Neutral Citation Number: [2019] EWCA Civ 1610

Case No: A3/2018/1700

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)
Mr Justice Morgan and Judge Roger Berner
[2018] UKUT 0152 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 03/10/2019

Before:

LORD JUSTICE NEWEY
LADY JUSTICE ASPLIN
and
LADY JUSTICE ROSE

- -

Between:

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Appellants**
- and -	
COAL STAFF SUPERANNUATION SCHEME TRUSTEES LIMITED	**Respondent**

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- -

Mr Rupert Baldry QC and Mr Oliver Conolly (instructed by the **General Counsel and Solicitor to HM Revenue and Customs**) for the **Appellants**
Mr Malcolm Gammie QC and Mr James Rivett QC (instructed by **Pinsent Masons LLP**) for the **Respondent**

Hearing dates: 25-27 June 2019

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Approved Judgment

Lord Justice Newey, Lady Justice Asplin and Lady Justice Rose:

1. Stock lending involves an owner of shares ("the lender") transferring them to another party ("the borrower") on the basis that the latter will return either the same shares or equivalent ones. Title to the shares passes to the borrower who can, in consequence, choose to lend them on or to sell them as well as to retain them. Since the shares no longer belong to the lender, he is not entitled to receive any dividends payable on them during the term of the loan; those are due to the person who in fact holds the shares at the relevant time. Typically, however, the agreement pursuant to which the loan is made provides for the borrower to pay the lender a sum equivalent to any dividend that might be paid. Tax legislation terms such payments "manufactured dividends" ("MDs") when they relate to shares in companies resident in the United Kingdom and "manufactured overseas dividends" ("MODs") in the case of overseas companies. The lender will also expect to be paid a fee.

2. Such transactions are nowadays commonplace. The First-tier Tribunal ("the FTT") noted in paragraph 88 of its decision that the reasons for which borrowers enter into stock lending arrangements include these:

> "(1) In order to engage in short selling of shares, where borrowers sell the borrowed shares immediately in the hope that the price will have fallen by the end of the loan term at which point they will re-purchase the shares for transfer back to the lender.
>
> (2) To ensure settlement for agreed trades or buy orders which might otherwise fail. In this regard stock lending helps to provide liquidity for the market.
>
> (3) A borrower might also move ownership of shares from one jurisdiction to another in order to optimise dividend receipts, known as dividend arbitrage."

Another possible motivation given by the respondent's investment operations manager related to scrip selling, in respect of which he explained in a witness statement:

> "Scrip selling occurs where an issuer offers shareholders the choice of receiving a cash dividend or reinvesting it in additional securities (scrip). The Fund may not be able to take the more attractive scrip alternative because its holdings would become larger than permitted under the Fund's investment guidelines. A borrower may therefore borrow the shares and elect to receive the scrip then sell it. The lender will typically expect to share in this benefit through a larger fee."

3. The respondent, the Coal Staff Superannuation Scheme Trustees Limited ("the Trustee"), is the trustee of the British Coal Staff Superannuation Scheme ("the Fund"), which is a registered pension scheme. The Fund has participated in stock lending transactions for many years. During the period relevant to this appeal, JP Morgan Chase Bank ("JP Morgan"), the Fund's custodian, would undertake stock

lending on its behalf. The agreement with the borrower would typically be based on the standard form "Overseas Securities Lender's Agreement". An agreement dated 23 December 1998 ("the OSLA") can be taken as representative. A recital to this recorded that the parties wished to agree a procedure under which securities would be made available "in order to enable the Borrower, subject to any Inland Revenue provisions then in force, to fulfil a contract to sell such Securities or to on lend such Securities to a third party to enable such party to fulfil a contract to sell such Securities". The agreement provided for "all right, title and interest" in the shares to pass to the borrower and for the redelivery of equivalent securities. The borrower was to pay to the lender by way of fee "sums calculated by applying such rate as shall be agreed between the Parties from time to time to the daily Value of the relevant Securities". If dividends were declared on the shares, the borrower was to "pay and deliver a sum of money or property equivalent to the same … to the Lender or its Nominee, irrespective of whether the Borrower received the same" (clause 4(B)(i)). Clause 4(B) went on to say the following as regards "Income" such as dividends:

> "(ii) Subject to sub-paragraph (iii) below, in the case of any Income comprising a payment, the amount (the 'Manufactured Dividend') payable by the Borrower shall be equal to the amount of the relevant Income together with an amount equivalent to any deduction, withholding or payment for or on account of tax made by the relevant issuer (or on its behalf) in respect of such Income together with an amount equal to any other tax credit associated with such Income unless a lesser amount is agreed between the Parties or an Appropriate Tax Voucher (together with any further amount which may be agreed between the Parties to be paid) is provided in lieu of such deduction, withholding tax credit or payment.
>
> (iii) Where either the Borrower, or any person to whom the Borrower has on-lent the Securities, is unable to make payment of the Manufactured Dividend to the Lender without accounting to the Inland Revenue for any amount of relevant tax (as required by Schedule 23A to the Income and Corporation Taxes Act 1988) the Borrower shall pay to the Lender or its Nominee, in cash, the Manufactured Dividend less amounts equal to such tax. The Borrower shall at the same time if requested supply Appropriate Tax Vouchers to the Lender."

4. There is no suggestion that the stock lending which the Fund undertook had a tax avoidance motivation. The Upper Tribunal ("the UT") observed in paragraph 5 of its decision that stock lending involves "wholly commercial transactions entered into on ordinary market terms and in the ordinary course of market operations".

5. The present proceedings concern MODs which the Fund received in the tax years 2002-2003 to 2007-2008. The FTT was supplied with a schedule containing

information about six sample transactions. The FTT said this about one of these (in paragraph 107 of its decision):

> "For example, one of the transactions involved a loan of 5.5 million shares in an Italian company to Lehman Bros, London. The loan period was 6 March 2006 to 12 May 2006. On 27 April 2006 the Italian company paid a dividend of €1,210,000. Italy operated a withholding tax of 15% on dividends. The borrower paid a MOD of €1,210,000, amounting to €1,028,500 net of withholding tax. The MOD withholding tax amounted to €181,500."

6. The Trustee claims to be entitled to the repayment of sums totalling £8,827,316 in respect of tax deducted from the MODs from this period pursuant to paragraph 4 of schedule 23A of the Income and Corporation Taxes Act 1988 ("ICTA"). The Trustee's case is that the legislation pursuant to which the deductions were made infringed European Union law relating to freedom of movement of capital. The FTT (Judge Jonathan Cannan and Mrs Helen Myerscough) dismissed the Trustee's appeal, but the Trustee succeeded before the UT (Morgan J and Judge Roger Berner). HM Revenue and Customs ("HMRC") now challenge the UT's decision in this Court.

7. Similar claims have, we understand, been made by other pension funds, life insurance companies, investment funds and charities. This is therefore seen as a test case. HMRC have estimated that the total amount of tax and interest at stake is in the region of £905 million.

8. We shall refer to tax deducted under paragraph 4 of schedule 23A to ICTA as "Deducted Tax".

Freedom of movement of capital

9. Freedom of movement of capital is provided for in chapter 4 of title IV of the Treaty on the Functioning of the European Union ("the TFEU"), comprising articles 63 to 66. Article 63, replacing article 56 of the Treaty establishing the European Community ("the TEC"), states:

> "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."

10. Article 65 of the TFEU (formerly article 58 of the TEC), which supplements article 63, is in these terms:

> "1. The provisions of Article 63 shall be without prejudice to the right of Member States:

> (a) to apply the relevant provisions of their tax law 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;
>
> (b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
>
> 2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with the Treaties.
>
> 3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63.
>
> 4. In the absence of measures pursuant to Article 64(3), the Commission or, in the absence of a Commission decision within three months from the request of the Member State concerned, the Council, may adopt a decision stating that restrictive tax measures adopted by a Member State concerning one or more third countries are to be considered compatible with the Treaties in so far as they are justified by one of the objectives of the Union and compatible with the proper functioning of the internal market. The Council shall act unanimously on application by a Member State."

11. The meaning of "movement of capital" falls to be determined by reference to the "nomenclature" to be found in annex I to Council Directive 88/361/EEC (see Case C-222/97 *Trummer and Mayer* [1999] ECR I-1661, at paragraph 7 of the judgment). The list given in the nomenclature includes "Acquisition by residents of foreign securities dealt in on a stock exchange". In Case C-35/98 *Staatssecretaris van Financiën v Verkooijen* [2002] STC 654, the Court of Justice of the European Union ("the CJEU") explained that "receipt of dividends on shares … may … be linked to 'Acquisition by residents of foreign securities dealt in on a stock exchange'" and "[s]uch an operation is thus indissociable from a capital movement" (paragraph 29 of the judgment).

12. A measure will represent a "restriction" if it is "liable to discourage" exercise of the right to free movement of capital (see Case C-375/12 *Bouanich v Directeur des services fiscaux de la Drôme* EU:C:2014:138, at paragraph 44 of the judgment). In Case C-319/02 *Manninen* [2004] ECR I-7477, [2005] Ch 236 ("*Manninen*"), for example, Finnish tax legislation was held to constitute a restriction because it had "the effect of deterring fully taxable persons in Finland from investing their capital in companies established in another Member State" and also had "a restrictive effect as regards companies established in other Member States, in that it constitutes an

obstacle to their raising capital in Finland" (see paragraphs 22-24 of the judgment). In Case C-293/06 *Deutsche Shell GmbH v Finanzamt für Grossunternehmen in Hamburg* [2008] STC 1721 ("*Deutsche Shell*"), the CJEU spoke of "all measures which prohibit, impede or render less attractive the exercise of that freedom" being regarded as obstacles to freedom of establishment (as regards which similar principles apply) (see paragraph 28 of the judgment).

13. Measures relating to double taxation have been held to amount to restrictions on the free movement of capital. *Manninen* was such a case. A distinction falls to be made, however, between "economic" and "juridical" double taxation. Advocate General Geelhoed explained the difference in these terms in Case C-446/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners* [2007] STC 326:

> "2. … In principle, two levels of taxation can arise when taxing the distribution of company profits. The first is at the company level, in the form of corporation tax on the company's profits. The levying of corporation tax at company level is common to all member states. The second is at the shareholder level, which can take the form of either income taxation on the receipt of the dividends by the shareholder (a method used by most member states), and/or withholding tax to be withheld by the company upon distribution.
>
> 3. The existence of these two possible levels of taxation may lead, on the one hand, to economic double taxation (taxation of the same income twice, in the hands of two different taxpayers) and, on the other hand, juridical double taxation (taxation of the same income twice in the hands of the same taxpayer). Economic double taxation, when, for example, the same profits are taxed first in the hands of the company as corporation tax, and second in the hands of the shareholder as income tax. Juridical double taxation, when, for example, a shareholder suffers first withholding tax and then income tax, levied by different states, on the same profits."

14. "Juridical" double taxation may not be open to objection even where "liable to discourage" exercise of the right to the free movement of capital. Thus, in Joined Cases C-436/08 and C-437/08 *Haribo Lakritzen Hans Riegel BetriebsgmbH and another v Finanzamt Linz* [2011] STC 917 legislation relating to economic double taxation was held to be prohibited by article 63 of the TFEU, but a Member State was not obliged "to provide, in its tax legislation, that a credit is to be granted for the withholding tax levied on dividends in another Member State or in a non-member State in order to prevent the juridical double taxation … of the dividends received by a company in the first Member State". In this connection, the CJEU said this:

> "167. It must be remembered that it is for each member state to organise, in compliance with European Union law, its system for taxing distributed profits and, in that context, to define the tax base and the tax rate which apply to the shareholder receiving them (see, in particular, *Test Claimants in Class IV of the ACT Group Litigation* (para 50); *Test Claimants in the FII*

> *Group Litigation* (para 47); and Case C-194/06 *Orange European Smallcap Fund* [2008] ECR I-3747 (para 30)).
>
> 168. It follows that dividends distributed by a company established in one member state to a shareholder resident in another member state are liable to be subject to juridical double taxation where the two member states choose to exercise their fiscal competence and to subject those dividends to taxation in the hands of the shareholder (*Damseaux v Belgium* (Case C-128/08) [2009] STC 2689, [2009] ECR I-6823, para 26).
>
> 169. However, the court has already ruled that the disadvantages which may arise from the parallel exercise of powers of taxation by different member states, in so far as such an exercise is not discriminatory, do not constitute restrictions prohibited by the Treaty (*EC Commission v Spain* (Case C-153/08) [2009] ECR I-9735, para 56 and the case law cited).
>
> 170. Since European Union law, as it currently stands, does not lay down any general criteria for the attribution of areas of competence between the member states in relation to the elimination of double taxation within the European Union, the fact that both the member state in which the dividends are paid and the member state in which the shareholder is resident are liable to tax those dividends does not mean that the member state of residence is obliged, under European Union law, to prevent the disadvantages which could arise from the exercise of competence thus attributed by the two member states (see *Damseaux* (paras 30 and 34), and *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Kereskedelmi Kft v Adó- és Pénzügyi Ellenőrzési Hivatal Hatósági Főosztály* (Case C-96/08) [2010] STC 1680, paras 27 and 28).
>
> 171. Accordingly, art 63 cannot be interpreted as obliging a member state to provide, in its tax legislation, that a credit is to be granted for the withholding tax levied on dividends in another member state in order to prevent the juridical double taxation—resulting from the parallel exercise by the member states concerned of their respective powers of taxation—of the dividends received by a company established in the first member state (see, to this effect, *Kerckhaert v Belgium* (Case C-513/04) [2007] STC 1349, [2006] ECR I-10967, [2007] 1 WLR 1685, paras 22 to 24)."

15. Further, a restriction may be permissible if "justified by overriding reasons in the public interest" and its application is "appropriate to ensuring the attainment of the objective in question" and does "not go beyond what is necessary to attain it" (Case C-231/05 *Oy AA* [2007] ECR I-6393, [2008] STC 991 ("*Oy AA*"), at paragraph 44 of the judgment; see also Case C-311/08 *Société de Gestion Industrielle SA (SGI)* v *Belgian State* [2010] ECR I-05145 ("*SGI*"), at paragraph 56 of the judgment).

Domestic legislation

Taxation of pension funds

16. Pension schemes such as the Fund are and were during the relevant period exempt from tax on their investment income, including dividend income (see section 592(2) of ICTA and section 186(1) of the Finance Act 2004 ("FA 2004")).

Relief from double taxation on dividends

17. At the material times, double tax agreements to which the UK was a party were given effect by section 788 of ICTA. Further, unilateral, relief was afforded by section 790, which provided for tax payable under another country's law to be allowed as a credit against income tax or corporation tax, notwithstanding the absence of a relevant double tax agreement. In either case, that was subject to section 796, which limited the amount of the credit for foreign tax which was to be allowed to a person against income tax to the amount of such tax that would otherwise be payable. That meant that a shareholder in a foreign company could set withholding tax imposed by the country where the company was resident against tax for which he would otherwise be liable, but that a shareholder with no relevant tax liability (such as a pension scheme with exemption from tax on investment income) could not benefit from the credit.

Taxation of manufactured dividends and manufactured overseas dividends

18. The parties explained the regime that applied as regards taxation of MDs and MODs by reference to ICTA. Latterly, the relevant provisions were in fact to be found in the Income Tax Act 2007, which was introduced as part of the tax law re-write project. No one, however, having suggested that this change was of any significance, we shall refer exclusively to ICTA.

19. Section 736A of ICTA provided for schedule 23A to the Act to have effect in relation to MDs and MODs. Under that schedule, an MD was treated as if it were an actual dividend. Paragraph 2(1) of the schedule explained that the paragraph was to apply "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". The paragraph went on to provide, by paragraph 2(2), that where an MD was paid by a dividend manufacturer which was a company resident in the UK:

> "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".

It is to be noted that dividends paid by UK companies are not subject to any withholding tax.

20. The scheme applicable to MODs, which was more complex, was principally to be found in paragraph 4 of schedule 23A to ICTA. This read as follows:

> "(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 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.
>
> …
>
> (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.

…

(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.
>
> …."

21. A UK borrower was thus treated as making an "annual payment" of a sum equal to the gross amount of the dividend of which the MOD was representative and required to deduct from that on account of income tax a figure equal to an amount of tax "representative of … the amount … 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" (as "relevant withholding tax") (see paragraphs 4(2) and 4(5)(a) of schedule 23A to ICTA). From the point of view of the lender, the deduction (viz. Deducted Tax) was to be treated as an amount withheld on

account of overseas tax rather than as an amount on account of income tax (see paragraph 4(4)). The fact that Deducted Tax was to be regarded as "withheld on account of overseas tax" lies at the heart of the present proceedings. Had Deducted Tax instead been treated as "withheld on account of income tax", a lender exempt from such tax (as the Fund was) would have been entitled to claim repayment from HMRC. Since, however, Deducted Tax was to be viewed as "withheld on account of overseas tax", section 796 of ICTA was in point and a lender could merely set Deducted Tax off against other tax due from him (see paragraph 17 above). That meant that a lender with tax exemption and so no relevant liability to tax was unable to recover any Deducted Tax.

22. Schedule 23A to ICTA was supplemented by the Income Tax (Manufactured Overseas Dividends) Regulations 1993 ("the 1993 Regulations"). Regulation 3 provided for the rate of "relevant withholding tax" that applied to a MOD to be fixed by reference to "the rate which is equal to the rate (or, if more than one, the highest rate) at which tax would have been payable" on an overseas dividend paid to a UK resident on the same date as the MOD. Later regulations dealt with offsetting of tax by "overseas dividend manufacturers", matching of dividends and MODs, and accounting for tax by overseas dividend manufacturers. So far as the first of these is concerned, regulation 9 allowed an overseas dividend manufacturer which was an "approved United Kingdom intermediary" (or "AUKI") to set off the following against sums due on account of amounts deducted from MODs:

> "(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."

Where tax attributable to overseas dividends or MODs was set off on this basis, the AUKI could not claim any double taxation relief in respect of the tax withheld by the overseas tax authority, even if the AUKI had in fact received the actual dividend from the overseas company. In each of the stock lending transactions relevant to these proceedings, the borrower was an AUKI.

23. Turning to matching of dividends and MODs, if an AUKI both received an actual dividend and paid a MOD representative of that dividend, the two were matched under regulation 10 of the 1993 Regulations. The AUKI was then to forward to the

lender a voucher in respect of overseas tax on the dividend. As regards accounting for tax, regulation 11 required an overseas dividend manufacturer to make periodic returns to HMRC and to pay sums due for deductions made under paragraph 4(2) of schedule 23A to ICTA. In practice, however, an AUKI might well have been able to offset all or some of its liability in respect of such deductions against credits to which it was otherwise entitled.

24. Although paragraph 4 of schedule 23A to ICTA was stated to apply where a stock lending agreement provided for payment of an amount representative of an overseas dividend, it could in fact be applicable even where that was not the case. This is because schedule 23A was further supplemented by section 736B. Section 736B operated where, among other things, a dividend was paid on shares transferred pursuant to a stock lending arrangement and there was no provision for the lender to receive payments representative of the dividend. In such a case, schedule 23A was to apply as if the borrower were required to pay the lender an amount representative of the dividend. Tax thus fell to be deducted under paragraph 4(2) of schedule 23A wherever a stock lending agreement relating to overseas shares was concluded, not just where the agreement stated that the borrower was to pay an amount representative of an overseas dividend.

25. The general idea was that the tax treatment of manufactured dividends should mirror that of the dividends they represented. The FTT gave these examples of the way in which the regime was intended to operate:

> "119. By way of illustration, if a UK company paid a dividend of £100 to an AUKI in respect of shares which were subject to stock lending, the AUKI would receive £100. The AUKI would then pay a sum of £100 to the stock lender, in our case the Fund. The lender would therefore receive £100, which is the same amount as it would have received if it had not lent the shares.
>
> 120. If a company paying a dividend of €100 to an AUKI was resident in another EU Member State which operated a withholding tax regime it might deduct say €15 and pay €85 to the AUKI. The AUKI would then be obliged to pay the €100 MOD to the lender but subject to deduction of [Deducted Tax] of €15. The AUKI would be entitled to offset the [overseas] withholding tax of €15 it had suffered against its liability to account to HMRC for [Deducted Tax] also of €15."

In the latter case, the lender is treated as having received an overseas dividend of €100 from which €15 has been withheld on account of overseas tax so that (as the FTT explained in paragraph 121 of its decision) the recipient:

> "can set off the [Deducted Tax of €15] against its income tax liability, but only to the extent that it has an income tax liability. A pension fund will have no income tax liability and is unable to offset the [Deducted Tax]. However it is in the same position as if it had not lent the shares and had received the dividend directly from the EU company."

26. Matters might not, however, be this simple. In practice, a dividend on shares that had been lent to an AUKI would not necessarily be paid to the AUKI. The AUKI might have lent the shares on or sold them. In fact, it probably would have done so if it had borrowed the shares for any of the three reasons given in the first of the passages quoted in paragraph 2 above. The dividend would then be payable to whoever now held the shares rather than to the AUKI.

27. As, moreover, was stressed by Mr Malcolm Gammie QC, who appeared with Mr James Rivett QC for the Trustee, the actual dividend might not in fact be subject to the overseas withholding tax which was to be assumed under ICTA. Take, for example, a loan to an AUKI of shares in an Italian company. Were the borrower still to have the shares, so that it became entitled to a dividend, 15% withholding tax would be deducted in Italy in accordance with the UK/Italy double taxation convention. The borrower would therefore receive only 85% of the gross dividend, just as the Fund would have done had it not lent the shares. If, however, the borrower had lent on or sold the shares, the new shareholder might not be subject to 15% withholding tax. An extract from the European Tax Handbook 2008 indicates that Italy applied a withholding tax of 12.5% to dividends payable to Italian individuals and also, in the case of shares without voting rights, non-residents. Further, tax treaties into which Italy had entered sometimes provided for withholding tax of no more than 10% or even 5%. Thus, if the shares were now in the hands of, say, a French company, it would seem that the withholding tax imposed by Italy might be just 5%. Having regard to regulation 3 of the 1993 Regulations, the "relevant withholding tax" would nonetheless be 15% for the purposes of paragraph 4 of schedule 23A of ICTA. Deducted Tax would then substantially exceed the Italian withholding tax on the actual dividend of which the MOD was representative.

28. The MODs legislation was repealed with effect from 1 January 2014.

The issues

29. Three issues arise:

    i) Did the MOD regime amount to a "restriction" on the movement of capital?

       The FTT answered this question in the negative, but the UT thought otherwise and held that the regime constituted a restriction on the movement of capital. HMRC challenge that conclusion, but the Trustee maintains that the UT was correct.

    ii) If so, was the restriction justified?

       The FTT considered that if (contrary to its view) there was a restriction, it was justified. The UT, on the other hand, decided that the restriction it had found to exist could not be justified. Once again, HMRC dispute the UT's conclusion, while the Trustee supports it.

    iii) If not, what remedy should be granted to the Trustee?

       Given its conclusions on restriction and justification, the FTT did not need to address remedy and preferred not to do so. The UT held that paragraph 4(4) of

schedule 23A to ICTA could 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" (paragraph 146 of the decision), with the result that the Trustee "was entitled to be repaid the income tax equal to the relevant withholding tax deducted from the gross amount of the manufactured overseas dividend" (paragraph 147). The Trustee contends that the UT was correct. HMRC argue that, supposing that (contrary to its case) the MOD regime breached article 63 of the TFEU, the right course would be to disapply paragraph 4 of schedule 23A in its entirety.

30. It was common ground before us that there was a relevant "movement of capital" for the purposes of article 63 of the TFEU. In this connection, the FTT said this:

> "111. The movement of capital relied on by the [Trustee] is in the acquisition of foreign shares, rather than simply the lending of such shares. Mr Gammie submitted that stock lending was indissociable from ownership of foreign shares. It involved acquisition and re-acquisition of foreign shares. The fact that the lending transaction takes place between UK entities does not take it outside the scope of Article 56.
>
> 112. Clearly one of the rights associated with ownership of shares is the right to enter into stock lending transactions using those shares. The nature of the stock lending transactions undertaken by the Fund involved a transfer of legal and beneficial ownership of the shares to the borrower, on terms that the same or equivalent shares would be transferred back on a future date. In our view acquisition, disposal and re-acquisition of foreign shares on the terms of the OSLA plainly involve movements of capital."

31. Mr Gammie argued that there were three relevant movements of capital: the initial acquisition of overseas shares, the transfer of the overseas shares under a stock loan and payment of a MOD (which, Mr Gammie submitted, was indissociable from the capital movement involved in the stock loan itself). In contrast, Mr Rupert Baldry QC, who appeared for HMRC with Mr Oliver Conolly, contended that it is only the investment in the overseas shares that matters. We do not think we need decide who is right. It is enough for our purposes that the parties agree that there was a movement of capital.

Issue 1: Restriction

The decisions below

32. The FTT identified the real question in the context of this issue as "whether a pension fund would be dissuaded from purchasing or retaining foreign shares in favour of UK shares because of the MOD regime" and answered it in the negative (paragraph 116 of its decision). The basis on which it arrived at that conclusion can be seen from paragraph 127, in which it said:

> "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."

The FTT went on in paragraph 129:

> "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."

33. The UT considered that the FTT had erred "First … 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" (paragraph 69 of the UT decision). In the UT's view, the "correct comparison … is between the UK tax treatment of MDs and the UK tax treatment of MODs" and that revealed "a difference in treatment such as to amount to a restriction" (paragraph 72). In that connection, the UT said this:

> "65. … 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 [i.e. Deducted 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 [i.e. Deducted Tax], the tax having been deducted being treated not as UK income tax, but as overseas tax.
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> 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."

34. The UT noted that 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 it did not see that as important. It commented that "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" (paragraph 72 of its decision). Here, "the only jurisdiction seeking to tax the MODs was the UK" (paragraph 78) and (so the UT said in paragraph 78):

> "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."

"The overseas tax on the foreign dividend," the UT said in paragraph 82, "cannot be taken into account to justify the imposition of a similar (if not always corresponding) amount of UK tax on a MOD."

The parties' submissions in outline

35. The thrust of Mr Baldry's submissions was to the effect that the MOD regime did not give rise to any "adverse consequences" for the Trustee and did not therefore have any dissuasive effect. Requiring the borrower to gross up the dividend by the amount of the overseas withholding tax and deduct an equal amount did not affect the Trustee's net return. There was no good reason to think that the Trustee would have received more than the amount of the overseas dividend net of overseas withholding tax had the MOD regime not existed. Further, MDs and MODs were treated alike: both were exempted from income tax in the hands of the Trustee. Mr Baldry pointed out, moreover, that the MOD regime was not a tax-collecting exercise but rather "a bespoke mechanism to pass the double tax credit to the right place". He said, too, that HMRC had not in fact collected £8 million from the Trustee's stock lending.

36. For his part, Mr Gammie endorsed the UT's decision. He was emphatic that what is at issue is not overseas tax on overseas dividends but UK tax on sums payable pursuant to contracts between the Trustee and AUKIs. While juridical double taxation may not be open to objection under EU law, this case does not concern that: the tax that was to be deducted under the MOD regime was distinct from any withholding tax that another Member State might have imposed on the actual dividends of which the contractual payments were representative. In any case, the tax deducted need not have corresponded to any tax withheld by another Member State. The actual dividend of which a MOD was representative will have been received by an unknown person subject to an unknown amount of tax. No overseas tax may in fact have been withheld on the dividend for which the UK was required to give credit. True it may be that Member States' failure to eliminate juridical double taxation gives rise to arbitrage opportunities, but it is not open to a Member State such as the UK to adopt domestic tax measures to negate or limit the benefit of such opportunities as may arise from ordinary market operations and as a result to impede, restrict or make less attractive shareholders' participation in securities markets while leaving them free to participate on more favourable terms in the Member State's own financial market.

Analysis

37. The FTT was plainly correct that the fact that dividends on non-UK shares could be subject to overseas withholding tax was liable to dissuade an investor such as the Fund from buying such shares. It would have known that the credit in respect of overseas tax for which sections 788 and 790 of ICTA provided would be of no assistance to it (see paragraph 17 above) and so that it would have no means of recovering any such tax to which any non-UK shares it held were subject. If, therefore, the country in which the relevant company was resident imposed a withholding tax of, say, 15%, the investor would benefit to the extent of only 85% of any dividend. In contrast, the investor would receive the full amount of a dividend from a UK company, without any deduction of tax.

38. It seems to us, moreover, that the UT went too far when it said that the UK tax charge was "unrelated to … the actual amount of overseas tax that might have been deducted by the overseas company paying the dividend" (see paragraph 33 above). Take a case in which an AUKI retained shares it had been lent rather than lending them on or selling them. In such a case, the tax that the AUKI was required to deduct from the MOD under paragraph 4 of schedule 23A to ICTA will in all probability have

corresponded to overseas withholding tax levied on the actual dividend. It is, moreover, impossible to conceive that the AUKI would have been willing to pay the Trustee any more than the net sum it had itself received.

39. More generally, it cannot realistically be supposed that the MOD regime reduced the Fund's MODs by the full amount of the tax deducted pursuant to paragraph 4 of schedule 23A to ICTA. Plainly, the Trustee could not have hoped to be paid the gross amount of a dividend where a borrower had kept the shares and so received only the net figure itself. Again, supposing that a borrower had engaged in "dividend arbitrage" (as to which, see paragraph 2 above), there could have been no real prospect of the Trustee obtaining all the profit: at best, it might have shared in the gain that could be realised. Further, the actual dividend on the overseas shares will commonly have been subject to at least some overseas withholding tax, and that will have limited both the benefits available from arbitrage and, presumably, the uplift in price that a borrower could achieve by selling the shares "cum dividend".

40. On the other hand, it seems to us that Mr Gammie was correct when he submitted that the rate at which tax was deducted under the MOD regime was not *necessarily* the rate at which tax was withheld by the relevant overseas country on the real dividend. The actual shareholder, who need not even have been a UK resident, could potentially have been subject to overseas withholding tax at a different rate from the rate of "relevant withholding tax" prescribed pursuant to the 1993 Regulations for the purposes of Deducted Tax. In fact, it is not inevitable that any overseas withholding tax at all would have been levied. This confirms what Mr Gammie submitted, namely that although the imposition of Deducted Tax may be intended to reflect the relevant overseas withholding tax regime, it is not a part of that regime, nor is it a necessary consequence of overseas taxation of the actual dividend.

41. In the circumstances, we cannot accept Mr Baldry's submission that the MOD regime did not give rise to any "adverse consequences" for the Trustee. True it may be, as the FTT said, that the Trustee was left in the position that it would have been in had it not lent the shares, but that cannot be determinative. While, as we have said, the MOD regime will not have reduced the Fund's MODs by the full amount of the tax deducted pursuant to it, it can be expected to have impaired them to some degree. More often than not, the borrower will not have retained the shares and the dividend of which the MOD was representative may not then have been subject to overseas withholding tax at the rate used for the MOD regime, if at all. That suggests that, but for the MOD regime, the Trustee could have hoped to lend overseas shares on better terms. It could rationally be supposed that borrowers might at least sometimes be willing to pay the Trustee more than the net amount of a dividend after deduction of "relevant withholding tax" in accordance with paragraph 4 of schedule 23A to ICTA. It follows, as we see it, that the MOD regime limited the returns available to investors such as the Fund from stock lending of overseas shares and, hence, was liable to discourage such investors from buying or retaining overseas shares. Investment in UK shares, of course, gave rise to no such issues.

42. That "juridical" double taxation is permissible as EU law stands cannot assist HMRC. Mr Gammie maintained that juridical taxation was immaterial because a MOD was distinct from the dividend of which it was representative: there could therefore, he argued, be no question of the same income being taxed twice. Whatever scope for argument there might be about that, the fact remains that the MOD regime required

Deducted Tax to be deducted from a MOD regardless of whether another Member State was imposing tax on the corresponding dividend. That of itself must be fatal to any argument based on juridical double taxation. The MOD regime will have served to impose a deduction for tax even where the actual dividend was not subject to an equivalent deduction.

43. For completeness, we should mention that, although article 65(1) of the TFEU was mentioned in HMRC's skeleton argument, no argument founded on it was in the event developed.

Conclusion

44. Like the UT, we consider that the MOD regime amounted to a "restriction" on the movement of capital.

Issue 2: Justification

45. As mentioned in paragraph 15 above, where a measure is found to constitute a restriction of one of the fundamental freedoms, it will not be unlawful if it can be justified on grounds recognised by the CJEU. The wording frequently used by the CJEU to describe the test for justification is that used, for example, in Case C-446/03 *Marks & Spencer plc v David Halsey (HM Inspector of Taxes)* [2005] ECR I-10837 ("*Marks & Spencer*") at paragraph 35. A restriction on free movement:

> "…is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it."

46. Many of the cases relied on by the parties concerned restrictions on freedom of establishment or the free movement of workers rather than free movement of capital but the justifications that are recognised as validating a restriction are the same in each case. A number of different justifications have been considered by the CJEU over the years.

47. HMRC submitted that commensurate with the expansion by the CJEU of the concept of a restriction in the case law, so there has in recent years been an expansion in the availability of justifications. Member States used very rarely to succeed with the defence of justification but in recent times there has been, Mr Baldry said, a resurgence of possible justifications in the case law. The two justifications relied on by HMRC in this appeal are first the need to ensure the balanced allocation of the taxing powers of the Member States and secondly, the need to ensure fiscal cohesion. We consider these in turn.

The balanced allocation of taxing powers and preventing tax avoidance

48. One can unpack this justification a little. It goes further than simply to say that each Member State is entitled to impose its own taxes on income or profits that an entity within its jurisdiction accounts for as having been earned there. It recognises that

each Member State is entitled to ensure that it can collect tax on the income or profit in fact earned by that entity from activities carried out within its jurisdiction by preventing such an entity from moving profits to or losses from a related entity in a different Member State. This potential justification was recognised in *Marks & Spencer*, a case concerning statutory provisions allowing resident companies in a corporate group to offset their profits and losses amongst themselves. Marks & Spencer was refused relief for losses incurred by its overseas businesses because the group relief was available only for losses recorded in the UK. The CJEU held that this was a restriction on freedom of establishment. When it came then to consider justification, the Court was careful to distinguish between a case where the balanced allocation of taxing powers was really in issue and a case where a Member State was merely seeking to make good a loss of tax it had foregone because the taxed company within its jurisdiction had decided to generate some of its profits in a different Member State rather than carrying on all its economic activity in the same Member State. The Court said that a reduction in tax revenue cannot be regarded as an overriding reason in the public interest justifying a measure which is in principle contrary to a fundamental freedom. The Court went on:

> "45. None the less, as the United Kingdom rightly observes, the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses.
>
> 46. In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred."

49. *Marks & Spencer*, Case C-347/04 *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte* [2007] ECR I-2647, and other early cases such as Case C-196/04 *Cadbury Schweppes plc v Commissioners of Inland Revenue* ECR I-7995, [2007] Ch. 30 referred to the balancing of taxing powers as a combination of three elements; the preservation of the allocation of the power to impose taxes together with the risk of tax losses being taken into account twice and thirdly the risk of tax avoidance. The CJEU in *Marks & Spencer* held that the restrictive provisions could be justified only by those three elements "taken together". In *Oy AA* the CJEU held that a restrictive measure could be justified even though only two of the three elements were present. *Oy AA* was a reference for a preliminary ruling from the Supreme Administrative Court in Finland concerning Finnish legislation taxing intra-group financial transfers. Under the relevant Finnish rules, intragroup transfers of untaxed income were deductible from the taxable business income of the transferor company and regarded as the taxable business income of the transferee company. The transfer in issue was a transfer to a loss-making, UK-based parent company AA Ltd from the funds of a Finnish indirect subsidiary Oy AA. Oy AA was prevented by the rules from deducting that transferred fund from its taxable income in Finland because only intragroup transfers between

Finnish companies were so deductible. The Court held that the legislation at issue treated subsidiaries of foreign parent companies less favourably making it less attractive for companies established in other Member States to exercise the freedom of establishment in Finland. The rules therefore constituted a restriction. As to justification, the Court recognised that only two of the three elements referred to in *Marks & Spencer* might be present - the legislation in question was not concerned with preventing tax losses being deductible twice. That did not rule out reliance on the justification; it would be enough if the other two elements were satisfied. The legislation in *Oy AA* was regarded by the Court as sufficiently close to that in issue in *Marks & Spencer* to be capable of justification. It was still directed at preventing companies from in effect having a right to elect to have their losses taken into account in one rather than another Member State. To allow that would, the Court held, undermine the system of the allocation of the power to tax because the Member State of the subsidiary in the case before it "would be forced to renounce its right, in its capacity as the State of residence of that subsidiary, to tax the profits of that subsidiary in favour, possibly, of the Member State in which the parent company has its establishment": paragraph 56. As regards the prevention of tax avoidance, the Court recognised that the possibility of transferring the taxable income of the subsidiary to a parent company in another Member State carried the risk that "by means of purely artificial arrangements" income transfers could be organised within the group towards companies in low tax rate Member States. The Finnish rules prevented such practices. The Court therefore concluded at paragraph 60 that the need to safeguard the balanced allocation of the power to tax combined with the need to prevent tax avoidance was a legitimate objective pursued by the rules; the rules were justified by overriding reasons in the public interest; and they were appropriate for ensuring the attainment of that objective. The fact that the legislation at issue was not specifically aimed at purely artificial arrangements did not prevent it from being proportionate taken as a whole. A more limited condition for deductibility, for example allowing deductibility where the transferred income was in fact taxed in the hands of the recipient in the other Member State or allowing it only where the transferee was a loss-making company, would not be sufficient. Even outside those circumstances, the choice of taxation of the Member State would effectively be a matter for the group of companies.

50. Advocate General Kokott in her opinion in *Oy AA* also emphasised the limits of this potential justification, particularly as regards the element of preventing tax avoidance. She noted that prevention of "tax avoidance" in so far as a company transfers losses from low taxation to high taxation jurisdictions does not of itself justify a restriction. The fact that undertakings seek to profit from the differences between national tax systems is a legitimate form of economic conduct and is indeed inevitable in an internal market in which taxation of corporations is not harmonised: paragraph 62. A restriction can only be justified if such tax optimisation also undermines the allocation of powers to impose taxes between Member States. In the case before her, the Advocate General considered that safeguarding the allocation of powers to impose taxes would not be achieved by a rule which made the tax deductibility of the transfer conditional on proof that the income was in fact taxed in the hands of the recipient company. Even if it were taxed in the other Member State, that would still involve a transfer by the Finnish state to the state of the recipient sister company of the power to impose taxes.

51. Advocate General Kokott in *Oy AA* also considered that the provision was "proportionate within the narrower meaning of that term". That meaning was established in *Marks & Spencer* paragraphs 53 to 56 where the CJEU regarded it as disproportionate not to recognise a cross-border transfer in the particular exceptional situation which arose in that case. There was no information in the reference for a preliminary ruling to suggest that Oy AA was in some exceptional situation and therefore no reason to consider whether the principle of proportionality required divergences from the allocation of powers to impose taxes in exceptional cases.

52. A justification along the same lines was found to exist in *SGI*. In this case SGI, a Belgian company, complained that the Belgian tax authorities had added back to its profits the amount of unusual or gratuitous advantages which it had granted to other related companies that were established in other Member States. There was no corresponding rule with regard to unusual or gratuitous advantages granted to a related company resident in Belgium. "Unusual" in this context meant, the CJEU said, "contrary to the normal course of events and established business rules and practice in the light of the prevailing economic circumstances and the financial situation of the parties": see paragraph 4 of the judgment. The Court recalled at paragraph 60 that the balanced allocation justification may be accepted, "in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory". In its judgment, the Court appears to have moved away from the combination of elements approach of the previous case law and treated the balanced allocation of taxing powers as a separate justification from the prevention of tax avoidance. As regards the former, the Court stated at paragraph 63 that to permit resident companies to transfer their profits in the form of unusual or gratuitous advantages to other companies in the group established in another Member State may well undermine the balanced allocation of powers. If the companies could do that the Member State of the company granting the advantages would be forced to renounce its right, in its capacity as the State of residence of that company, to tax its income in favour, possibly, of the Member State in which the recipient company has its establishment. Turning then to the prevention of tax avoidance it regarded this as a justification where the national measures specifically targeted wholly artificial arrangements designed to circumvent the legislation of the Member State concerned. If the legislation was not so designed, it could nonetheless be justified if the objective of preventing tax avoidance was taken together with that of preserving the balanced allocation of powers. The Court held that:

> "69. In the light of those two considerations, concerning the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance, taken together, it must be held that legislation such as that at issue in the main proceedings pursues legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that it is appropriate for ensuring the attainment of those objectives.."

53. The UT in the present appeal dealt with justification in paragraphs 86 onward of its decision. As regards justification based on the balanced allocation of taxing powers, the UT at paragraph 105 held that the justification recognised by the CJEU is limited

in scope and has been confined to restrictions which prevent taxpayers from effectively choosing in which Member State to be taxed. The UT did not regard the MOD regime as analogous to that kind of legislation. The tax involved was only UK tax; there was no overseas tax imposed on the MOD that needed to be balanced. There was withholding tax on the actual dividend but that did not justify the restriction imposed in the MOD regime.

54. Mr Baldry argued that the case law on the balanced allocation of taxing powers applied to the MOD regime because under tax treaties the UK has agreed with other Member States how to share the taxing rights on a cross-border dividend. Under the agreement with Italy, for example, Italy is entitled to tax 15% of the dividend. The UK is also entitled to tax the remainder of the gross dividend, provided it gives credit for the 15% charged by Italy. If the stock lending rules treat the lender as the person entitled to that 15% credit the balanced allocation is achieved, but it would be disturbed if the UK is required to give a double tax relief credit of 15% to more than one person in the chain. So, Mr Baldry submitted, the relevant withholding tax charge can be seen as preserving the balanced allocation which arises under the bilateral treaty. He submitted further that the MOD regime serves to prevent tax avoidance because if there was no MOD regime, the system was capable of being "worked" as he put it. The pension fund could lend its shares to a taxable person just before the date when the dividend is declared, the taxable person could claim the credit and then give the shares back to the pension fund. The borrower and lender could then split the credit between them. Tax driven lending, he concluded, is therefore discouraged by the MOD regime.

55. We do not see that Mr Baldry's arguments can bring the MOD regime within the scope of the justification as expounded by the CJEU. The MOD regime is very different from the kinds of legislation that have so far been recognised as capable of justification on this ground. There may be some lack of clarity in the CJEU's case law as it currently stands as to the interaction between the need to maintain a balanced allocation of taxing powers and the need to prevent tax avoidance. However, the MOD regime is directed at neither goal. The UT was right to hold at paragraph 109 that a desire on the part of HMRC to reproduce in its treatment of MODs the position that pertains in relation to actual dividends, namely that an exempt taxpayer cannot obtain a refund of overseas tax withheld on the payment of the actual dividend, was not a desire aimed at preserving the UK's entitlement to tax profits accruing within this jurisdiction. The MOD regime really has nothing to do with striking a balance between the taxing powers of the UK and the taxing powers of the Member State in which the company paying the dividend is resident. The transaction between the borrower and the lender of the shares is not a transaction designed to move income or profits into a more favourable taxing jurisdiction so as to force the UK to renounce its right to tax profits that are earned here. The position is not improved by the fact that there is a relationship, as we have discussed earlier, between the rate at which Deducted Tax is charged and the rate of foreign withholding tax. That does not prevent the MOD tax from being a wholly domestic matter.

56. We agree further with the UT's conclusion that the MOD regime is not a measure aimed at preventing wholly artificial arrangements which are designed to avoid the payment of tax. First, as Mr Gammie pointed out, given that the restriction complained of here arises in relation to those, like the Trustee, who are exempt from

income tax, it is difficult to describe the restriction as designed to avoid tax that would otherwise be payable. It is, rather, designed to ensure that the inability of a tax exempt person to obtain a refund for overseas tax withheld from an actual dividend is extended to prevent a tax exempt person from obtaining a refund of the Deducted Tax in respect of the payment of the MOD. The kind of "tax driven lending" that Mr Baldry said is discouraged by the MOD regime seems to us to fall squarely within the kind of legitimate cross-border conduct that entities are entitled to engage in, according to Advocate General Kokott's opinion in *Oy AA* at paragraphs 62 and 63.

57. Even if one could describe that situation as tax avoidance within the scope of the justification currently recognised by the CJEU, we agree with the UT's conclusion that the MOD regime is disproportionate. The CJEU case law indicates that in order to be proportionate, the legislation imposing the restriction must not only be targeted at artificial arrangements but must provide a mechanism whereby the taxpayer is able to make representations to the taxing authority to show that there was a commercial justification for the transaction concerned. In *SGI* the Court, having held that the taxation of unusual or gratuitous advantages was potentially justified by the combination of the need to maintain the balanced allocation of taxing powers and to prevent tax avoidance, stated that it remained necessary to examine whether the legislation went beyond what was necessary to attain the objectives pursued. The Court went on:

> "71. National legislation which provides for a consideration of objective 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 … 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 there may have been for that transaction.…
>
> 72. Second, where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence."

58. The Court held that provided the referring court was satisfied that the legislation exhibited those two characteristics, the national legislation would be proportionate to the objectives pursued by it. This analysis followed the approach of the CJEU in the earlier judgment in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2157 when assessing the proportionality of legislation which recharacterised payments of interest between group companies by treating them as distributions: see paragraphs 82 onwards of the judgment.

59. Clearly, the MOD regime exhibits neither of those characteristics. As Mr Gammie pointed out, the MOD provisions charge UK tax whether or not there has been any

juridical double taxation for which the British Government must give relief to the actual recipient of the dividend. For example the Trustee might loan the stock to an AUKI and the AUKI might then sell the stock to another exempt fund which received the dividend net of withholding tax. The UK would not give relief for the overseas withholding tax because the exempt fund cannot use the tax credit it receives on payment to it of the actual dividend. But the regime will still treat the MOD paid to the Trustee as bearing income tax at the rate of the Deducted Tax for which the AUKI will have to account on behalf of the lender. The MOD is not therefore a proportionate response to the issue that might be worthy of justification.

60. There is no suggestion here that any of the transactions engaged in by the Trustee were wholly artificial arrangements. There is no provision in the legislation for the parties to a stock lending agreement to make representations to HMRC as to the commercial reasons for the loan of the shares; this is not surprising given that the MOD regime is not confined to artificial arrangements. The disadvantage that the exempt taxpayer suffers as a result of being unable to use the income tax credit arising from the borrower's account to HMRC of the Deducted Tax is not limited to that element of the Deducted Tax which represents some artificial excess over what would apply in commercial circumstances.

61. The UT was therefore correct to reject the justification based on the balanced allocation of taxing powers and the prevention of tax avoidance, whether one takes those two arguments in combination or separately.

Fiscal cohesion

62. Fiscal cohesion was first recognised by the CJEU as a justification in Case C-204/90 *Bachmann v Belgium* [1992] ECR I-276. In that case a German national employed in Belgium sought to deduct from his taxable income the contributions he paid in Germany for sickness and invalidity insurance contracts he had entered into before he came to work in Belgium. The relevant Belgian law provided that only contributions paid to insurance companies in Belgium could be deducted. The CJEU held that this was a restriction on the free movement of persons. The Court held at paragraph 21 that there was a connection between the deductibility of contributions and the liability to tax of sums ultimately payable by the insurers under pension contracts. The cohesion of such a tax system therefore 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 insurer. This was clearly not the case if those sums would be paid out by the insurer in a different Member State. Various possible mechanisms were considered and rejected for entitling Belgian tax authorities to recover tax on Mr Bachmann's subsequent pension payments in Germany but the Court concluded that as Community law then stood, it was not possible to ensure the cohesion of the tax system by measures which were less restrictive. The measures were therefore justified by the need to ensure the cohesion of the tax system of which they form part.

63. Since *Bachmann*, Member States attempting to rely on this justification have had little success. *Manninen* concerned the compatibility of Finnish legislation which allowed shareholders a tax credit to avoid economic double taxation on dividends received from companies established in Finland but did not allow a similar credit in respect of dividends received from Swedish companies even though the profits distributed by

the Swedish company in the form of dividends had already borne corporation tax in Sweden. A double taxation treaty in force allowed Mr Manninen to claim a tax credit of 15% for the tax deducted at source in Sweden. The CJEU had no difficulty in finding that the difference in treatment was a restriction on the free movement of capital which was in principle prohibited by the TEC. The Court rejected a claim that the restriction was necessary to ensure the cohesion of the national tax system. The Court in *Manninen* held that in order for a restriction to be justified by the need to preserve the cohesion of the tax system, a direct link had to be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy. In addition the need to safeguard the cohesion of the tax system must be examined in the light of the objective pursued by the tax legislation in question: paragraph 43. The Court recognised that absent the restriction in question, there would be a reduction in Finland's tax receipts in relation to dividends paid by the Swedish company. That reduction in tax revenue could not be regarded as an overriding reason in the public interest to justify a measure which is in principle contrary to a fundamental freedom. The facts were different therefore from the facts of *Bachmann* and the justification based on fiscal cohesion was not made out.

64. The need for a direct link between the tax advantage conferred and the corresponding tax levy which comprised the restriction was emphasised again by the CJEU in *Deutsche Shell*. The Court held that there must be "a strict correlation between the deductible element and the taxable element": see paragraph 39. The scope of the fiscal cohesion justification was revisited by the CJEU more recently in Case C-35/11 *Test Claimants in the FII Group Litigation (No 3)* [2013] 2 WLR 1416. The legislation at issue in that case appeared to treat dividends which the company elected to have treated as having been paid from foreign sourced income and other dividends equally but adopted a different method for preventing economic double taxation in respect of each kind. The referring court had concluded that the way the system operated in practice meant that the two methods did not in fact ensure equivalent tax treatment: see paragraph 52. The legislation did therefore amount to a restriction on freedom of establishment and on movement of capital. The question then arose as to whether the rules were objectively justified by the need to ensure the cohesion of the national tax system. The Court referred back to *Bachmann* and *Manninen*. It confirmed the need for a direct link between the tax advantage concerned and the offsetting of that advantage by a particular tax levy but held that a direct link did exist between the advantage granted by the tax credit or tax exemption on the one hand and on the other hand the tax to which the distributed profits had already been subject. The reliance on the fiscal cohesion justification failed, however, because the Court went on to hold that the restriction was not necessary or proportionate in order to maintain the cohesion of the system designed to prevent economic double taxation. A different system would have ensured the internal cohesion of the tax system while being less prejudicial to the free movement of capital: see paragraph 62.

65. The UT in the present appeal held at paragraph 127 that the FTT had erred in concluding that this justification was made out in respect of the MOD regime.

66. We agree with that conclusion. Mr Baldry submitted that a direct link can be established within the MOD regime between the advantages given and the counteracting disadvantages imposed. The liability of the AUKI to deduct tax on the MOD is directly linked within the system for granting relief to the recipient of the

MOD for the withheld overseas tax. He argued that if one takes the Deducted Tax charge away, the cohesion of the UK tax system would be disturbed because, in effect, the UK would be liable to give a tax credit for a single payment of overseas tax to both the owner of the share at the date the dividend was paid and the recipient of the MOD. That he said would frustrate the cohesion of the MOD regime.

67. The difficulty with that submission is the same difficulty which faces HMRC at each stage of the analysis in this case; the MOD regime is a construct which, though based in some respects on the withholding tax regime in respect of actual overseas dividends, is separate from that latter regime. The policy of seeking cohesion to some degree between the taxation of actual dividends and the taxation of MODs is a domestic policy of the UK Government and it is that policy, rather than any direct link between the credit allowed to the borrower and the imposition of the Deducted Tax which underlies the MOD provisions. The restriction of which the Trustee is complaining in this case does not arise from how the MOD regime operates for the majority of lenders who are taxpayers with a liability to income tax sufficient to use up the benefit of the Deducted Tax having been accounted for to HMRC on their behalf by the borrower. We do not see that the cohesion of the MOD regime is undermined if a tax exempt lender is entitled, like a tax paying lender, to obtain the full benefit of the credit arising from the accounting for the Deducted Tax.

Conclusion

68. We therefore agree with the conclusion reached by the UT that the restriction in the MOD regime cannot be justified.

Issue 3: Remedy

69. As we have found that the MOD regime contained in schedule 23A to ICTA as it applied to the Trustee contained a restriction on the freedom of movement of capital for the purposes of article 63 of the TFEU and that the restriction cannot be justified, it is necessary to consider the appropriate remedy. We have identified the nature of the restriction above. It is necessary, therefore, to determine whether the relevant provisions of ICTA which lead to a result which is incompatible with EU law can be interpreted so as to render them compatible or whether they must be disapplied.

70. There was no dispute before us as to the principles which apply in such circumstances. The Court or Tribunal is required to interpret the provisions of domestic legislation which are incompatible with EU law, so far as possible, to make it compatible. In order to do so, the Court may read in or excise words or phrases, or limit provisions, as long as the amendments "go with the grain" or the cardinal features of the legislation. See *Vodafone 2 v Revenue and Customs Commissioners* [2009] EWCA Civ 446, [2010] Ch 77, at paragraphs 37-38 and *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2010] EWCA Civ 103, [2010] STC 1251, at paragraph 97.

71. As the UT pointed out at paragraph 130 of its decision in this case, the relevant principles when determining whether legislation is amenable to a conforming interpretation were succinctly set out by the then Chancellor, Sir Andrew Morritt, in the *Vodafone 2* case. That was a case in which the Court was required to determine whether the relevant provisions in ICTA concerned with controlled foreign companies

were amenable to a conforming construction, the CJEU having determined in an earlier case that they introduced a restriction on freedom of establishment contrary to article 43 of the TEC which could be justified only if the objective of the restriction were to prevent wholly artificial arrangements designed to escape the tax normally payable. Accordingly, if the measure applied where it was proven, on the basis of objective factors, that despite the existence of tax motives, the controlled company was actually established in the host Member State and carried on genuine economic activities there, it was contrary to article 43 of the TEC. The Court of Appeal held that a conforming construction was possible and could be achieved by inserting an additional exception to the conforming foreign company legislation. See paragraph 44.

72. Sir Andrew Morritt C (with whom Longmore and Goldring LJJ agreed) set out the guiding principles as follows:

> "37. We were referred in the parties' respective written arguments and orally to a number of reported cases on the principles to be observed in looking for a conforming interpretation in either the European Community or Human Rights contexts. In chronological order they are *Pickstone v Freemans plc* [1989] AC 66; *Marleasing SA v La Comercial Internacional de Alimentación SA* [1990] ECR I-4135; *Litster v Forth Dry Dock & Engineering Co Ltd* [1990] 1 AC 546; *Imperial Chemical Industries plc v Colmer (No 2)* [1999] 1 WLR 2035; *Ghaidan v Godin-Mendoza* [2004] 2 AC 557; *R (IDT Card Services Ireland Ltd) v Customs and Excise Comrs* [2006] STC 1252; *Revenue and Customs Comrs v EB Central Services Ltd* [2008] STC 2209 and the *Fleming/Condé Nast* cases [2008] 1 WLR 195. The principles which those cases established or illustrated were helpfully summarised by counsel for HMRC in terms from which counsel for V2 did not dissent. Such principles are that:
>
> '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 (per Lord Oliver of Aylmerton in the *Pickstone* case, at p 126B); (b) it does not require ambiguity in the legislative language (per Lord Oliver in the *Pickstone* case, at p 126B and per Lord Nicholls of Birkenhead in *Ghaidan's* case, at para 32); (c) it is not an exercise in semantics or linguistics (per Lord Nicholls in *Ghaidan's* case, at paras 31 and 35; per Lord Steyn, at paras 48–49; per Lord Rodger of Earlsferry, at paras 110–115); (d) it permits departure from the strict and literal application of the words which the legislature has elected to use (per Lord Oliver in the *Litster* case, at p 577A; per Lord Nicholls in *Ghaidan's* case, at para 31); (e) it permits the implication of words necessary to comply with Community law obligations (per Lord Templeman in the *Pickstone* case, at pp 120H-121A; per

> Lord Oliver in the *Litster* case, at p 577A); and (f) the precise form of the words to be implied does not matter (per Lord Keith of Kinkel in the *Pickstone* case, at p 112D; per Lord Rodger in *Ghaidan's* case, at para 122; per Arden LJ in the *IDT Card Services* case, at para 114).'
>
> 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": see per Lord Nicholls in *Ghaidan v Godin-Mendoza* [2004] 2 AC 557, para 33; Dyson LJ in *Revenue and Customs Comrs v EB Central Services Ltd* [2008] STC 2209, para 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 per Lord Nicholls, at para 33, Lord Rodger, at paras 110–113 in *Ghaidan's* case; per Arden LJ in *R (IDT Card Services Ireland Ltd) v Customs and Excise Comrs* [2006] STC 1252, paras 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 the *Ghaidan* case, per Lord Nicholls, at para 33; per Lord Rodger, at para 115; per Arden LJ in the *IDT Card Services* case, at para 113.'"

73. Longmore LJ also noted at paragraph 70 that:

> "In the human rights context it has been said that the boundary between interpretation and legislation will have been crossed if it is proposed to give a statute a meaning which departs substantially from a fundamental feature of the Act (see *In re S (Minors) (Care Order: Implementation of Care Plan)* [2002] 2 AC 291, para 40, per Lord Nicholls of Birkenhead), if the proposed meaning would remove the 'core and essence' or 'the pith and substance' of the Act or if it would insert something inconsistent with one of the Act's 'cardinal principles': *Ghaidan v Godin-Mendoza* [2004] 2 AC 557, paras 111 and 114, per Lord Rodger of Earlsferry. Nor can the process of interpretation create a wholly different scheme from any scheme provided by the Act: per Lord Rodger of Earlsferry at para 110."

74. The issues were also considered in *Test Claimants in the FII Group Litigation v HMRC* [2010] EWCA Civ 103; [2010] STC 1251. One of the questions for the Court was whether the advance corporation tax provisions could be interpreted so as to be

compatible with EU law, as declared by the CJEU in that case. Arden LJ, with whom Stanley Burnton LJ agreed, stated at paragraph 97 that:

> ". . . It is well-established that the court must interpret a statute which is on the face of it inconsistent with Community law so far as possible so that it is compatible with Community law. This enables the court to read in words or limit provisions, provided that this can be done by the process of interpretation properly so called and does not go against 'the grain' or cardinal features of the legislation: *R (IDT Card Services Ireland Ltd) v Customs and Excise* [2006] EWCA Civ 29, [2006] STC 1252; and *Vodafone 2 v HMRC* [2009] EWCA Civ 446, [2010] 2 WLR 288."

75. Furthermore, in *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2012] UKSC 19, [2012] 2 AC 337 Lord Sumption held at paragraph 176 that:

> "*Marleasing*, at any rate as it has been applied in England, is authority for a highly muscular approach to the construction of national legislation so as to bring it into conformity with the directly effective Treaty obligations of the United Kingdom. It is no doubt correct that, however strained a conforming construction may be, and however unlikely it is to have occurred to a reasonable person reading the statute at the time, a later judicial decision to adopt a conforming construction will be deemed to declare the law retrospectively in the same way as any other judicial decision. But it does not follow that there was not, at the time, an unlawful requirement to pay the tax. It simply means that the unlawfulness consists in the exaction of the tax by the Inland Revenue, in accordance with the non-conforming interpretation of what must (on this hypothesis) be deemed to be a conforming statute…."

76. It is also accepted that it is only if a conforming interpretation cannot be formulated that the Court is required to disapply the unlawful provision but only to the extent which is necessary to ensure that the person who has suffered the restriction is not deprived of their directly enforceable rights under EU law.

77. The UT concluded at paragraph 145 of its decision that it was not persuaded that the position was not capable of remedy by a conforming interpretation so that disapplication of paragraph 4(4) of schedule 23A to ICTA would be required. It noted that such a disapplication would apply to all cases. It concluded that the better approach was to provide for a more limited disapplication by way of a conforming interpretation. It held that:

> "146 . . . 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…."

78. In his oral submissions before us Mr Baldry departed from the position set out in his skeleton. He submitted that the regime in schedule 23A to ICTA should be disapplied in its entirety in relation to a person who is exempt from income tax such as the Trustee. He did so on the basis that no conforming construction was possible. He said that a cardinal feature of the MOD regime contained in paragraph 4 of schedule 23A is the treatment of a MOD as if it were an actual overseas dividend in the hands of the recipient and that the whole purpose is to allow the double taxation relief regime to apply to the MOD. Furthermore, he said that it is a core feature of that double tax relief regime that a person who is not a taxpayer and does not have sufficient tax liabilities is not entitled to payment of the overseas tax credit and, accordingly, one would be "going against the grain" to seek to give paragraph 4 a conforming interpretation. He said that if one applies the guidelines in the *Vodafone 2* case, it is clear that a conforming interpretation is just not possible.

79. It seems to us that this is, in effect, a resurrection of Mr Baldry's argument that schedule 23A does not contain a restriction at all but is merely intended as a mirror image of double tax relief regime, in the context of remedy. We have already rejected that reasoning.

80. In any event, Mr Baldry went on to criticise the approach of the UT by means of a more detailed analysis of paragraph 4 of schedule 23A to ICTA. He submitted that paragraph 4(2) contains the tax collection mechanism applied by the borrower under the stock lending transaction and that paragraph 4(4) contains the provisions as to the tax treatment in the hands of the lender. Accordingly, he said that the sub-paragraphs contain twin fictions which work together and cannot be divorced from one another. He said that it would be a flagrant re-writing of the legislation if paragraph 4(4) were treated as if it did not exist but paragraph 4(2) was retained because paragraph 4(4) explains how the MOD is to be treated in the hands of the recipient, namely as if it is an overseas dividend. He said therefore, that it would go against the grain or a cardinal principle of the legislation were paragraph 4(4) alone to be deleted. He submitted that to do so would be to allow the Trustee to benefit from one statutory fiction in paragraph 4(2) without the balancing provision.

81. Mr Baldry said that this is what the interpretation adopted by the UT does. It entitles the Trustee to rely upon paragraph 4(2) to turn the hypothetical amount with which it is concerned into income in its hands in the form of a taxable annual payment (under section 349 of ICTA) from which it is said that tax has been unlawfully deducted and to deem that tax to have been paid. Such a construction would permit the Trustee to benefit from the grossing up of the deemed overseas dividend under paragraph 4(2) in order to produce the gross amount of the MOD and allow it to recover in full the entire amount of the relevant withholding tax on that gross amount. He said therefore, that this amounts to a confection of fictions under which all of the deemed tax is

deemed to have been paid by the Trustee so that it can be reclaimed and amounts to an impermissible re-writing of the legislative scheme.

82. Mr Gammie, on the other hand, endorsed the UT's conclusion. He reminded us that it is the imposition of UK tax upon a body exempt from income tax by virtue of section 186 of FA 2004, in relation to stock lending of overseas shares giving rise to MODs which is contrary to EU law. He said that it is the deduction of UK tax in such circumstances which is unlawful and the construction adopted by the UT simply restores the default position of section 186 of FA 2004 that the Trustee is exempt from tax on its investment income. He said that it is wrong to characterise paragraph 4(2) as a fiction. He submitted that that is the charging provision by which the income is allocated to the particular charging regime.

83. The objectionable treatment, Mr Gammie said, is contained in paragraph 4(4) because it is that sub-paragraph which imposes the fiction by treating the UK income under the stock lending agreement as if it were foreign income and UK tax as if it were foreign tax. But for that sub-paragraph, the MOD would be received by the exempt body, in this case, the Trustee, without deduction of tax. Accordingly, tax has been charged unlawfully and must be repaid.

84. Furthermore, Mr Gammie submitted that there is no need to be able to show that the tax has actually been paid or accounted for by the AUKI. The deduction of tax by the AUKI from the amount received by the Trustee is sufficient. He also emphasised that it is irrelevant whether, in fact, such a conforming construction leads to a windfall for the Trustee. Tax has been charged which ought not to have been because it causes a restriction. Accordingly, it must be repaid.

85. It seems to us that the UT was right to conclude as it did at paragraph 146 of its decision. We consider that it is possible to interpret schedule 23A and paragraph 4, in particular, in a manner which conforms with the requirements of EU law and that the interpretation adopted by the UT addresses the restriction which we have found to exist. Paragraph 4(4) should be read as being subject to an exception so that it does not apply in the case of the recipient of a MOD which, by virtue of section 186 of FA 2004, has no liability to income tax, to the extent to which that recipient is, by virtue of section 796 of ICTA, not entitled to credit for the relevant withholding tax.

86. As the UT pointed out at paragraph 142 of its decision, the position considered by the CJEU in Case C-628/15 *Trustees of the BT Pension Scheme v Revenue and Customs Commissioners* [2018] Ch 230 is closely analogous to the treatment of MODs. The Court in that case held that article 63 of the TFEU conferred on shareholders receiving dividends treated as foreign investment dividends ("FIDs") the right to the same tax treatment for those dividends as that reserved for dividends originating from income received from UK resident companies. The FIDs and non-FIDs were each UK dividends as in this case the MODs and MDs were both UK source payments. By analogy, the lender in a stock lending transaction should be entitled to a remedy in order to remove the disadvantage which applies to a MOD as a result of it being treated as if its origin were in a foreign dividend on overseas shares.

87. It follows, therefore, that we reject Mr Baldry's argument that such a construction "goes against the grain" of the legislation. As Mr Gammie pointed out, it is the deduction of UK tax upon a body exempt from income tax by virtue of section 186 of

FA 2004, in relation to stock lending in relation to overseas shares giving rise to MODs, which is contrary to EU law. The construction adopted by the UT simply restores the default position of section 186 of FA 2004 that the Trustee is exempt from tax on its investment income.

88. We also reject the argument that such a construction gives rise to a windfall. The Trustee is seeking to recover the tax which was deducted by the borrower before the Trustee's receipt of the MOD. As the UT described at paragraph 141 of its decision:

> " . . . 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."

89. As the CJEU explained in the *BT Pension Scheme* case, the fact that the Trustee represents a pension scheme which is exempt from income tax does not affect its right to recover unlawfully levied tax. The Court stated as follows:

> "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: *Amministrazione delle Finanze dello Stato v SpA San Giorgio* (Case 199/82) [1983] ECR 3595, para 12; *Société Comateb v Directeur Général des Douanes et Droits Indirects* (Joined Cases C-192/95 to C-218/95) [1997] ECR I-165; [1997] STC 1006, para 20 and *Lady & Kid A/S v Skatteministeriet* (Case C-398/09) [2011] ECR I-7375; [2012] All ER (EC) 410, para 17.
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> 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 above, 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, *Metallgesellschaft Ltd v Inland Revenue Comrs* (Joined Cases C-397/98 and C-410/98) [2001]

> Ch 620, para 87; *Test Claimants in the FII Group Litigation* (Case C-446/04) [2012] 2 AC 436, para 205 and *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 article 63 FEU."

90. Accordingly, we consider that the remedy adopted by the UT is the appropriate one.

Conclusion

91. The appeal is dismissed.