid payment of the tax normally due on the profits generated by activities carried out on national territory.

112. Mr Baldry submitted that if this was the case, and it was necessary for HMRC to argue that the MODs legislation was specifically targeted at tax avoidance, the legislation was indeed so targeted. The fact that it applied even when there was no tax avoidance motive or activity does not mean, in his submission, that it was not intended to target such activity.

113. Mr Baldry referred to what the FTT said at [134]:

> "[HMRC] submitted that in the absence of the MOD regime it would be open to a tax-exempt lender such as a pension fund to lend shares to a taxable borrower. The borrower would be entitled to claim credit for the withholding tax on dividends received. There would therefore be an advantage to lending shares without any commercial reason because the borrower and the lender could share the benefit of the credit which would not otherwise be available to the lender."

Mr Baldry submitted that an attempt to benefit from credit available to a taxable person by sharing that benefit is a clear example of tax avoidance.

114. Whether or not one of the purposes of the legislation was to prevent the sharing of tax credits in the way outlined by the FTT, what is clear is that the legislation cannot be regarded as having the prevention of such activity as a specific objective. In the same way as in *Masco* the Danish thin capitalisation legislation was of general application, irrespective of the nature of the arrangements between the parties, so too was the MODs regime. The only reference to tax avoidance in the MODs legislation itself is in paragraph 7A of Schedule 23A ICTA, which makes specific provision (broadly, disallowing relevant deductions or reliefs to the extent the relief is referable to a manufactured payment which is attributable to an unallowable purpose) in

relation to manufactured payments (both MDs and MODS). Notably, paragraph 7A draws a distinction between tax avoidance purposes and business and other commercial purposes; a business or other commercial purpose is not an unallowable purpose.

5 115. That distinction is an important one. Even if we had been persuaded that the MODs legislation could be justified on the basis of the prevention of tax avoidance in the terms we have described, we would have found that it was not proportionate to that aim. In applying generally, it could not in any sense be regarded as not going beyond what was necessary to attain the objectives relating to such prevention. It was 10 accepted that the Trustee both acquired the Overseas Shares and undertook the stock lending transactions for wholly commercial reasons, and that there were no artificial arrangements for the avoidance of tax. The application of any provisions designed for the prevention of avoidance of tax to such transactions would be bound to be disproportionate. In all cases, the legislation would be required to enable taxpayers to 15 show commercial justification (see *SGI*, at [71]).

116. We conclude that the MODs regime cannot be justified on the basis of the prevention of tax avoidance.

Fiscal cohesion

117. Fiscal cohesion as a justification for a restriction on the exercise of a 20 fundamental freedom first surfaced in *Bachmann v Belgian State* (Case C-204/90) [1994] STC 855. In that case, the restriction in question was not a restriction on the movement of capital (*Bachmann*, at [34] – [35]), but a restriction on the free movement of workers. The case concerned the refusal by the Belgian authorities to allow a German national working in Belgium a deduction for contributions paid to a 25 German insurance company under certain sickness and invalidity insurance contracts. Deductions were allowed only in the case of contributions to recognised mutual insurance companies, which did not include any non-Belgian insurers.

118. The Court of Justice held, at [28], that in the field of pensions and life assurance, provisions such as those contained in the Belgian legislation at issue were 30 justified by the need to ensure the cohesion of the tax system of which they formed part. The Court reasoned, at [23], that the cohesion of the Belgian tax system presupposed that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax the sums payable by the insurers. Having examined means whereby such an ability to tax 35 might be achieved, the Court concluded, at [27], that it was not possible, as Community law stood, to ensure the cohesion of the Belgian tax system in this respect by means of less restrictive measures than the existing Belgian legislation.

119. In *Proceedings brought by Manninen* (Case C-319/02) [2004] STC 1444, the restriction in question, which was a restriction on the freedom of movement of capital, 40 was a difference in the Finnish tax treatment of dividends received by persons who were fully taxable in Finland depending on whether the dividend was received from a company established in Finland or a company established elsewhere. Such taxpayers

were subject to income tax at the rate of 29% on dividends received from both Finnish companies and foreign companies. But in the former case the Finnish companies were liable to corporation tax (also at 29%) and the taxpayers received a corresponding tax credit against their own income tax liability; in the latter case there was credit only for foreign withholding tax under the applicable double tax treaty. The full amount of corporation tax paid by the foreign company was not taken into account.

120. Referring to *Bachmann*, the Court, at [42], noted that, in order for an argument based on justification of a restriction on the basis of fiscal cohesion to succeed, a direct link had to be established "between a tax advantage on the one hand and the offsetting of that tax advantage by a particular tax deduction". That formulation does not, of course, make sense, as it is the deduction itself that constitutes the tax advantage. The position, thankfully, is clarified by the Court in *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam* (Case C-379/05) [2008] STC 2851, where, at [46], the correct formulation is given, namely that the direct link must be between the tax advantage concerned and a "particular tax levy".

121. The levy in question in *Manninen* was the Finnish corporation tax. That was matched by the tax advantage afforded by the tax credit in favour of the Finnish recipients of the dividends. The Court was prepared to countenance that the Finnish tax legislation was based on a link between the tax charge and the tax credit even though the charge was to corporation tax and was on the company and the tax credit was against income tax and given to the recipient of the dividend (*Manninen*, at [45]). However, at [46], it held that the Finnish legislation, the aim of which was to prevent double taxation of company profits distributed to shareholders, was not necessary to preserve the cohesion of the Finnish tax system. That was because the same objective could be achieved by granting a corresponding tax credit in respect of foreign dividends. The fact that Finland would then be granting a domestic tax credit in respect of foreign corporation tax and that this would entail a reduction in its tax receipts could not be relied upon. The Court noted, at [49], that it has been consistently held that reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom (see, for example, *Proceedings brought by Danner* (Case C-136/00) [2002] STC 1283).

122. The link between a tax credit or tax exemption in relation to the receipt of dividends, and the tax on the distributed profits, was confirmed in *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* ("*FII ECJ 2*") (Case C-35/11) [2013] STC 612, at [59]. It is thus the case that the tax charge and the corresponding deduction or credit or other advantage need not apply to the same person if nonetheless a relevant link can be established by reference to the objective of the tax system at issue.

123. Mr Baldry submitted that the overall objective of the MODs regime was to ensure that the credit attaching to the foreign withholding tax on the real dividend flowed to the ultimate recipient of the manufactured dividend. The legislation established a chain of tax charges and reliefs, such as the set off provisions in relation

to AUKIs, which were designed to achieve, and did achieve, that objective. We have some difficulty with that description. It can apply only to the case where there is a foreign dividend with a tax credit for which, in the normal course, the UK would give relief. But in many cases there may be no such dividend. Whilst the gross amount of the overseas dividend for the purpose of paragraph 4 of Schedule 23A ICTA is calculated by reference to the foreign dividend in question, there is no requirement that such a dividend be received into the UK. The relevant withholding tax is not a real withholding tax on a real foreign dividend, but a statutory construct involving UK tax alone.

124. Even where the circumstances are such that a foreign dividend is received into the UK subject to real foreign withholding tax, there could only be fiscal coherence were the liability for the relevant withholding tax to be matched by an equivalent credit or deduction. Although that may be the case where the recipient has an income tax liability, it is not so for an exempt pension fund. There is thus, in any event, no fiscal coherence in the treatment of the pension fund. The treatment is incoherent in as much as it matches a liability to account for UK income tax on the part of the Borrower with a denial of a tax credit for the Lender in the case of the Trustee.

125. Mr Baldry submitted that it was plain that the MOD withholding tax charge was offset by a credit available to the AUKI under regulation 9 of the MOD Regulations, and that such a relationship between a charge and a credit is capable of giving rise to the necessary direct link in order to establish justification. That, in our view, misses the point. Whereas the treatment of an AUKI may, by reason of the set off provisions, be fiscally coherent, by enabling the charge to the relevant withholding tax to be offset, in certain circumstances, against a credit either for tax in respect of overseas dividends or tax in respect of MODs or otherwise (but we make no decision in respect of the AUKI's position), it is not the treatment of the AUKI that is in issue. The AUKI was itself exposed to a liability to UK tax as a consequence of paying a MOD. That could either be a direct liability to the MOD withholding tax itself, or an indirect liability, where the MOD withholding tax was offset by a credit and that credit was no longer available to the AUKI to offset another liability to tax. If the UK's system was to be fiscally coherent, that liability to tax would have to be matched by a corresponding relief or credit. No such relief or credit was available to the Trustee.

126. The FTT was persuaded by Mr Baldry's arguments. It said (at [145]):

> "In the present case we are satisfied that there is a direct link between the rights of an AUKI to set off … and the MOD withholding tax suffered by the Fund and accounted for by the AUKI. The MOD regime matches the tax advantage and the tax liability exactly. It cannot be said that it is in any way disproportionate. We are satisfied therefore that any restriction in the MOD regime was justified by reference to fiscal cohesion in the UK tax system."

127. For the reasons we have given, we consider that the FTT erred in law in reaching that conclusion. We do not consider that the restriction imposed by the

MOD regime on the freedom of movement of capital can be justified by reference to the fiscal cohesion of that regime.

Remedy for breach of Article 63 TFEU

128. Having held that the MODs regime, in its effect on the Trustee, is a restriction on the freedom of movement of capital, and that it is one that cannot be justified, we turn to consider what remedy (if any) can be afforded on this appeal to the Trustee.

129. There was no dispute as to the principles to be applied, which can therefore be stated quite shortly. It is well established that the court or tribunal is required to interpret domestic legislation which is incompatible with EU law, so far as possible, to make it so compatible. This enables the court or tribunal to read in words or limit provisions, provided that the meaning "goes with the grain" or the cardinal features of the legislation (see, for example, *Vodafone 2 v Revenue and Customs Commissioners (No 2)* [2009] EWCA Civ 446, [2009] STC 1480, at [37] – [38]; *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* ("*FII CA*") [2010] EWCA Civ 103, [2010] STC 1251, at [97]). On the basis of a finding that the MODs legislation gives rise to an unlawful restriction, that legislation should be read so as to eliminate that restriction and thus render the legislation compatible with EU law.

130. The principles were summarised by the Chancellor (Sir Andrew Morritt C) in *Vodafone 2*, at [37] – [38], in the following way:

> "… 'In summary, the obligation on the English courts to construe domestic legislation consistently with Community law obligations is both broad and far-reaching. In particular:
>
> (a) It is not constrained by conventional rules of construction (see *Pickstone* [1988] 2 All ER 803 at 817, [1989] AC 66 at 126 per Lord Oliver);
>
> (b) It does not require ambiguity in the legislative language (*Pickstone* [1988] 2 All ER 803 at 817, [1989] AC 66 at 126 per Lord Oliver; *Ghaidan* [2004] 3 All ER 411 at [32], [2004] 2 AC 557 at [32] per Lord Nicholls);
>
> (c) It is not an exercise in semantics or linguistics (see *Ghaidan* [2004] 3 All ER 411 at [31] and [35], [2004] 2 AC 557 at [31] and [35] per Lord Nicholls; per Lord Steyn at [48]–[49]; and Lord Rodger at [110]–[115]);
>
> (d) It permits departure from the strict and literal application of the words which the legislature has elected to use (*Litster* [1989] 1 All ER 1134 at 1138, [1990] 1 AC 546 at 577 per Lord Oliver; *Ghaidan* [2004] 3 All ER 411 at [31], [2004] 2 AC 557 at [31] per Lord Nicholls);
>
> (e) It permits the implication of words necessary to comply with Community law obligations (see *Pickstone* [1988] 2 All ER 803 at 814–815, [1989] AC 66 at 120–121 per Lord Templeman; *Litster* [1990] 1 AC 546 at 577, [1989] 1 All ER 1134 at 1138 per Lord Oliver); and

(f) The precise form of the words to be implied does not matter (*Pickstone* [1988] 2 All ER 803 at 807, [1989] AC 66 at 112 per Lord Keith; *Ghaidan* [2004] 3 All ER 411 at [122], [2004] 2 AC 557 at [122] per Lord Rodger; and *IDT Card Services Ireland Ltd* [2006] STC 1252 at [114] per Arden LJ).'

[38] Counsel for HMRC went on to point out, again without dissent from counsel for V2, that:

'The only constraints on the broad and far-reaching nature of the interpretative obligation are that:

(a) The meaning should "go with the grain of the legislation" and be "compatible with the underlying thrust of the legislation being construed." (*Ghaidan* [2004] 3 All ER 411 at [33], [2004] 2 AC 557 at [33] per Lord Nicholls; Dyson LJ in *EB Central Services* [2008] STC 2209 at [81]). An interpretation should not be adopted which is inconsistent with a fundamental or cardinal feature of the legislation since this would cross the boundary between interpretation and amendment; (See *Ghaidan* at [33] and [110]–[113] per Lord Nicholls and Lord Rodger respectively; Arden LJ in *IDT Card Services* at [82] and [113]) and

(b) The exercise of the interpretative obligation cannot require the courts to make decisions for which they are not equipped or give rise to important practical repercussions which the court is not equipped to evaluate. (See *Ghaidan* per Lord Nicholls at [33]; Lord Rodger at [115]; Arden L in *IDT Card Services* at [113].)'

131. It is also common ground that it is only if a conforming interpretation is not possible that a court or tribunal will be required to disapply the unlawful provision, but only to the extent necessary to ensure that taxpayers are not improperly deprived of directly enforceable EU law rights (see, for example, *Imperial Chemical Industries plc v Colmer (Inspector of Taxes)* [1999] STC 1089, per Lord Nolan at pp 1094-5; *Fleming (trading as Bodycraft) v Revenue and Customs Commissioners; Condé Nast v Revenue and Customs Commissioners* [2008] UKHL 2, [2008] STC 324, per Lord Walker at [25]).

132. Without suggesting any process by which the MODs legislation could be given a conforming interpretation so as to protect the directly enforceable rights of the Trustee, and on the basis therefore that it was not possible to do so, Mr Gammie advocated the disapplication of paragraph 4(4) of Schedule 23A ICTA. He submitted that the effect of such disapplication would be that, to the extent that the Trustee had suffered UK income tax on MODs received by reference to the Overseas Shares which were the subject of the stock lending transactions which are the subject of this appeal, the Trustee would be treated as having received an annual payment and would be entitled, under s 186 FA 2004, to recover the income tax deducted at source in the usual way.

133. Mr Baldry submitted that such a disapplication would produce a windfall for the Trustee, and for pension funds generally. He argued, by reference to *FII CA*, that a taxpayer is not entitled to either a conforming construction or a disapplication based on a putative breach of EU law in order to obtain a windfall. He submitted that what

the Trustee was contending for was a selective disapplication, involving taking the benefit of the grossing up of the relevant overseas dividend in order to produce the gross amount of the MOD, but seeking to recover in full the entire amount of the relevant withholding tax on that gross amount. The result, Mr Baldry submitted, would in effect be that the UK exchequer would be compensating the Trustee for having suffered foreign withholding tax, even though the UK was under no obligation under EU law to do so.

134. In support of his arguments, Mr Baldry invited us to consider a basic example. He postulated an overseas dividend on the Overseas Shares of 100, which has overseas withholding tax of 15 and a net payment of 85. If the pension fund receives the real dividend it gets a net 85. Where there is a MOD, the pension fund (Lender) receives a manufactured dividend of 85 (so that it is in the same position as if it had received the overseas dividend directly). The AUKI (Borrower) receives the net overseas dividend from the issuer of the Overseas Shares. It has a MOD charge of 15 which it sets against the foreign tax credit of 15 (in other words, the overseas withholding tax). The AUKI is therefore "flat".

135. Mr Baldry then turned to the position he argued would obtain if the Trustee's disapplication argument were to be accepted. The pension fund would be entitled to a repayment of the 15 MOD withholding tax. The AUKI is still "flat", the 15 MOD withholding tax having been offset by the foreign tax credit of 15. The pension fund, however, receives 85 from the AUKI as a manufactured dividend and 15 from HMRC as a tax "repayment". So the pension fund receives 100.

136. Contrasting that position with the case where the pension fund received the overseas dividend directly, Mr Baldry argued that the difference of 15 between the net receipt of the pension fund of such a dividend (85) and the receipt of 100 on the MOD after repayment of the 15 withholding tax (100) would be a windfall to which the pension fund was not entitled under EU law.

137. Mr Baldry also asked us to consider the position of HMRC. He submitted that in the typical MOD transaction HMRC would receive nothing in tax. In the AUKI, there is a tax charge of 15 (the MOD withholding tax) against which there is a foreign tax credit of 15. So HMRC is flat. He characterised the Trustee's argument as being that there is a tax charge of 15, met by the credit for overseas withholding tax of 15, *plus* a repayment of 15 to the pension fund. So, argued Mr Baldry, on the Trustee's argument, HMRC must bear the 15, which pays for the pension fund's windfall.

138. We do not accept Mr Baldry's description of the effects of a typical MOD transaction. As we have described, where an AUKI sets off foreign tax credits against the MOD withholding tax for which it would otherwise be required to account to HMRC, what the MOD withholding tax does is to neutralise those foreign tax credits in the hands of the AUKI. That means that, instead of the AUKI, as the beneficial owner of the overseas dividends giving rise to those credits (which, in a typical case, will not be dividends on the Overseas Shares to which the MOD is referable), being entitled to reduce its own UK tax liability by reference to those credits, the credit is effectively passed on to the recipient of the MOD.

139. Neither the AUKI nor HMRC are, to use Mr Baldry's expression, "flat". Absent the application of the MOD withholding tax, the AUKI would be entitled to a credit for foreign tax against its own UK tax liability of 15. Subject to any other reliefs to which an AUKI, depending on its own position, might be entitled, that 15 is a tax liability of the AUKI which is payable to HMRC. It is an essential feature of the MOD regime that credit for the deemed foreign tax on the overseas dividend represented by the MOD is given only once. As it does attach to the MOD received by the Lender, it must be represented by a tax charge on the Borrower. That tax charge either takes the form of the MOD withholding tax itself, to the extent that set off under the MOD Regulations does not apply, or else, if set off does apply, to the extent of the neutralisation of foreign tax credits otherwise available to the AUKI in the amount of the MOD withholding tax. HMRC are not "flat" because either the MOD withholding tax must be paid by the AUKI to HMRC (and the AUKI deducts that tax from the amount otherwise payable to the Lender), or else the AUKI must forgo double tax relief (which would otherwise reduce the AUKI's own liability to UK tax) up to the amount of the MOD withholding tax (and the AUKI then retains the tax deducted from the amount payable to the Lender). The MOD withholding tax is thus ultimately borne by the Lender.

140. There are echoes in Mr Baldry's windfall argument to a similar submission made on behalf of HMRC in the *BT Pension Scheme* case, in the Upper Tribunal at [2013] UKUT 0105 (TCC), [2013] STC 1781. That argument was rejected by the tribunal. The fact that the FID-paying companies were entitled to repayment of the ACT they had accounted for to the extent that it was not utilised against mainstream corporation tax did not deflect the tribunal from concluding that the pension fund receiving a FID was entitled to a full UK tax credit irrespective of the position of the FID-paying company. The position of the AUKI is equally irrelevant in this case.

141. At all events, even if, contrary to our analysis, the AUKI could be regarded as flat in the terms described by Mr Baldry, it is nonetheless the case that the MOD withholding tax is a deduction, under paragraph 4(2) of Schedule 23A ICTA, from the income which paragraph 4(4) provides is the income of the MOD recipient for tax purposes, namely the gross amount of the MOD. It is thus a UK tax charge on that recipient. Any limitation on recovery of that tax charge, in circumstances where no such charge is deducted in the case of MDs, would be a difference in treatment in relation to dividends on Overseas Shares when compared to dividends on UK Shares.

142. On the reference by the Court of Appeal to the Court of Justice in the *BT Pension Scheme* case (which as we have described above is reported at *Trustees of the BT Pension Scheme v Revenue and Customs Commissioners* (Case C-628/15) [2017] STC 2075), the Court held that Article 63 of the TFEU conferred on shareholders receiving dividends treated as FIDs the right to the same tax treatment for those dividends as that reserved, to those shareholders, for dividends which had their origin in the income which the UK-resident distributing company had received from another UK company (judgment, at [48]). The dividends (FIDs and non-FIDs) were each UK dividends, as in this case the MODs and the MDs are both UK source payments. Translated into equal treatment as between MODs and MDs, a shareholder should be entitled to a remedy to remove the disadvantage attaching to a MOD on account of it

having its origin in foreign dividends on the Overseas Shares that are the subject of the stock lending transactions.

143. The Court went on to consider an argument of the UK government that the pension fund, which was exempt from tax on the dividends it received, should not be entitled to a remedy. The Court said:

> "50. It is also the settled case law of the court that the right to a refund of charges levied by a member state in breach of rules of EU law is the consequence and complement of the rights conferred on individuals by provisions of EU law, as interpreted by the court. The member state is therefore required, in principle, to repay charges levied in breach of EU law (see, to that effect, judgments of 9 November 1983, *Amministrazione delle Finanze dello Stato v SpA San Giorgio* (Case 199/82) [1983] ECR 3595, para 12; of 14 January 1997, *Société Comateb v Directeur General des Douanes et Droits Indirects and related references* (Joined cases C-192/95 to C-218/95) [1997] STC 1006, [1997] ECR I-165, para 20, and of 6 September 2011, *Lady & Kid A/S v Skatteministeriet* (Case C-398/09) [2012] STC 854, [2011] ECR I-7375, para 17).
>
> 51. According to the United Kingdom government, however, such a right to a refund of charges unduly levied does not exist in the present case, given that the Trustees, not being subject to income tax in respect of dividends, did not pay any tax in respect of the dividends to which the claimed tax credits relate.
>
> 52. However, it must be recalled that the right to a refund, within the meaning of the case law cited in para 50 of the present judgment, is concerned not only with the amounts paid to the member state by way of unlawful charges but also any deducted amount the refund of which is essential in restoring the equal treatment required by the provisions of the FEU Treaty on the freedoms of movement (see, by analogy, judgments of 8 March 2001, *Metallgesellschaft Ltd v IRC; Hoechst AG v IRC* (Joined cases C-397/98 and C-410/98) [2001] STC 452, [2001] ECR I-1727, para 87; of 12 December 2006, *Test Claimants in the FII Group Litigation v IRC* (Case C-446/04) [2007] STC 326, [2006] ECR I-11753, para 205, and of 19 July 2012, *Littlewoods Retail Ltd v Revenue and Customs Comrs* (Case C-591/10) [2012] STC 1714, para 25), including, consequently, the amounts due to the individual in respect of a tax credit of which he has been deprived under the national legislation precluded by EU law.
>
> 53. Thus, in circumstances such as those at issue in the main proceedings, shareholders not subject to income tax in respect of dividends, who have received dividends treated as FIDs without, however, having obtained a tax credit pertaining to those dividends, such as the Trustees, are entitled to the payment of the tax credit of which they have been unduly deprived under the national legislation incompatible with art 63 TFEU."

144. There is accordingly no prospective windfall to the pension fund, any more than the tax credit available to a non-exempt Lender on a MOD could, under the MOD

legislation as it stood, be described as a windfall. There is instead a UK tax cost to the pension fund equal to the MOD withholding tax which in the relevant periods it was, by reason of the unlawful restriction, unable to recover.

145. That detriment to the Trustee must be remedied in order that the UK legislation can conform to EU law. We are, however, not persuaded that the position is incapable of remedy by a conforming interpretation of the UK legislation, such that disapplication of paragraph 4(4) of Schedule 23A ICTA is required. The difficulty with disapplication is that it would apply to all cases, including those to which the particular constraints imposed by s 796 ICTA on relief for foreign tax in the case of exempt funds would not apply. We heard no argument as to the effect of disapplication on such recipients of MODs, and we are reluctant to consider such a wide-ranging approach.

146. In our judgment, a better approach is to provide, in effect, for a more limited disapplication by way of a conforming interpretation. That, as the summary of the principles in *Vodafone 2* shows, can include the implication of words necessary to comply with EU law obligations. Our view is that paragraph 4(4) of Schedule 23A ICTA can be construed as being subject to an exception (and so not applying to this limited extent) in the case of a recipient of a manufactured overseas dividend which, by virtue of s 186 FA 2004, has no liability to income tax, to the extent to which the recipient is, by virtue of s 796 ICTA, not entitled to credit for the relevant withholding tax.

147. The result is that the Trustee, under the MOD legislation as so construed, was entitled to be repaid the income tax equal to the relevant withholding tax deducted from the gross amount of the manufactured overseas dividend. The Trustee's claim accordingly succeeds.

Reference to the CJEU

148. We have reached a different conclusion from that arrived at by the FTT. But having considered the relevant EU case law, we have done so with complete confidence. That case law is extensive and it provides a clear set of established principles, the application of which to the particular circumstances of a given case is essentially one for the domestic courts and tribunals. This is not a case, in our judgment, where the circumstances are such as to require further guidance on the principles from the Court of Justice. Accordingly, we do not consider it necessary for a reference to the Court of Justice to be made.

Decision

149. We have found that the FTT erred in law:

(a) in its finding that the MOD regime did not involve any restriction on the movement of capital; and

(b) in its findings that, if there was such a restriction, it was justified by any of (i) the balanced allocation of taxing powers; (ii) the prevention of

tax avoidance; (iii) a combination of (i) and (ii); or (iv) the preservation of the fiscal cohesion of the UK tax system.

150. In those circumstances, the FTT's decision falls to be set aside, and we re-make that decision in accordance with our reasoning and conclusions in this decision.

5 151. In the result, the Trustee's appeal is allowed.

MR JUSTICE MORGAN
UPPER TRIBUNAL JUDGE ROGER BERNER

10

RELEASE DATE: 16 May 2016

APPENDIX 1

Material statutory provisions

Income and Corporation Taxes Act 1988

5 **736A Manufactured dividends and interest**

Schedule 23A to this Act shall have effect in relation to certain cases where under a contract or other arrangements for the transfer of shares or other securities a person is required to pay to the other party an amount representative of a dividend or payment of interest on the securities.

10 **796 Limits on credit: income tax**

(1) The amount of the credit for foreign tax which, under any arrangements, is to be allowed to a person against income tax for any year of assessment shall not exceed the difference between the amounts of income tax which would be borne by him for the year (no credit being allowed for foreign tax but allowing for the making of any other
15 income tax reduction under the Income Tax Acts)—

(a) if he were charged to tax on his total income for the year, computed in accordance with section 795; and

(b) if he were charged to tax on the same income, computed in the same way, but excluding the income in respect of which the credit is to be allowed.

20 (2) Where credit for foreign tax is to be allowed in respect of income from more than one source, subsection (1) above shall be applied successively to the income from each source, but so that on each successive application, paragraph (a) shall apply to the total income exclusive of the income to which the subsection has already been applied.

25 (3) Without prejudice to subsections (1) and (2) above, the total credit for foreign tax to be allowed to a person against income tax for any year of assessment under all arrangements having effect by virtue of section 788 shall not exceed the total income tax payable by him for that year of assessment, less any income tax which he is entitled to charge against any other person.

30 **Schedule 23A**
Manufactured dividends and interest

Interpretation

1—(1) In this Schedule—

"dividend manufacturer" has the meaning given by paragraph 2(1) below;

"dividend manufacturing regulations" means regulations made by the Treasury under this Schedule;

…

"manufactured dividend", … and "manufactured overseas dividend" shall be construed respectively in accordance with paragraphs 2, … and 4 below, as shall references to the gross amount thereof;

"overseas dividend" means any interest, dividend or other annual payment payable in respect of any overseas securities;

"overseas dividend manufacturer" has the meaning given by paragraph 4(1) below;

"overseas securities" means—

(a) shares, stock or other securities issued by a government or public or local authority of a territory outside the United Kingdom or by any other body of persons not resident in the United Kingdom;

…

"overseas tax" means tax under the law of a territory outside the United Kingdom;

"overseas tax credit" means any such credit under the law of a territory outside the United Kingdom in respect of overseas tax as corresponds to a tax credit;

"prescribed" means prescribed in dividend manufacturing regulations;

…

"transfer" includes any sale or other disposal;

"United Kingdom equities" means shares of any company resident in the United Kingdom;

...

Manufactured dividends on UK equities: general

2—(1) This paragraph applies in any case where, under a contract or other arrangements for the transfer of United Kingdom equities, one of the parties (a "dividend manufacturer") is required to pay to the other ("the recipient") an amount (a "manufactured dividend") which is representative of a dividend on the equities.

(2) Where a manufactured dividend is paid by a dividend manufacturer who is a company resident in the United Kingdom, the Tax Acts shall have effect—

(a) in relation to the recipient, and persons claiming title through or under him, as if the manufactured dividend were a dividend on the UK equities in question; and

(b) in relation to the dividend manufacturer, as if the amount paid were a dividend of his.

(3) Where a manufactured dividend to which sub-paragraph (2) above does not apply is paid by any person—

…

(b) the Tax Acts shall have effect in relation to the recipient, and persons claiming title through or under him, as if the manufactured dividend were a dividend on the United Kingdom equities in question; and

(c) the Tax Acts shall have effect in relation to the dividend manufacturer subject to the provisions of paragraph 2A below.

…

(6) Where—

(a) a dividend manufacturer pays a manufactured dividend to which sub-paragraph (3) above applies

…

the dividend manufacturer shall, on paying the manufactured dividend, provide the recipient with a statement in writing setting out the matters specified in sub-paragraph (7) below.

(7) Those matters are—

(a) the amount of the manufactured dividend;

(b) the date of the payment of the manufactured dividend; and

(c) the amount of the tax credit to which, by virtue of sub-paragraph (3)(b) above, the recipient or a person claiming title through or under him either—

(i) is entitled in respect of the manufactured dividend, or

(ii) would be so entitled were all the conditions of a right to a tax credit satisfied, in the case of the recipient or that person, as respects the dividend which the recipient is deemed to receive.

(8) The duty imposed by sub-paragraph (6) above shall be enforceable at the suit or instance of the recipient.

…

Manufactured overseas dividends

4—(1) This paragraph applies in any case where, under a contract or other arrangements for the transfer of overseas securities, one of the parties (the "overseas dividend manufacturer") is required to pay to the other ("the recipient") an amount representative of an overseas dividend on the overseas securities; and in this Schedule the "manufactured overseas dividend" means any payment which the overseas dividend manufacturer makes in discharge of that requirement.

(1A) Where a manufactured overseas dividend is paid as set out in sub-paragraph (1) above it shall be treated—

(a) as an expense of the trade where a company carries on a trade to which that payment relates;

(b) where a company has investment business to which the payment relates, for the purposes of section 75 as expenses of management;

(c) in the case of a company carrying on life assurance business—

(i) so far as the payment is referable to basic life assurance and general annuity business, for the purposes of section 76 as if it were an expense payable falling to be brought into account at Step 3 of subsection (7) of that section, and

(ii) the payment is to be treated as referable to basic life assurance and general annuity business to the extent that the overseas dividend of which it is representative is or would, if it were received by the company, be so referable by virtue of section 432A.

(2) Subject to sub-paragraph (3) below, where this paragraph applies the gross amount of the manufactured overseas dividend shall be treated, except in determining whether it is deductible, for all purposes of the Tax Acts as an annual payment, within section 349, but—

(a) the amount which is to be deducted from that gross amount on account of income tax shall be an amount equal to the relevant withholding tax on that gross amount; and

(b) in the application of section 350(4) in relation to manufactured overseas dividends the reference to Schedule 16 shall be taken as reference to dividend manufacturing regulations;

and paragraph (a) above is without prejudice to any further amount required to be deducted under dividend manufacturing regulations by virtue of sub-paragraph (8) below.

…

(3) If, in a case where this paragraph applies, the overseas dividend manufacturer is not resident in the United Kingdom and the manufactured overseas dividend is paid by him otherwise than in the course of a trade which he carries on through a branch or agency in the United Kingdom, sub-paragraph (2) above shall not apply; but if the manufactured overseas dividend is received by a United Kingdom recipient, that recipient shall account for and pay an amount of tax in respect of the manufactured overseas dividend equal to that which the overseas dividend manufacturer would have been required to account for and pay had he been resident in the United Kingdom; and any reference in this Schedule to an amount deducted under sub-paragraph (2) above includes a reference to an amount of tax accounted for and paid under this sub-paragraph.

(3A) For the purposes of sub-paragraph (3) above a person who receives a manufactured overseas dividend is a United Kingdom recipient if—

(a) he is resident in the United Kingdom; or

(b) he is not so resident but receives that dividend for the purposes of a trade carried on through a branch or agency in the United Kingdom.

(3B) Dividend manufacturing regulations may make provision, in relation to cases falling within sub-paragraph (3) above, for the amount of tax required under that sub-paragraph to be taken to be reduced, to such extent and for such purposes as may be determined under the regulations, by reference to amounts of overseas tax charged on, or in respect of—

(a) the making of the manufactured overseas dividend; or

(b) the overseas dividend of which the manufactured overseas dividend is representative.

(4) Where a manufactured overseas dividend is paid after deduction of the amount required by sub-paragraph (2) above, or where the amount of tax required under sub-paragraph (3) above in respect of such a dividend has been accounted for and paid, then for all purposes of the Tax Acts as they apply in relation to persons resident in the United Kingdom or to persons not so resident but carrying on business through a branch or agency in the United Kingdom—

(a) the manufactured overseas dividend shall be treated in relation to the recipient, and all persons claiming title through or under him, as if it were an overseas dividend of an amount equal to the gross amount of the manufactured overseas dividend, but paid after the withholding therefrom, on account of overseas tax, of the amount deducted under sub-paragraph (2) above; and

(b) the amount so deducted shall accordingly be treated in relation to the recipient, and all persons claiming title through or under him, as an amount so withheld instead of as an amount on account of income tax.

(5) For the purposes of this paragraph—

(a) "relevant withholding tax", in relation to the gross amount of a manufactured overseas dividend, means an amount of tax representative of—

(i) the amount (if any) that would have been deducted by way of overseas tax from an overseas dividend on the overseas securities of the same gross amount as the manufactured overseas dividend; and

(ii) the amount of the overseas tax credit (if any) in respect of such an overseas dividend;

(b) the gross amount of a manufactured overseas dividend is an amount equal to the gross amount of that overseas dividend of which the manufactured overseas dividend is representative, as mentioned in sub-paragraph (1) above; and

(c) the gross amount of an overseas dividend is an amount equal to the aggregate of—

(i) so much of the overseas dividend as remains after the deduction of the overseas tax (if any) chargeable on it;

(ii) the amount of the overseas tax (if any) so deducted; and

(iii) the amount of the overseas tax credit (if any) in respect of the overseas dividend.

(6) Dividend manufacturing regulations may make provision with respect to the rates of relevant withholding tax which are to apply in relation to manufactured overseas dividends in relation to different overseas territories, but in prescribing those rates the Treasury shall have regard to—

(a) the rates at which overseas tax would have fallen to be deducted, and

(b) the rates of overseas tax credits,

in overseas territories, or in the particular overseas territory, in respect of payments of overseas dividends on overseas securities.

(7) Dividend manufacturing regulations may make provision for a person who, in any chargeable period, is an overseas dividend manufacturer to be entitled in prescribed circumstances to set off in accordance with the regulations and to the prescribed extent, amounts falling within paragraph (a) of sub-paragraph (7AA) below against the sums falling within paragraph (b) of that sub-paragraph, and to account to the Board for, or as the case may be, claim credit in respect of, the balance.

(7AA) Those amounts and sums are—

(a) amounts of overseas tax in respect of overseas dividends received by him in that chargeable period, amounts of overseas tax charged on, or in respect of, the making of manufactured overseas dividends so received by him and amounts deducted under sub-paragraph (2) above from any such manufactured overseas dividends; and

(b) the sums due from him on account of the amounts deducted by him under sub-paragraph (2) above from the manufactured overseas dividends paid by him in that chargeable period.

…

Irregular manufactured payments

7—(1) In any case where (apart from this paragraph)—

(a) an amount paid by way of manufactured dividend would exceed the amount of the dividend of which it is representative, or

(b) the aggregate of—

(i) an amount paid by way of manufactured interest or manufactured overseas dividend, and

(ii) the tax required to be accounted for in connection with the making of that payment,

would exceed the gross amount (as determined in accordance with paragraph 3 or 4 above) of the interest or overseas dividend of which it is representative, as the case may be,

the payment shall, to the extent of an amount equal to the excess, not be regarded for the purposes of this Schedule as made in discharge of the requirement referred to in paragraph 2(1), 3(1) or 4(1) above, as the case may be, but shall instead to that extent be taken for all purposes of the Tax Acts to constitute a separate fee for entering into the contract or other arrangements under which it was made, notwithstanding anything in paragraphs 2 or 3 above or anything in paragraph 4 other than in sub-paragraph (1A).

…

Manufactured payments under arrangements having an unallowable purpose

7A—(1) This paragraph applies in any case where—

(a) a manufactured payment falls to be made by a company in an accounting period in pursuance of any arrangements (see sub-paragraphs (9) and (10) for definitions), and

(b) the arrangements have an unallowable purpose at any time (see sub-paragraphs (3) to (5)).

But this is subject to sub-paragraph (8) below (cases where tax relief is denied apart from this paragraph).

5 (2) The company is not entitled, by virtue of anything in this Schedule or any provision of regulations under it, or otherwise, to any relevant tax relief (see sub-paragraph (10)), to the extent that the relief is in respect of, or referable to, the whole or any part of so much of the manufactured payment as, on a just and reasonable apportionment, is attributable to the unallowable purpose.

10 (3) Arrangements have an unallowable purpose at any time if at that time the purposes for which the company is a party to—

(a) the arrangements,

(b) any related transaction (see sub-paragraphs (6) and (7)), or

(c) any transaction in pursuance of the arrangements,

15 include a purpose ("the unallowable purpose") which is not among the business or other commercial purposes of the company.

(4) The business and other commercial purposes of a company do not include the purposes of any part of its activities in respect of which it is not within the charge to corporation tax.

20 (5) Where one of the purposes for which a company is at any time a party to—

(a) any arrangements,

(b) any related transaction in the case of any arrangements, or

(c) any transaction in pursuance of any arrangements,

is a tax avoidance purpose, that purpose shall be taken to be a business or other 25 commercial purpose of the company only where it is not the main purpose, or one of the main purposes, for which the company is party to the arrangements or transaction at that time.

(6) One or more transactions are to be regarded as related transactions, in the case of any arrangements, if it would be reasonable to assume, from either or both of—

30 (a) the likely effect of the transactions, and

(b) the circumstances in which the transactions are entered into or effected,

that none of the transactions would have been entered into or effected independently of the arrangements.

(7) Transactions are not prevented from being related transactions, in the case of any arrangements, just because the transactions—

(a) are not between the same parties, or

(b) are not between the parties to the arrangements.

5 (8) This paragraph does not apply if, as a result of any of the following provisions—

(a) section 75(4)(b) (expenses of management of companies with investment business: unallowable purposes),

(b) section 76(4)(d) (expenses of insurance companies: unallowable purposes),

10 (c) paragraph 13 of Schedule 9 to the Finance Act 1996 (loan relationships with unallowable purposes),

the company in question is not entitled to a relevant tax relief in respect of, or referable to, the whole or any part of the manufactured payment.

The references to sections 75 and 76 are references to those provisions as they have
15 effect in relation to accounting periods beginning on or after 1st April 2004.

(9) Any reference in this paragraph to a manufactured payment falling to be made by a company includes a reference to a manufactured payment which is deemed by or under any provision of the Tax Acts to be made by a company (and references to a transaction, or to a company being party to a transaction, are to be construed
20 accordingly).

(10) In this paragraph—

"arrangements" includes schemes, arrangements and understandings of any kind, whether or not legally enforceable, and shall be taken to include any related transactions;

25 "manufactured payment" means any of the following—

(a) any manufactured dividend;

(b) …

(c) any manufactured overseas dividend;

"related transaction" shall be construed in accordance with sub-paragraphs (6) and (7)
30 above;

"relevant tax relief" means any of the following—

(a) any deduction in computing profits or gains for the purposes of corporation tax;

(b) any deduction against total profits;

(c) the bringing into account of any debit for the purposes of Chapter 2 of
5 Part 4 of the Finance Act 1996 (loan relationships);

(d) the surrender of an amount by way of group relief; "tax advantage" has the same meaning as in Chapter 1 of Part 17 (tax avoidance);

"tax avoidance purpose" means any purpose that consists in securing a tax advantage (whether for the company in question or any other person);

10 and sub-paragraphs (3) to (7) above have effect for the purposes of this paragraph.

Finance Act 2004

Chapter 4 of Part 4 (Registered pension schemes: tax reliefs and exemptions)

186 Income

15 (1) No liability to income tax arises in respect of—

(a) income derived from investments or deposits held for the purposes of a registered pension scheme, or

(b) underwriting commissions applied for the purposes of a registered pension scheme which are not relevant foreign income and which would
20 otherwise be chargeable to income tax under Chapter 8 of Part 5 of ITTOIA 2005 (income not otherwise charged).

(2) The exemption provided by subsection (1) does not apply to income derived from investments or deposits held as a member of a property investment LLP; and for this purpose "income" includes relevant stock lending fees, in relation to any investments,
25 to which subsection (1) would apply by virtue of section 129B of ICTA (inclusion of relevant stock lending fees in income).

(3) In this Part "investments", in relation to a registered pension scheme, includes futures contracts and options contracts; and income derived from transactions relating to futures contracts or options contracts is to be treated as derived from the contracts.

30 (4) For that purpose a contract is not prevented from being a futures contract or an options contract by the fact that a party is or may be entitled to receive or liable to make, or entitled to receive and liable to make, only a payment of a sum (as opposed to a transfer of assets) in full settlement of all obligations.

Income Tax (Manufactured Overseas Dividends) Regulations 1993 (SI 1193/2004)

9—(1) In the circumstances prescribed by paragraph (2) and subject to paragraph (4), a person who is an overseas dividend manufacturer in any chargeable period shall be entitled to set off the amounts specified in paragraph (1A) against the sums specified in paragraph (1B).

(1A) The amounts specified in this paragraph are—

(a) amounts of overseas tax in respect of overseas dividends received by the overseas dividend manufacturer in the chargeable period;

(b) amounts of overseas tax charged on, or in respect of, the making of manufactured overseas dividends so received by him;

(c) amounts deducted under paragraph 4(2) of Schedule 23A from manufactured overseas dividends so received by him;

(d) amounts accounted for and paid under paragraph 4(3) of Schedule 23A in respect of manufactured overseas dividends so received by him;

(e) amounts accounted for and paid under regulation 4(3) in respect of manufactured overseas dividends so received by him.

(1B) The sums specified in this paragraph are sums due from the overseas dividend manufacturer on account of the amounts deducted by him under paragraph 4(2) of Schedule 23A from the manufactured overseas dividends paid by him in the chargeable period.

(2) The circumstances prescribed by this paragraph are where—

(a) the overseas dividend manufacturer is an approved United Kingdom intermediary,

(b) the overseas dividends and manufactured overseas dividends referred to in paragraph (1A), if received by an overseas dividend manufacturer within sub-paragraph (a) of this paragraph who carries on a business in the ordinary course of which he receives overseas dividends and manufactured overseas dividends and pays manufactured overseas dividends, are such that a profit on the sale of the overseas securities to which those overseas dividends and manufactured overseas dividends relate would form part of the trading profits of that business,

…

(d) except in a case to which paragraph (3) applies, the overseas dividends or, as the case may be, the manufactured overseas dividends received by him, do not fall to be matched, in accordance with regulation 10(1), against manufactured overseas dividends paid by him in that period.

10—(1) For the purpose of paragraphs (2)(d) and (3) of regulation 9, overseas dividends paid on overseas securities of a particular kind in respect of a particular dividend date which are received in any chargeable period by an overseas dividend manufacturer, and manufactured overseas dividends representative of those overseas dividends which are received by him in that period—

(a) shall be matched against manufactured overseas dividends representative of those overseas dividends which are paid by him in that period in accordance with the following order of priority—

(i) manufactured overseas dividends received without deduction of tax other than manufactured overseas dividends in respect of which tax falls to be accounted for and paid under paragraph 4(3) of Schedule 23A or regulation 4(3);

(ii) overseas dividends received; and

(iii) manufactured overseas dividends received to which tax referred to in regulation 9(1A) is attributable; and

(b) shall first be matched against manufactured overseas dividends paid without deduction of tax under paragraph 4(2) of Schedule 23A by virtue of regulation 5,

and the balance, if any, shall be matched against manufactured overseas dividends paid by him from which tax has been deducted under paragraph 4(2) of Schedule 23A.

(2) Where under paragraph (1) an overseas dividend or manufactured overseas dividend received is matched with a manufactured overseas dividend paid to a United Kingdom recipient, any voucher relating to the deduction of overseas tax from the overseas dividend shall, subject to paragraph (3), be forwarded to the United Kingdom recipient.

(3) Where under paragraph (1) an overseas dividend received, or a manufactured overseas dividend received on or in respect of the making of which overseas tax has been charged, is matched with more than one manufactured overseas dividend paid to a United Kingdom recipient, the overseas dividend manufacturer—

(a) shall endeavour to obtain from the payer of the overseas dividend a voucher corresponding to each such manufactured overseas dividend so paid, or

(b) if, despite reasonable attempts to do so, he is unable to obtain such a voucher, shall prepare a voucher corresponding to each such manufactured overseas dividend and showing the following amounts—

(i) so much of the gross amount of the overseas dividend as corresponds to the gross amount of the manufactured overseas dividend so paid,

(ii) so much of the overseas tax in respect of the overseas dividend or manufactured overseas dividend received as would be eligible for relief as mentioned in regulation 9(7) and relates to the amount of the overseas dividend calculated in paragraph (i) above, and

5 (iii) so much of the actual amount of the overseas dividend or manufactured overseas dividend received as corresponds to the amount of the manufactured overseas dividend so paid, and

(c) shall forward the voucher obtained or, as the case may be, prepared by him to the United Kingdom recipient of the manufactured overseas dividend
10 paid by him to which the voucher relates, instead of the voucher referred to in paragraph (2).

(4) Where a voucher has been forwarded as mentioned in paragraph (3)(c) and subsequently a manufactured overseas dividend received by an overseas dividend manufacturer to which that voucher relates is matched under paragraph (1) with more
15 than one manufactured overseas dividend paid to a United Kingdom recipient, the overseas dividend manufacturer—

(a) shall endeavour to obtain from the payer of the overseas dividend of which the manufactured overseas dividend received is representative or (as the case may be) from the payer of the manufactured overseas dividend received a
20 voucher corresponding to each such manufactured overseas dividend so paid, or

(b) if, despite reasonable attempts to do so, he is unable to obtain such a voucher, shall prepare a voucher corresponding to each such manufactured overseas dividend so paid and showing the details specified in paragraphs (i) to (iii) of paragraph (3)(b), and

25 (c) shall forward the voucher obtained or, as the case may be, prepared by him to the United Kingdom recipient of the manufactured overseas dividend to which the voucher relates.

11—

(1) Within 30 days of the end of a chargeable period—

30 (a) an overseas dividend manufacturer shall pay to the Board all amounts which he was liable to deduct under paragraph 4(2) of Schedule 23A on account of income tax from manufactured overseas dividends paid by him in that period;

(b) an overseas dividend manufacturer who is an approved United Kingdom intermediary shall pay to the Board the amount of any excess payable under
35 regulation 9(6) attributable to that period;

(c) a United Kingdom recipient shall pay to the Board all amounts of tax for which he was liable to account under paragraph 4(3) of Schedule 23A in respect of manufactured overseas dividends received by him in that period;

(d) an approved United Kingdom intermediary or an approved United Kingdom collecting agent shall pay to the Board all amounts of tax for which he was liable to account under regulation 4(3) in respect of manufactured overseas dividends received by him in that period.

5 …

APPENDIX 2

Extract from Inland Revenue Guidance (December 2003) on Manufactured Payments on Overseas Securities

A3. Offsetting by an AUKI (paragraph 13.1)

5 A3.1 *No matching under Regulation 10 – excess receipts*

AUKI receives and manufactures the following overseas dividends:

	Receipts	tax		Payments	tax
ABC	85	15	JKL	80	20
DEF	75	25*	MNO	90	10
GHI	90	10			
Tax suffered		50	Tax accountable		30

*None of the 25 tax suffered is reclaimable from the overseas tax authority.

All the receipts and payments go into the offsetting pool created by Regulation 9, with the effect that the tax accountable on MODs paid of 30 is covered by the overseas tax suffered of
10 50 leaving the AUKI with nothing to pay. Double tax relief is available only on the balance of tax suffered of 20.

A3.2 *No matching under Regulation 10 – excess payments*

AUKI receives and manufactures the following overseas dividends:

	Receipts	tax		Payments	tax
ABC	85	15	GHI	90	10
DEF	75	25	JKL	80	20
			MNO	90	10
			PQR	85	15
Tax suffered		40	Tax accountable		55

15 In this case, the 40 overseas tax suffered is set against the 55 due on MODs paid, leaving a balance payable under Regulation 9(6) of 15. None of the overseas tax suffered of 40 is available for double tax relief.