Press Summary

27 April 2022

Commissioners for Her Majesty's Revenue and Customs (Appellant) *v* Coal Staff Superannuation Scheme Trustees Ltd (Respondent) [2022] UKSC 10
On appeal from: [2019] EWCA Civ 1610

Justices: Lord Reed (President), Lord Hodge (Deputy President), Lord Briggs, Lord Sales, Lord Hamblen

Background to the Appeal

The Respondent (the "**Trustee**") is the corporate trustee of a tax-exempt United Kingdom (UK) pension fund. It held a large portfolio of UK and overseas shares. To generate revenue, it engaged in a practice known as stock lending. This involves a shareholder (the lender) transferring ownership of shares to another party (the borrower) on terms that the borrower will (i) return equivalent shares to the lender at the end of the lending period and (ii) pay an amount to the lender equivalent to the dividends paid on the shares during that period. These payments are known as a "manufactured dividend" ("**MD**") if the shares are held in a UK company. If the shares are in a non-UK company, they are known as a "manufactured overseas dividend" ("**MOD**").

This appeal concerns the alleged differential treatment for tax purposes of MDs and MODs received by tax-exempt taxpayers such as the Trustee. That differential treatment is said by the Trustee to be unlawful as a matter of European law because it constitutes a restriction on the free movement of capital, contrary to Article 63 of the Treaty on the Functioning of the European Union ("**TFEU**").

The Trustee pays no UK tax on dividends it receives from shares in both UK and overseas companies. In relation to overseas companies however, the dividend may be subject to a withholding tax ("**WHT**") charged by the country in which the company is based. To prevent double taxation of UK taxpayers, the UK grants a tax credit to the shareholder lender known as withholding tax credit. That tax credit is of no effect in relation to a tax-exempt shareholder such as the Trustee however because it has no relevant tax liability to which the credit can be applied.

Under EU law, this phenomenon of dividends being taxed both in the country where the company is based and in the country where the shareholder is based (known as "juridical

double taxation") is accepted as an unfortunate fact of life which does not generally fall foul of Article 63 TFEU.

Being contractual payments rather than actual dividends, MODs are not liable to WHT. To prevent differential treatment for tax purposes between real dividends and manufactured dividends, however, the UK implemented a regime whereby MODs were subjected to a deemed withholding tax (the "**MOD WHT**") payable at source by the borrower of the shares. To compensate for this deduction, the share lender was granted a corresponding tax credit equivalent to that which would have been available to avoid juridical double taxation had it received an actual overseas dividend rather than a MOD.

In the case of a tax-exempt share lender such as the Trustee, however, the effect of the MOD WHT was to reduce its net income for which it was compensated only with tax credits for which it had no use. Unlike in relation to actual dividends, that did not amount to juridical double taxation, because it arose solely as a result of the UK scheme for taxing MODs which was a policy choice. The Trustee therefore complained that the MOD WHT regime amounted to a restriction contrary to Article 63 because, given that no MOD WHT was deducted in relation to MDs, it disincentivised tax-exempt entities from acquiring and stock lending shares in overseas companies relative to shares in UK companies.

The Trustee claimed that, as a result, it was entitled to repayment of the MOD WHT as tax deducted on its own income. Its own claim amounted to some £8.8 million, but the practice of stock lending by tax-exempt entities was widespread while the UK MOD WHT regime was in operation. This case therefore serves as a test case for more than £600 million in MOD WHT which, subject to the outcome of this appeal, the Revenue may have to repay.

At first instance before the First-tier Tribunal, the Revenue succeeded on the basis that there was no restriction which offended Article 63 TFEU. The Upper Tribunal overturned that decision, finding in favour of the Trustee. The Court of Appeal arrived at the same outcome as the Upper Tribunal though by different reasoning. The Revenue appealed to the Supreme Court.

Judgment

The Supreme Court unanimously allows the appeal. Lord Briggs and Lord Sales give a joint judgment with which the other members of the Court agree.

Reasons for the Judgment

In order to determine whether or not the MOD tax regime contravened Article 63 TFEU, the appropriate question to ask was whether, "but for" the MOD tax regime, investors would be sufficiently better off from engaging in stock lending such that its presence was a disincentive beyond that already created by juridical double taxation to them acquiring overseas shares, as opposed to UK shares **[42]-[43]**.

The Court of Appeal concluded that the MOD tax regime did create such a disincentive because, without the MOD WHT being deducted prior to the MOD being paid to the lender, lenders could negotiate for a larger MOD which reflected the benefit to the borrower of dealing with the borrowed shares in a way which reduced the WHT which the borrower actually paid by using dividend arbitrage (i.e. moving the ownership of the borrowed shares to entities in different countries so as to optimise the rate of WHT payable on them) **[44]**.

Lord Briggs and Lord Sales consider that to be a flawed market economic analysis. The benefit to the stock lender of any additional benefits generated by the borrower's use of the shares (for example, dividend arbitrage) is to be found in the size of the lending fee, not of the MOD. In a sophisticated market, it is to be assumed that the lending fee already had a relationship to the expected benefits accruing to the borrower from the shares **[45]-[47]**.

Whether there was any relevant dissuasive effect constituting a breach of Article 63 TFEU therefore depended on whether the obligation on the borrower, here Authorised UK Intermediaries ("**AUKIs**"), to account to the Revenue for the MOD WHT was likely to have reduced the amount which the borrower would otherwise have been prepared to pay the lender as a lending fee for the opportunity to, for example, engage in dividend arbitrage. That depended, in turn, on whether the MOD tax regime would result in the AUKI actually having to pay anything to the Revenue by way of MOD WHT deductions **[48]**.

The Revenue did not, in fact, receive any cash payments attributable to MOD WHT. The reason for this was that AUKIs typically had more than enough withholding tax credits to soak up, by way of set-off, all the MOD WHT payable by them. To suggest that the MOD tax regime would potentially have the effect of discouraging investment in foreign shares relative to UK shares by tax-exempt investors was therefore no more than pure speculation which was insufficient to make out a breach of Article 63 TFEU. The AUKIs were not, in reality, paying anything more to the Revenue due to the MOD tax regime than they would have done otherwise **[48]**.

Even if there is a dissuasive effect, Lord Briggs and Lord Sales conclude that the appeal should nonetheless succeed based on the remedy sought by Trustee **[51]**.

The Trustee's complaint is that the UK tax regime should have provided it with usable tax credits in relation to the liability of a borrower to pay the MOD WHT, on the basis that it was a UK tax deducted at source from the share lender **[57]**. Lord Briggs and Lord Sales reject this. The purpose of the MOD regime and contractual arrangements between lenders and borrowers was to mimic the position which would have existed had the lender retained the shares. From the lender's perspective, the tax credit it received under the MOD tax regime was exactly the same in its effect as the tax credit in respect of WHT which it would suffer if it retained the shares **[58]-[60]**.

The tax credits which the Trustee claims should have been paid to it were therefore ultimately in respect of WHT levied and retained by foreign tax authorities. The UK tax authorities did not receive those sums, but had decided as a matter of policy to provide access to credits in relation to tax levied by foreign states. Although the UK used its domestic tax regime to achieve this, that did not mean as a matter of substance that the foreign WHT was to be treated as if it had been collected and retained by the UK tax authorities **[63]-[64]**.

Further, although the dissuasive effect regarding investment in foreign shares identified by the Court of Appeal was comparatively small, the relief sought by the Trustee was a sum equal to the full amount of the credits. The remedy claimed was therefore wholly disproportionate when compared with the breach **[68]-[69]**. Having reviewed the relevant principles of the European Court of Justice, Lord Briggs and Lord Sales conclude that a remedy to be provided in respect of a breach of Article 63 is required to be proportionate to the relevant violation of EU law **[82]**. Where the issue is not the restitution of money received by the state but the provision by the state of a financial benefit (i.e. the payment of credits in relation to taxes paid to another state as in this case), the remedy has to be tailored to the wrong committed in breach of EU law **[86]**.

On the facts of the present case, if there was a breach of Article 63 it was only on the basis that the MOD WHT regime omitted to allow for the grant of a tax credit payment to the extent that a tax-exempt lender like the Trustee could show that it had been unable to benefit from the possibility of sharing in the financial gains from dividend arbitrage by an AUKI. That is the extent of the relief to which the Trustee is entitled, if the remedy is to be kept proportionate to the wrong suffered. However, the Trustee has never sought to claim for such a loss nor presented any evidence to show that in fact it suffered any such loss **[90]-[92]**.

References in square brackets are to paragraphs in the judgment

NOTE:
This summary is provided to assist in understanding the Court's decision. It does not form part of the reasons for the decision. The full judgment of the Court is the only authoritative document. Judgments are public documents and are available at: Decided cases - The Supreme Court