Court of Appeal – *The Test Claimants in the FII Group Litigation v HMRC* [2016] EWCA Civ 1180

On 24 November 2016, the Court of Appeal (CoA) released the latest judgment in the long-running group litigation saga of the Franked Investment Income (FII) Group Litigation.

The case arises out of the UK's tax treatment of inbound EU sourced dividends received from group subsidiaries, both on receipt and their onward distribution, and the clear difference in treatment compared with the UK domestic rules which applied at the time to dividends received from UK resident entities.

Several previous judgments have determined the issues of liability and claimant taxpayers may seek restitution for payments of Schedule D Case V (DV) tax and advance corporation tax (ACT) to the extent they were in breach of EU law.

This decision considers several points concerning the quantification of taxpayers' claims and the appropriate level of credit which should be applied, which were originally decided by the High Court in a judgment released on 18 December 2014.

The High Court's decision was upheld by the CoA on the vast majority of issues.

The headline points which arise from this judgment are as follows:

DV tax

The CoA agreed with the High Court that the level of tax credit which the receiving UK company was entitled to offset against the DV tax liability arising on the overseas dividend was the higher of:

- the amount of tax actually paid on the underlying overseas profits out of which the dividend was paid; and
- the foreign nominal rate (FNR) of tax which then applied in the relevant Member States where the profits had been subject to tax before reaching the UK, applying, where necessary, a weighted average.

The CoA upheld the High Court's ruling that credit must also be given for withholding tax (WHT) suffered. Furthermore, the decisions made on each of the 'special cases' considered by the High Court were also upheld:

- dividends distributing gains on the disposal of group subsidiaries which were exempt from tax under local rules still carried a credit;
- dividends paid up by a UK trading company to an EU holding company and then on to a UK parent still carried a credit.

ACT

The CoA also upheld the method decided by the High Court for determining the appropriate credit, confirming that credit should be given against ACT for underlying tax paid, as well as for tax at the FNR and any WHT suffered.

A credit should be granted at the higher of (capped at the UK rate of ACT which applied):

- the ULT and WHT actually paid and attributable to the dividend; and
- a nominal rate credit calculated by applying the relevant FNR to the gross foreign profits distributed by the dividend.

The CoA also considered how ACT paid should be linked with EU-source income to give effect to the earlier Court of Justice of the European Union (CJEU) decisions in the *FII Group Litigation*, agreeing with the High Court's preferred approach.

This involves feeding the credit required by EU law into the ACT system at the UK 'water's edge' and then treating the aggregate of the dividend and the credit in the same way as domestic FII. The credit is treated as available for use within the group and is offset against the actual ACT payable on subsequent distributions.

Dealing with another of the special cases considered by the High Court, the CoA confirmed that a company deriving income from German silent partnerships was not entitled to credit in respect of ACT paid when it paid dividends out of that income.

Foreign Income Dividends (FIDs)

HMRC had previously been refused permission to appeal the High Court's decision that the FIDs regime was unlawful, but renewed its application in the CoA. The High Court also considered FIDs in Evonik Degussa v HMRC [2016] EWHC 86 (Ch), released on 22 January 2016, and gave summary judgment in favour of the claimant. HMRC applied for permission to appeal against this judgment and argued that the High Court was wrong to decide that the unlawfulness of *all* ACT paid by the claimant on FIDs had been established at the CJEU.

Permission to appeal in both cases was granted by the CoA and the appeals were decided and dismissed as part of this judgment. Time value claims for the *entire* sum of ACT paid on FIDs, and then later repaid once matched and offset against a 'qualifying foreign dividend' were upheld.

Remedies

HMRC argued they should be entitled to a credit against the repayment of overpaid ACT to one taxpayer in respect of double taxation treaty credits which were paid to its third country resident ultimate parents. This appeal was allowed, the CoA deciding such a credit could be claimed by HMRC.

HMRC argued that they were not enriched in the full amounts of the payments of ACT they received to the extent that they were required to give corresponding tax credits to the recipients of the

dividends. Their appeal on this issue was dismissed with the CoA deciding HMRC were initially enriched by the full amounts.

The High Court held that it was not possible for HMRC to claim to reduce the compensation payable under the mistake claims in respect of utilised ACT on the grounds that the amount by which they were enriched was less than the time value of money calculated on the basis of compound interest. HMRC's appeal on this point was allowed in that they were entitled to raise an 'actual benefit' argument, but the CoA went on to determine that HMRC had not made out this argument on the facts.

The High Court also rejected, on the facts, HMRC's claim that the Government would be worse off by having to make restitution because the mistaken payments had resulted in equivalent extra expenditure, although it held that this 'change of position' defence was available in principle. The taxpayer's cross-appeal against the decision in principle was dismissed, but the CoA went on to determine that HMRC had not made out this argument on the facts.

Finally, HMRC's appeals on certain findings of the High Court concerning the effect of principles of EU law were dismissed. The CoA agreed with the High Court that under EU law:

- HMRC are precluded from arguing for the set-off of tax credits;
- HMRC cannot argue the 'actual benefit' was less than the objective use value of the prematurely paid ACT in order to reduce potential tax repayments; and
- HMRC cannot raise a 'change of position' defence to the taxpayers' mistake-based claims.

Discoverability – Limitation periods for mistake-based claims

Disagreeing with the High Court on this issue, the CoA determined that the earliest date on which a 'reasonably diligent' taxpayer could have discovered the mistake of law was 12 December 2006. This is the date of release of the CJEU's first judgment in the *FII Group Litigation.* The CoA considered that this was the date that it was authoritatively established that the UK's tax regime was unlawful.

Mistake-based claims in the High Court will therefore be in time if they were issued within six years from 12 December 2006 (pursuant to s32(1)(c) Limitation Act 1980).

Contact

Richard Doran

T: +44 (0)20 7694 4196
E: richard.doran@kpmg.co.uk

Stephen Whitehead

T: +44 (0)20 7311 2829
E: stephen.whitehead@kpmg.co.uk