Reprinted from
British Tax Review
Issue 2, 2019

Sweet & Maxwell
5 Canada Square
Canary Wharf
London
E14 5AQ
(Law Publishers)

To subscribe, please go to
http://www.sweetandmaxwell.co.uk/catalogue/productdetails.aspx?recordid=338&productid=6614.

Full text articles from the British Tax Review are also available via subscription to *www.westlaw.co.uk*, or *https://www.checkpointworld.com*.

SWEET & MAXWELL

Case Notes

Prudential Assurance Co Ltd v HMRC: remedying EU discrimination in foreign portfolio dividend cases

The Supreme Court's decision in *Prudential Assurance Co Ltd v HMRC* (*Prudential*)[1] is a landmark decision on the availability of relief for taxpayers who did not receive any UK tax exemption or credit for taxes incurred on dividends from foreign portfolio investments (in contrast to dividends received from UK portfolio investments). This case has its foundation in the fact that the UK tax system was considered to be in breach of EU law and *Prudential* was a test case brought to ascertain the appropriate remedy for some of these breaches. This decision also highlights important points in relation to unjust enrichment and compound interest claims.

Background

The UK's dividend tax regime

Some arguments raised by HMRC in *Prudential* in relation to the first issue (discussed below) are predicated on the difference between "portfolio investments" and "non-portfolio investments" (hereinafter non-portfolio investments are referred to as direct investments) and therefore a short description of the differences between the two is warranted. A "direct investment" is usually one which gives the investing corporate shareholder (the Investing Company) an element of control over the underlying investment company (the Investment Company).[2] In the UK (and in the EU) it is considered that there is direct investment when an Investing Company controls (or is a subsidiary of a company that controls) "directly or indirectly not less than 10% of the voting power"[3] in the Investment Company (which, practically, often also results in the Investing Company controlling an equivalent percentage of the Investment Company's share capital). In contrast, a "portfolio investment" is one where the Investing Company's control of the Investment Company falls below the relevant control threshold[4] (in the UK this threshold is 10 per cent as mentioned above).

To alleviate the effects of double economic taxation of dividend income (that is, income being subject to corporation tax at both the Investment Company and Investing Company levels), at the time to which this dispute relates, the UK adopted three distinct approaches, depending on whether the investment was a direct investment or a portfolio investment, and on whether the

1 *Prudential Assurance Co Ltd v HMRC* [2018] UKSC 39; [2018] STC 1657.
2 R. Vann, "General Report" in IFA, *Trends in Company Shareholder Taxation: Single or Double Taxation, Cahiers de Droit Fiscal International* (The Hague: Kluwer Law International, 2003), Vol.88a, 33.
3 HMRC, Internal Manual, *International Manual* (published 9 April 2016; updated 18 July 2018), INTM164060, "UK residents with foreign income or gains: dividends: Direct investors - underlying tax", available at: *https://www.gov.uk/hmrc-internal-manuals/international-manual/intm164060* [Accessed 19 March 2019].
4 Vann, above fn.2, 33.

dividend was paid by a UK-resident Investment Company to a UK Investing Company or by a foreign Investment Company to a UK Investing Company:

1. *Domestic direct investment and domestic portfolio investment:* where a dividend (direct or portfolio) was paid by a UK-resident Investment Company to another UK-resident Investing Company, section 208 of the Income and Corporation Taxes Act 1988 (ICTA 1988) provided that these dividends were exempt from UK corporation tax in the hands of the Investing Company. This exemption applied irrespective of how much tax the Investment Company had paid/would pay, that is, even if the Investment Company's effective rate of tax was lower than the nominal rate or if no tax was paid at all.[5]
2. *Foreign direct investment:* no equivalent exemption was available for dividends received by a UK-resident Investing Company from a direct investment in a non-resident Investment Company and the Investing Company was subject to UK corporation tax on such dividends. However, the Investing Company was entitled to tax relief under section 788 ICTA 1988 ("Relief by agreement with other territories") or section 790 ICTA 1988 ("Unilateral relief") for tax incurred in the jurisdiction of the Investment Company.
3. *Foreign portfolio investment:* no statutory relief was provided for UK corporation tax on dividends received from portfolio investments in non-resident Investment Companies.[6] Albeit the Investing Company may have been entitled to relief in relation to withholding taxes imposed on dividends in the Investment Company jurisdiction, it is important to note that this does not eliminate economic double taxation of the dividend since withholding taxes are tax charges on the Investing Company and not the Investment Company. Therefore, the purpose of a withholding tax credit is simply to ensure that the same entity is not taxed twice on the same income (that is, it "eliminate[s] a double legal charge to tax"[7]). *Prudential* concerned dividends received from foreign portfolio investments.

Further to the CJEU decision in *Test Claimants in the FII Group Litigation v IRC* (*FII I*)[8] (and the Reasoned Order of the CJEU in *Test Claimants in the CFC and Dividend Group Litigation v IRC*[9]), the CJEU found that the differential treatment of dividends received from domestic portfolio investments and foreign portfolio investments was incompatible with the EU principle of free movement of capital in accordance with Article 63 of the Treaty on the Functioning of the European Union (TFEU) (previously Article 56 of the Treaty Establishing the European Community (EC)). The CJEU had noted in *FII I* that this incompatibility could be remedied by a "mixed system",[10] that is, maintaining the system of corporate tax exemptions for dividends from a domestic source, while providing a tax credit against UK corporation tax for corporation

[5] *Prudential*, above fn.1, [2018] STC 1657 at [15].
[6] *Prudential*, above fn.1, [2018] STC 1657 at [4].
[7] *Test Claimants in the FII Group Litigation v IRC* (*FII I*) (C-446/04) [2006] ECR I-11753; [2007] STC 326 at [63].
[8] *FII I* (C-446/04), above fn.7, [2006] ECR I-11753.
[9] *Test Claimants in the CFC and Dividend Group Litigation v IRC* (C-201/05) [2008] ECR I-2875; [2008] STC 1513.
[10] *FII I* (C-446/04), above fn.7, [2006] ECR I-11753 at [46]–[57].

tax paid in the foreign source jurisdiction. The appropriate tax credit was the focus of the Supreme Court's deliberations, as set out below.

Advance corporation tax[11]

Prior to 6 April 1999, advance corporation tax (ACT) was levied on UK companies paying "qualifying distributions"[12] which include dividends. Recipients of such distributions were entitled to a tax credit equivalent to such proportion of the amount or value of the distribution as corresponded to the rate of ACT in force in the relevant financial year when the distribution was made (the ACT Tax Credit).[13] Franked investment income (FII) was defined as the aggregate of the distribution income and the ACT Tax Credit[14] and a franked payment (FP) was defined as the aggregate of the distribution paid and

> "such proportion of that amount or value that corresponds to the rate of advance corporation tax in force for the financial year in which that distribution is made".[15]

If a UK-resident company paid and received distributions in a relevant accounting period, it paid ACT on only the difference between its FP and FII (if FP was higher). Any ACT paid could later be set-off against the company's main corporation tax (MCT) liability (assuming there were profits in that accounting period) when due for the relevant accounting period.

Issue 1: what was the appropriate tax credit?

The first issue the Supreme Court was asked to consider was what exactly constituted an "appropriate tax credit".[16] Was it: 1. a credit for the effective rate of tax paid in the foreign jurisdiction (Effective Rate) by the Investment Company; or 2. the foreign nominal rate of tax (FNR) to which the foreign Investment Company may be subject? This is an important point, because it considered how the incompatibility with EU law could be remedied.

The Supreme Court found that the tax credit should be given at the FNR, not the Effective Rate.[17] In arriving at this decision, it followed, in relation to dividends from foreign portfolio investments, the same approach adopted by the CJEU in *Test Claimants in the FII Group Litigation v IRC* (*FII II*)[18] in relation to dividends from foreign direct investments. The Supreme Court refused to follow HMRC's position that dividends from direct and portfolio investments should be treated differently and noted that, even though differences may exist in control and shareholding between direct and portfolio investments, this does not provide a valid rationale for treating direct and portfolio investments differently on questions of avoiding discrimination.[19]

[11] This description is adapted from *Prudential*, above fn.1, [2018] STC 1657 at [82]–[86].
[12] ICTA 1988 s.14.
[13] ICTA 1988 s.231.
[14] ICTA 1988 s.238(1).
[15] ICTA 1988 s.238(1).
[16] *Prudential*, above fn.1, [2018] STC 1657 at [9].
[17] *Prudential*, above fn.1, [2018] STC 1657 at [27].
[18] *Test Claimants in the FII Group Litigation v IRC* (C-35/11) [2013] STC 612.
[19] *Prudential*, above fn.1, [2018] STC 1657 at [18].

A major reason behind the Supreme Court's decision in *Prudential*[20] (and the CJEU's in *FII II*[21]) was the finding, as reported in *FII II*, that "in the United Kingdom the effective level of taxation of the profits of resident companies is lower than the nominal rate of tax in the majority of cases"[22] (as a consequence of various reliefs including group relief and loss relief).[23] This finding directly leads to the conclusion that (in most cases), if a tax credit is provided by way of the Effective Rate, dividends from foreign portfolio investments are subject to tax at a higher rate than those from domestic portfolio investments. This is because if an Investment Company was UK-resident then, irrespective of whether the Investment Company paid tax at the nominal rate, a lower effective rate, or paid no tax at all, any dividend income would be exempt from corporation tax in the hands of the Investing Company (with no further tax payable), which can be seen as akin to a tax credit for the UK nominal rate of tax.[24] This becomes more apparent when looking at an example of this situation. Adapting an example from the written submissions by the European Commission in *FII II*:

An Investment Company in Country X (Investment Company A) generated a profit of £100 and passed the entire sum to a UK-resident Investing Company as a dividend. It is assumed that the nominal tax rate in the UK and in Country X is 20 per cent. As a consequence of various reliefs in Country X, Investment Company A's Effective Rate of tax is 15 per cent.[25] On these facts, if a tax credit was available to the Investing Company at only the Effective Rate then the Investing Company would be eligible for a tax credit of 15 per cent (that is, the Effective Rate of tax in Country X) but would be subject to a further 5 per cent tax in the UK as the UK nominal rate of tax is 20 per cent (and no reliefs are available).

In contrast, an Investment Company in the UK (Investment Company B) also generated a profit of £100 and passed the entire sum to a UK-resident Investing Company as a dividend. It is again assumed that the nominal tax rate in the UK is 20 per cent and that as a consequence of various tax reliefs in the UK, Investment Company B's Effective Rate of tax is 15 per cent. In this situation, even though the Effective Rate of tax is lower than the UK nominal rate of tax (as was also the case for Investment Company A), the Investing Company would not be subject to any further tax on the dividends received from Investment Company B, as the dividends are exempt from tax in the hands of the Investing Company (that is, effectively equivalent to a tax credit on the nominal rate of tax, 20 per cent). Therefore, this helps to illustrate the point that even if a tax credit in relation to dividends received from foreign portfolio investments is granted at the Effective Rate, there will still be discrimination between foreign portfolio investments and domestic portfolio investments.

However, on the basis of the above example, if a tax credit were to be provided to the Investing Company holding a portfolio investment in Investment Company A, on the basis of FNR then the "tax credit" would be equivalent to the exemption from tax on dividends received by an

[20] *Prudential*, above fn.1, [2018] STC 1657.
[21] *FII II* (C-35/11), above fn.18, [2013] STC 612.
[22] *FII II* (C-35/11), above fn.18, [2013] STC 612 at [51].
[23] *Prudential*, above fn.1, [2018] STC 1657 at [19].
[24] *FII II* (C-35/11), above fn.18, [2013] STC 612 at [61].
[25] UK tax reliefs are not available to foreign Investment Companies.

Investing Company holding a portfolio investment in Investment Company B (as the exemption from tax is equivalent to a tax credit for the UK nominal rate).

Although the Supreme Court acknowledged that this solution may result in some situations where there might be "inequities" and "incongruities" (which have not been discussed further here) it stated that it would reject a further reference to the CJEU on the basis that it considered that the CJEU was apprised of these potential issues when adopting the FNR and therefore it considered it unlikely that the CJEU would reconsider its decision.[26]

Issue 4 in this case was closely related to this Issue 1 and would only have been relevant if the Supreme Court ruled that a tax credit on the basis of FNR was not available. Given that the Supreme Court did not consider this issue further because of its decision on Issue 1 that a tax credit was to be provided on the basis of FNR, Issue 4 has not been considered further here.

Issue 2: compound interest or simple interest?

The question the Supreme Court had then to consider was whether compound interest was payable as restitution under the law of unjust enrichment for

> "(a) unlawfully levied ACT[[27]] which was subsequently set off against lawfully levied MCT, from the date of payment by PAC [Prudential] to the date of set-off;
> (b) all other unlawfully levied tax (including unlawfully levied ACT which was never set off against lawful MCT, and unlawfully levied ACT which was set off against unlawfully levied MCT), from the date of payment by PAC [Prudential] to the date of repayment by HMRC; and
> (c) the time value of utilised ACT (resulting from (a) above), from the date of set-off to the date of payment by HMRC".[28]

The decision of the Supreme Court is significant in the context of unjust enrichment and compound interest claims since the Supreme Court departed from the House of Lords' judgment in *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v IRC* (*Sempra Metals*)[29] on the issue of "the court's jurisdiction to reverse unjust enrichment",[30] and followed the Supreme Court judgments in *Investment Trust Companies (In Liquidation) v HMRC* (*Investment Trust*)[31] and *Littlewoods Ltd v HMRC* (*Littlewoods*).[32] However, the House of Lords' decision in *Sempra*

[26] *Prudential*, above fn.1, [2018] STC 1657 at [31].
[27] The Supreme Court interpreted references to "lawful ACT" as an "element within an undifferentiated ACT charge which did not represent unduly levied tax on overseas-sourced dividends. Lawful ACT on the (UK-resident) company A's distribution refers to such ACT as is due after giving effect to (i) the exemption given to income from dividends of UK-resident companies and (ii)…the tax credit which EU law requires to be given to income from dividends from overseas companies" in *Prudential*, above fn.1, [2018] STC 1657 at [87]. "Unlawful ACT" was construed accordingly. The Supreme Court interpreted references to "unlawful MCT" as "such part of the charge to MCT as is attributable to the failure to give the overseas-sourced dividends, which company A received, a tax credit at the FNR to achieve equivalence to the exemption which s 208 gave to dividends received from UK-resident companies" in *Prudential*, above fn.1, [2018] STC 1657 at [87]. "Lawful MCT" was construed accordingly.
[28] *Prudential*, above fn.1, [2018] STC 1657 at [34].
[29] *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v IRC* [2007] UKHL 34; [2007] STC 1559.
[30] *Prudential*, above fn.1, [2018] STC 1657 at [79].
[31] *Investment Trust Companies (In Liquidation) v HMRC* [2017] UKSC 29; [2017] STC 985.
[32] *Littlewoods Ltd v HMRC* [2017] UKSC 70; [2017] STC 2413.

Metals has not been entirely overruled. *Sempra Metals* considered issues in relation to: 1. the Court's jurisdiction to use interest to reverse unjust enrichment; and 2. the award of interest as damages. Since the matters in dispute in *Prudential*[33] only concerned the Court's jurisdiction to award interest to reverse unjust enrichment, the Supreme Court noted that the decision in *Prudential* would not impact the precedential value of *Sempra Metals* in relation to the award of interest as damages.[34] Therefore, it appears that the House of Lords' decision in *Sempra Metals* in relation to the award of interest as damages still holds precedential value.

The genesis of this issue can be traced back to the decision of the CJEU in *Metallgesellschaft Ltd v IRC, Hoechst AG v IRC* (*Metallgesellschaft*)[35] where the CJEU provided:

> "[W]here the breach of Community law arises, not from the payment of the tax itself but from its being levied prematurely, the award of interest represents the 'reimbursement' of that which was improperly paid and would appear to be essential in restoring the equal treatment guaranteed by article 52 of the [EC] Treaty.…in an action for restitution the principal sum due is none other than the amount of interest which would have been generated by the sum, use of which was lost as a result of the premature levy of the tax."[36]

The issue in *Sempra Metals*[37] (which applied *Metallgesellschaft*[38] in the UK) was the same as point (a) in the paragraph quoted above.[39] The House of Lords found in favour of the taxpayer on the basis that the payment of ACT to HMRC in advance provided HMRC with the opportunity to use these sums, therefore giving rise to a separate transfer of value by the taxpayer to HMRC (that is, in addition to the payment of the money itself which also constituted a transfer of value). On this basis, the House of Lords found that restitution should be provided for this additional transfer of value.[40] It further provided that restitution of compound interest on sums which had been paid in advance due to a mistake was an appropriate remedy and compound interest was appropriate restitution for the time value of money.[41]

In reversing *Sempra Metals*[42] on this issue the Supreme Court highlighted various legal developments, which contributed to its judgment. Two of these points are of particular importance:

1. The Supreme Court disagreed with the House of Lords in *Sempra Metals* in that the Supreme Court held that there was no separate transfer of value from the taxpayer to HMRC (in addition to the money that was paid by mistake) and therefore found that there was no claim under unjust enrichment for this transfer.[43] Instead it was held that the mistaken payment created a debt claim, and that simple interest was usually payable on a debt claim under section 35A of the Senior Courts

[33] *Prudential*, above fn.1, [2018] STC 1657.
[34] *Prudential*, above fn.1, [2018] STC 1657 at [79].
[35] *Metallgesellschaft Ltd v IRC, Hoechst AG v IRC* (Joined Cases C-397/98 and C-410/98) [2001] ECR I-1727; [2001] STC 452.
[36] *Metallgesellschaft* (Joined Cases C-397/98 and C-410/98), above fn.35, [2001] ECR I-1727 at [87]–[88].
[37] *Sempra Metals*, above fn.29, [2007] UKHL 34.
[38] *Metallgesellschaft* (Joined Cases C-397/98 and C-410/98), above fn.35, [2001] ECR I-1727.
[39] See text attached to fn.28, above. *Prudential*, above fn.1, [2018] STC 1657 at [42].
[40] *Prudential*, above fn.1, [2018] STC 1657 at [70].
[41] *Prudential*, above fn.1, [2018] STC 1657 at [44]–[54].
[42] *Sempra Metals*, above fn.29, [2007] UKHL 34.
[43] *Prudential*, above fn.1, [2018] STC 1657 at [72].

Act 1981 (SCA).[44] The Supreme Court explained this by adopting Lord Reed's analysis in *Investment Trust*.[45] The Supreme Court found that there was a normatively defective transfer of value in relation to the money paid to HMRC by mistake as: there was a direct benefit provided to HMRC; this benefit led to the enrichment of HMRC; this enrichment was at the taxpayer's expense; the taxpayer sustained a loss due to this payment; there was no intention of making a gift of this money to HMRC; and HMRC's enrichment caused the loss to the taxpayer.[46] However, when considering the second transfer of value it found that there was in its opinion no separate transfer of value with respect to the opportunity to use the money because, in contrast to the mistaken payment of money, there was no direct transfer of value to HMRC; instead it found that there was merely a "causal connection between the claimant's incurring a loss (in the relevant sense) and the defendant's receiving a benefit [and this] was not enough to establish a transfer of value".[47] This, in the Supreme Court's opinion, did not create a defective transfer of value in relation to the opportunity to use the money and correspondingly a claim for interest under the law of unjust enrichment was not sustainable; instead, the Supreme Court attributed the claim to HMRC's failure to pay a debt due and the remedy for this is simple interest under the section 35A SCA.[48] This was the case in relation to claims (b) and (c) (in the paragraph quoted above[49]).

In relation to claim (a) (in the paragraph quoted above[50]), the Supreme Court noted that, although on a strict interpretation of section 35A SCA a claim for simple interest may not be available since section 35A SCA only applies to debt (or damages) recovery claims, and would not apply where sums (that is, unlawfully-levied ACT) had been set-off against lawful MCT, simple interest would still be payable in this situation as a consequence of *Metallgesellschaft*.[51]

2. The Supreme Court extended the analysis followed in *Littlewoods*[52] to this case, finding that simple interest on overpaid tax was an adequate award and this satisfied the principle of effectiveness under EU law.[53] There was no requirement for compound interest to satisfy this principle.[54] The extension of *Littlewoods*[55] (a case on VAT) to this case, extends this analysis to direct tax cases as well.

Since Issues 3 and 5 are very specific to ACT, these are only briefly considered.

[44] *Prudential*, above fn.1, [2018] STC 1657 at [72].
[45] *Investment Trust*, above fn.31, [2017] UKSC 29.
[46] *Prudential*, above fn.1, [2018] STC 1657 at [68]–[69].
[47] *Prudential*, above fn.1, [2018] STC 1657 at [68]–[72].
[48] *Prudential*, above fn.1, [2018] STC 1657 at [77].
[49] See text attached to fn.28, above.
[50] See text attached to fn.28, above.
[51] *Prudential*, above fn.1, [2018] STC 1657 at [78].
[52] *Littlewoods*, above fn.32, [2017] UKSC 70.
[53] *Prudential*, above fn.1, [2018] STC 1657 at [56].
[54] *Prudential*, above fn.1, [2018] STC 1657 at [56].
[55] *Littlewoods*, above fn.32, [2017] UKSC 70.

Issue 3: was there a claim in restitution to recover lawful ACT set against unlawful MCT tax?

The Supreme Court found that there was no claim in restitution to recover lawful ACT set against unlawful MCT.[56] It was found that the payment of lawful ACT was not a defective transfer of value (and therefore there was no unjust enrichment) as the relevant ACT was properly payable under law.[57] If a charge to MCT was unlawful (see footnote 27, above), then the MCT charge was a nullity and ACT could not be set off against a nullity, and so to the extent there was surplus ACT taxpayers could either elect to carry back the lawful ACT and set off against lawful MCT from an earlier period,[58] or alternatively the ACT would automatically be carried forward to the next accounting period. [59]

Issue 5(A): where ACT from a pool which includes unlawful and lawful ACT is utilised against unlawful MCT, is the unlawful ACT regarded as a pre-payment of unlawful MCT or is the ACT utilised regarded as partly lawful and unlawful pro rata?

Applying its analysis from the other issues the Supreme Court found that the pro rata method would not apply given that the charge to unlawful MCT was a nullity and therefore, lawful ACT could not be set off against unlawful MCT (as would have been the case under a pro rata method).[60] The Supreme Court decided that unlawful ACT is first to be treated as being set off against unlawful MCT and if there is no unlawful MCT then unlawful ACT is to be treated as being set off against lawful MCT.

Where unlawful ACT is set against unlawful MCT, since both charges are a nullity, the ACT is itself recoverable. Where the unlawful ACT is set off against lawful MCT, then simple interest is recoverable on the ACT under section 35A SCA, as a restitutionary remedy.

Issue 5(B): where domestic FII was carried back to an earlier quarter is it to be regarded as having been applied to relieve lawful and unlawful ACT pro rata or only lawful ACT?

The Supreme Court found that domestic FII carried back to an earlier quarter was to be regarded as being applied to relieve only lawful ACT.[61]

Conclusion

The decision of the Supreme Court is significant. It was a win for taxpayers in so far as the Supreme Court found that a tax credit in relation to dividends received from portfolio investments should be based on the FNR. It was disappointing from a taxpayer perspective that the Supreme Court found that there was no claim for unjust enrichment in relation to HMRC's opportunity to use the money it had received in breach of EU law, and found that no compound interest was payable. However, the judgment still reserved the right of taxpayers to receive simple interest.

[56] *Prudential*, above fn.1, [2018] STC 1657 at [104].
[57] *Prudential*, above fn.1, [2018] STC 1657 at [102].
[58] ICTA 1988 s.239(3).
[59] ICTA 1988 s.239(4); *Prudential*, above fn.1, [2018] STC 1657 at [101].
[60] *Prudential*, above fn.1, [2018] STC 1657 at [110].
[61] *Prudential*, above fn.1, [2018] STC 1657 at [121].

There is various other litigation on related matters pending before the courts. This is not the end of the road for taxes levied in breach of EU law.

Giles Salmond[*] **and Kunal Nathwani**[**]

Advance corporation tax; Compound interest; EU law; Foreign income dividends; Overpayments; Portfolios; Tax credits; Unjust enrichment

[*] Partner, Eversheds Sutherland (International) LLP, UK Head of Tax Disputes.
[**] Associate, Eversheds Sutherland (International) LLP, International Tax Disputes.