[2016] UKFTT 450 (TC)

TC05203

Appeal number: TC/2013/06003

INCOME TAX – pension fund – manufactured overseas dividends – Schedule 23A ICTA 1988 – Article 56 Treaty Establishing the European Community – whether restriction on the movement of capital – whether justified – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

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

- and -

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

TRIBUNAL: JUDGE JONATHAN CANNAN
MRS HELEN MYERSCOUGH

Sitting in public at the Royal Courts of Justice, Strand, WC2A 2LL on 2-4 November 2015

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

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

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DECISION

Background

1. The Appellant is a corporate trustee which has responsibility for managing the British Coal Staff Superannuation Scheme ("the Fund"). It has claimed repayment of withholding tax in connection with stock lending transactions entered into in tax years 2002-03 to 2007-08.

2. Typical stock lending arrangements involve institutional investors transferring legal and beneficial ownership of shares to a borrower on terms that at the end of the stock loan the shares or an equivalent number of shares will be transferred back to the lender. The borrower as legal and beneficial owner of the shares will be entitled to dividends payable on the shares during the term of the loan. The borrower might have lent the shares onwards or might have sold the shares to another person, in which case it will be the latter person as legal and beneficial owner of the shares who will be entitled to the actual dividends. The contractual terms of a stock lending transaction typically involve an obligation on the borrower to provide the lender with a payment of equivalent value to any dividends paid during the term of the loan. In UK tax law such payments are known as 'manufactured dividends', and when they relate to dividends derived from overseas shares, as 'manufactured overseas dividends' (or "MODs").

3. By way of summary, in the tax years covered by this appeal the UK imposed no charge to UK income tax or corporation tax on manufactured dividends paid in respect of shares in UK companies. In contrast it imposed a UK withholding tax on MODs where a withholding tax would have been imposed by the country of origin had the MOD been an actual dividend. The UK withholding tax would be recoverable by a UK taxpayer. The legislation we are concerned with was repealed with effect from 1 January 2014.

4. The Fund is a UK registered pension fund and therefore exempt from tax on its investment income, including dividend income from UK shares held as investments. The same exemption applies to manufactured dividends received by the Fund in respect of UK shares. However in relation to MODs the scheme of the legislation meant that credit for the MOD withholding tax was only available where the recipient had a UK income tax liability for the year of assessment. The Appellant had no such income tax liability and was therefore unable to claim credit for the MOD withholding tax.

5. In broad terms the question on this appeal is whether EU law permitted the UK to exercise its taxing powers to charge UK withholding tax on MODS when it does not charge any tax or equivalent tax on manufactured dividends in relation to UK shares.

6. The Fund maintains that the difference in treatment between manufactured dividends in respect of UK shares and MODs was in breach of Article 56 of the Treaty Establishing the European Community (now Article 63 of the Treaty on the

Functioning of the European Union). Those provisions prohibit restrictions on the movement of capital between Member States and between Member States and third countries.

7. The Respondents contend that the UK legislation did not involve any restriction on the movement of capital. In the alternative, if there was a restriction then it is justified on public interest grounds recognised by the case law of the European Court of Justice and the Court of Justice of the European Union (which together we refer to as "the CJEU").

8. There are a number of other pension funds which have contributed to the cost of this appeal where the Respondents are yet to make a decision on similar claims to repayment of MOD withholding tax. To that extent this appeal is a test case.

9. There was no dispute between the parties as to the effect of the UK domestic legislation. Nor was there any real issue of fact. We set out below the legislative framework in relation to the taxation of manufactured dividends and MODs, followed by our findings of fact. We then discuss the competing submissions of the parties and the reasoning for our decision.

Legislative Framework

10. It is common ground that as a matter of UK domestic tax law the Fund is not entitled to the repayments claimed. On that basis and in the interests of clarity we shall summarise the legislative framework with reference to the relevant statutory provisions but without quoting extensively from those provisions.

11. The MODs legislation was contained in Schedule 23A Income and Corporation Taxes Act 1988 ("ICTA 1988"). In some of the later periods covered by the appeal the legislation was re-written, but without any material differences, in the Income Tax Act 2007. The legislation was repealed with effect from 1 January 2014. The parties focussed their submissions mainly by reference to the ICTA 1988 provisions and we shall do the same.

12. Paragraph 2 Schedule 23A applied wherever under a contract or other arrangements for the transfer of UK shares, one of the parties (a "dividend manufacturer") was required to pay an amount to the other party (a "manufactured dividend") which was representative of a dividend on the shares.

13. The basic scheme of paragraph 2 Schedule 23A was to treat the manufactured dividend for all purposes of the UK tax code as being in substance a dividend received from a UK company. Where the dividend manufacturer was a UK resident company, the manufactured dividend was treated as if it were a dividend paid by the dividend manufacturer (paragraph 2(2) Schedule 23A).

14. The effect of this fiction was that the recipient of a manufactured dividend paid in respect of UK Shares was deemed to receive a dividend from a UK company.

15. At all material times the UK has exempted registered pension funds, including the Fund, from tax on their investment income, including dividend income from UK shares held as investments (s.186 Finance Act 2004). Accordingly, manufactured dividends received by the Fund in respect of UK Shares were not subject to any charge to UK income tax or deduction of tax at source.

16. A different regime applied for payments made in respect of dividends on overseas shares ("the MOD regime"). Paragraph 4 of Schedule 23A applied wherever under a contract or other arrangements for the transfer of overseas securities, one of the parties (an 'overseas dividend manufacturer') was required to pay an amount to the other party (a MOD) which was representative of a dividend on the overseas shares.

17. The basic scheme of paragraph 4 Schedule 23A, in particular paragraph 4(2) was to impose a UK withholding tax ('the MOD withholding tax') on the MOD. The MOD withholding tax was calculated by reference to the gross amount of the MOD at the highest rate at which tax would have been payable to the relevant overseas tax jurisdiction and not otherwise repayable on an actual dividend paid to a recipient in the UK who was subject to UK tax on such a dividend.

18. The mechanism by which the MOD withholding tax was imposed and accounted for under Schedule 23A involved treating the gross amount of the MOD as an annual payment within s.349 ICTA 1988. The effect was that the payer was obliged to deduct and account for UK income tax in respect of the lender's tax liability on the MOD.

19. Under paragraph 4(2) Schedule 23A the amount of UK income tax which was to be deducted from the gross amount of the MOD was an amount equal to "the relevant withholding tax". Paragraph 4(5) defined the relevant withholding tax in relation to a MOD as an amount representative of the amount that would have been deducted by way of overseas tax from an overseas dividend of the same gross amount as the MOD, and the amount of any overseas tax credit in respect of such an overseas dividend. Separate regulations in the form of *The Income Tax (Manufactured Overseas Dividend) Regulations 1993* ("the Regulations") provided for different rates of relevant withholding tax to apply in relation to shares located in different overseas territories.

20. For periods after 30 September 2007 the Regulations were amended so that where appropriate, the person paying the MOD was required to withhold tax at a rate by reference to the 'status' of the stock lender. For example taking into account whether the lender was a company or a pension fund.

21. Paragraph 4(4) Schedule 23A provided that the recipient of a MOD was deemed to have suffered overseas tax on the MOD. In the ordinary course that would give rise to the possibility of double taxation relief, either treaty relief or unilateral relief. However s.796 ICTA 1988 provides that relief in respect of tax paid in overseas territories, including tax deemed to have been so paid by Schedule 23A, is available only to the extent that the taxpayer has a UK income tax liability for the year of

assessment. UK pension funds have no such liability and therefore they are unable to claim double taxation relief.

22. It is paragraph 4(4) which the Fund says is in breach of EU law. Its full terms are as follows:

> "*Where a manufactured overseas dividend is paid after deduction of the amount required by sub-paragraph (2) above … then for all purposes of the Tax Acts as they apply in relation to persons resident 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.*"

23. All of the transactions we are concerned with in this appeal were conducted through JP Morgan Chase Bank ("JPM") which was appointed as the Fund's agent for the purpose of lending shares. The shares were lent to third party securities dealers each of which was an "approved UK intermediary" or "AUKI" as defined in the Regulations. The shares could be lent onwards or sold and the ultimate borrower or owner of the shares could be a person anywhere in the world.

24. It is the AUKI which is obliged to account for the MOD withholding tax on payments to JPM representing overseas dividends Paragraph 9 of the Regulations provides that in certain circumstances an AUKI is entitled to set off overseas tax suffered by it on actual dividends and MOD withholding tax deducted from MODs received by him against sums due from it as withholding tax on MODs paid by him. The Regulations contain various matching provisions which do not affect the underlying principle of the set off provisions.

The Taxation of Dividends Generally

25. Sections 383 and 402 Income Tax (Trading and Other Income) Act 2005 provide that income tax is charged on dividends of UK resident companies and non-UK resident companies respectively. Section 397 provides that in general a UK resident receiving a dividend from a UK company which is charged to tax is entitled to a tax credit equal to one ninth of the amount of the dividend which can be deducted from income tax charged on total income. Section 397A applies with effect from 2008-09 where a UK resident receives a dividend from a non-UK company which is charged to tax. Again, in general the UK resident is entitled to a tax credit of one ninth.

26. As we have noted above, income including dividend income received by a UK registered pension fund is exempt from income tax. If a pension fund receives a dividend of £100 from a UK company then that dividend is exempt from income tax. If an EU company in a Member State which has a withholding tax regime pays a dividend of €100 to a UK pension fund then the pension fund might receive say €85. It would be entitled to a tax credit of €15 but it would have no income tax liability against which to set off that tax credit by way of double taxation relief. The €85 would be exempt from tax in the UK.

27. We were taken to a number of CJEU authorities which have considered the compatibility of domestic law and EU law in the field of cross-border dividends. Those cases distinguish "economic double taxation" and "juridical double taxation". Economic double taxation is used to describe the situation where a company suffers corporate tax on the profits that it earns whilst a shareholder also suffers tax on a dividend paid out of those profits. Economic double taxation is commonly relieved either:

(1) by reducing the rate of corporate tax on profits out of which the dividend is paid, or

(2) by use of an imputation system which imputes to a shareholder a credit in respect of corporate tax paid by the company.

28. Juridical double taxation is the imposition of tax by two different states on the same income. A withholding tax on dividends gives rise to juridical double taxation where the withholding tax is applied in one Member State or a third country and the dividend is also taxed in the Member State in which the shareholder is resident. The extent to which juridical taxation is relieved is generally a matter for the shareholder's state of origin and EU law principles will not be engaged unless there is some discrimination in the manner in which it is relieved (See *Haribo Lakritzen Hans Riegel Betriebs GmbH v Linanzamt Linz Case C-436/08* at [166] – [172]).

29. In the example given above, the €15 withholding tax paid in the EU Member State is juridical taxation and the UK is not bound to give relief for such taxation. In fact the UK does give such relief but only to the extent that that there is UK income tax against which it can be set off. Hence there is no relief for pension funds.

30. In *Kerckhaert and Morres v Belgium Case C-513-04* the CJEU was concerned with dividends from a French resident company in the hands of shareholders resident in Belgium. At that time France operated an imputation system to avoid economic double taxation with the credit being known as the avoir fiscal. The France Belgium Double Taxation Convention provided a degree of relief for juridical double taxation. A Belgian resident receiving a dividend paid by a French company would generally have the right to repayment of the avoir fiscal after deduction of a 15% withholding tax on the gross dividend, that is the distributed dividend plus the tax credit. The Belgian tax due on the amount net of withholding tax was also subject to a degree of relief. In essence all dividends were subject to a 25% rate of income tax in Belgium whatever their source.

31. The taxpayers were refused relief in Belgium for the 15% withholding tax suffered in France. The question referred to the CJEU was whether Article 56 prohibited the restriction of relief in Belgium. Whilst we were taken to both the Opinion of the Advocate General and the judgment of the Court the background and principles were comprehensively stated in the Opinion. At [18] and [19] of his Opinion Advocate General Geelhoed stated the relevant principles to be applied in these terms:

> *18. ... [Articles 43 and 56] prohibit restrictions on free movement of establishment and capital going beyond those resulting inevitably from the fact that tax systems are national, unless these restrictions are justified and proportionate. This means in particular that, in order to fall under the free movement provisions of the Treaty, disadvantageous tax treatment should follow from direct or covert discrimination resulting from the rules of one jurisdiction, and not purely from disparities or the division of tax jurisdiction between two or more Member States' tax systems, or from the coexistence of national tax administrations.*
>
> *19. In the case of a Member State exercising worldwide (home state) tax jurisdiction, this principle means essentially that such a state must treat foreign-source income of its residents consistently with the way it has divided its tax base. In so far as it has divided its tax base to include this foreign-source income - i.e., by treating it as taxable income - it must not discriminate between foreign-source and domestic income. In particular, its legislation should not have the effect that foreign-source income is treated less favourably than domestic-source income. For example, in so far as a home State chooses to relieve economic double taxation on its residents' dividends, it must provide the same relief for incoming foreign-source dividends as for domestic dividends, and must take foreign corporation tax paid into account for this purpose.*

32. We understand that it was this reasoning which led the UK to introduce s.397A ITOIA 2005

33. The Advocate General went on to find that the Belgian rules did not directly discriminate because all dividends were subject to the same 25% rate of tax. At [22] he considered whether there was any indirect discrimination:

> "*22. ... this still leaves the question whether the Belgian legislation amounts to indirect discrimination - that is, despite being equally applicable in law to foreign-source dividends, it has a discriminatory effect in fact. Put otherwise, do the rules restrict free movement of capital in a way that goes beyond the restrictions resulting inevitably from the fact that tax systems are national?*"

34. The Advocate General rejected the taxpayers' argument that because of the 15% withholding tax there was a greater overall tax burden on French sourced dividends than on Belgian sourced dividends. As a matter of fact he found that Belgian residents receiving French sourced dividends were actually better off than when they received Belgian sourced dividends.

35. The Advocate General went on to remark at [28] that if the French system had not provided for any avoir fiscal to be distributed to Belgian residents then this would have resulted in juridical double taxation giving the resident an overall greater burden of taxation. At [30] and [36] he stated:

5 "*30. In this regard, I would recall that the free movement provisions of the Treaty do not as such oblige home states to relieve juridical double taxation resulting from the dislocation of tax base between two Member States.*

…

36. … the mere fact that a home state such as Belgium might not have chosen to
10 *relieve juridical double taxation on dividends would not in itself be contrary to Articles 43 or 56 EC, as long as that State complied with the obligation not to discriminate between foreign-source and domestic-source dividends in exercising its tax jurisdiction, which obligation I outlined above. Any distortion of economic activity resulting from such a choice would result from the fact that*
15 *different tax systems must, in the present state of development of Community law, exist side by side, which may mean disadvantages for economic actors in some cases, and advantages in other cases.*"

36. It is against this background, distinguishing economic double taxation and juridical double taxation, that the parties made their submissions which we consider
20 below.

Article 56 – Restrictions on the Movement of Capital

37. We set out in this section the terms of Article 56 and some of the CJEU case law on Article 56. The following provisions of the Treaty Establishing the European Community ("the Treaty") are relevant for present purposes:

25 "*Article 56*

1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Members States and third countries shall be prohibited.

…

30 *Article 58*

1. The provisions of Article 56 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
35 *residence or with regard to the place where their capital is invested.*

(b) to take all requisite measures to prevent infringement of national law and regulations, in particular in the field of taxation ...

2. The provisions of this chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

3. The measures and procedures referred to in paragraph 1 ... shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56."

38. There is a large body of case law in the CJEU dealing with various aspects of the free movement of capital provisions in the context of cross-border taxation. Similar principles arise out of cases dealing with the freedom of establishment. We were referred in detail to a large number of cases. We shall not set out the factual background and the issues arising in all those case, but we are grateful to both counsel for the analysis which they provided by way of submissions. In broad terms the cases deal with the following matters:

(1) whether there is a movement of capital,

(2) whether there is a restriction on the movement of capital, and

(3) whether any such restriction can be justified.

39. The CJEU has made clear that the nomenclature of the directive under which free movement of capital was originally implemented (*Directive 88/361*) may be relied upon in explaining what is and what is not a movement of capital. See for example *Trummer & Mayer v Austria Case C-222/97* and *Verkooijen v Netherlands Case C-35/98*.

40. The nomenclature states that a movement of capital covers various specific transactions including "*operations in securities normally dealt in on the capital market*" and "*Acquisition by residents of foreign securities dealt in on a stock exchange ....*". It does not provide an exhaustive list of capital movements. The preamble states that capital movements are taken to cover "*... all the financial techniques available on the market approached for the purpose of carrying out the operation in question. For example, the concept of acquisition of securities and other financial instruments covers not only spot transactions but also all the dealing techniques available ...* ".

41. In *Manninen v Finland Case C-319/02* there was a challenge to the Finnish system whereby dividends from Finnish companies had the benefit of an imputation credit but dividends from Swedish companies, which were taxable, did not have the benefit of any credit. Economic double taxation was therefore relieved in relation to dividends from Finnish companies but not in relation to dividends from Swedish companies. The CJEU held that this gave rise to an unlawful restriction on the free movement of capital.

42. Advocate General Kokott had stated at [28] of her opinion:

"*Any measure that makes the cross-border transfer of capital more difficult or less attractive and is thus liable to deter the investor constitutes a restriction on the free movement of capital. In this respect the concept of a restriction of capital movements corresponds to the concept of a restriction that the Court has developed with regard to the other fundamental freedoms, especially the freedom of movement of goods.*"

43. *Van Hilten-van der Heijden v Netherlands Case C-513/03* involved Dutch inheritance tax, and a provision that a Dutch national who transferred her residence to another state, was deemed still to be living in the Netherlands if she died less than 10 years after leaving the Netherlands. The CJEU found that an inheritance was a movement of capital and fell within "*personal capital movements*" within the nomenclature. However it found that the Dutch provisions did not amount to a restriction. At [46] and [47] it stated:

" *46. By enacting identical taxation provisions for the estates of nationals who have transferred their residence abroad and of those who have remained in the Member State concerned, such legislation cannot discourage the former from making investments in that Member State from another State nor the latter from doing so in another Member State from the Member State concerned, and, regardless of the place where the assets in question are situated, nor can it diminish the value of the estate of a national who has transferred his residence abroad. The fact that such legislation covers neither nationals resident abroad for more than 10 years nor those who have never resided in the Member State concerned is irrelevant in that regard. Since it applies only to nationals of the Member State concerned, it cannot constitute a restriction on the movement of capital of nationals of the other Member States.*

47. As regards the differences in treatment between residents who are nationals of the Member State concerned and those who are nationals of other Member States resulting from national legislation such as that in question in the main proceedings, it must be observed that such distinctions, for the purposes of allocating powers of taxation, cannot be regarded as constituting discrimination prohibited by Article 73b of the Treaty. They flow, in the absence of any unifying or harmonising measures adopted in the Community context, from the Member States" power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation…"

44. Kerckhaert, where the CJEU found that there was no restriction, was distinguished by the CJEU in *Bouanich v France Case C-375/12* which concerned the application of a cap on the direct taxation of income of French residents at 50% of total income. The cap did not take into account the withholding tax suffered on dividends from Swedish resident companies. The CJEU rejected arguments that this amounted to juridical double taxation which there was no requirement to relieve and that it was a disadvantage arising from the parallel exercise of tax jurisdiction by Sweden and France. It held that the granting of the "tax shield" concerned only the

French jurisdiction and could fall within Article 56. In Kerckhaert the Belgium system applied the same rate of tax to all dividends. The different treatment arose from the exercise in parallel of two tax jurisdictions.

45. It is clear also that there is nothing wrong in principle where a Member State exempts from tax domestic dividends received by a company resident in that Member State and taxes overseas dividends received by way of an imputation system with the benefit of a credit and an offset for tax paid in that other Member State (see *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue Case C-446/04 at [47] and [48]*).

46. Where a person seeks to challenge a provision on the grounds that it is a restriction on the free movement of capital it is not necessary to establish that the provision has actually had the effect of deterring cross-border movements of capital. It is sufficient that it is capable of having that effect. See *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue Case C-524/04* at [62].

47. The prohibition against restrictions on the freedom of establishment was considered in *de Lasteyrie du Saillant v France Case C-9/02*. At [43] the CJEU held that restrictions were prohibited "*even if of limited scope or minor importance*".

48. All the cases where the CJEU refers to restrictions as amounting to restrictions even if they are of limited scope or of minor importance are cases in the context of freedom of establishment. Mr Baldry QC who appeared on behalf of the Respondents accepted that the same principle would apply to restrictions on the free movement of capital. Mr Baldry accepted that there is a fairly low threshold, but it is a matter of degree. By way of example in *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue C-446/04* ("FII No 1") at [53] the CJEU held that the fact an imputation system with credit for the tax paid on underlying profits involved an additional administrative burden not present for domestic dividends which were exempt would not involve any restriction on freedom of establishment or by analogy on movement of capital.

49. The prohibition against restrictions on free movement of capital applies not just in relation to movements between Member States, but also between Member States and third countries. A nuanced approach may apply in relation to third countries (See *Skatteverket v A Case C-101/05*), but neither party suggested that the principles relevant for present purposes were any different.

50. In Verkooijen the CJEU held that a provision of Dutch tax law that restricted an exemption from income tax on dividends to those dividends paid in respect of companies established in the Netherlands was a restriction on the free movement of capital. Essentially the payment of a dividend was indissociable from a capital movement referred to in the nomenclature, namely the "*acquisition by foreign residents of foreign securities dealt in on a stock exchange*". In other words, the dividends go with the shares and the acquisition of a share in another Member State is a movement of capital.

51. The CJEU went on to say that although direct taxation fell within the competence of Member States, that competence must be exercised consistently with EU law. At [34] the CJEU stated:

> "*34. A legislative provision such as the one at issue in the main proceedings has the effect of dissuading nationals of a Member State residing in the Netherlands from investing their capital in companies which have their seat in another Member State. It is also clear from the legislative history of that provision that the exemption of dividends, accompanied by the limitation of that exemption to dividends on shares in companies which have their seat in the Netherlands, was intended specifically to promote investments by individuals in companies so established in the Netherlands in order to increase their equity capital.*
>
> *35. Such a provision also has a restrictive effect as regards companies established in other Member States: it constitutes an obstacle to the raising of capital in the Netherlands since the dividends which such companies pay to Netherlands residents receive less favourable tax treatment than dividends distributed by a company established in the Netherlands, so that their shares are less attractive to investors residing in the Netherlands than shares in companies which have their seat in that Member State.*
>
> *36. It follows that to make the grant of a tax advantage, such as the dividend exemption, relating to taxation of the income of natural persons who are shareholders subject to the condition that the dividends are paid by companies established within national territory constitutes a restriction on capital movements prohibited by Article 1 of Directive 88/361.*"

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

53. Where it is established that there is a restriction on the free movement of capital it is necessary to consider whether the restriction can be justified. The CJEU in Verkooijen went on to reject submissions that the restriction was justified. At [46] it stated:

> " *46. … it is necessary to examine whether the restriction on capital movements arising from a legislative provision such as that at issue in the main proceedings may be objectively justified by any overriding reason in the general interest.*"

54. The authorities show that there are various forms of justification which all come under the broad heading of overriding reasons in the public interest:

(1) Article 58(1)(a) of the Treaty gives Member States the right to apply 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 provided that such provisions apply to situations which are not objectively comparable.

(2) To preserve the cohesion of the tax system in question.

(3) To preserve the balanced allocation between Member States of the power to impose taxes.

(4) To prevent tax avoidance.

55. Many of the authorities cited to us in relation to the justification of restrictions identified the principles involved and illustrated the circumstances where restrictions may or may not be justified. The authorities often deal with more than one form of justification. In his closing submissions Mr Baldry did not rely on Article 58(1)(a) but we shall nevertheless say something about it.

56. Arguments relying on Article 58(1)(a) were rejected in Verkooijen. Similar arguments were also rejected in *Persche v Finanzamt Lüdenscheid Case C-318/07* where the CJEU held that provisions of German law restricting tax relief for gifts to charities to those charities established in Germany were an unlawful restriction on the movement of capital. It stated as follows:

> "40. *It is true that, under Article 58(1)(a) EC, Article 56 EC is without prejudice to the right of Member States to distinguish, in their tax law, between taxpayers who are not in the same situation with regard to the place where their capital is invested.*
>
> *41. However, it is important to distinguish unequal treatment permitted under Article 58(1)(a) EC from arbitrary discrimination or disguised restrictions prohibited under Article 58(3) EC. Indeed, for national tax legislation such as that at issue in the main proceedings, which distinguishes between national bodies and those established in another Member State, to be regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must concern situations which are not objectively comparable or it must be justified by an overriding reason in the public interest, such as the need to safeguard effective fiscal supervision. In order to be justified, moreover, the difference in treatment must not go beyond what is necessary in order to attain the objective of the legislation in question (see, to that effect, Centro di Musicologia Walter Stauffer, paragraph 32 and the case-law cited).*"

57. At [46] the CJEU stated:

> " *46. … It is settled case-law that the need to prevent the reduction of tax revenues is neither among the objectives stated in Article 58 EC nor an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty…*"

58. We were also referred to *Busley v Finanzamt Stuttgart-Korperschaften Case C-35/08* and *Mattner v Finanzamt Velbert Case C-510/08* where the CJEU found

restrictions in the context of an inherited property and gifts which were not otherwise justified.

59. Article 58(1)(a) as a derogation from the fundamental principle of free movement of capital must be interpreted strictly (see for example *Santander Asset Management SGIIC SA v France Case C-338/11*).

60. In Bouanich, having found that the provisions amounted to a restriction on the movement of capital, the CJEU went on to consider whether they could be justified by reference to what was Article 58(1)(a) and (3) of the Treaty (now Article 65 of the TFEU). At [63] it summarised the approach to justification was follows:

> "*63. … the unequal treatment permitted under Article 65(1)(a) TFEU must be distinguished from the discrimination prohibited by Article 65(3) TFEU. According to the Court's case-law, for a national tax provision which distinguishes between taxpayers depending on the place where their capital is invested to be capable of being regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment applies to situations which are not objectively comparable or is justified by overriding reasons in the public interest (see, to that effect, Case C-35/98 Verkooijen [2000] ECR I-4071, paragraph 43; Manninen, paragraph 29; and Orange European Smallcap Fund, paragraph 59).*"

61. The CJEU had found that the situations were objectively comparable and was therefore concerned with the public interest justification which it described at [65] and [66] as follows:

> "*65. … a restriction on the free movement of capital or the freedom of establishment such as follows from the legislation at issue in the main proceedings is permissible only if it is justified by an overriding reason in the public interest. It is further necessary, in such a case, that the restriction is appropriate for ensuring the attainment of the objective in question and does not go beyond what is necessary to attain it (see National Grid Indus, paragraph 42; Case C-250/08 Commission v Belgium [2011] ECR I-0000, paragraph 51; and, to that effect, Test Claimants in the FII Group Litigation, paragraphs 54 and 55).*
>
> *66. Therefore, it must be determined whether the restriction at issue in the main proceedings can be justified by the overriding reasons in the public interest relied upon by the various governments which presented observations to the Court, concerning the need to maintain the coherence of the French tax system and to ensure a balanced allocation of powers of taxation between the French Republic and the Kingdom of Sweden."*

62. The CJEU found that there was no public interest justification. We were also referred to *Finanzamt Speyer-Germersheim v Steko Industriemontage GmbH Case C-377/07* in relation to whether situations were objectively comparable.

63. Arguments seeking to justify restrictions on the free movement of capital or freedom of establishment by reference to cohesion of the tax system, preservation of the balanced allocation of powers of taxation between the Member States and prevention of tax avoidance were variously considered in *Beker v Germany Case C-168/11*, *Denkavit v France Case C-170/05 Amurta SGPS v Netherlands Case C-379/05 Eurowings v Germany Case C-294/97*, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue Case C-524/04, Lankhorst-Hohorst GmbH v Germany Case C-324/00*, *Oy AA v Finland Case C-231/05, Cadbury Schweppes v Commissioners of Inland Revenue Case C-196/04.*

64. It is not necessary to refer to all these cases in detail in order to illustrate the relevant principles and the application of those principles to the legislation of the particular Member States involved.

65. Restrictions may be justified to preserve the coherence of the tax system. Those arguments originated in the case of *Bachmann v Belgium Case C-204/90* and arose in the context of a German national employed in Belgium. The Belgian tax authorities refused to allow deduction from his total income of contributions paid in Germany for policies giving various sickness and life assurance benefits. The CJEU recognised a direct link between the deductibility of such contributions and the taxation of income from the policies. Under the Belgian tax code there was no deductibility for contributions but sums derived from the insurers were exempt from tax. That treatment was justified by reference to the cohesion of the Belgian tax code. A Member State was only obliged to allow deduction for contributions if the sums payable by the insurers were taxable.

66. In Amurta the CJEU was concerned with Netherlands withholding tax on dividends paid to certain Portuguese shareholders which did not apply to comparable shareholders resident in the Netherlands. UK Government submitted that the cohesion of the tax system must be assessed at the cross-border level, taking into account the fact that relief for Dutch withholding tax was available to a company resident in Portugal under the terms of a double taxation convention. The CJEU rejected that submission at [52] noting that the application of the withholding tax was not conditional on the existence of the convention. More generally, in relation to arguments based on cohesion it stated as follows at [46]:

> " *46. … for an argument based on such a justification to succeed, a direct link must be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy (Manninen, paragraph 42, and Case C-524/04 Test Claimants in the Thin Cap Group Litigation [2007] ECR I-0000, paragraph 68).*"

67. Similar arguments were rejected in *Finanzamt Offenback v Keller Holding GmbH Case C-471/04*, a case concerning different treatment of financing costs in relation to indirect subsidiaries of a German holding company established in Germany and Austria.

68. Justification by reference to cohesion arguments was considered by the CJEU in *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue Case C-35/11* ("FII No 2"). The case had previously gone to the CJEU in 2006 in FII No 1 and was broadly concerned with the regime for franked investment income in the form of dividends paid by a UK subsidiary to a UK parent company. Franked investment income could be used to cover dividends paid by the parent company so as to offset the liability to advance corporation tax. Essentially the dividend income included a credit for ACT which was not available in the case of dividends received from an overseas subsidiary. The CJEU held that the difference in tax treatment of domestic and foreign dividends in the case of direct investments did not in principle give rise to a breach of the Treaty provided that the tax rate applicable to foreign dividends was not higher than the rate applicable to domestic dividends and that the domestic tax credit was at least equal to the amount paid in the Member State of the company paying the dividend.

69. When the case was referred back to the CJEU in 2013 one issue concerned justification of a restriction arising from the different effective rates of tax. The CJEU resurrected an argument of the UK Government in FII No 1 that the different treatment was justified by reference to cohesion of the UK tax system. At [56]-[59] it stated as follows:

> "*56 The United Kingdom Government contended in Test Claimants in the FII Group Litigation that the rules at issue in the main proceedings were objectively justified by the need to ensure the cohesion of the national tax system.*
>
> *57 It should be recalled that the Court has already accepted that the need to preserve the cohesion of a tax system may justify a restriction on the exercise of the freedoms of movement guaranteed by the Treaty (Case C-204/90 Bachmann [1992] ECR I-249, paragraph 21; Case C-319/02 Manninen [2004] ECR I-7477, paragraph 42; Case C-157/07 Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt [2008] ECR I-8061, paragraph 43; and Commission v Belgium, paragraph 70).*
>
> *58 However, in accordance with settled case-law, the existence of a direct link must be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy (Commission v Belgium, paragraph 71 and the case-law cited), the direct nature of that link falling to be examined in the light of the objective pursued by the rules in question (Case C-418/07 Papillon [2008] ECR I-8947, paragraph 44, and Case C-303/07 Aberdeen Property Fininvest Alpha [2009] ECR I-5145, paragraph 72).*
>
> *59 Having regard to the objective pursued by the rules at issue in the main proceedings, a direct link exists between, on the one hand, the tax advantage granted, namely the tax credit in the case of foreign-sourced dividends and the tax exemption for nationally-sourced dividends, and, on the other, the tax to which the distributed profits have already been subject.*"

70. Having found that the restriction was justified for the purposes of fiscal cohesion, the CJEU went on to consider at [60] and [61] whether the measures used were proportionate:

"*60 As to the proportionality of the restriction, whilst application of the imputation method to foreign-sourced dividends and of the exemption method to nationally-sourced dividends may be justified in order to avoid economic double taxation of distributed profits, it is not, however, necessary, in order to maintain the cohesion of the tax system in question, that account be taken, on the one hand, of the effective level of taxation to which the distributed profits have been subject to calculate the tax advantage when applying the imputation method and, on the other, of only the nominal rate of tax chargeable on the distributed profits when applying the exemption method.*

61 The tax exemption to which a resident company receiving nationally-sourced dividends is entitled is granted irrespective of the effective level of taxation to which the profits out of which the dividends have been paid were subject. That exemption, in so far as it is intended to avoid economic double taxation of distributed profits, is thus based on the assumption that those profits were taxed at the nominal rate of tax in the hands of the company paying dividends. It thus resembles grant of a tax credit calculated by reference to that nominal rate of tax."

71. Restrictions may be justified to the extent that they preserve the balanced allocation of the power to impose taxes. In Beker the CJEU described this justification in the following terms:

"57. ... a justification related to the need to safeguard the balanced allocation between the Member States of the power to tax 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 powers of taxation in relation to activities carried out in its territory (see, to that effect, Case C-347/04 Rewe Zentralfinanz [2007] ECR I-2647, paragraph 42; Case C-231/05 Oy AA [2007] ECR I-6373, paragraph 54; and Case C-311/08 SGI [2010] ECR I-487, paragraph 60)."

72. The facts of Beker concerned the credit in the German tax system for withholding tax paid on dividends in other countries. That credit was restricted to the amount of German tax on the dividend. In principle this amounted to relief for juridical double taxation and was thus outside the Treaty provisions on free movement of capital. However the way in which the maximum credit was worked out involved apportioning special expenditure relating to personal or family circumstances which was deductible in Germany. The effect was that relief for such expenditure was only allowed by reference to the proportion of domestic income to total income so reducing the amount of the tax credit for foreign income.

73. The CJEU found that there was a restriction. It rejected any justification based on the allocation between Member States of the power to impose taxes. In particular it

rejected the German Government's argument that a state of residence is not obliged to compensate for disadvantages linked to the failure of the other Member State to take into account the taxpayer's personal or family circumstances.

74. In Denkavit the CJEU held that France could not rely on the terms of the Franco-Netherlands double taxation convention in order to avoid the obligations imposed on it by the Treaty. In particular, at [43] and [44]:

> " *43. ... it should first of all be noted that, in the absence of harmonising measures at Community level and of conventions concluded between all the member states for the purposes of the second indent of art 293 EC, the member states retain competence for determining the criteria for taxation on income with a view to eliminating double taxation by means, inter alia, of international conventions. In those circumstances, the member states remain at liberty to determine the connecting factors for the allocation of fiscal jurisdiction by means of bilateral agreements (see, to that effect, Saint-Gobain ZN, para 57, and Bouanich v Skatteverket (Case C-265/04) (2006) 8 ITLR 433, [2006] ECR I-923, para 49).*
>
> *44. The fact remains that, as far as the exercise of the power of taxation so allocated is concerned, the member states may not, having regard to the principle referred to in para 19 of this judgment, disregard Community rules (*Saint-Gobain ZN*, para 58). In particular, such an allocation of fiscal jurisdiction does not permit member states to introduce discriminatory measures which are contrary to the Community rules (Bouanich, para 50).*"

75. This form of justification is closely connected with the fourth justification, namely the prevention of tax avoidance. In *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue Case C-524/04* the UK Government argued that provisions relating to thin capitalisation were justified on the basis that they were targeting a particular form of tax avoidance. In brief the abuse that they sought to counter was presenting as debt finance what in substance was equity finance in order to obtain a more favourable tax treatment where a subsidiary was located in a relatively high tax jurisdiction. Relief was restricted by reference to an "arm's length" test. The CJEU stated as follows:

> " *74. In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory (Cadbury Schweppes and Cadbury Schweppes Overseas, paragraph 55).*
>
> *75. Like the practices referred to in paragraph 49 of the judgment in Marks & Spencer, which involved arranging transfers of losses incurred within a group of companies to companies established in the Member States which applied the highest rates of taxation and in which the tax value of those losses was therefore*

the greatest, the type of conduct described in the preceding paragraph is such as to undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between Member States of the power to impose taxes (Cadbury Schweppes and Cadbury Schweppes Overseas, paragraph 56)."

76. Oy AA was a similar case which involved subvention payments between related companies as an alternative to surrender of losses. Finland allowed a Finnish company to make a subvention payment to a loss-making Finnish company on the basis that it could obtain relief for the payment as long as the recipient was taxable in respect of the payment. However no relief was available in respect of cross-border subvention payments. The CJEU held there was a restriction on the movement of capital but that it could be justified as follows:

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

77. When the Thin Cap Group Litigation returned to the Court of Appeal *([2011] EWCA Civ 127*) Stanley Burnton LJ referred to the CJEU decision in SGI concerning legislation in Belgium which placed a cap on relief for gratuitous payments. At [54] he quoted from that judgment as follows:

"*60 First, as regards the balanced allocation between Member States of the power to tax, it should be recalled that such a 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. …*

61 The Court has recognised that the preservation of the allocation of the power to impose taxes between Member States may 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 (see inter alia, Oy AA at [54], …

65 Second, as regards the prevention of tax avoidance, it should be recalled that a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned (see, to that effect, ICI [1998] 3 CMLR 293 at [26]; Marks & Spencer at [57]; Cadbury [2007] 1 CMLR 2 at [51]; and Test Claimants in the Thin Cap Group Litigation at [72]).

66 In that context, national legislation which is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements—devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory—may nevertheless be regarded as justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States (see, to that effect, Oy AA at [63])."

78. At [55] Stanley Burnton LJ concluded:

"*55. The judgments of the ECJ in Oy AA and SGI have given welcome clarity to European law in the present context. It is now clear that the objectives of ensuring the balanced allocation between Member States of the power to tax, together with the prevention of tax avoidance, may justify legislation that would otherwise be an unlawful interference with the freedom of establishment guaranteed by Article 43. Secondly, the application of an arm's length test is appropriate and sufficient for this purpose. It is a proportionate measure to achieve those objectives. The Belgian legislation was upheld (subject to the verification referred to in paragraph 75 of the judgment) although it was not limited to "purely artificial arrangement(s), the essential purpose of which is to circumvent the tax legislation of that Member State", but extended to any transaction within a group that was "unusual". In paragraphs 71 and 72 of its judgment, the Court explained (and on one view placed a gloss on) what had been said in Thin Cap as to "the commercial justification for the transaction" that the taxpayer must be allowed to put forward. In paragraph 72 of the judgment in SGI, what must be established is whether "the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions": in other words, the application of the arm's length test.*"

79. We deal below with the parties' submissions on whether there is a restriction on the movement of capital on the facts of the present case and if so whether that restriction is justified. In the event that we were to find the MODs regime was a restriction on the movement of capital and that such a restriction could not be justified, it would be necessary to consider the effect of a breach of the Treaty.

80. In *Fleming (t/a Bodycraft) v HM Revenue & Customs [2008] UKHL 2* Lord Walker stated at [24] and [49]:

"*24. It is a fundamental principle of the law of the European Union ("EU"), recognised in section 2(1) of the European Communities Act 1972, that if national legislation infringes directly enforceable Community rights, the national court is obliged to disapply the offending provision. The provision is not made void but it must be treated as being (as Lord Bridge of Harwich put it in R v Secretary of State for Transport, Ex p Factortame Ltd [1990] 2 AC 85, 140)*

"without prejudice to the directly enforceable Community rights of nationals of any member state of the EEC."

The principle has often been recognised [in] your Lordships' House, including (in the context of taxes) Imperial Chemical Industries plc v Colmer (No 2) [1999] 1 WLR 2035, 2041 (Lord Nolan) and recently Autologic Holdings plc v Inland Revenue Commissioners [2006] 1 AC 118, paras 16-17 (Lord Nicholls of Birkenhead)."

"*49. The Commissioners have throughout this litigation accepted, in the light of Marks & Spencer II, that the 1996-7 amendments infringed EU law. They must be disapplied to the extent that they improperly deprived taxpayers of directly enforceable Community rights, but no further. The process of disapplication does not involve reading words into the national legislation (that would be, as already noted, to confuse it with conforming interpretation). It involves the identification of the class or classes of taxpayers who are so circumstanced that the offending provisions must not be invoked against them, either in particular cases or at all.*"

81. In *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue [2010] EWCA Civ 103* the Court of Appeal held that the appropriate remedy for breach of the Treaty should not simply involve treating foreign dividends as being franked investment income. That would give the UK parent company an entitlement to a tax credit irrespective of the amount of tax paid by the foreign subsidiary. Rather the remedy was set out at [107]:

"*107. It therefore falls to this Court to determine the appropriate conforming interpretation. In our judgment, a conforming interpretation can be achieved simply by reading in words that make it clear that it is not just resident companies that can claim a credit under section 231 but also other persons entitled to do so by Community law to the extent that they are so entitled. The extent of that entitlement can then be investigated when the section falls to be applied, rather than the difficulties more properly arising at the point of application being erected as an objection to conforming interpretation. It will apply even if the extent of the entitlement is not fully ascertained until after the ECJ has answered any question put to it in a further reference.*"

82. We have set out in summary above the relevant principles of law and illustrations of the application of those principles to particular situations. It is the application of those principles to the MOD regime that is the real issue between the parties on this appeal.

Findings of Fact

83. We now turn to the evidence and to our findings of fact. The parties provided us with a helpful Statement of Agreed Facts. We also had evidence from Mr Paul McCormick, the Appellant's Investment Operations Manager. Based on the Statement

of Agreed Facts and Mr McCormick's evidence we make the following findings of fact.

84. The Fund received MODs in the tax years 2002-03 to 2007-08. In relation to each stock lending transaction the borrower was an AUKI. By a letter dated 29 January 2009, the Fund made claims for repayment of the MOD withholding tax deducted in relation to MODs received in the years 2002-03 to 2005-06. A claim for repayment was also made in relation to 2006-07 by way of an amendment to the Fund's self assessment return. In relation to 2007-08 the claim for repayment was included in the Fund's self assessment return. The total sums reclaimed were as follows:

Year	**Amount £**
2002-03	2,957,979
2003-04	1,122,854
2004-05	777,470
2005-06	949,925
2006-07	1,372,974
2007-08	1,646,114
Total:	**£ 8,827,316**

85. Following enquiries into the various claims and returns, the Fund's claims to repayment were refused by HMRC and closure notices for open enquiries were issued on 2 May 2013. The claims were made under section 42 Taxes Management Act 1970 ("TMA 1970") and it was common ground that the claims were appropriately made under that section. Shortly before the hearing the Respondents applied to amend their Statement of Case to take issue with the claims to the extent that they were or ought to have been made under section 33 TMA 1970. The Appellant had objected to that amendment. In light of the agreement that section 42 was in point it was not necessary for us to deal with the Respondents' application.

86. The Fund is an institutional investor and as such is a long term holder of shares issued by UK and non-UK resident companies. Those shares are held by JPM as custodian for which JPM receives a custodian fee. The non-UK resident companies include those established in the European Union and also shares of companies established in third countries. The Fund periodically lends some or all of its shares to other parties. It has conducted stock lending transactions for many years on the terms of a securities lending agreement ("SLA") with JPM. JPM lends shares in accordance with set guidelines approved by the Fund which are designed to ensure that the Fund generates as much income as possible from its investments within an acceptable level of risk. In entering into stock lending transactions the Fund generates an additional return on its investment holdings. In the years 2004-05 to 2007-08 on average the

Fund earned fees of approximately £1.1 million per year, net of JPM's fees for acting as its agent in stock lending transactions.

87. The Fund requires JPM to obtain collateral from borrowers based on set criteria. The nature of that collateral is described below. JPM monitors collateral cover and if a share price goes up during the period of a stock loan JPM will request additional collateral. In the event that a borrower does not return the securities lent, JPM would use the collateral to purchase replacement securities for the Fund. JPM also provides an indemnity to cover any shortfall.

88. Borrowers of shares enter in to stock lending arrangements of this nature for various reasons including:

(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.

89. Save for the third reason, stock lending arrangements facilitate the functioning of the UK securities market. The Fund maximises its income and the Respondents did not suggest that the Fund's stock lending programme involved any tax avoidance purpose.

90. The stock lending programme is closely monitored by the Fund on a monthly basis. This involves consideration of revenue generated, collateral cover, risk analysis, comparison to other UK pension funds operating stock lending programmes and any failed trades, where a borrower fails to return the shares. JPM provides a quarterly report on the Fund's stock lending programme and on stock lending markets generally. There are regular meetings with JPM to discuss the stock lending programme.

91. Dividends payable on shares during the term of a stock loan pursuant to such arrangements are paid to the owner of the shares. The owner would either be the borrower or another party to whom the borrower had lent or sold the shares. Pursuant to the SLA, JPM was entitled to receive on behalf of the Fund a dividend compensation payment from the borrower. In the case of overseas shares that payment is a MOD. Where a MOD was paid in respect of a dividend to which a foreign withholding tax would normally apply on receipt of an actual dividend by the Fund, the borrower was required to deduct the MOD withholding tax from the payment pursuant to the relevant UK legislation described above.

92. At the end of the term of the loan the borrower was contractually obliged to return either the same or equivalent shares to JPM. In addition JPM was contractually

obliged to return to the borrower an amount equivalent to the collateral provided by it. The Fund was obliged to pay JPM a fee for acting on its behalf in relation to these arrangements.

93. The SLA was entered into between the Fund and JPM on 12 October 2000. It governed the contractual relationship between the Fund and JPM in relation to stock lending in the periods covered by this appeal.

94. Section 2 of the SLA provided that JPM was appointed by the Fund to lend certain securities as agent for the Fund. In consideration for the securities lending services to be provided by JPM to the Fund under the terms of the SLA, JPM was entitled to certain fees identified in Section 8 of the SLA.

95. JPM was authorised to lend securities to any borrower specifically approved by the Fund. There was an obligation in the SLA for JPM to provide the Fund with a fair allocation of lending opportunities vis-a-vis other lenders who JPM acted for. The SLA provided that when JPM was lending on behalf of the Fund as agent it was JPM who was obliged to deal with the delivery of shares to the borrower and associated administration. JPM was obliged to keep records of lending undertaken on behalf of the Fund and the income derived therefrom.

96. Pursuant to the SLA, JPM entered into borrowing agreements with borrowers on behalf of the Fund. In relation to overseas securities those agreements typically took the form of a standard "Overseas Securities Lending Agreement" ("OSLA"). The OSLAs were continuing agreements as between JPM and individual borrowers and governed all subsequent lending transactions.

97. The OSLA required a borrower to send a borrowing request to JPM to initiate the lending process. The borrower was required to specify the description, title and amount of the securities required, the proposed settlement date and the duration of the loan. JPM was obliged to transfer all right, title and interest in the shares to the borrower subject to the terms of the OSLA.

98. Under the terms of the OSLA:

(1) the borrower undertook to redeliver, at the end of the term the same or an equivalent number of shares;

(2) JPM or its nominee was to receive a MOD from the borrower whenever a dividend was payable on the underlying shares;

(3) the borrower undertook that where it held shares of the same description as those transferred it would use its best endeavours to arrange for the voting rights to be exercised in accordance with JPM's instructions;

(4) where any rights were exercisable during the term of the loan then JPM was entitled on behalf of the Fund to give notice to the borrower a reasonable time before the latest time for exercise of the right stating it wished to receive the shares receivable in accordance with an exercise of the right.

99. The MOD was to be equal to the dividend payable together with an amount equivalent to any withholding tax on the dividend and an amount equal to any other tax credit associated with the dividend. The borrower was entitled to provide JPM with an appropriate tax voucher in lieu of any such withholding tax or tax credit.

5 100. In each case the OSLA authorised the borrower to deduct MOD withholding tax from the MOD pursuant to the applicable UK tax legislation and at the same time supply the appropriate tax voucher. The MOD was paid to JPM, as agent for the Fund, net of the MOD withholding tax. The MOD was then credited by JPM to the Fund's account with JPM in accordance with the SLA.

10 101. The OSLA provided a mechanism for calculating the value of the collateral to be provided by the borrower. Collateral could be in the form of US government securities, US dollars, euros, euro denominated government securities, gilts or letters or credit denominated in US dollars, pound sterling or euros. The borrower was obliged to effect a transfer of full title to the collateral to JPM.

15 102. Where cash collateral was provided, JPM was authorised by the SLA to reinvest this and the Fund provided JPM with criteria for reinvestment.

103. The SLA provided that loans were generally terminable on demand but with the approval of the Fund a loan could instead be made on the basis of a reasonably anticipated termination date. The OSLA provided that on termination of the loan the 20 borrower was obliged to transfer to JPM full title to "equivalent securities" defined as securities of an identical type, nominal value, description and amount to those borrowed.

104. Where cash collateral had been provided the OSLA provided that JPM was obliged to repay it at the same time as the borrower delivered the equivalent 25 securities. Where other collateral was provided equivalent collateral was to be redelivered at the end of the term of the loan.

105. The Fund through JPM was entitled under the OSLA to a fee in respect of each loan of shares. This sum was calculated by applying an agreed rate to the daily value of the shares.

30 106. We were provided with a schedule containing information relating to six MODs included in the claims made by the Fund. These had been selected by HMRC as a representative sample of share lending transactions. In each case the schedule identified details of the individual stock lending transaction where MODs had been received by the Fund. In 4 cases the shares lent were in companies resident in the EU. 35 In 2 cases they were resident in third countries.

107. 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 40 €1,210,000, amounting to €1,028,500 net of withholding tax. The MOD withholding tax amounted to €181,500.

Discussion and Reasons

108. We now consider the parties' submissions and our reasons for reaching the decision. The following issues arise:

(1) Do the transactions involve a movement of capital?

5 (2) If so, does the MOD regime amount to a restriction on the movement of capital?

(3) If so, is that restriction justified?

(4) If not, how is the breach of Article 56 to be remedied?

10 *(1) Is there a Movement of Capital?*

109. We can deal with this point quite shortly, as indeed both parties did. It can be seen from the nomenclature to Directive 88/361 and the CJEU authorities to which we were referred in this context that the concept of a capital movement is extremely wide.

15 110. Mr Baldry submitted that the lending of shares by a UK lender to a UK borrower, whether those are domestic or foreign shares, does not involve a movement of capital. It seems to us that is right, but there may still be a relevant movement of capital. It was common ground that the acquisition of overseas shares is a movement of capital.

20 111. The movement of capital relied on by the Appellant 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.

25 112. 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-
30 acquisition of foreign shares on the terms of the OSLA plainly involve movements of capital.

(2) Does the MOD Regime amount to a Restriction on the Movement of Capital?

113. It is not controversial that each Member State is entitled to exercise its own tax
35 competencies, including the right to tax or not to tax transactions, but subject to EU law on restrictions on freedom of establishment and on movement of capital. In deciding whether there is a restriction on movement of capital it is necessary to look at the real effect of the domestic legislation.

114. Mr Gammie QC who appeared for the Fund submitted that the MOD regime plainly involved a restriction on the movement of capital. It gave rise to a disadvantage to persons investing outside the UK. Manufactured dividends in relation to UK companies were exempt from UK tax whereas MODs were subject to UK tax. That regime was liable to discourage acquisition and ownership of foreign shares. He submitted that the fact that other Member States may tax a dividend from the shares was irrelevant. Those Member States did not tax the MOD, which was only taxed in the UK.

115. Mr Baldry submitted that the MODs regime did not discourage people from lending foreign shares because the tax treatment of the income in the UK was identical compared to the treatment of dividends on shares which had not been lent. It seems to us that is a different point. The restriction relied on by Mr Gammie arose from the fact that people would be dissuaded from purchasing or retaining foreign shares rather than from lending existing holdings

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

117. We have described in outline above the system for UK taxation of dividends, including the provisions whereby credit for a foreign withholding tax is only available to the extent that the recipient has a UK tax liability against which it can offset the credit. We agree with Mr Baldry that such a limitation on relief for juridical double taxation in the UK is simply a product of UK's decision exercising its own tax competencies to exempt pension funds from UK tax. There is no suggestion that the UK's decision is contrary to EU law. The difference in treatment between UK dividends received by a pension fund, where the income is exempt, and foreign dividends where the fund is entitled to a credit for foreign tax but has no tax liability against which to set it off, is caused by the decision of other Member States to impose a withholding tax. We do not agree with Mr Gammie's submission that the withholding tax imposed by other Member States is irrelevant, or that we should focus on the fact that a MOD was subject to a UK withholding tax and was not taxed in other Member States.

118. The regime for manufactured dividends, including MODs, was directed towards ensuring that the recipient was taxed in the same way as if it had received the underlying dividend. It was therefore necessary to get the credit for foreign withholding tax to the shareholder in a way which would restrict relief for that withholding tax by reference to the tax liability of the shareholder in the UK.

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 the MOD withholding tax of €15. The AUKI would be entitled to offset the withholding tax of €15 it had suffered against its liability to account to HMRC for the MOD withholding tax also of €15.

121. The effect is that the recipient is treated as having received an annual payment of €85 and can set off the MOD withholding tax 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 MOD withholding 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.

122. Paragraph 9 of the Regulations provides that an AUKI can set off amounts deducted by way of overseas tax on dividends received and MOD withholding tax on MODs received by it against its liability to deduct MOD withholding tax on MODs paid by it in any period. The effect of those provisions was therefore that the AUKI suffered no tax liability and the ultimate recipient of the MOD was in the same position as if it had received the overseas dividends directly.

123. Mr Baldry placed great reliance on the set off provisions applicable to AUKIs. He submitted that the effect of the provisions was that the only tax which had been suffered was the overseas withholding tax, which the Fund could not have the benefit of because it was exempt from UK tax. The effect was that the Fund did not suffer UK tax, rather it suffered the overseas withholding tax.

124. Further, he submitted that in making the present claims the Fund was seeking a more advantageous treatment for its income from shares which had been lent than if it had simply received the dividends directly. As such he submitted that there was no dissuasive effect in the MOD regime. His submission was that the MOD regime simply maintained the position that would have existed if the shares had not been lent.

125. The only difference between manufactured dividends and MODs was that manufactured dividends were exempt whereas MODs were taxable but with a credit system. He relied on *Test Claimants in the FII Group Litigation* which held that there was nothing wrong in principle with a system which treated domestic dividends as exempt and overseas dividends as taxable with credit for overseas tax, provided that the tax rate applicable to foreign dividends was not higher than the rate applicable to domestic dividends. The difficulties arising in that case from different effective rates of tax did not arise in the present appeal because the overseas tax being charged was offset at exactly the same rate as the credit was given.

126. Mr Gammie submitted that it was clear the Fund had suffered UK tax. An MOD was an item of income which the borrower was contractually required to pay to the

lender. The MOD withholding tax was a deduction required by the UK legislation. It was UK tax on the MOD, not an overseas tax on the dividend. The set off provisions were simply the collection mechanism and did not affect the fact that the Fund had received the MODs as payments which were subject to a UK withholding tax. The UK could not simply "pretend" that this was an overseas tax and not a UK tax.

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

128. We agree that if one simply looked at the MOD regime in isolation, regardless of the underlying tax treatment of dividends, then it might appear that it would dissuade acquisition of foreign shares. A pension fund might consider that it would be disadvantaged if it invested in foreign shares because stock lending transactions in foreign shares resulted in a withholding tax on the MOD levied by the UK whereas identical transactions in UK shares resulted in a manufactured dividend which was exempt from UK tax.

129. However it is not appropriate in our view to take such a narrow approach. The MOD regime simply reflects the taxation treatment of the underlying dividends. It is one aspect of a regime which seeks to equate manufactured dividends from UK and overseas shares with the tax treatment of actual dividends. Looked at in that context it seems clear to us that it does not amount to a restriction on the acquisition of foreign shares. Even if a pension fund was intending to purchase shares specifically with a view to entering into stock lending transactions, it would not be dissuaded by the MOD aspect of the regime from purchasing foreign shares. It might consider that UK shares would be a better prospect because the manufactured dividends were exempt. The reason for that is not because of the MOD regime. It is because the underlying dividend paid by the overseas company is subject to a withholding tax and the UK has chosen not to give the benefit of any credit for that withholding tax to an exempt pension fund.

130. We do not consider therefore that the MOD regime involves any restriction on the movement of capital.

(3) Justification of any Restriction on the Movement of Capital?

131. If we are wrong, and the MOD regime does involve a restriction on the movement of capital then the authorities show that a restriction may be justified by reference to overriding reasons in the public interest. More specifically, the question is whether the MOD regime:

(1) distinguishes 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 in relation to situations which are not objectively comparable,

(2) preserves the cohesion of the UK tax system,

(3) preserves the balanced allocation between Member States of the power to impose taxes, or

(4) prevents tax avoidance.

132. An issue separate to justification can arise in relation to "direct investments" in companies resident in third countries. Direct investments are shareholdings of sufficient size to give influence over the company in which shares are held. Restrictions on such movements of capital may be validated by what is known as the "standstill provision" contained in Article 57 of the Treaty. This applies to restrictions concerning third countries which existed on or before 31 December 1993. In their amended Statement of Case the Respondents relied on the standstill provision. However it was common ground that the facts of the appeal do not relate to direct investments. With the agreement of the parties we have not therefore considered the standstill provision.

133. Mr Baldry's submissions offered two justifications. Firstly what Mr Baldry described as a "combined justification" of the balanced allocation of taxing rights and the prevention of tax avoidance. We have already noted that those two justifications are closely connected. Secondly whether the restriction was justified to preserve the coherence of the UK tax system.

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

135. In this respect it was said that the MOD regime prevented tax avoidance. It was not aimed at tax avoidance in the sense of wholly artificial arrangements. However he submitted that it is clear from Oy AA and the Thin Cap Group Litigation that reliance on the justification does not require the Member State to demonstrate that the taxpayers are doing something which is wholly artificial. Nor could the taxpayers respond by saying that their transaction was commercial. The MOD regime was a

proportionate response to the threat of the straightforward tax avoidance outlined above.

136. Mr Baldry also submitted that the MODs regime preserved the balanced allocation of taxing powers. The UK had decided to relieve juridical double taxation by giving relief for foreign withholding tax on dividends but not to exempt persons such as pension funds. The MOD regime maintained that position in the context of stock lending.

137. Plainly it is not sufficient for a Member State to say that a measure is justified because otherwise that Member State would lose tax revenues. Mr Gammie sought to distinguish the Thin Cap Group Litigation on the basis that it was concerned with what amounted to a transfer of the UK's potential tax base to another state by means of deductible interest payments. In the present appeal there was nothing to prevent the UK from taxing all the manufactured dividends paid to UK lenders. He submitted that Mr Baldry had not explained how the balanced allocation of taxing rights had been affected.

138. Mr Gammie pointed out that the MOD regime had no specific tax avoidance conditions attached to it. The regime was not aimed at preventing tax avoidance, unlike the thin capitalisation provisions. It applied to all stock lending, including ordinary commercial market transactions. There were provisions within Schedule 23A which were designed to stop particular avoidance in the generation of manufactured dividends, such as paragraph 7A of the Regulations.

139. There was some suggestion that the MOD regime could not be justified by reference to the balanced allocation of taxing powers and could not have been a proportionate method of doing so given that it was abolished with effect from 1 January 2014. However we were not addressed on how stock lending transactions were taxed following abolition of the MOD regime and we cannot therefore read anything into the repeal of the provisions for taxing manufactured dividends.

140. We agree with Mr Baldry that the MOD regime does prevent what would otherwise be a straightforward way for pension funds to avoid the provisions which restrict credit for foreign withholding taxes. Further, that it preserves the balanced allocation of taxing powers between Member States. In particular it preserves the UK's decision to exempt pension funds from income tax but to restrict that exemption in the case of foreign withholding taxes. In the absence of a system such as the MOD regime the UK would be unable to maintain the effectiveness of that decision.

141. The second justification relied upon by Mr Baldry was fiscal cohesion. His submission was that if it is necessary to repay the MOD withholding tax to the Fund without any regard to the right of an AUKI to set off the same tax then it would undermine the cohesion of the UK tax system. He accepted that justification by reference to fiscal cohesion required a direct link between a tax advantage and the offsetting of that advantage by a tax levy. He acknowledged that no fiscal cohesion arguments based on Bachmann had succeeded in the 20 years following that case but that they resurfaced in FII (No 2) where a direct link was found between the tax credit

on foreign dividends with exemption for UK dividends and the tax to which those distributed profits had already been subject.

142. In the present case Mr Baldry submitted that there was a direct link between liability on the part of an AUKI to deduct MOD withholding tax on MODs paid and the ability of the AUKI to set it off against withholding tax on overseas dividends or MODs received. Even if the liability is seen as that of the lender, the lender gets the benefit of the set off rights exercised by the AUKI. He further submitted in this context that the MOD regime was a proportionate way of maintaining fiscal cohesion. It was proportionate because AUKIs were given a credit which exactly matched the relevant foreign withholding tax.

143. Mr Gammie submitted in general terms that the MOD regime was concerned with economic double taxation and not juridical double taxation because a MOD was not itself an item of income on which any other Member State imposed a tax charge. He further submitted that the authorities show that loss of tax revenue cannot amount to justification for a restriction and that the existence of double taxation conventions cannot justify discriminatory treatment. He emphasised that whilst, as a matter of jurisdiction, Member States have competence to decide whether to tax or not to tax, they must do so by reference to the principles of the single market. The fact that a measure may be coherent in the context of the system of a particular Member State would not justify discrimination in the context of the single market. It was no justification even if the purpose of the MOD regime was to achieve some form of economic equivalence between an investment return in the form of actual dividends and that from manufactured dividends. That was not the correct comparison. The correct analysis was simply to compare the UK treatment of manufactured dividends from UK shares to that of MODs.

144. It seems to us that fiscal cohesion is concerned with ensuring consistent treatment as between relief from tax on the one hand and a linked tax charge on the other. More generally between a tax advantage and a tax levy. In Bachmann this concerned relief for the policy premiums and taxation of the proceeds from the policies. In FII (No 2) it was between the tax credit attaching to foreign dividends together with the exemption of UK dividends and the underlying tax on company profits.

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

(4) Remedy for a Breach of Article 56

146. We have found that even if there was a restriction on the movement of capital then it was justified. Thus there was no breach of Article 56. For the sake of completeness we record the submissions made in relation to remedy.

147. Mr Gammie submitted that the only aspect of the MOD regime which put the Fund at a disadvantage was paragraph 4(4) Schedule 23A which provides that even though this is a UK tax it should be treated as if it were a foreign tax. If it were treated as an amount of UK income tax that had been deducted then the Fund would have been entitled to repayment of the tax deducted pursuant to section 186 Finance Act 2004. He submitted that disapplying paragraph 4(4) was is only effective way to remedy the breach.

148. Mr Baldry described the remedy sought by the Fund as "*a highly selective disapplication*". In particular the Fund was seeking to retain those aspects of the MOD regime pursuant to which they were entitled to treat the MOD as a gross receipt with a tax credit, but to disapply those aspects which prevented recovery of that tax credit. The effect of that approach would be to give a windfall similar to that rejected by the Court of Appeal in the FII. He submitted that any breach of Article 56 had not caused the Fund to actually pay tax. Thus the Fund could not have a right to repayment. Put another way, it had no directly enforceable right to a refund.

149. Given our decision on restriction and justification it is not necessary for us to consider what remedy there should be for a breach of Article 56 and we prefer not to do so in this decision.

Conclusion

150. For the reasons given above we dismiss the appeal.

151. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JONATHAN CANNAN
TRIBUNAL JUDGE

RELEASE DATE: 27 JUNE 2016