[2015] UKFTT 0175 (TC)

TC04368

CORPORATION TAX — double taxation relief — ICTA s 18 Sch D Case V and Pt XVIII — series of intra-group transactions leading to declaration of dividends by overseas subsidiaries — whether intermediate dividends were "dividends" within statutory meaning or disguised repayment of loans — repayment of loans — underlying tax limited to tax paid on true dividends taken to profit — appeal dismissed

Appeal number: TC/2012/03040

FIRST-TIER TRIBUNAL
TAX CHAMBER

BETWEEN

	NEXT BRAND LIMITED	**Appellant**
	- and –	
	THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondents**

Tribunal: Judge Colin Bishopp

Sitting in public in London on 17 and 18 March 2014

Mr Jonathan Peacock QC and Mr Philip Walford, counsel, instructed by PwC LLP, for the appellants

Mr David Goldberg QC and Ms Nicola Shaw QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the respondents

DECISION

Introduction

1. The issue in this appeal is whether the appellant, Next Brand Limited ("NBL"), is entitled to double taxation relief ("DTR") for "underlying tax" (the meaning of which is explained below) of £45,895,448, an amount which would eliminate all, or almost all, of the United Kingdom tax otherwise payable on a dividend of HK$1.45 billion (about £106.5 million) which NBL received from its Hong Kong subsidiaries in March 2006. As little turns on precise figures I shall use, in many cases, round numbers and, where the currency referred to is not sterling, shall add the sterling equivalents with which I was provided, which are often approximate and do not necessarily reflect current exchange rates. The figures which follow should therefore be taken to be illustrative rather than exact.

2. Put shortly, NBL's case is that the dividend was the means by which profits earned by its subsidiaries in the Far East were brought to the United Kingdom. Ordinarily tax would be chargeable in the UK on the dividend under Case V of Schedule D (to which I come in more detail below). NBL maintains that the effect of certain arrangements into which it and other members of its trading group entered is to engage the DTR provisions of Part XVIII of the Income and Corporation Taxes Act 1988 ("ICTA"), and that they lead to the credit to which I have referred. HMRC have rejected the claim for relief on the ground, shortly stated, that the arrangements amount to a series of artificial steps by which NBL sought to inflate the value of the DTR to which it was properly entitled. Their case, in particular, is that one of the steps, said to be the payment of a dividend, was in reality the repayment of a loan, and that the calculation of the DTR which NBL has claimed is wrong.

3. NBL's corporation tax return for the accounting period ended 31 January 2007 included a claim for DTR by reference to underlying tax of £45,895,448 (slightly more than the Case V liability, and capped at the lower amount by s 799(1)(b) of ICTA). HMRC accept that NBL has a legitimate claim for DTR of £13,227,225, but have disallowed the balance of £32,268,223 or, more accurately, the difference between the capped amount and £13,227,225. Formally, the appeal is against a closure notice of 24 November 2011 notifying NBL of the completion of HMRC's enquiries, pursuant to para 32 of Sch 18 to the Finance Act 2007, into that return. The effect of the notice was to reduce NBL's total claim to DTR from the amount claimed to the amount accepted to be due. There were no other amendments to the return of relevance.

4. NBL was represented before me by Mr Jonathan Peacock QC, leading Mr Philip Walford, and HMRC by Mr David Goldberg QC, with Ms Nicola Shaw QC.

The arrangements

5. The arrangements to which I have referred included a number of events and transactions, all relating to or undertaken between members of the Next group of companies, whose ultimate parent is Next plc, a FTSE 100 company. The group

supplies the well-known NEXT brand of merchandise through a chain of retail shops, predominantly in the United Kingdom and the Republic of Ireland, in franchise stores abroad, and by means of a home shopping operation. The companies which were involved in the relevant events, all incorporated in England and Wales and UK-resident unless otherwise stated, are as follows:

- Next Group plc ("NGP"), which is the group's main intermediate holding company, and an immediate subsidiary of Next plc. NGP provides general management, treasury and property related services to group companies and third parties.
- NBL, which acts as an investment company and is an intermediate holding company. Its immediate parent is NGP.
- Next Retail Limited ("NRL"), which is also an immediate subsidiary of NGP, and the main trading company within the group.
- Next Near East Limited ("NNEL"), which was the main UK trading company of the group until it transferred its trade to NRL in 2003. NNEL then ceased trading, but it receives income by way of interest on that part of the consideration for the disposal of its trade that was left outstanding (though the capital balance has been reduced as well).
- Next Sourcing Limited ("NSL"), a Hong Kong-registered and resident trading company, which acts as a purchasing agent on behalf of the group and related companies.
- Cairns Limited ("Cairns"), also Hong Kong-registered and resident, and a subsidiary of NSL, which serviced the needs of Next's associated company Cotton Traders Ltd until it ceased trading in 2006.
- Next Europe BV ("NEBV"), a Netherlands-registered and resident company which is an intermediate holding company in the group and an immediate subsidiary of NBL. Until 22 December 2005, NEBV owned NSL's issued ordinary share capital.

6. I take the following description of the relevant events (a description which represents my findings of fact) from the agreed statement of facts with which I was provided, and the evidence of the only witness who gave oral evidence, Mr David Keens, who is the group finance director and a director of many of the group companies, including NGP, NBL, NSL, NRL, NNEL and Cairns, though not NEBV.

7. Mr Keens explained that since March 2000 the group has been engaged in a continuing programme of share buybacks, aimed in substantial part in improving earnings per issued share, regarded by many investors as an important measure of performance. Over the five years from 2000 the group repurchased over 30 per cent of its equity, while at the same time paying high dividends, a practice which has continued. Its ability to do so depends on its generating sufficient distributable reserves from profits. Historically, he said, the United Kingdom had delivered the greatest return on capital invested, and it was also the jurisdiction in which most of the group's borrowings had been made. It was therefore in the group's interests

to bring overseas profits to the UK in order to service debt, earn a return on surplus funds, pay dividends and repurchase its shares. I accept (and HMRC do not argue otherwise) that the group has had a policy of bringing distributable profits to the UK, and that it has done so for ordinary commercial reasons.

8. Although the profits of subsidiaries were commonly transferred through parents to NGP by way of dividend, the subsidiaries also made loans, both direct and indirect, by which surplus funds moved up the group. In particular, in January 2005 a loan of approximately HK$723 million (about £49 million) from NSL and its subsidiaries to NEBV was outstanding. Between January 2005 and January 2006 the outstanding balance increased to HK$1.16 billion (about £74 million). NEBV had in turn made loans to NGP— approximately €98 million at January 2005, rising to €143 million by January 2006 (equivalent to about £68m and £98m respectively). There were in addition, in January 2006, outstanding loans from NNEL to NRL of approximately £2 billion, and from NNEL to NGP of about £800 million; the last of those loans increased to over £1 billion by January 2007.

9. The events relevant for present purposes began on 22 December 2005, when the ordinary shares in NSL were sold by NEBV to NBL for a consideration of £348,000 (the carrying value of the investment), whereupon NBL became the legal and beneficial owner of those shares (save that one share is held by NGP as nominee for NBL). The effect of the sale was to make NSL a direct subsidiary of NBL, with the consequence that it became possible for NSL to declare a dividend in favour of NBL.

10. On the same day NNEL amended its articles of association and increased its authorised share capital from £53,300,000 to £58,300,000 by the creation of a new class of Irredeemable Preference Shares. Following this change the share capital was (and I understand still is) divided into:

(a) 3,300,000 Fixed Rate Preference Shares of £1 each;

(b) 50,000,000 Non-Voting Ordinary Shares of £1 each; and

(c) 500,000,000 Non-Voting Irredeemable Preference Shares of 1p each.

11. The amended articles of association provided that:

(a) holders of Irredeemable Preference Shares were entitled to the right, in priority to the holders of any other class of share, to receive out of the company’s profits available for distribution:

(i) a single non-cumulative special dividend per share equal to the sum of 99 pence plus an amount accruing, from the third day after the first allotment and issue of such shares, at an annual rate of 6 per cent of 99 pence, and payable on the business day following a call by written notice made by the holder on the company; and

(ii) a non-cumulative dividend at the rate of 6 per cent per annum on the paid up value of each share, payable twice each year;

(b) holders of Fixed Rate Preference Shares were entitled to the right, in priority to any dividend rights of the holders of Non-Voting Ordinary Shares, to receive a fixed cumulative dividend equal to 5 per cent per annum of the nominal value of each share and payable yearly, together with general voting rights; and

(c) holders of Non-Voting Ordinary Shares were entitled to the right to receive a dividend equal to the total amount of the profits of the company available for distribution after payment of the dividends on the other two classes of share.

12. On the same day, 22 December 2005:

(a) NGP lent £75 million to NRL;

(b) NRL subscribed for, and NNEL issued to it, 75,000,000 Irredeemable Preference Shares of 1p at a premium of 99p per share, and NRL paid the total subscription price of £75 million. No other Irredeemable Preference Shares were issued in the periods relevant to this appeal.

(c) NNEL lent £75 million to NGP.

In other words, NGP received back the money with which it started, but in the process intra-group loans were created and an issue of shares was made.

13. Of the 3,300,000 Fixed Rate Preference Shares in NNEL, 2,667,002 have been issued. Of those, 2,000,000 are held by Mourant & Company Trustees Limited in its capacity as trustee of the 2003 NEXT Share Ownership Plan trust, and the remaining 667,002 shares are legally and beneficially owned by NGP. NNEL and the 2003 NEXT Share Ownership Plan trust are treated as part of the Next group for financial reporting purposes.

14. Of the 50,000,000 Non-Voting Ordinary Shares in NNEL, 40,486,500 shares have been issued. All of them are legally and beneficially owned by NGP save that one share is held by NBL as nominee for NGP.

15. On 7 March 2006:

(a) NGP lent HK$1,025,500,000 (equivalent to about £76 million) to NSL;

(b) NRL sold its 75,000,000 Irredeemable Preference Shares in NNEL to NSL for £75,888,042, which was a price equal to the cost of the shares of £75,000,000 together with the accrued value of the dividends on them of £888,042;

(c) NSL paid NRL the full sale consideration and became the beneficial owner of the shares. NRL remained the legal owner of the shares, but made a declaration that it held them as nominee for NSL. It is recorded in the statement of agreed facts, though I think nothing turns on it, that NRL included a chargeable gain of £540,282 on the disposal of the shares in its tax return, to which no amendment has been made by HMRC.

(c) NRL repaid the loan of £75 million which NGP had made to it on 22 December 2005, together with loan interest of £847,603.

16. The net effect of these transactions, in round figures, is that the money NGP lent to NSL was returned to it, and in the process a new loan was created while another was discharged. In addition, the Irredeemable Preference Shares issued to NRL (whose debt had been discharged) were transferred to NSL (which incurred the new debt). The result, though not the form, of the transactions was that both the Irredeemable Preference Shares and the indebtedness were transferred from NRL to NSL.

17. On 17 March 2006 NSL gave advance warning that it would be making a call on NNEL for the special dividend for which NNEL's amended articles of association provided (see para (11)(a)(i) above). NNEL subsequently received formal notice of the call from NSL.

18. On 20 March 2006:

(a) NGP repaid the loan of £75 million which NNEL had made to it on 22 December 2005 and lent NNEL a further £292,521;

(b) NNEL declared and paid to NSL dividends totalling £75,292,521, comprising:

(i) a cash dividend in the aggregate sum of £75,287,466, representing the special dividend for which its amended articles of association provided, namely £74,250,000 at 99p per share, plus £1,037,466 calculated as 6% pa of 99p per share from 25 December 2005 until payment: see para 11(a)(i) above; and

(ii) a further cash dividend in the aggregate sum of £5,055 (the non-cumulative 6% pa dividend referred to at para 11(a)(ii) above) in respect of the period from 1 February 2004 to 29 January 2005; and

(c) NSL made a loan to NGP of £75,292,521.

19. The net effect of these transactions was that the money NGP had paid out was returned to it, and in the process one loan was repaid and two more were created. I should add for completeness that NNEL's after-tax profits, derived from trading or investment activities, for the period from 1 February 2004 to 29 January 2005 were £116,173,031, on which NNEL had paid £49,788,442 of UK corporation tax, leaving £66,384,589 net. It is, however, recorded in the relevant minutes that the directors had satisfied themselves that NNEL had sufficient distributable profits to enable it to pay the dividends mentioned at para 18(b)(i) and (ii) ("the NNEL dividends"). HMRC take no issue with that statement—indeed, they point out that NNEL had significantly more distributable profits (some retained from earlier years) than were needed for the payment of the NNEL dividends. It is, however, those dividends which, they say, represent in reality the repayment of a loan and interest on that loan respectively.

20. On the following day, 21 March 2006:

(a) NGP repaid the loan of £75,292,521 which NSL had made on the previous day;

(b) NGP lent a further £31,184,200 (about HK$425 million) to NSL;

(c) Cairns declared a dividend of HK$27,127,857 (just less than £2 million) in favour of NSL;

(d) payment to NSL of that dividend was effected by a reduction in the inter-company account;

(e) NSL declared and paid a cash dividend of HK$1.45 billion (equivalent to £106,476,722) to NBL ("the Case V dividend");

(f) NBL lent £106,500,000 to NGP.

21. It was recorded in the relevant minutes of Cairns' board that the directors had satisfied themselves that there were sufficient distributable profits to enable it to declare the dividend referred to at para 20(c) above ("the Cairns dividend"). Again, HMRC take no issue with that statement. The amount of the dividend was equal to the sum of the company's after-tax profits for the fourteen accounting periods up to and including the year ended 31 January 2005, on which Cairns had paid Hong Kong tax of HK$5,280,152 (then £387,733).

22. The relevant NSL board minutes note the receipt of the dividends from NNEL and the dividend from Cairns, and record that the directors had satisfied themselves that there were sufficient distributable profits in the periods to 20 March 2006 to enable NSL to pay the dividend referred to at para 20(e) above ("the NSL dividend"). As before, HMRC do not challenge that statement, but they say that, save to a limited extent, the NNEL dividends did not contribute to NSL's distributable profits. NSL had paid Hong Kong tax on its trading profits of HK$190,362,030 of which the proportion attributable to the profits covering the dividends is HK$180,295,396 (about £13.25 million), and HMRC accept that this amount attracts DTR.

23. The net effect of the 21 March 2006 transactions is that NGP received back the £75,292,521 it had paid out in order to discharge the previous day's loan, together with £31,207,479 which was derived from NSL's and Cairns' profits earned from the group's Far East operations.

24. I should add for completeness, though nothing turns on it, that in December 2006 NBL declared and paid dividends of £80,069,160 to NGP, and NGP declared and paid to Next plc a dividend of £500 million.

25. The overall effect of the movements of money before the payment of those dividends was broadly neutral: NGP ended up with a little more than £3 million less, NBL with just under £400,000 less and Cairns with £2 million less than the amounts with which they began, whereas NRL, NSL and NEBV received sums of, in the aggregate, the same amount. It does not seem to me to matter that the money remained within the group; what matters is the direction in which the cash flowed. As I have said, I do not doubt Mr Keens' evidence that it was group policy to move profits up from subsidiaries to the ultimate holding company, but it follows from what I have said in the preceding paragraphs that the arrangements

did not further that policy; on the contrary, the effect of the movements was to move cash (albeit, in their context, relatively modest amounts) down the group and in particular towards rather than away from the Hong Kong subsidiaries which, together, gained net cash of about £3 million at the expense of NGP and NBL.

26. An analysis of the loans shows that at the end of the series of transactions NGP was owed just under £1 million and NBL £106,500,000 while NNEL and NSL were indebted to them, in the aggregate, in precisely the same amount. HMRC say that this comparison demonstrates the reality of the transactions, namely that loans were artificially created in order that NNEL could declare and pay a large dividend to NSL, using money which NBL had provided; thus, viewed realistically, all the various companies had done was undertake a series of steps designed to create the illusion that a large amount of taxed profit had been brought to the UK. What the group did amounted, when properly analysed, to a device designed to convert a very modest amount of profit which had borne UK tax into more than £32 million of relief, but which did not succeed in that aim. Moreover, what NBL claimed was the substance of the various steps was not borne out by the accounting treatment of them which the group companies had adopted. These arguments are at the centre of the disagreement between the parties, and I shall return to them later.

27. Mr Keens accepted, as he gave his oral evidence, that the Case V dividend could have been paid by NSL even if it had not received the NNEL dividends, as it had sufficient distributable reserves at that time. It was put to him by Mr Goldberg that the NNEL share issue and the NNEL dividends were unnecessary, as a means of moving profits up the group, and that they had taken place merely as a means of securing greater tax relief. Mr Keens, who is a certified chartered accountant but not a tax specialist, agreed that all of the steps had been planned in advance and that "one of the purposes was to ensure that the group did not pay tax on a worldwide basis of any greater sum than legislation demanded".

28. In fact, although NBL maintains that it had a genuine underlying purpose of bringing overseas profits to the UK, it does not, in fact, seriously dispute the proposition that the arrangements were designed to maximise the DTR to which it might be entitled. It accepts not only that they were all planned in advance, but also that tax advice was obtained on their effects. Mr Peacock contended that there was nothing illegitimate in NBL's having adopted pre-planned arrangements, that it was indeed common practice to plan corporate transactions in advance, and that a group such as Next would routinely take advice on the consequences, including tax consequences, of transactions into which it intended to enter. As a matter of fact, because of concerns about Hong Kong stamp duty, the transactions nearly did not proceed; in the event they were simply delayed. There was also nothing to be read into its seeking to reduce or eliminate the tax due, an objective which Parliament had recognised in 2009 when legislative amendments were made which, as a general rule, eliminated a UK tax charge on dividends received by UK companies, including those received from their overseas subsidiaries.

29. Mr Peacock also accepted that the board minutes which authorised the payment of the dividends had been drafted in advance. There was, he said, again nothing at all irregular about that; it was common practice to prepare minutes in advance, the only requirement being that the board members did in fact discuss the matter and that they reached the decision recorded by the minutes (see the observation to that effect of Stanley Burnton J in *R (Inland Revenue Commissioners) v Kingston Crown Court* [2001] EWHC Admin 581, [2001] STC 1615, at [21]).

30. Mr Goldberg did not take any real issue with those propositions, and it does not seem to me that the fact that the transactions were pre-planned, or had a tax purpose, assists me greatly in determining the question before me which is, in its simplest form, what was the true nature of the various steps? I merely add, although it is an obvious point, that I agree with Mr Goldberg that the legislation should be applied as it was at the material time; the fact that, as Mr Peacock said, Parliament may have amended it later is an irrelevant consideration. Moreover, the essence of Mr Goldberg's submissions on this point was not that NBL had anticipated a legislative amendment, but that it was attempting to secure relief for UK tax which had not been borne on the relevant portion of the money which was used in order to pay the Case V dividend.

The accountancy evidence

31. Both parties had retained accounting experts: Mr Peter Holgate FCA, a partner in PricewaterhouseCoopers LLP, instructed by NBL, and Mr Richard Lawrence FCA, now employed by HMRC but previously a director at Ernst & Young LLP, who provided a report on HMRC's instructions. Their reports revealed some differences between them, of relatively limited scope, and they met, in the conventional manner, in order to resolve those differences so far as possible, and to identify those which remained. It became clear during their meeting that there was nothing of any substance between them which could not be resolved by some clarification of their reports. I was provided with copies of those reports, including the joint report they prepared following their meeting, and they did not give oral evidence. I do not, in fact, need to record more than a very small part of their evidence, though I will return to it from time to time when dealing with, in particular, Mr Goldberg's submissions.

32. It was agreed between the experts that (with some minor exceptions of no present consequence) all of the companies had accounted correctly for the various payments they had made and received. In particular, NNEL had recognised that the irredeemable preference shares and the special dividend should be classified in accordance with their substance, which was debt, and the repayment of debt, respectively. In their joint report the accountants put it in this way:

> "The £74,250,000 [*ie* the special dividend of 99p per share] was not presented as [an] interest expense. This was because NNEL correctly accounted for the irredeemable preference shares in accordance with their substance and classified them as debt. Accordingly, the £0.99 per share element of the single non-cumulative special dividend was presented as a repayment of debt. Nevertheless, the dividend presented as a repayment of debt remains as a matter of law a distribution."

33. Similarly, NSL did not account for the special dividend in its income statement, but wrote down the value of the shares by the amount of the receipt, thus treating it as a capital item. By contrast, NSL treated the Cairns dividend and the further dividend of £5,055 (see para 18(b)(ii) above) as income receipts.

34. It was also agreed between the experts that the payment of the NNEL dividends did reduce NNEL's profits available for distribution, by an equivalent amount, though it is also clear from Mr Holgate's report that NNEL's distributable profit at the relevant time was almost £600 million, covering the dividends paid several times over. The NNEL dividends were, however, reflected in its accounts for the year as a transfer from retained earnings to "other reserves not available for distribution" rather than as a payment out of distributable profits.

The relevant law

35. It is common ground that ordinarily the Case V dividend, representing "income arising from possessions out of the United Kingdom", would be subject to UK tax in accordance with Case V of Schedule D, as it was defined by s 18 of ICTA. It is also common ground that it is only by showing that the DTR provisions apply to the dividend that NBL can escape that charge to tax. At the relevant time the DTR provisions were to be found in Part XVIII of ICTA, consisting of ss 788 to 812. In order that the overall scheme of Part XVIII can be understood I set out the applicable provisions, with some incidental commentary, below; where necessary I shall repeat the provisions individually when I come to the parties' submissions about them. All the extracts from the legislation which follow are in the form in which it was in force at the relevant time.

36. Section 788 dealt with the position in those cases in which there was a relevant double taxation treaty between the United Kingdom and another country, but there was no such treaty in this case. It was necessary instead to look to the "unilateral relief" for which s 790 provided. So far as material to this appeal, that section was in these terms:

> "(1) To the extent appearing from the following provisions of this section, relief from income tax and corporation tax in respect of income and chargeable gains shall be given in respect of tax payable under the law of any territory outside the United Kingdom by allowing that tax as a credit against income tax or corporation tax, notwithstanding that there are not for the time being in force any arrangements under section 788 providing for such relief.
>
> (2) Relief under subsection (1) above is referred to in this Part as 'unilateral relief'.
>
> (3) Unilateral relief shall be such relief as would fall to be given under Chapter II of this Part if arrangements in relation to the territory in question containing the provisions specified in subsections (4) to (10C) below were in force by virtue of section 788, but subject to any particular provision made with respect to unilateral relief in that Chapter; and any expression in that Chapter which imports a reference to relief under arrangements for the time being having effect by virtue of that section shall be deemed to import also a reference to unilateral relief."

37. It can be seen from those subsections that the rules relating to unilateral relief generally followed those relating to treaty relief, subject to some modification. Chapter II of Part XVIII, to which I shall come shortly, contained the detailed rules about the relief, including the method by which the amount of the relief was to be calculated. Section 790(4) contained the primary relieving provision:

> "Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any United Kingdom income tax or corporation tax computed by reference to that income or gain …."

38. Subsections (6) and (6A) added further provisions relevant in this case:

> "(6) Where a dividend paid by a company resident in the territory is paid to a company falling within subsection (6A) below which either directly or indirectly controls, or is a subsidiary of a company which directly or indirectly controls—
>
> (a) not less than 10 per cent of the voting power in the company paying the dividend …
>
> any tax in respect of its profits paid under the law of the territory by the company paying the dividend shall be taken into account in considering whether any, and if so what, credit is to be allowed in respect of the dividend.
>
> In this subsection references to one company being a subsidiary of another are to be construed in accordance with section 792(2).
>
> (6A) A company falls within this subsection if—
>
> (a) it is resident in the United Kingdom; …."

39. It is undisputed that sub-s (6) applied to the Case V dividend, in that the Next group structure satisfied its "voting power" requirements.

40. Chapter II of Part XVIII began with s 792, of which only two provisions are of relevance here. The first is the, at first sight oxymoronic, definition to be found in sub-s (1) of "underlying tax" which meant "in relation to any dividend, tax which is not chargeable in respect of that dividend directly or by deduction". What it meant, however, was tax which had been borne indirectly, usually by its having been assessed on the profits out of which the dividend was paid—hence the phrase "underlying tax". The second relevant provision is sub-s (2), which made it clear (as is undisputed) that NSL was a subsidiary of NBL for the purposes of s 790.

41. Section 793(1) set out the manner in which the relief was to be given:

> "Subject to the provisions of this Chapter, where under any arrangements credit is to be allowed against any of the United Kingdom taxes chargeable in respect of any income or chargeable gain, the amount of the United Kingdom taxes so chargeable shall be reduced by the amount of the credit."

42. Thus the starting point, subject to any later modifying provision, was that if credit for underlying overseas tax was available, it reduced the United Kingdom

tax payable pound for pound. Subsection (2) provided that the relief could be set only against UK income tax and corporation tax.

43. Section 795 dealt with the manner in which the amount of the income which had borne, or was to be treated as having borne, foreign tax was to be calculated, Subsection (1), as the parties agreed, is of no application, and it is necessary to turn only to sub-s (2):

> "Where credit for foreign tax falls under any arrangements to be allowed in respect of any income or gain and subsection (1) above does not apply, then, in computing the amount of the income or gain for the purposes of income tax or corporation tax—
>
> (a) no deduction shall be made for foreign tax or special withholding tax, whether in respect of the same or any other income or gain; and
>
> (b) the amount of the income shall, in the case of a dividend, be treated as increased by—
>
> (i) any underlying tax which, under the arrangements, is to be taken into account in considering whether any and if so what credit is to be allowed in respect of the dividend …"

44. In essence, the dividend had to be grossed up by the amount of the underlying tax, and the UK tax due (before relief) was calculated by reference to the grossed-up amount. However, s 797, which I do not think it necessary to set out, limited the rate at which the dividend could be grossed up to the current rate of UK corporation tax—thus if the overseas rate was 40% and the UK rate 30%, the additional 10% was left out of account.

45. Provisions for the computation of the underlying tax appeared at s 799:

> "(1) Where in the case of any dividend arrangements provide for underlying tax to be taken into account in considering whether any and if so what credit is to be allowed against the United Kingdom taxes in respect of the dividend, the tax to be taken into account by virtue of that provision shall be so much of the foreign tax borne on the relevant profits by the body corporate paying the dividend as
>
> (a) is properly attributable to the proportion of the relevant profits represented by the dividend, and
>
> (b) does not exceed the amount calculated by applying the formula set out in subsection (1A) below.
>
> (1A) The formula is—
>
> (D + U) x M%
>
> where—
>
> D is the amount of the dividend;
>
> U is the amount of underlying tax that would fall to be taken into account as mentioned in subsection (1) above, apart from paragraph (b) of that subsection; and
>
> M% is the maximum relievable rate;

and for the purposes of this subsection the maximum relievable rate is the rate of corporation tax in force when the dividend was paid.…

(3) For the purposes of subsection (1) above the relevant profits, subject to subsection (4) below, are—

(a) if the dividend is paid for a specified period, the profits of that period; and

(b) [repealed]

(c) if the dividend is not paid for a specified period, the profits of the last period for which accounts of the body corporate were made up which ended before the dividend became payable.

(4) If, in a case falling under paragraph (a) or (c) of subsection (3) above, the total dividend exceeds the profits available for distribution of the period mentioned in that paragraph the relevant profits shall be the profits of that period plus so much of the profits available for distribution of preceding periods (other than profits previously distributed or previously treated as relevant profits for the purposes of this section or section 506 of the 1970 Act) as is equal to the excess; and for the purposes of this subsection the profits of the most recent preceding period shall first be taken into account, then the profits of the next most recent preceding period, and so on.

(5) For the purposes of paragraphs (a) and (c) of subsection (3) above, 'profits', in the case of any period, means the profits available for distribution.

(6) In subsections (4) and (5) above, 'profits available for distribution' means, in the case of any company, the profits available for distribution as shown in accounts relating to the company—

(a) drawn up in accordance with the law of the company's home State, and

(b) making no provision for reserves, bad debts, impairment losses or contingencies other than such as is required to be made under that law.

(7) In this section, 'home State', in the case of any company, means the country or territory under whose law the company is incorporated or formed."

46. The formula set out at sub-s (1A) is known as the "mixer cap". It will be necessary to examine how it and the remaining provisions of s 799 apply in this case later.

47. The only remaining provision of ICTA which is of relevance is s 801, entitled "Dividends paid between related companies: relief for UK and third country taxes", the material parts of which were as follows:

"(1) Where a company resident outside the United Kingdom ('the overseas company') pays a dividend to a company falling within subsection (1A) below ('the relevant company') and the overseas company is related to the relevant company, then for the purpose of allowing credit under any arrangements against corporation tax in respect of the dividend, there shall be taken into account, as if it were tax payable under the law of the territory in which the overseas company is resident—

(a) any United Kingdom income tax or corporation tax payable by the overseas company in respect of its profits; and

(b) any tax which, under the law of any other territory, is payable by the overseas company in respect of its profits.

(1A) A company falls within this subsection if—

(a) it is resident in the United Kingdom; or

(b) it is resident outside the United Kingdom but the dividend mentioned in subsection (1) above forms part of the profits of a permanent establishment of the company's in the United Kingdom.

(2) Where the overseas company has received a dividend from a third company and the third company is related to the overseas company, then, subject to subsection (4) below, there shall be treated for the purposes of subsection (1) above as tax paid by the overseas company in respect of its profits any underlying tax payable by the third company, to the extent that it would be taken into account under this Part if the dividend had been paid by a company resident outside the United Kingdom to a company resident in the United Kingdom and arrangements had provided for underlying tax to be taken into account.

(2A) Section 799(1)(b) applies for the purposes of subsection (2) above only—

(a) if the overseas company and the third company are not resident in the same territory …

(3) Where the third company has received a dividend from a fourth company and the fourth company is related to the third company, then, subject to subsection (4) below, tax payable by the fourth company shall similarly be treated for the purposes of subsection (2) above as tax paid by the third company; and so on for successive companies each of which is related to the one before."

48. The three subsections together addressed the case in which there was a chain of dividends paid by related companies, for example (as in this case) from a subsidiary to its parent, and by the receiving company to its own parent. The provisions allowed for eligible underlying tax relating to the first dividend to be carried forward to the next dividend, and so on. If (again, as in this case) the sub-subsidiary was taxed in the UK, while the intermediate subsidiary was an overseas company, the underlying tax attaching to the first dividend was treated, once it had been carried forward to the second dividend, as overseas tax. It is undisputed that these provisions are relevant to this case and that all of the companies involved in the arrangements were "related", as that term was defined by sub-s (5) (which was in similar terms to s 790(6A)).

The issues

49. The issues were identified by Mr Peacock as follows:

(a) whether the NNEL dividends (see para 18(b)(i) and (ii) above) were "dividends" for the purposes of the relevant provisions of ICTA;

(b) whether any underlying tax payable by NNEL could be taken into account in NBL's claim for DTR in respect of the Case V dividend (see para 20(e) above); and

(c) if yes, the amount of the underlying tax for which credit was available.

50. Mr Goldberg did not disagree with that formulation. I add for clarity that it is not in issue that the underlying tax paid by Cairns (£387,000: see para 21 above), and underlying tax paid by NSL itself (£13,239,000: para 22 above), can be taken into account; what is not agreed is the extent to which tax which (it is accepted) NNEL has paid constitutes underlying tax attached to the Case V dividend.

NBL's case

51. Mr Peacock accepted that the first of the issues identified above was critical: if HMRC were right to argue that the NNEL dividends were not "dividends" for the purposes of the relevant statutory provisions NBL's claim must fail. But, he said, HMRC's case on that issue was misconceived.

52. Although Part XVIII provides for relief from UK corporation tax in respect of foreign tax borne or deemed to have been borne on a dividend, it nowhere offers a definition of the term "dividend". That problem was addressed by Peter Gibson LJ in *Memec plc v Inland Revenue Commissioners* [1998] STC 754 in which he said, at 768, after addressing the taxpayer's arguments to the contrary,

> "The form of the subsection is to state as a condition precedent, 'Where [the overseas company] pays a dividend to [the United Kingdom company]'. That presupposes that 'dividend' has its ordinary meaning in United Kingdom law. Unless the condition is satisfied the subsection cannot have effect. The subsequent reference [in ICTA s 801(1)] to the arrangements is not worded in such a way as would require 'dividend' to have the meaning, if any, given to the term in the arrangements. In my judgment express wording would have been needed to extend the meaning of 'dividend' beyond its ordinary significance in United Kingdom law.
>
> The ordinary meaning of 'dividend' is that it is a payment of a part of the profits for a period in respect of a share in a company (see *Esso Petroleum Co Ltd v Ministry of Defence* [1989] STC 805 at 807, [1990] Ch 163 at 165). In s 209(2) of [ICTA], 'distribution' in relation to any company, means—
>
> '(a) any dividend paid by the company, including a capital dividend;
>
> (b) ... any other distribution out of assets of the company (whether in cash or otherwise) in respect of shares in the company ...'
>
> As the judge said, that is consistent with, and tends to confirm, the proposition that the meaning of 'dividend' in [ICTA] … is the ordinary meaning as stated in the *Esso* case. Further, the usage of the term throughout Pt XVIII is consistent with that ordinary meaning."

53. Both *Memec* and *Esso* were concerned with particular types of dividend, rather than dividends of a generic nature, but in *First Nationwide v Revenue and Customs Commissioners* [2011] STC 1540 the Upper Tribunal (Warren J and Judge Sadler) did have to consider the meaning to be attached to the word

"dividend" in a more general sense, in the process examining what had been said in *Memec* and *Esso* (among other authorities). At [25] they observed that:

> "The payment of a dividend is commonly effected by the well-known mechanism of a declaration of dividend, followed by payment with a mandate or other form of information to shareholders which will express the payment to be a dividend in respect of the shares on which it is paid, and will specify the amount of dividend, the date on which it is paid, the accounting period in respect of which it is paid, and (at least in the case of a dividend paid on ordinary shares) whether it is an interim or a final dividend for the period in question."

54. That analysis made it clear that there was nothing to distinguish the meaning of a dividend in tax terms from its ordinary meaning in a company law context. The NNEL dividends, said Mr Peacock, satisfied the description offered in *First Nationwide*: they were paid out of distributable profits and there can be no reason to doubt that the payments represented dividends lawfully declared, that is out of distributable profits. There was no doubt that NNEL had sufficient distributable profits; so much was agreed between the experts and indeed recorded in the agreed statement of facts. HMRC's approach, in their statement of case, of limiting the meaning of dividends to "distributions of profits which have borne the tax for which credit is sought" is simply wrong, because it is necessary to identify what is, or is not, a dividend before moving on to consider what underlying tax attaches to it. The argument was, in any event, misplaced since the disputed underlying tax of £32,268,223 had been borne on the distributable profits of NNEL.

55. HMRC's further argument that, viewed realistically, the special dividend was not a dividend but the repayment of a loan was remarkable. It is difficult to imagine that, had the recipient of the dividend been a UK-resident corporation or individual, rather than a Hong Kong company, HMRC would have been willing to accept that the NNEL dividends represented a repayment of capital and not taxable income. The argument depended, not on a realistic view of the facts, but on HMRC's perception of economic equivalence. It has been established law since, at least, the unanimous decision of the House of Lords in *Bouch v Sproule* (1887) 12 App Cas 385 that the nature of a payment effecting a distribution is determined by the mechanism that a company employs to make it. The principle was restated by Moses LJ when the *First Nationwide* case reached the Court of Appeal ([2012] STC 1261 at 25]):

> "… United Kingdom law recognises only two species of payment in respect of shares: capital or income payments. Further, the jurisprudence establishes that it is the form by which the payments are made which determines their character."

56. The mechanism of distribution adopted in this case was the payment of a dividend. That payment had the character of income; it did not alter or diminish the shares by reference to which it was made, and therefore could not be regarded as a repayment of capital. The size of the dividend, large though it was by reference to the nominal value of the shares, did not affect that proposition. In *First Nationwide* 50,050 £1 redeemable preference were issued by a Cayman Islands company for a subscription price which included a premium of

£49,999,950. The shares carried the right to two dividends of £25,500,000 each, which (as Cayman Islands law permitted) could be paid only out of the company's share premium account. This tribunal, the Upper Tribunal and the Court of Appeal all concluded that the dividends represented income, even though the company did not have distributable profits from which the payments might have been made, and on any realistic view there had been nothing more than a payment into share premium account followed by a payment out again. It was the mechanism of payment which was determinative.

57. Here, NNEL had substantial distributable profits derived from a genuine trade that it had carried on. The statement in Mr Holgate's report that NNEL's distributable profits of £116,173,031, which had borne UK tax of £49,788,442, were reduced by the amount of the NNEL dividends was unchallenged. The NNEL dividends had all the hallmarks of dividends in the ordinary sense of that term, and should be treated accordingly.

58. It is not permissible, as HMRC seek to do, to re-characterise transactions because they are motivated by tax considerations or because they have been planned in advance. As Lord Hoffmann said in *Norglen Ltd v Reeds Rains Prudential Ltd* [1999] 2 AC 1, at 14, "It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loopholes." Rather, the correct approach to applying tax legislation to a particular set of facts is well-established and is encapsulated in the observation of Lord Walker in *Tower MCashback LLP1 v Revenue and Customs Commissioners* [2011] UKSC 19, [2011] 2 AC 457 at [67] that "the court is concerned to test the facts, realistically viewed, against the statutory context, purposively construed".

59. HMRC's attack upon the supposed circularity of the cash movements is likewise misconceived. First, there was no circularity in the sense relied upon by HMRC. The loans were all referable to the group relationship of the various companies. As NGP operates the central treasury function for the group it is to be expected that it will participate in the making and repayment of loans. It is commonplace for groups of companies to operate, in some respects, as if they were a single company and both tax and companies legislation caters for that eventuality. In addition, the loans which came into existence in the course of the transactions represented only a relatively minor part of the overall matrix of debts owed by one group company to another. In particular (as I have recorded above) NGP owed NNEL £0.8 billion, and at January 2006 NRL owed about £2 billion to NNEL. When set against those sums it can be seen that the debts created by the transactions were comparatively small.

60. Second, even if HMRC could demonstrate that the transactions were circular and, as they say, self-cancelling, it was irrelevant to their tax treatment. They cannot be simply re-characterised to reflect what HMRC say should be the tax treatment; the tax treatment follows the character of the transactions viewed realistically. So much is evident from various statements made in *Tower MCashback,* by Lord Walker at [77], by the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684, at [37] to [39] and [42]; and by Mummery LJ in *Mayes* v *Revenue and Customs Commissioners* [2011] STC 1269, at [74], [76], and [78].

61. Viewed realistically, the arrangements in this case amounted to the lawful payment of a dividend by a subsidiary to its parent. All of the relevant legislative and mechanical requirements were met. It was irrelevant that the subsidiary borrowed the money in order to finance the dividend since the source of the money actually used is immaterial; the only requirement is that NNEL had sufficient distributable reserves from which it could pay the dividends. In this case not only NNEL but all of the companies paying dividends had sufficient distributable profits out of which they could lawfully pay them; indeed, NNEL had distributable reserves profits in excess of £0.5 billion, comfortably more than was needed in order to pay a dividend of £75,292,521.

62. It was common ground between the experts the parties had instructed that the various companies had accounted correctly for the payments they had made and received. HMRC were right to say that NNEL had accounted for the preference dividends by treating the 99p per share element of that dividend as the repayment of a liability and the remainder as an interest expense. But nothing could be read into that accounting treatment.

63. Both NBL and NRL had adopted International Financial Reporting Standards ("IFRS") for the first time when they prepared their financial statements for the year ended 28 January 2006; they had previously followed UK GAAP (generally accepted accounting practice). NSL continued to use Hong Kong reporting standards. The guidance issued at the time by the Institute of Chartered Accountants in England and Wales to those companies moving from UK GAAP to IFRS made it clear that the accounting presentation of a transaction cannot affect its legal character. It is true that the presentation of a financial instrument should reflect its substance, but that requirement means no more than that the economic equivalence of the transaction must be recorded. Thus the form of a repo is the sale of a security for, say, £100 with an agreement to repurchase it later for £110. There is a genuine sale and a genuine repurchase. An accountant, however, would treat the transaction as a secured loan of £100, with a provision for the payment of £10 of interest. In order to avoid any doubt, legislation was introduced to ensure that such a transaction was taxed as if it were a secured loan: that is, the £10 is treated and taxed as notional interest. But the underlying transaction remains a sale followed by a repurchase.

64. It is uncontroversial that irredeemable preference shares, like other kinds of preference shares, may be economically equivalent to debt, but it does not follow that the shares and the dividend must be treated for tax purposes as if they were debt and repayment respectively. There was no deeming provision here, corresponding to that affecting repos, and consequently no ground on which the preference shares should be treated as debt rather than, as in form and reality they are, as equity. Some such legislation was introduced in 2009, but it cannot affect these transactions; at the relevant time there was no legislation which treated the preference shares as a debt instrument, or which treated the special dividends as the repayment of a loan or as an interest expense. In the absence of legislation requiring a transaction which, as a matter of form and reality, has one character to be treated as if it were of a different character it must be treated for what it is. The obligation is to look at the transaction, albeit realistically, and apply the tax legislation to it accordingly; it is not permissible to impose tax by reference to an

economically equivalent transaction. That was made clear by Lord Hoffmann in *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311 at [61]:

> "… a transaction which, for the avoidance of tax, has been structured to produce, say, capital, and does produce capital in the ordinary commercial sense of that concept … cannot be 're-characterised' as producing income."

65. The legal form reflects the reality that NNEL issued preference shares, and paid dividends on them. What Lord Hoffmann said in *MacNiven* makes it clear beyond argument that there is no possible ground for treating them for tax purposes as something other than what they were.

66. Once it is accepted that the NNEL dividends are to be treated as dividends, it becomes necessary to determine how the provisions of Part XVIII operate to determine what underlying tax may be taken into account. On this issue there are, said Mr Peacock, two areas of disagreement between the parties. The first lies in their differing approaches to the interaction of ss 799 and 801. NBL's case is that it is sufficient that tax has actually been paid by the third company—here, NNEL—and that, by virtue of the combined operation of the deeming provisions in s 801(1) and (2), it is treated as being "tax paid by the overseas company in respect of its profits" and then as "tax payable under the law of the territory in which the overseas company is resident". HMRC argue that there is an additional requirement, namely that the relevant profits of the overseas company (here, NSL) have been increased by the amount of the dividend received; and that there is a distinction to be made between "tax borne on the relevant profits" (the phrase used in s 799(1)) and the tax paid by the company paying the relevant dividend. The second point of disagreement lies in their approaches to the application of the formula in s 799.

67. Mr Peacock's starting point in respect of the first of those issues is that it is not in dispute, since s 790 so provides, that where a UK company receives a dividend from an overseas company of which either it or a parent controls at least 10 per cent the UK company is in principle permitted credit for underlying tax in respect of the dividend. Once such a dividend has been identified, s 799 is engaged. Subsection 799(1), unlike sub-s (1A), which was added by the Finance Act 2000, does not contain a formula, but it is uncontroversial that what it prescribes may be reduced to a formula to the effect that the underlying tax to be taken into account is equal to:

$$\text{Foreign Tax} \times \frac{\text{Dividend}}{\text{Relevant Profits}}$$

68. How that formula is to be applied was considered by the House of Lords in *Bowater Paper Corporation Limited v Murgatroyd* (1969) 46 TC 37. The question in that case was whether the figure for "relevant profits" should be based on the dividend-paying company's profits available for distribution or, instead, on the profits on which tax had been assessed, net of that tax. The House of Lords decided that it should be the former. That conclusion was consistent with the wording of sub-ss (3) and (4), which refer to profits of a period or periods, without reference to the incidence of tax on them.

69. Although s 799 indicates what proportion of the foreign tax is to be treated as underlying tax, it does not shed any light on what is to be treated as foreign tax, for which one must turn to s 801. In cases in which there have been a succession of dividends leading to an ultimate UK recipient it is necessary to start at the bottom and work one's way up, applying the s 799(1) formula and the s 799(2) mixer cap at each stage, save that the mixer cap does not apply, by virtue of sub-s (2A), if the paying and receiving companies are in the same territory. Appended to NBL's skeleton argument were several worked examples of the application of the rules in various cases, which I have found helpful, though I do not think it necessary to append them to this decision.

70. The statutory provisions need to be applied separately to the dividend paid by Cairns to NSL (see para 20(c) above) and to the NNEL dividends. NBL's case is that the process here is as follows.

71. Section 801(2A)(a) applies to the Cairns dividend, since both companies were resident in Hong Kong. Cairns' relevant profits for the purposes of the s 799 formula amounted to £1,992,059 in respect of which it had borne Hong Kong tax of £387,733 (see para 21 above). If that dividend had been paid by a company resident outside the UK to a company resident in the UK, the amount of underlying tax to be taken into account would simply be that given by section 799(1)(a):

$$\text{£387,733 (tax)} \quad \times \quad \frac{\text{£1,992,059 (dividend)}}{\text{£1,992,059 (relevant profit)}} \quad = \text{£387,733}$$

Section 801(2) treats this amount, £387,733, of underlying tax as tax paid by NSL in respect of its profits for the purposes of s 801(1).

72. Section 801(2A)(a) does not apply to the NNEL dividends. NNEL's relevant profits for the purposes of s 799 were £116,173,031, on which NNEL had borne UK corporation tax of £49,788,442 (see para 19 above). If the dividends had been paid by a company resident outside the UK to a company resident in the UK, the amount of underlying tax to be taken into account under s 799(1)(a) would be:

$$\text{£49,788,442 (tax)} \quad \times \quad \frac{\text{£75,292,521 (dividend)}}{\text{£116,173,031 (relevant profit)}} \quad = \text{£32,268,223}$$

73. One would ordinarily then apply the mixer cap, but in this case it would make no difference as the tax in question is UK corporation tax. Section 801(2) treats this amount, £32,268,223, of underlying tax as further tax paid by NSL in respect of its profits for the purposes of s 801(1).

74. The next step is to apply the statutory fiction in s 801(1) in combination with the deeming provisions of s 801(2). The underlying tax borne by Cairns and NNEL (£387,733 and £32,268,223 respectively) are treated, for the purpose of allowing credit against corporation tax in respect of the Case V dividend, as amounts of Hong Kong tax paid by NSL in respect of its profits. The result of so doing is that, in applying s 799, those two amounts of tax must be added to the Hong Kong tax that NSL had actually borne on its own relevant profits of £106,476,722, *ie* £13,239,492 (see para 22 above). The aggregate of those three

amounts was £45,895,448. Accordingly, said Mr Peacock, the amount of underlying tax to be taken into account under s 799(1)(a) was:

$$£45,895,448\ (\text{tax}) \times \frac{£106,476,722\ (\text{dividend})}{£106,476,722\ (\text{relevant profit})} = £45,895,448$$

75. Application of the mixer cap (I do not think it necessary for the purposes of this decision to set out the uncontroversial arithmetic) reduces this figure to £45,711,651, which is the amount claimed by NBL. If all those calculations are correct, the amount of the dividend actually paid, £106,476,722, must be grossed up by the underlying tax of £45,895,448 by virtue of s 795(2), so as to arrive at total Case V income of £152,372,170. That amount would give rise to a UK tax charge of £45,711,651, which would (if NBL's case is correct) be eliminated by the amount of the credit.

76. The remaining issue to be resolved rests in the difference between the parties about whether underlying tax is to be calculated by reference to tax borne on the relevant profits (HMRC's position) or simply on tax actually paid by the company paying the dividend (NBL's position). As the agreed statement of facts shows, NNEL's profits for the period from 1 February 2004 to 29 January 2005 were £116,173,031, on which it had paid UK corporation tax of £49,788,422. This, said Mr Peacock, was tax that NNEL had actually paid, and as a matter of principle credit should be given in respect of it. It is important to bear in mind, he said, that there is nothing in the legislation which restricts the tax which may be taken into account to that directly related to the profit recognised in the profit and loss account; tax payable on, for example, a held-over gain would be included in the calculation for the purposes of s799 of the "tax borne" for the period in which the gain crystallised. For those reasons HMRC's attempt to restrict the credit to the tax payable on the non-cumulative 6% pa dividend of £5,055 (see para 18(b)(ii) above) or on a small portion of the distributable profits (an argument with which I deal in connection with Mr Goldberg's submissions) was misconceived.

77. The legislation does not restrict the underlying tax for which credit may be taken, in a case in which there is a chain of dividends, by reference to the proportion of a dividend that is included in the profits of the recipient company higher up the chain. Instead, it looks at each stage at the proportion of distributable profit that has been paid up—that is, it is the paying company's perspective which matters. It is necessary to adopt that approach since the relieving provisions are not confined to wholly-owned subsidiaries, but extend to cases where there is a shareholding of as little as 10%. Accordingly, if a dividend carrying underlying tax increases the recipient company's tax liability, the amount of underlying tax which is available for relief higher up the chain is also increased. The extent of the underlying tax which may actually be taken into account is limited by reference to the proportion of its relevant profits which are paid out by the company paying the dividend: the appropriate proportion of the tax borne by the paying company is "attached" to the dividend. The fact that tax has been suffered on the profits is reflected in the amount available for distribution and therefore in the amount of the dividend. The purpose of the legislation is to provide a mechanism for allocating the tax that a company has borne on its profits between all its economic owners (provided they have at least a

10% interest), to the extent and in the proportions that distributable profits are paid up to them.

78. It should also be remembered, said Mr Peacock, that the legislative scheme is dependent upon the application of the statutory fictions set out in s 801. Those fictions treat UK or third country taxes payable in respect of an overseas company's profits as tax of that overseas company's jurisdiction and, in consequence, the tax in question has to be treated as tax borne on those profits for the purposes of s 799. There is nothing to be found in the legislation which limits the tax to be brought into the calculations to tax borne on the profit from which the relevant dividend—here, the Case V dividend—was paid. That can be seen from the use of the phrases "tax payable" and "tax paid" in s 801(1) and (2): those provisions define what is to be brought into account. Section 799, which does use the phrase "tax borne" is, as its title ("Computation of underlying tax") indicates, a provision prescribing the manner in which the amount of the underlying tax is to be determined: it is "so much of the foreign tax … as is properly attributable to the proportion of the relevant profits represented by the dividend". In undertaking that exercise it is plain that one must have regard only to the position of the payer.

79. The determination of the "proportion of the relevant profits" which is "represented by the dividend" is not an arcane matter, but a simple mathematical exercise by which the dividend is compared, as s 799(5) requires, to the "profits available for distribution" and which relate to the periods identified in sub-ss (3) and (4). The attribution must be proper, as s 799(1)(a) requires, but that means no more than that one must carry out a calculation to obtain a precise numerical answer. It is not possible to read any greater, or additional, requirement into the provision.

HMRC's case

80. Mr Goldberg's starting point was that when one traced the various payments through the participating companies, while bringing into the picture the tax which had actually been borne on the profits comprised in them, it could be seen that the reality was that £151,050 of profit which had borne UK tax of £64,735 was paid by NNEL to NSL, which mixed that profit with another £106,325,672 of profits which had not borne UK tax, and then returned the money to the UK as part of the Case V dividend with the consequence, according to NBL, that the £64,735 of tax actually borne by NNEL had been transformed into DTR of £32,268,223. Put in that way, he said, the claim seemed implausible, and as a matter of fact it was implausible and was rightly rejected.

81. He laid some emphasis on the accounting treatment of the transactions which the companies had adopted. Although the NNEL dividends had, as the accountants agreed and Mr Goldberg accepted, the legal form of dividends, NNEL accounted for them by treating £74,250,000 (equal to the premium it had received on the issue of the shares) of the total of £75,292,521 as the repayment of a borrowing and the balance of £1,042,521 as a financial cost. The larger amount was not treated as a reduction in net assets or retained earnings but was, instead, transferred from retained earnings to other reserves. In other words, that £74,250,000 was not derived from taxed profits.

82. Consistently with NNEL's approach, NSL (whose accounts were presented in US dollars) accounted for the receipt by taking only US$276,000 (equivalent to £159,000 at the time) to its income statement. That amount was as little as 0.13686481% of NNEL's after tax profits for 2005 of £116,173,031. The balance (about £75,133,521) was treated as a reduction in the cost to NSL of buying the irredeemable preference shares from NRL; it followed that none of that balance could be said to have contributed to NSL's distributable profits, from which the Case V dividend was derived. It is not disputed that the dividend paid by Cairns to NSL (equivalent to £1,992,059) distributed the entirety of Cairns' after-tax profits, which had borne Hong Kong tax equivalent to £387,333.

83. When it paid the Case V dividend, NSL had relevant profits, which had borne Hong Kong tax, in excess of the amount of that dividend; it distributed 95% of those profits. It followed from the manner in which it had accounted for the receipt of the NNEL dividends that no more than £159,000 can have contributed to the profits from which NSL paid the Case V dividend. As 95% of those profits were distributed, the contribution to the Case V dividend of the £159,000 amounted to no more than 95% of £159,000, or £151,050, and, therefore, £106,325,672 of the Case V dividend must have been paid out of Hong Kong profits which had borne Hong Kong, but not UK, tax. Hong Kong tax was charged at a significantly lower rate than UK corporation tax.

84. Thus a realistic view of the transactions shows that:

(a) the irredeemable preference shares were not issued to NRL or transferred to NSL to enable dividends to be paid by NNEL to NSL but in order that their cost could be written off in NSL;

(b) although NSL appeared to have received a large dividend, only £159,000 of it was added to its distributable profits;

(c) £74,250,000 of the cash used to pay the NNEL dividend was not derived from NNEL's taxed profits but was simply cash moved around within the group;

(d) although it is accepted that NNEL's retained earnings had borne UK tax, the characterisation in its accounts of that £74,250,000 as the repayment of a borrowing was inconsistent with the proposition that it was used in the payment of the NNEL dividend;

(e) only £151,050 (explained above) of the profits used by NSL to pay the Case V dividend had borne UK tax;

(f) the UK tax which had been so borne was no more than £64,375, which is 95% of 0.13686481% of the UK tax NNEL had paid, of £49,788,442; yet

(g) NBL claims that it should be entitled to credit of £32,268,223 for tax actually paid of £64,375.

85. HMRC do not dispute that the Cairns dividend carried with it the benefit of underlying tax of £387,333, or that the Case V dividend carried with it the benefit of underlying tax calculated by reference to all of the tax actually paid by Cairns and NSL. They say that there is a fundamental difference between the NNEL

dividend on the one hand and the Cairns dividend and Case V dividend on the other in that, while only £159,000 of the NNEL dividend of £75,292,521 features in NSL's income statement, the Cairns dividend and the Case V dividend feature in full in their recipients' income statements. They were conventional dividends paid out of distributable profits. The NNEL dividend, by contrast, derived from an issue of shares followed by, as was the sole purpose of issuing them, their being written down.

86. It was not a material consideration that the NNEL dividends were dividends in company law terms. The accounting treatment adopted meant that, rather than being used in paying the dividend to NSL, NNEL's retained earnings were not distributed but were simply moved sideways within NNEL to "other reserves", and similarly NSL treated the bulk of what it received as a capital item and not an accretion to profit. The accountants were agreed that this was the correct accounting treatment, since it reflected the substance of what the companies had done, and the fact that the issue of preference shares is equivalent to taking on a debt. Thus although the NNEL dividend was a dividend, it was not a dividend within the contemplation of, or which engaged, the provisions of Part XVIII.

87. It is not permissible, said Mr Goldberg, to attribute receipts and payments, in a company's accounts, in a manner which has a practical effect on the amount of its distributable reserves, but argue for a different attribution for tax purposes: see *Chancery Lane Safe Deposit and Offices Co Ltd v Inland Revenue Commissioners* [1966] AC 85. In that case the taxpayer company borrowed money to pay for the rebuilding of its trading premises. On the advice of its auditors it charged part of the interest payments to capital in its accounts, even though there were profits in the relevant years out of which that part of the interest might have been paid. The company was assessed to tax on the ground that the portion of interest that was debited to capital account was in fact paid out of capital and not out of profits and gains brought into charge to tax. The company claimed that the relevant sums had been paid out of taxed income, although charged to capital in the accounts. The House of Lords decided, albeit by a majority, that as the company, by its own free choice, had made a deliberate attribution, having practical effects, of the interest to capital it was precluded from subsequently making an inconsistent attribution for tax purposes and could not treat a payment actually made out of capital as notionally made out of income.

88. The position here, said Mr Goldberg, was the same: the companies had treated the bulk of the NNEL dividends as capital payments and receipts, they had been correct to do so, the accounting treatment had an effect on the level of NSL's distributable profits, and it was not open to NBL to claim that, nevertheless, it was entitled to credit for underlying tax which had not been borne by the profits out of which the Case V dividend was paid.

89. That conclusion, Mr Goldberg added, was consistent with the plain purpose of DTR, namely to prevent the same profit, or what is in substance the same profit, from being taxed twice. The legislation works, in the case of a chain of dividends paid by subsidiaries to their parents (or, more precisely, companies having at least a 10% shareholding) by treating the tax paid by a company at the bottom of the chain as tax paid by a company higher up it. But this treatment

assumes for its operation that the dividends passing up the chain are derived from profits which have borne the tax for which credit is claimed; it is an assumption which respects the symmetry to which the Supreme Court referred, even if in respect of a different legislative provision, in *DCC Holdings (UK) Ltd v Revenue and Customs Commissioners* [2011] STC 326. It is why NBL can claim credit for tax paid by Cairns and by NSL, but not for the greater part of the tax paid by NNEL.

90. The calculation of the underlying tax attributable to the NNEL dividend, reflecting the amount of that dividend which was actually derived from distributable profits rather than the whole amount paid, is properly:

$$\text{£}49{,}788{,}442 \text{ (tax)} \times \frac{\text{£}159{,}000 \text{ (from profit)}}{\text{£}116{,}173{,}031 \text{ (relevant profit)}} = \text{£}68{,}142$$

That calculation, Mr Goldberg said, is one which respects the purpose of the legislation by taking, in the numerator, only the element which has borne tax, and relieving that rather than some other amount which bears no relation to the tax actually borne.

91. One can, he added, arrive at the same answer by an examination of the wording used in ICTA s 790(6). It applied in a case in which "… a dividend paid by a company resident in the territory is paid to a company ...". The inference to be drawn from that phrase is that the dividend to be taken into account by the recipient company must be of the same amount as is said to have been paid by the payer. In this case the payer, NNEL, says it has paid a dividend of £75,292,521 although, for accounts purposes, it has treated £74,250,000 of it as the repayment a loan. Consistently with that treatment, the recipient, NSL, says it has received, as income, only £159,000. The only dividend within the scope of the DTR provisions which can realistically be said to have been paid by NNEL to NSL is £159,000. The balance of £75,133,521 is not, in relation to NSL, a dividend within the meaning of s 790(6) even though it may be a dividend for some or all other purposes.

92. In addition, the wording of ICTA s 799(1) shows that what the legislation is looking at is profits which have borne tax, and not merely the nominal amount of the dividend. The relevant part of the subsection is:

> "… the tax to be taken into account … shall be so much of the foreign tax borne on the relevant profits by the body corporate paying the dividend as
>
> (a) is properly attributable to the proportion of the relevant profits represented by the dividend …."

93. If one applies that provision to the NNEL dividends it becomes clear from the manner in which the accounting entries were made that the proportion of the tax borne by NNEL which is to be taken into account by NSL, and passed on to NBL by operation of s 801, cannot represent more than 0.13686481% of that tax, because it is only that proportion of NNEL's relevant profits which features in the relevant profits of NSL: a dividend cannot represent, in the recipient's hands, more than it contributes to the recipient's relevant profits, nor can it represent more of the payer's relevant profits than were actually used in paying it. It is an

impossible proposition that, by operation of the statutory provisions, NSL is to be treated as having borne tax of £45,895,448 on an income receipt of £159,000.

Discussion and conclusions

94. Mr Peacock's starting point was that, because the NNEL dividends had the form of dividends in company law terms, they must be treated for all purposes as dividends. Even if that is correct as a proposition, it does not seem to me to be a decisive point because, although the DTR provisions refer to and are engaged by the payment of dividends, the extracts from the legislation which I have set out show, by their repeated references to income, gains and profits, that they mean dividends representing the payment of profit, and not dividends with some other purpose. I shall develop this point further at a later stage.

95. The experts' agreement that accounting entries should reflect the substance of a transaction rather than its legal form where the two differ is, I think, uncontroversial. What is significant, in my view, is that they also agree that, whatever the legal form of the NNEL dividend, the greater part of it represented, in substance, not a payment out of distributable profits but the repayment of a loan. I agree with Mr Goldberg that the accounting entries cannot be treated as merely accounting entries with no great consequence; as he said, the relevant money was moved to "other reserves" and therefore ceased to be, if ever it was, money available for distribution. In this context an observation of Lord Wilberforce in the *Chancery Lane Safe Deposit* case, to which as it happens Mr Peacock referred me, seems to be in point. At p 137 he said:

> "Here the company has done more than merely to produce accounts of a domestic character: it has made a decision—and if the adjective adds anything it was certainly a deliberate decision—to charge part of the interest to a capital account. This had, as no doubt it was intended to have, the practical effect of not charging current revenue with expenditure which might properly be considered as of a capital character. The effect of so doing was to affect the amount brought in by the company to its account of distributable profits and, ultimately, the balance to the credit of its profit and loss account. What binds the company in these circumstances is not its accounts as such but the decision, recorded in the accounts, to charge the interest in this way with this result."

96. It does not seem to me, in the light of that observation, that it is permissible for NBL to say that the facts that the transaction was in substance the repayment of a debt, was accounted for accordingly by both payer and recipient, and had consequential effects in the presentation of their respective financial standing, should all be disregarded because the payment had the form of a dividend. The accounts treated the payment for what it truly was, and it is in my view clear from what was said by the majority in *Chancery Lane Safe Deposit* that it is not open to NBL to argue that, for tax purposes, it should be treated as something else, namely a distribution of profit. Thus I agree with Mr Goldberg's proposition, odd though it seems at first sight, that the NNEL dividend was the "wrong kind of dividend".

97. Even if Mr Peacock is right that it is immaterial how a dividend is treated for accounting purposes, I also agree with Mr Goldberg that the legislation, when

properly construed and applied to the facts of this case, does not lead to the result for which NBL contends. Mr Peacock's arguments simply assume that, because the NNEL dividends were declared as dividends and the board had satisfied itself that NNEL had sufficient distributable profits at that time, it followed, without more, that the dividends amounted to a distribution of those profits. The argument disregards what is said by ICTA s 799(1), namely that

> "the tax to be taken into account … shall be so much of the foreign tax borne on the relevant profits by the body corporate paying the dividend as
>
> (a) is properly attributable to the proportion of the relevant profits represented by the dividend …."

98. I do not consider that it is enough for DTR to be available to a company higher up the chain that the paying company, in this case NNEL, has distributable profits which have borne tax and that it has paid a dividend; it must be shown that the dividend is derived from the profits. Here, NNEL's own accounting treatment of the transactions undermined the proposition that there was such a derivation. Mr Peacock attempted to counter that difficulty by pointing to observations made by Viscount Dilhorne in *Tuck v National Freight Corporation* [1979] 1 WLR 37 at 47 in which he criticised the phrase "properly attributable", in another context, as an imprecise use of language from which it was difficult to derive a meaning. I am not persuaded that there is any such difficulty here. Attribution is a concept familiar to any tax lawyer, and it is in my view clear that the draftsman of s 799 intended that relief should be available for tax which had been borne on profits used for the purpose of paying a dividend. That is an interpretation entirely consistent with the purpose of Part XVIII, to avoid double taxation. If Mr Peacock is right, there would be only a casual connection between tax actually borne and the relief.

99. It might be said that this is little more than the accounting argument put in a different way, but the point assumes greater significance when one comes to NSL. For convenience I set out ICTA s 801(2) again:

> "Where the overseas company has received a dividend from a third company and the third company is related to the overseas company, then … there shall be treated for the purposes of subsection (1) above as tax paid by the overseas company in respect of its profits any underlying tax payable by the third company, to the extent that it would be taken into account under this Part if the dividend had been paid by a company resident outside the United Kingdom to a company resident in the United Kingdom and arrangements had provided for underlying tax to be taken into account."

100. It is apparent from its wording that the subsection contains the mechanism for determining what is to be treated as "tax paid by the overseas company in respect of its profits". Mr Peacock's argument, in essence, is that (and assuming for this purpose that the NNEL dividends did carry with them the amount of underlying tax for which he contends) all of that tax is to be treated as "tax paid by the overseas company in respect of its profits" regardless of the fact that, save for £159,000, the dividend made no contribution to those profits. That, in my judgment, is not a mere accounting point: NSL treated the greater part of what it received as the repayment of a loan, and brought only the £159,000 into the pool of distributable profits which were available for paying the Case V dividend.

101. If I am right about the interpretation of s 799(1), the question is not whether the payment took the form of a dividend, or even whether it had the character of income or capital (although the latter may be a material evidential factor), but whether the payment was of profits which have borne tax. The flaw in Mr Peacock's argument, as I see it, lies in his claim (see para 54 above) that the NNEL dividends were paid out of distributable profits which had borne tax. The available evidence, NNEL's own accounts, is to the contrary. Once it is recognised that, save for the modest amount which HMRC accept, very little UK tax had been borne on the money utilised for the payment of the NNEL dividends there is no difficulty in applying the statutory formula to the true amount of tax and arriving at the answer for which HMRC, in my view correctly, contend.

102. Even if Mr Peacock is right about NNEL, in that it is sufficient that (whatever the accounting treatment) the dividend had the effect of reducing the amount available for distribution, the argument cannot hold good for NSL which, however one views the matter, did not utilise the bulk of the NNEL dividend for the purpose of paying the Case V dividend. Section 799(1) requires one to have regard to "the proportion of the relevant profits represented by the dividend" (the relevant profits being the profits available for distribution of NSL as shown in its accounts: see s 799(5) and (6)), and then to the tax borne on those profits. Save to the limited extent already described, the Case V dividend did not represent profits transferred from NNEL, but the distributable profits earned by NSL and Cairns from their own trading activities, as shown in their accounts. Those profits had borne only Hong Kong tax.

103. In my judgment, save for the sums which HMRC accept to be properly due, the statutory requirements providing for DTR are not met and NBL's claim is ill-founded.

104. The appeal is, therefore, dismissed.

105. 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.

COLIN BISHOPP
TRIBUNAL JUDGE

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