Neutral Citation Number: [2016] EWCA Civ 376

Case No: A3/2014/0511 & A3/2015/1006

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
(Chancery Division)
Mr Justice Henderson
[2013] EWHC 3249 (Ch) & [2015] EWHC 118 (Ch)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 19/04/2016

Before :

LORD JUSTICE LEWISON
LORD JUSTICE CHRISTOPHER CLARKE
and
LORD JUSTICE SALES

- -

Between:

The Prudential Assurance Company Limited	**Respondent**
- and -	
Commissioners for Her Majesty's Revenue and Customs	**Appellants**

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- -

David Ewart QC, Rupert Baldry QC, Andrew Burrows QC (Hon) and Barbara Belgrano (instructed by **HM Revenue and Customs Solicitor's Office**) for the **Appellants**
Graham Aaronson QC, Tom Beazley QC and Jonathan Bremner (instructed by **Joseph Hage Aaronson LLP**) for the **Respondent**

Hearing dates: 11/03/2016 to 18/03/2016

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Approved Judgment

Lord Justice Lewison:

Introduction

1. This is the judgment of the court, to which all three of us have contributed.

2. The issues on this appeal all relate to what have been called “portfolio holdings”; that is to say dividends paid on shares in foreign companies held as investments, where the investor holds less than 10 per cent of the voting power in the company in question.

3. Article 56 of the EC Treaty (now article 63 of the Treaty on the Functioning of the European Union) prohibits “all restrictions on the movement of capital between Member States and between Member States and third countries”; and also prohibits “all restrictions on payments between Member States and between Member States and third countries.” It is now established by decisions of the ECJ and CJEU (to which we refer indiscriminately as the CJEU) that the UK’s tax treatment of dividends received by UK companies was in breach of that article, and hence unlawful, to the extent that it discriminated between dividends paid by UK companies and dividends paid by foreign companies. Although it will be necessary to return to some of the details in due course, in very broad (and oversimplified) outline the position under EU law is as follows.

4. In (Case C-446/04) *Test Claimants in the FII Group Litigation* [2012] 2 AC 436 (“*FII (ECJ) I*”) the CJEU ruled that UK legislation which (a) exempted nationally sourced portfolio dividends from corporation tax, but (b) subjected foreign sourced dividends to that tax and allowed credit for no more than withholding tax levied by the state in which the paying company was resident amounted to an unjustified restriction on the freedom of establishment prohibited by article 43 EC and also on the movement of capital prohibited by article 56 EC. The illegality would be cured if the member state granted the company receiving the foreign dividend a tax credit for the “amount actually paid” by the company making the distribution in the state in which the distributing company is resident. In its reasoned order of 23 April 2008 the CJEU ruled that the rate of tax applied to foreign-sourced dividends must be no higher than the rate of tax applied to nationally-sourced dividends; and the tax credit must be at least equal to the amount paid in the member state of the company making the distribution, up to the limit of the tax charged in the member state of the company receiving the dividend. In principle the same applies to dividends received by an insurance company. Underlying both decisions was a factual assumption that nominal rates of tax and effective rates of tax were the same save in exceptional circumstances.

5. Where a member state unlawfully levies tax in breach of EU law the taxpayer has a right to recover the amount unlawfully levied: *Amministrazione delle Finanze dello Stato v SpA San Giorgio* (Case 199/82) [1983] ECR 3595, [1985] 2 CMLR 658 at [12]. Such a claim is often known in the jargon as a *San Giorgio* claim. The claimant in the current action, The Prudential Assurance Company Ltd (“Prudential”), advances such a claim.

6. Since the CJEU gave its rulings the domestic courts have been trying, with varying degrees of success, to work out what it decided and how its decisions should be applied.

This litigation

7. Prudential issued its claim form on 8 April 2003; so this litigation has now been going on for over 13 years. Whether the final end is in sight after all this time remains to be seen. However, in view of some of the issues that have been debated on this appeal it is necessary to recapitulate some of the course of the litigation. A Group Litigation Order ("GLO") was first made on 30 July 2003; and it has since been amended on a number of occasions. Park J was the first of the management judges appointed under the GLO.

8. When Park J made his order for directions on 12 December 2003 it was envisaged that a trial of the issues would take place for 10-15 days early in 2004. One of the issues that he ordered to be determined at the trial was described in his order as "quantum". He did however envisage that there would be two stages, because paragraph 3.4 and 3.5 of his order provided:

> "3.4 The trials of all test claims are to be heard together.
>
> 3.5 Save for the quantification of the amount of damages and compensation or restitution all issues in the test claims including liability for restitution shall be heard together…. The parties have liberty to apply for directions for the determination of any matters which remain in contention regarding the quantification of the amount of damages and compensation … following the trial of the test claims."

9. The precise difference between "quantum" which was to be determined at stage one and "quantification" which was to be determined at stage two was not defined further. Although the trial began on 24 January 2005 it was overtaken by an order for a reference to the CJEU in March 2005 for a decision on preliminary issues. The national proceedings were stayed in the meantime. Three years later, on 23 April 2008, the CJEU gave its decision on the preliminary issues by way of a reasoned order. Armed with the answers to the preliminary issues, the case returned to the Chancery Division; and on 5 November 2008 Henderson J gave directions for trial. Those directions included (a) the grant of permission to HMRC to serve an amended Defence (b) disclosure (c) directions for the exchange of evidence and (d) an envisaged trial date in the summer or autumn of 2009. Further directions for amended statements of case were given on 12 March 2009, with further directions for disclosure and exchange of evidence. The trial took place on 18 and 19 November 2009.

10. However before judgment could be delivered, on 23 February 2010 the Court of Appeal handed down its judgment in *Test Claimants in the FII Group Litigation v HMRC* [2010] EWCA Civ 103 ("*FII (CA)")* which necessitated a delay in the finalisation of the judge's judgment and a resumption of the trial. Henderson J's order of 29 March 2010 ordered the trial to be resumed on 20 May 2010, and gave directions for further submissions. Although the trial resumed on that day, it was adjourned yet again. The decision of the Court of Appeal went on appeal to the Supreme Court, which handed down its own judgment on 23 May 2012 ([2013] UKSC 19, [2013] 2 AC 337). The Supreme Court found it necessary to make a further reference to the CJEU. The CJEU gave a ruling in (Case C-35/11) *Test Claimants in*

the FII Group Litigation v HMRC on 13 November 2012 ("*FII (ECJ) II"*); and the case came back before Henderson J. On 20 December 2012 Henderson J gave further directions for trial, this time to begin on the earliest date after 4 March 2013. He also gave directions about the exchange of yet further witness statements and for the agreement of a list of issues. The trial finally resumed on 15 July 2013, over 10 years after the claim form had been issued, and after two trips to Europe and an outing in the Supreme Court. Since the judge's judgment in the present case the CJEU has delivered a third ruling.

11. Henderson J's judgment is a masterpiece of exposition and reasoning. It contains a comprehensive analysis of all the issues canvassed before him. He now has more experience of the interaction between EU law and the interstices of the UK system of taxation than anyone else; and his views are entitled to great weight. A previous judgment of his in a related action was described in this court as a *tour de force*. This one deserves the same accolade. It is to be found at [2013] EWHC 3249 (Ch), [2014] STC 1236. This is the main judgment under appeal, which is to be read with the consequential judgment on relief at [2015] EWHC 118 (Ch) ("the Second Judgment").

12. There is one important feature of the litigation (apart from the inordinate length which it has taken) which is contrary to the usual practice. Although Prudential pleaded a claim in its Particulars of Claim (subsequently amended to introduce a claim relating to advance corporation tax ("ACT")) it did so only in very general terms without any of the factual allegations that one would expect in more conventional litigation. Equally, although HMRC pleaded a defence, it too did so in very general terms. In both cases important matters of contention were simply not identified in the pleadings, so that anyone reading them would have had very little idea about what was actually in issue. Very surprisingly, although HMRC pleaded that the claims were statute-barred by the Limitation Act 1980, Prudential did not serve a Reply raising any countervailing argument, despite the fact that it apparently wished to assert that the limitation period had been extended under section 32 (1)(c) of the Act as a result of its mistake. One might have gathered inferentially from HMRC's defence that section 32(1)(c) was potentially in play, but the reader would have had no idea when Prudential discovered the mistake on which it relied; and there was certainly no indication that HMRC might wish to argue that Prudential could with reasonable diligence have discovered the mistake earlier than it in fact did. This would simply have been unacceptable in ordinary litigation; and we cannot see why it should have been any different in the present case. Although the parties did agree a list of issues, these too were framed in very general terms. To take one example, under the heading "Remedies" one of the issues was:

> "Is there a restitutionary defence available – e.g. defence of change of position, passing on, "fiscal chaos" and, if so, are the requirements of any such defence fulfilled and to what extent."

13. The framing of this issue leaves these questions at large, with no asserted factual foundation on which these defences might rest, and no indication of what either side would argue on the question posed. Moreover the "e.g." raises the possibility that other defences might be raised.

14. The justification for this approach was, we were told, the observations of Lord Woolf in *Boake Allen Ltd v HMRC* [2007] UKHL 25, [2007] 1 WLR 1386. This was another case, conducted under a GLO, which explored the ramifications of the decision of the ECJ in the *Hoechst* case ((Joined Cases C-397 and 410/98) *Metallgesellschaft Ltd v IRC, Hoechst AG v IRC* [2001] Ch 620). Park J had decided the substantive legal point against the claimants, but had also decided a point relating to the amendment of pleadings in their favour. The claimants appealed on the substantive point to the Court of Appeal ([2006] EWCA Civ 25, [2006] STC 606); and HMRC cross-appealed on the pleading point. The claimants' appeal failed but HMRC's cross-appeal succeeded. In dealing with the cross-appeal Mummery LJ said at [131]:

> "While it is good sense not to be pernickety about pleadings, the basic requirement that material facts should be pleaded is there for a good reason—so that the other side can respond to the pleaded case by way of admission or denial of facts, thereby defining the issues for decision for the benefit of the parties and the court. Proper pleading of the material facts is essential for the orderly progress of the case and for its sound determination. The definition of the issues has an impact on such important matters as disclosure of relevant documents and the relevant oral evidence to be adduced at trial. In my view, the fact that the nature of the grievance may be obvious to the respondent or that the respondent can ask for further information to be supplied by the claimant are not normally valid excuses for a claimant's failure to formulate and serve a properly pleaded case setting out the material facts in support of the cause of action. If the pleading has to be amended, it is reasonable that the party, who has not complied with well-known pleading requirements, should suffer the consequences with regard to such matters as limitation."

15. The claimants appealed again to the House of Lords. The cross-appeal was not before the House; with the consequence that Lord Woolf's observations on procedure were obiter. Moreover none of their Lordships expressly associated themselves with what he said. Lord Woolf's concern was to minimise the costs for individual claimants litigating under a GLO. At [31] he said:

> "All litigants are entitled to be protected from incurring unnecessary costs. This is the objective of the GLO regime. Primarily, it seeks to achieve its objective, so far as this is possible, by reducing the number of steps litigants, who have a common interest, have to take individually to establish their rights and instead enables them to be taken collectively as part of a GLO Group. This means that irrespective of the number of individuals in the group each procedural step in the actions need only be taken once. This is of benefit not only to members of the group, but also those against whom proceedings are brought."

16. This does not suggest that basic steps in litigation may be ignored or not taken at all. All that Lord Woolf was saying was that the steps in question need only be taken

once, collectively, on behalf of all members of the group, rather than being taken by each litigant individually. It was in that context that he said at [33] that:

> "In the context of a GLO, a claim form need be no more than the simplest of documents."

17. Moreover, Lord Woolf was speaking of a claim form; not of Particulars of Claim or, indeed, of the Defence. In the previous paragraph of his speech he had drawn attention to the case management powers available to the court. These now include in PD 19B para 14 powers relating to Particulars of Claim. Paragraph 14.1 reads:

> "The management court may direct that the GLO claimants serve 'Group Particulars of Claim' which set out the various claims of all the claimants on the Group Register at the time the particulars are filed. Such particulars of claim will usually contain –
>
> (1) general allegations relating to all claims; and
>
> (2) a schedule containing entries relating to each individual claim specifying which of the general allegations are relied on and any specific facts relevant to the claimant."

18. This paragraph plainly envisages that Particulars of Claim will be served. Particulars of Claim must comply with CPR Part 16. If the claim is made under Part 8 rather than under Part 7, then the rules require relevant evidence to be served when the claimant makes his claim. Either way, relevant facts must in our view be pleaded. If they are facts generally applicable to all claimants, they may be pleaded in Group Particulars of Claim; if they are specific to a particular claimant they may be set out in a schedule. If the claim is made under Part 8, they must be contained in a witness statement. By the same token any relevant defence must also be pleaded. Indeed CPR Part 19 and the accompanying Practice Direction contain no special provisions relating to the defence; so the usual rules apply.

19. Finally, on this point, while Lord Woolf's observations were obiter, the decision of the Court of Appeal (which was not appealed to the House of Lords) is binding on us as regards the subject matter of the cross-appeal. Henderson J was right so to hold in *Europcar UK Ltd v HMRC* [2008] EWHC 1363 (Ch), [2008] STC 2751.

20. Although the underlying claims depend on EU law, procedural questions are (at least in general) governed by national law. Our procedural system is and remains an adversarial one. It is for the parties (subject to the control of the court) to define the issues on which the court is invited to adjudicate. This function is the purpose of statements of case. The setting out of a party's case in a statement of case enables the other party to know what points are in issue, what documents to disclose, what evidence to call and how to prepare for trial. It is inimical to a fair hearing that a party should be exposed to issues and arguments of which he has had no fair warning. If a party wishes to raise a new point, he should do so by amending a statement of case. We were told that by the time that skeleton arguments for trial were served each party would know what points were in issue. We do not regard that as sufficient. In this case, for example, HMRC's skeleton argument was served about 10 days before the

trial started. If (as in fact happened in this case) HMRC wished to argue that the evidence proposed to be called by Prudential was directed at the wrong issue (being an issue that had not been raised before) 10 days' prior notice was manifestly inadequate.

21. Although in days gone by the court would routinely allow late amendments to statements of case, in more recent time attitudes have changed. It is now the case that the court requires strong justification for a late amendment. This is not only in the interest of the opposing party but also consonant with the interests of other litigants in other cases before the court and the court's duty to allocate a proportionate share of the court's resources to any particular case. Where a new issue arises which is not foreshadowed in a statement of case, a party needs the court's permission to advance it. The court is then faced with a discretionary case management decision, to be exercised in accordance with the overriding objective.

22. As Mr Ewart QC for HMRC opened the appeal to us it soon became clear that the lack of pleadings meant that the parties disagreed about what was the scope of the trial; what were the issues that the judge had to decide; whether points had or had not been raised; whether or not they could be raised on appeal; and even what the judge had decided. This is no way to conduct litigation involving millions of pounds. We were told that this unacceptably cavalier approach to pleadings was a common feature of this kind of litigation. It must stop.

23. In our procedural law a trial is intended to be the final resolution of all matters in dispute between the parties. Although a party who is dissatisfied with the outcome of a trial may appeal to this court (usually with permission) the appellate process is, in general, limited to a review of the first instance decision. It is thus the starting point that parties are expected to put before the trial judge all questions both of fact and of law upon which they wish to have an adjudication.

24. There are a number of reasons for this. First, parties to litigation are entitled to know where they stand and to tailor their expenditure and efforts in dealing with (and only with) what is known to be in dispute: *Jones v MBNA International Bank* [2000] EWCA Civ 514. Second, it is a disproportionate allocation of court resources for the Court of Appeal (which usually sits in panels of three judges) to consider for the first time a point which could have been considered, and correctly answered, by a single judge at first instance. Moreover if the Court of Appeal deals with a point for the first time, it is neither a review nor a *re*hearing; which are the two processes contemplated by the CPR. Third, if resolution of a new point entails the re-opening of the trial it not only entails inevitable further delay, which is itself a reproach to the administration of justice, but is also wasteful of both the parties' and the court's resources and unfair to a party who conducted a trial on what has turned out to be a false basis. Fourth, there is a general public interest in the finality of litigation. It is for similar reasons that the Court of Appeal applies stringent criteria for the reception of fresh evidence on appeal.

25. If the point is a pure point of law, and especially where the point of law goes to the jurisdiction of the court, an appeal court may permit it to be taken for the first time on appeal. But where the point, if successful, would require further findings of fact to be made it is a very rare case indeed in which an appeal court would permit the point to

be taken. In addition before an appeal court permits a new point to be taken, it will require a cogent explanation of the omission to take the point below.

26. These points are discussed more fully in *Crane v Sky-in-Home Ltd* [2008] EWCA Civ 978.

27. Until very recently in deciding whether or not to grant permission to appeal the Court of Appeal heard only from the would-be appellant. Partly for that reason the mere fact that permission to appeal has been granted on a particular point does not prevent the respondent from objecting that the point on which permission has been granted is a new point which the appellant ought not to be able to advance for the first time on appeal: *Mullarkey v Broad* [2009] EWCA Civ 2 at [29].

28. In consequence of the lack of any formal statements of case which adequately defined the issues for trial we had to spend the first day and a half of this appeal deciding what points were open to HMRC to argue. At the conclusion of that part of the argument we excluded from the scope of the appeal a number of issues which in our judgment fell into one or more of the following groups:

i) They were wholly new issues;

ii) They were issues which HMRC tried to ventilate before the judge, but he refused on the ground that they were raised too late;

iii) They were issues which would have required further facts to be found;

iv) They were unpleaded issues which ought to have been pleaded.

29. We will refer to some of them in due course.

ACT and corporation tax

30. The judge gave a comprehensive description of the relevant features of the system of corporation tax in force at the time to which the claims relate in his judgment in *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2008] EWHC 2893 (Ch), [2009] STC 254. It is not necessary, for the purposes of this appeal, to do more than describe the bare outlines. When a UK-resident company paid a dividend to its shareholders it had to pay an amount of ACT to the Revenue. The rate of ACT was initially linked to the basic rate of income tax, and subsequently the lower rate. Individual shareholders were liable to income tax on dividends received. Their liability arose under Schedule F. However, the ACT paid by the company was "imputed" to the shareholders. What this meant was that the measure of the shareholder's income for tax purposes was the aggregate of the dividend plus the ACT which the company had paid to the Revenue; but the shareholder was entitled to a tax credit for the amount of the ACT that had been imputed to him in this way. That tax credit went to reduce his own liability to tax. In some cases the procedure might result in the Revenue making a payment to the claimant.

31. A UK-resident company receiving a dividend from another UK-resident company was not subject to corporation tax on the dividend. However, the paying company would itself have had to pay ACT. ACT paid could in principle be set against a company's corporation tax liability on its profits for the relevant accounting period (known as

"mainstream corporation tax" or MCT). Thus the recipient company received a tax credit which could be used to eliminate or reduce its own ACT liability in respect of distributions made by it to its own shareholders. The sum of the distribution and the tax credit was called "franked investment income" or FII. However, ACT became "surplus" where a company's corporation tax liability was insufficient to allow set-off. In the case of a holding company whose income was made up largely of dividends from UK companies (which were not subject to corporation tax) this might well happen. Surplus ACT could be carried forward or back by the company and could be surrendered to a company's UK-resident subsidiaries where they had a sufficient UK corporation tax liability to allow set-off. So in the case of a holding company receiving dividends from its subsidiary trading companies, the likelihood was that the holding company (which did not pay corporation tax) would surrender its surplus ACT to its trading subsidiaries, which did. The object of this system was to relieve economic double taxation (that is taxing the same stream of income twice even though it changed its character from profits to dividends).

32. However, a UK-resident company receiving a dividend from a non-resident company was subject to corporation tax on the dividend. This tax was charged under Case V of Schedule D, and the dividend received from the non-resident company did not qualify as FII. The recipient company was nevertheless entitled to some relief against economic double taxation. Such relief was given either unilaterally under domestic rules or under double taxation conventions entered into with other countries. The unilateral arrangements provided for the crediting against a company's UK corporation tax liability of withholding taxes paid on foreign dividends. The recipient company did not receive a tax credit on such dividends which could be used to eliminate or reduce the ACT payable on distributions made to its shareholders.

33. Life insurance companies, like Prudential, are subject to bespoke taxation rules. Henderson J described them, but since nothing now turns on differences between the taxation of insurance companies and the taxation of other companies, we do not need to repeat that description.

The illegality of the UK tax system

34. In (Case C-446/04) *FII (ECJ) I* the CJEU ruled that the UK legislation was illegal under EU law. In a number of different rulings it has tried to describe the nature of the illegality of the UK system and that of other member states. The general principle is that the freedoms of movement guaranteed by the TFEU preclude a member state from treating foreign-sourced dividends less favourably than nationally-sourced dividends, unless such a difference in treatment concerns situations which are not objectively comparable or is justified by overriding reasons in the general interest. Provided that a member state complies with that principle it has a measure of discretion in how it tackles the problem of eliminating economic double taxation.

35. The general principle just stated is the principle of equivalence, which pervades EU law. But in addition to that principle EU law recognises another all-pervading principle, namely the principle of effectiveness. This principle, in short, is that the vindication of rights granted by EU law must be neither practically impossible nor excessively difficult.

36. As the judge said at [84] it is necessary to understand in what respects the UK system was illegal in order to decide what the appropriate remedy is. This task is not made easier by the different ways in which the CJEU has expressed itself.

37. In the *FII (ECJ) I* the CJEU gave a number of important rulings, which the judge correctly summarised at [31] to [33]. We quote those paragraphs:

> "[31] …First, whatever mechanism a member state chooses to adopt in order to prevent or mitigate economic double taxation, the Treaty freedoms of movement prohibit treating foreign-sourced dividends less favourably than nationally sourced dividends, unless the less favourable treatment either (a) concerns situations which are not objectively comparable, or (b) is justified by overriding reasons in the general interest.
>
> [32] Secondly, there is no reason in principle why a member state should not operate a dual system (of exemption for national dividends and imputation for foreign dividends, as in the UK at the material time), provided that:
>
> (a) the member state does not impose a higher rate of tax on foreign dividends than it does on national dividends; and
>
> (b) it gives a credit for the amount of tax paid by the foreign company, up to (but not in excess of) the amount of tax paid by the national company on the dividends.
>
> [33] Thirdly, the mere fact that an imputation system imposes additional administrative burdens on taxpayers, when compared with an exemption system, for example requiring evidence of the amount of tax actually paid in the foreign country, does not infringe art 63 TFEU, because such burdens 'are an intrinsic part of the operation of a tax credit system'."

38. One reason why the CJEU blessed an imputation system (with a concomitant tax credit) was that if foreign dividends were exempt from national tax, the recipient of the dividend might be over-compensated if tax rates in the foreign state were lower than tax rates in the recipient's home state. One further reason for permitting the two different systems to operate in parallel is that a requirement on a member state to exempt from its own domestic tax dividends which have been taxed in another member state would interfere with the first member state's competence under EU law to decide its own taxation policies.

39. It will be noted that the CJEU envisaged that credit would be given for the "amount of tax paid" by the foreign company. This was in the context of the arguments presented to them, which they summarised as follows:

> "54. The claimants in the main proceedings none the less point out that when, under the relevant United Kingdom legislation, a nationally-sourced dividend is paid, it is exempt from corporation tax in the hands of the company receiving it,

> irrespective of the tax paid by the company making the distribution, that is to say, it is also exempt when, by reason of the reliefs available to it, the latter has no liability to tax or pays corporation tax at a rate lower than that which normally applies in the United Kingdom.
>
> 55. That point is not contested by the United Kingdom government, which *argues, however, that the application to the company making the distribution and to the company receiving it of different levels of taxation occurs only in highly exceptional circumstances, which do not arise in the main proceedings*.
>
> 56. In that respect, it is for the national court to determine whether the tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs." (Emphasis added)

40. It will be seen, therefore, that the answer that the CJEU gave was based on the assumption that "levels of taxation" only differed as between different companies in "highly exceptional circumstances". When the case came back to the UK the parties disagreed about the meaning of the phrase "levels of taxation" in paragraph [56]; and the second reference to the CJEU was designed to clarify what the CJEU meant. We will return to that in due course. The principle that the CJEU laid down at [72] was:

> "The answer to Question 1 must therefore be that arts 43 EC and 56 EC must be interpreted as meaning that, where a member state has a system for preventing or mitigating the imposition of a series of charges to tax or economic double taxation as regards dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way."

41. Mr Aaronson QC, for Prudential, stressed the phrase "in the same way".

42. In the meantime the CJEU returned to the question of foreign dividends in (Joined cases C-436/08 and C-437/08) *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v Finanzamt Linz* [2011] STC 917 ("*Haribo*"). As the judge noted, part of its importance lay in the fact that it dealt with portfolio dividends, and therefore only concerned article 49 TFEU (which had replaced article 56 EC) on free movement of capital. The court relied on *FII (ECJ) I* in holding that article 49 TFEU was engaged even in the case of portfolio dividends held as an investment: see [33] and [35]. The judge set out the national legislation involved in that case and the facts in some detail at [38] to [47], which we do not think we need to repeat. The court again confirmed that it was permissible for a member state to adopt an exemption for nationally-sourced dividends and an imputation method for foreign-sourced dividends.

43. As Mr Ewart correctly submitted, in all its discussion in *Haribo* the court consistently said that an imputation system was not precluded where the tax credit to be given to

foreign sourced dividends "is at least equal to the amount paid" in the home state of the foreign company: see [86], [87], [88]. Where that was the case, the court said at [89], the imputation method "enables dividends from non-resident companies to be accorded treatment equivalent to that accorded, by the exemption method, to dividends paid by resident companies."

44. However, in setting out the law at [84] to [86] the CJEU relied entirely on *FII (ECJ) I*. This is important for two reasons. First it shows that the court saw no difference in principle between a case in which the receiving company received dividends as parent of a subsidiary (as in *FII (ECJ) I*) and a case in which the receiving company received dividends merely as an investor (as in *Haribo*). The second reason is that if the foundation on which *Haribo* was based (i.e. *FII (ECJ) I*) shifts, one would expect the superstructure to shift as well.

Nominal rate or effective rate?

45. This issue concerns the amount of the tax credit to which the taxpayer is entitled by way of reduction of the unlawful charge to corporation tax on foreign dividends under Schedule D Case V ("Case V").

46. It is common ground that the effective tax rate that a taxpayer pays is less than the nominal rate of tax because in almost every case the taxpayer will be able to take advantage of reliefs and exemptions that the taxation system in question includes. It is also common ground that, with rare exceptions, the nominal rate of tax for corporations is uniform in any given taxation system.

47. The dispute is whether EU law requires, as the judge held, a tax credit for the higher of tax actually paid and the foreign nominal rate of tax of the dividend paying company capped at the UK corporation tax rate, or, as HMRC claim, a credit for the actual tax rate paid capped at the UK corporation tax rate.

48. In *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2008] EWHC 2893 (Ch) Henderson J had taken the view that the appropriate method of dealing with the problem was to hold that foreign distributions should be regarded as exempt from corporation tax in like manner as distributions from UK resident companies. The Court of Appeal rejected that at [100] – [103] because it could produce a windfall in the sense that if the foreign paying company was subject to tax at a much lower rate than that applicable to the UK recipient, or to no tax at all, the distributed profits from which the foreign dividend was paid would end up being taxed at less than the distributed profits from which the UK dividend was paid. So did the CJEU in *FII (ECJ) I*.

49. In *FII (ECJ) I* one of the conditions stipulated in order for exemption and imputation to be equivalent, was that the imputation system should give credit for the amount of tax actually paid by the foreign company up to the amount of the tax paid by the national company on the dividends: see [4] and [37] above. In the Reasoned Order of 12 December 2008 in (Case C-201/05) *The Test Claimants in the CFC and Dividend Group Litigation v CIR* the CJEU repeated and applied the principles it had laid down in *FII (ECJ) I*. In *Haribo* (see [42] above) the CJEU said, relying on *FII (ECJ) I*, that an imputation system was not precluded where the tax credit was "at least equal to the amount paid" in the home state of the foreign company: see [42] and [43] above. In

(Case C-310/09) *Ministre du Budget des Comptes publics et de la Fonction Publique v Accor* [2011] ECR 1-08115 ("*Accor*") the CJEU held at [92] that it was necessary for the company claiming a tax credit to provide information "relating to the nature and rate of the tax actually charged on those profits".

50. In *FII (ECJ) II* the CJEU had to consider the passage at [56] of the judgment in *FII (ECJ) I* which includes the sentence quoted at paragraph [39] above. The first question asked of the Court was whether the reference to "tax rates" and "different levels of taxation" referred solely to statutory or nominal rates of tax, or to effective rates of tax, or had some other and, if so, what meaning. The Advocate General held that the reference was to statutory or nominal rates only.

51. Henderson J correctly summarised the CJEU's decision as follows. The CJEU held (i) that in paragraph [56] it had intended to refer to both statutory and effective rates of tax; (ii) that the Case V tax charge was unlawful because it constituted a restriction on the freedoms of establishment and movement of capital under Articles 49 and 63; and (iii) that, although the restriction was *prima facie* justified by the need to ensure the cohesion of the national tax system, it nevertheless failed the test of proportionality.

52. The CJEU referred to three principles established by its existing jurisprudence, which are summarised at [67] of Henderson J's judgment. The third principle:

> "…..is that a Member State is free to adopt a dual exemption/imputation system for domestic and foreign dividends, and the two methods are in fact equivalent, so long as (a) the tax rate applied to foreign dividends is not higher than the rate applied to domestic dividends, and (b) the tax credit is at least equal to the amount paid in the State of the company making the distribution, up to the limit of the tax charged in the home State of the recipient (paragraph 39, referring to <u>FII (ECJ) I</u> at paragraphs 48 and 57, <u>*Haribo*</u> at paragraph 86, <u>*Accor*</u> at paragraph 88, and the reasoned order in the present case at paragraph 39)."

53. In paragraphs [43] to [49] of its judgment, described by the judge as "not entirely easy to follow", the CJEU explained in what circumstances an imputation system for foreign dividends would not be equivalent to an exemption system for domestic dividends. It did so in the following terms:

> "43. It must in fact be held that the tax rate applied to foreign-sourced dividends will be higher than the rate applied to nationally-sourced dividends within the meaning of the case-law cited in paragraph 39 of the present judgment, and therefore that the equivalence of the exemption and imputation methods will be compromised, in the following circumstances.
>
> 44. First, if the resident company which pays dividends is subject to a nominal rate of tax below the nominal rate of tax to which the resident company that receives the dividends is subject, the exemption of the nationally-sourced dividends from tax in the hands of the latter company will give rise to lower

taxation of the distributed profits than that which results from application of the imputation method to foreign-sourced dividends received by the same resident company, but this time from a non-resident company also subject to low taxation of its profits, inter alia because of a lower nominal rate of tax.

45. Application of the exemption method will give rise to taxation of the distributed nationally-sourced profits at the lower nominal rate of tax applicable to the company paying dividends, whilst application of the imputation method to foreign-sourced dividends will give rise to taxation of the distributed profits at the higher nominal rate of tax applicable to the company receiving dividends.

46. Second, exemption from tax of dividends paid by a resident company and application to dividends paid by a non-resident company of an imputation method which, like that laid down in the rules at issue in the main proceedings, takes account of the effective level of taxation of the profits in the State of origin also cease to be equivalent if the profits of the resident company which pays dividends are subject in the Member State of residence to an effective level of taxation lower than the nominal rate of tax which is applicable there.

47. The exemption of the nationally-sourced dividends from tax gives rise to no tax liability for the resident company which receives those dividends irrespective of the effective level of taxation to which the profits out of which the dividends have been paid were subject. By contrast, application of the imputation method to foreign-sourced dividends will lead to an additional tax liability so far as concerns the resident company receiving them if the effective level of taxation to which the profits of the company paying the dividends were subject falls short of the nominal rate of tax to which the profits of the resident company receiving the dividends are subject.

48. Unlike the exemption method, the imputation method therefore does not enable the benefit of the corporation tax reductions granted at an earlier stage to the company paying dividends to be passed on to the corporate shareholder.

49. Accordingly, the determination which the referring court was called upon to make by the Court, in paragraph 56 of its judgment in *Test Claimants in the FII Group Litigation*, relates both to the applicable nominal rates of tax and to the effective levels of taxation. The "tax rates" to which paragraph 56 refers relate to the nominal rate of tax and the "different levels of taxation … by reason of a change to the tax base" relate to the effective levels of taxation. The effective level of taxation may be lower than the nominal rate of tax by reason, in particular, of reliefs reducing the tax base."

54. Henderson J explained his understanding of paragraphs [44] and [45] of the CJEU's judgment in the following terms:

> "70 ….in paragraphs 44 and 45 the Court is concentrating on nominal rates of tax, and (except at one point) is leaving out of account any possible difference between the nominal rate and the effective rate. The Court begins by hypothesising a situation (probably quite rare in practice) where a resident company paying dividends (which I will call P1) is subject to a lower rate of tax than the recipient resident company (R). Exemption of those dividends in the hands of R means that they are taxed overall at only the lower of the two nominal rates (say 20% instead of 30%). That situation is then contrasted with the receipt by R of dividends from a foreign company (which I will call P2) which are subject to the imputation system. It is again assumed that the nominal rate of tax applicable to the dividends in P2's state of residence is lower than the 30% rate applicable to R (see the concluding words of paragraph 44, although the words "inter alia" suggest that there may also be other reasons for the lower taxation of P2's profits). Let it be assumed, as in the case of P1, that the lower rate is 20%. This time, however, the overall result is that the dividends are taxed in R's hands at the full rate of 30%. The tax credit available to set against the charge on R will be only 20%, and in the absence of any exemption the overall charge to tax on the dividends will be "topped up" to R's nominal rate. The contrast drawn in paragraph 44 is then lucidly summarised in paragraph 45.
>
> 71 The Court then considers the position where the lower rate of tax paid by P1 and P2 is not a lower *nominal* rate, but a lower *effective* rate. Suppose, for example, that in the states of residence of P1 and P2 the nominal rate applicable to the profits out of which the dividends were paid was 30% (the same as the nominal rate applicable to R), but P1 and P2 in fact paid tax on their profits at an effective rate of only 20%. In these circumstances, too, there is no equivalence between the exemption and the imputation systems, because the former results in an overall charge to tax of 20% whereas the latter results in an overall charge of 30%. As before, the difference is accounted for by the topping-up effect of the imputation system. These are the points which the Court is making in paragraphs 46 to 48."

55. As Henderson J rightly recorded the CJEU then concluded that the rules in force in the UK failed to ensure equivalent treatment of foreign dividends because, although the UK applied the same nominal rate of tax to resident companies which paid and received dividends (P1 and R in his example), the effective rate of tax paid by P1 was normally lower than the nominal rate.

56. Under the jurisprudence of the CJEU there are three questions: (a) whether the tax system involves a restriction on the rights granted by Articles 49 and 63 because it is

discriminatory; (b) whether the restriction is in principle justified; and (c) if so, whether the restriction is proportionate.

57. In *FII (ECJ) II* the Court decided that the restriction was in principle justified by the need to preserve the cohesion of the UK tax system because the necessary direct link existed between the tax advantage gained (whether it was a tax credit for foreign, or an exemption for domestic, dividends) and the tax to which the distributed profits had already been subject. But it held that the defence of justification failed because the cohesion of the national tax system did not require the difference in treatment which the UK had adopted. So the test of proportionality was not satisfied.

58. Like the judge we think it necessary to set out the relevant part of the Court's analysis in full:

> "60. As to the proportionality of the restriction, whilst application of the imputation method to foreign-sourced dividends and of the exemption method to nationally-sourced dividends may be justified in order to avoid economic double taxation of distributed profits, it is not, however, necessary, in order to maintain the cohesion of the tax system in question, that account be taken, on the one hand, of the effective level of taxation to which the distributed profits have been subject to calculate the tax advantage when applying the imputation method and, on the other, of only the nominal rate of tax chargeable on the distributed profits when applying the exemption method.
>
> 61. The tax exemption to which a resident company receiving nationally-sourced dividends is entitled is granted irrespective of the effective level of taxation to which the profits out of which the dividends have been paid were subject. That exemption, in so far as it is intended to avoid economic double taxation of distributed profits, is thus based on the assumption that those profits were taxed at the nominal rate of tax in the hands of the company paying dividends. It thus resembles a grant of a tax credit calculated by reference to that nominal rate of tax.
>
> 62. For the purpose of ensuring the cohesion of the tax system in question, national rules which took account in particular, also under the imputation method, of the nominal rate of tax to which the profits underlying the dividends paid have been subject would be appropriate for preventing the economic double taxation of the distributed profits and for ensuring the internal cohesion of the tax system while being less prejudicial to freedom of establishment and the free movement of capital.
>
> 63. It is to be observed in this connection that in *Haribo* …, paragraph 99, the Court, after pointing out that the Member States are, in principle, allowed to prevent the imposition of a series of charges to tax on dividends received by a resident

> company by applying the exemption method to nationally-sourced dividends and the imputation method to foreign-sourced dividends, noted that the national rules in question took account, for the purpose of calculating the amount of the tax credit under the imputation method, of the nominal rate of tax applicable in the State where the company paying dividends was established.
>
> 64. It is true that calculation, when applying the imputation method, of a tax credit on the basis of the nominal rate of tax to which the profits underlying the dividends paid have been subject may still lead to a less favourable tax treatment of foreign-sourced dividends, as a result in particular of the existence in the Member States of different rules relating to determination of the basis of assessment for corporation tax. However, it must be held that, when unfavourable treatment of that kind arises, it results from the exercise in parallel by different Member States of their fiscal sovereignty, which is compatible with the Treaty (see, to this effect, *Kerckhaert and Morres*, paragraph 20, and Case C-96/08 *CIBA* [2010] ECR I-2911, paragraph 25).
>
> 65. In light of the foregoing, the answer to the first question is that Articles 49 TFEU and 63 TFEU must be interpreted as precluding legislation of a member state which applies the exemption method to nationally-sourced dividends and the imputation method to foreign-sourced dividends if it is established, first, that the tax credit to which the company receiving the dividends is entitled under the imputation method is equivalent to the amount of tax actually paid on the profits underlying the distributed dividends and, second, that the effective level of taxation of company profits in the Member State concerned is generally lower than the prescribed nominal rate of tax."

59. At [75] the judge regarded the crucial aspect of this analysis as being the principle, "evidently accepted by the Court", that an exemption of national dividends is based on the assumption that the profits from which they are paid have been taxed at the (full) nominal rate of tax in the hands of the paying company. The assumption appeared to him to be highly unrealistic in the case of the UK. But it had already been adumbrated in *Haribo* and might be thought, as he put it, to have "as an abstract proposition … a certain logical appeal". He regarded the CJEU as having perceived the vice of the UK system to lie in the contrast between the (notional) full credit at the nominal rate afforded to national dividends, by virtue of the exemption and the credit at (only) the effective rate afforded to foreign dividends. He regarded the CJEU as being prepared to accept in principle as compatible with Articles 49 and 63 a dual system which combined exemption for national dividends with the grant of a tax credit at the foreign nominal rate for foreign dividends.

60. Henderson J then turned to consider how the infringement of EU law constituted by the application of the Case V charge on portfolio dividends paid by a company

resident outside the UK without any tax credit could be remedied. That infringement, he held, lay "at least" in the failure of the UK system to provide a tax credit for the actual underlying tax paid on the distributed profits in the source state, when the UK had chosen to counter economic double taxation of domestic dividends by the exemption route: see [85].

61. The judge was in broad agreement with the claimants that credit must be given at the nominal rate of tax in addition to a credit for the actual underlying tax [87] and [92]. He regarded the request for clarification in the second *FII* reference as having produced a fuller and more nuanced analysis of the problems associated with the Case V charge on foreign dividends, such analysis being based on the theoretical assumption that the exemption from tax of a dividend was to be regarded as equivalent to the grant of a tax credit at the nominal rate, and the concomitant principle that a state of residence which granted exemption of domestic dividends must, at least, grant credit for the nominal rate of tax paid in the source state, although it remained free to charge a higher rate of tax itself, and thus to top up the charge by the difference between the domestic and foreign nominal rates. That analysis, he held, flowed from and formed part of the CJEU's general elucidation of the overriding need to treat foreign and domestic dividends equivalently. It was as applicable to portfolio dividends as it was to non-portfolio dividends.

62. The judge recognised that to grant credit both for underlying tax actually paid and credit at the nominal foreign rate might appear unduly complex: see [95]. But he regarded the two credits as conceptually quite discrete and the apparently excessive result of aggregation as easily remedied by treating them as alternatives, with credit to be granted for whichever was the higher up to the limit of the Case V charge reduced by withholding tax.

63. He, therefore, concluded that the UK legislation would have been compliant with EU law if it had provided for such a "dual" credit in respect of portfolio dividends. Moreover credit for withholding tax fell to be granted as a matter of domestic law.

64. Having reached this conclusion he determined that a conforming interpretation could be given to section 790 of the Income and Corporation Taxes Act 1988 ("ICTA") by construing it as providing for the grant of a tax credit for foreign dividends to the extent necessary to comply with EU law: [103]. He rejected the submission of the claimants that the Case V charge should be disapplied because a conforming interpretation was not possible.

65. We regard the judge's analysis of the decision of the CJEU in *FII (ECJ) II* as well-founded. The decision of the Grand Chamber was plainly intended to provide clarification and exposition of the law on a topic of widespread importance in relation to which there had been doubt about what the CJEU had meant. Paragraph [65] of the decision, which is repeated in the *dispositif*, makes clear that Articles 49 and 63 preclude legislation which applies the exemption method to nationally-sourced dividends and the imputation method to foreign-sourced dividends if two conditions are established, namely (a) that the tax credit to which the recipient is entitled under the imputation method is equivalent to the amount of tax actually paid on the profits underlying the distributed dividends and (b) that the effective level of taxation of company profits in the Member State concerned is generally lower than the prescribed nominal rate of tax. In the present case condition (b) is satisfied.

66. In those circumstances Articles 49 and 63 must, in the light of the decision in *FII (ECJ) II*, be taken to preclude UK legislation which allows a dual system of exemption and imputation if the tax credit under the latter method is only equivalent to the amount of tax actually paid on the profits. The contention that the credit should be at the actual rate (if that rate is less than the nominal rate) cannot stand with the CJEU's decision.

67. As is apparent, the CJEU proceeded on the footing that the exemption of UK dividends from tax was based on the assumption that the distributed profits were taxed at the nominal rate of tax in the hands of the UK company paying the dividends. Moreover the examples given by the CJEU of the lack of equivalence between the imputation and the exemption methods depend on a comparison between the nominal rate applicable to the recipient in the UK and the lower nominal or effective rate in a foreign country.

68. Like the judge we regard this assumption as unrealistic. Mr Ewart characterised it as plainly erroneous. If the UK recipient company is exempt from tax on its dividend income from UK sources, the exemption operates to relieve it from the tax which it would otherwise pay. This it would do at its effective rate, which, depending on the reliefs to which it was entitled, could be very low or nil. Further, the tax payable by the paying company on the distributed profits would be paid at the effective rate of the company paying the dividend. This would not necessarily be the same as the effective rate of the recipient company nor, in all probability, the same as the nominal rate applicable to either company, as the CJEU recognised in *FII (ECJ) II* at [51]. By contrast in *Haribo* the CJEU appears to have thought that effective and nominal rates were, or might be, usually close.

69. Nevertheless the CJEU has decided that, if equivalence is to be secured, it is not sufficient to give credit only for the tax actually paid. It has thus chosen to solve the difficult question as to how to secure equivalence of treatment by adopting what might be regarded as a theoretical approach. The exemption from tax in respect of dividends from UK companies is treated as an exemption at the nominal rate of tax in the UK, in effect amounting to a tax credit at the nominal rate; and it is treated as being at that rate because the profits of the paying company are taxed at the nominal rate of tax also.

70. Such an approach has the benefit of simplicity of operation, in circumstances where no solution which is both perfect and practicable may be available, and avoids the need for determination of what was the actual tax paid on the distributed profits, or which would have been paid if they were profits earned by a UK company – something that may be extremely difficult or impossible.

71. It would also avoid, for the most part, the mischief ("topping up") which the CJEU identified in *FII (ECJ) II* whereby a greater amount of tax might be paid on the distributed profits (by payer or payer and recipient) in the case of foreign-sourced dividends than would be payable in the case of nationally-sourced dividends if the paying company paid tax at a lesser rate than the recipient. This was the situation envisaged at paragraphs [44] and [46] of *FII (ECJ) II*; which would be applicable if the credit should only be for the tax actually paid, as had been laid down in *FII (ECJ) I* and *Haribo*. Further, if the exemption in respect of UK-sourced dividends is regarded as a tax credit at the nominal rate, it could be said that giving such a credit in

respect of foreign-sourced dividends is closer to the exemption method than anything else.

72. In our view, we are bound by the decision of the CJEU.

73. However, Mr Ewart submitted that the answer to this issue was determined by the Reasoned Order which held, in terms, that legislation was not precluded by Articles 43 (now 49) or 56 (now 63) if, under the imputation system, a tax credit was granted for at least the tax actually paid by the company making the distribution in the foreign member State. We do not agree.

74. The Reasoned Order uses the words "at least": see paragraph 1 of the *dispositif* and, in relation to insurance companies, simply declares that the imputation/exemption system is illegal "in so far as it entails less favourable treatment" of dividends from non-resident companies. More importantly, the Reasoned Order has been overtaken by events, as has the decision in *Haribo*, which was wholly founded on the reasoning in *FII (ECJ) I*, in concluding that equivalence could be achieved by giving a credit for the tax actually paid. The decision in *FII (ECJ) II* is a development of the jurisprudence, by way of further analysis of the issue, prompted by a consideration of the fact, not previously apparent to the CJEU, that there was likely to be a substantial difference between nominal and effective rates of tax, and must be taken to represent the current position of EU law on the subject. Insofar as the reasoning in *FII (ECJ) I* and *Haribo* differs from that in *FII (ECJ) II*, the latter must take precedence, not least because it was in the latter case that the CJEU took into account the significance of the difference between nominal and effective rates of taxation.

75. Mr Ewart submitted that the decision in *FII (ECJ) II* could not be regarded as definitive since the CJEU was not prescribing the method to be used. It confined itself to saying that rules which took account of the nominal rate of tax (a phrase which he characterised as of uncertain meaning) would be appropriate without laying down what the solution must be. It seems to us, however, that in precluding a system which only gave a credit for the tax actually paid, and saying that one which took account of the nominal rate would be appropriate, it was in effect outlawing the former and opting for the latter. If equivalence is not obtained either by exempting foreign dividends from tax or by giving credit for the tax actually paid it is difficult to see what remedy remains unless it is the giving of credit at the nominal rate. At the least, that is a remedy to which the CJEU has given approval.

76. Whether the credit should be at the nominal or the actual rate of tax does not depend on whether the dividends are or are not portfolio dividends. In *FII (ECJ) I* the ECJ considered both portfolio and subsidiary dividends and held that the same principles applied to both: see paragraphs [73], [74] and [95]. There is no rational ground that we can discern, or which is apparent from the cases, for making a distinction between the two. None was made in *FII (ECJ) II*; nor in *Haribo*. There would have been grounds for doing so in the absence of Article 63 (ex 56) since portfolio dividends do not come within the protection of Article 49. But both Articles are in force. In our view the reasoning in *FII (ECJ) II* at [55] – [65] applies equally to all types of dividend. In addition the critical question is whether there is equivalence between the treatment of foreign and UK-sourced dividends. The UK tax regime exempts all UK-sourced dividends from tax. So the search must be for a system which provides the equivalent for foreign-sourced dividends of whatever type.

77. Although it was formally an issue before us we heard little argument on the method – disapplication of the legislation (whether partial or total) or a conforming interpretation – by which the illegality in issue might be remedied. In practice we can see little difference in this case between a partial disapplication and a conforming interpretation. In any event we are satisfied that the judge was entitled to reach the result that he did by a process of applying a conforming interpretation.

78. There remains for consideration whether or not the judge was right to hold that the credit should be at the higher of the actual or nominal rate (up to the limit of the Case V tax charge after a credit for withholding tax: see Declaration 1 C). This issue is unlikely to arise in practice although there can be some rare cases in which the actual rate will exceed the nominal. In our view the judge was right to take the higher of the two rates since the foundation of the jurisprudence is that there should be a credit for at least the tax actually paid. The controversy over whether, if the nominal rate is higher than the actual, there should be credit at the higher rate does not, in our view, mean that less than the actual rate is ever appropriate.

79. In the light of these conclusions it is not necessary to decide whether, if the credit was to be applied at the actual rate, Prudential, which cannot prove the tax actually charged, would, having regard to the principle of effectiveness, be entitled, as it submitted, to treat the nominal tax rate of the jurisdiction of the non-resident dividend-paying company or evidence of the underlying tax paid in the consolidated accounts of that company as a proxy for the tax actually paid.

80. HMRC wished to pursue an additional argument that in the case of an insurance company, which is subject to special rules of taxation, the effective rate of tax payable in the UK was no lower than the policy holders' rate of tax as applied to insurance companies. This argument had not been pleaded or canvassed at trial; and Prudential submitted that, if it had been, evidence would have been adduced to support its case. Indeed Prudential applied to adduce in evidence on appeal an expert's report in the event that HMRC were given permission to raise this point. We ruled that HMRC were not entitled to raise this point for the first time on appeal, since it was obvious that the course of evidence would have been different below had the point been raised in due time.

How to identify the unlawful ACT

81. HMRC wished to argue that before deciding what remedy Prudential were entitled to it was necessary to identify how much of the ACT it paid was unlawful. Since the CJEU has consistently regarded ACT as being no more than an advance payment of corporation tax, that in turn required ascertaining how much unlawful corporation tax had been levied. In the ordinary way a company would make a distribution out of its profits earned in a particular year, but would make the distribution after the end of that year (once its annual accounts had identified the amount of distributable profits for that year). This was not a point that was raised at the main trial before the judge. It was, however, raised at a hearing before him in the related case of *Test Claimants in the FII Group Litigation v Revenue and Customs Comrs* [2014] EWHC 4302 (Ch), [2015] STC 1471 ("*FII Quantification*"), which the judge heard after giving judgment in the main trial in this case. He rejected HMRC's case for reasons that he gave at length; and HMRC have appealed against that decision. The appeal is due to be heard by this court in June 2016. When our case came back before the judge in October

2014 HMRC sought to raise the same argument. The judge had of course already decided that it was wrong; but he also said in his Second Judgment at [30]:

> "I also consider that it is now too late for HMRC to pursue this argument. The adjourned trial in July 2013 was the trial of the action, including all issues of principle in relation to quantification. Although I am sometimes willing to allow more procedural latitude to the parties to test claims in group litigation than I normally would to parties to purely private proceedings, I think that if HMRC wanted to run an argument of this fundamental significance to the quantification of the claims they should have pleaded it in good time before the hearing, and then adduced calculations and evidence to explain and support their new case. As it is, however, the argument played no part at all in the trial, and it has surfaced for the first time at the stage of working out the January 2014 Order. If I were to accede to HMRC's request, the result would be to set in motion a third trial at which the issue would have to be properly pleaded from scratch, and then debated and resolved in much the same way as its counterpart was in *FII (High Court) II* [i.e. *FII Quantification*], but with the added advantage for HMRC that they would know my reasons for having rejected the similar methodology advanced by them in the latter case. I do not think it would be fair to Prudential and the other claimants in the Portfolio Dividend GLO to allow this to happen, when the point could and should have been raised, if it was to be run at all, at the trial in July 2013."

82. Prudential argued that HMRC should not be allowed to take this point on this appeal. The judge had ruled against HMRC at least in part on procedural grounds. In *FII (Quantification)* the point had occupied a great deal of time, and had been the subject of extensive evidence which the judge had considered carefully. The point could not be dealt with in the abstract but had to be considered in the light of the evidence. The judge heard evidence in *FII (Quantification)*; but there was no evidence in the present case. Although we allowed HMRC to argue the point, we made it clear that we reserved the question whether we would decide it or whether we would uphold the judge's decision to exclude it on case management grounds.

83. We were taken through the way that the case had been prepared for and presented at trial. Prudential introduced the claims relating to unlawful ACT by amendment in 2009. Paragraph 34 of the amended Particulars of Claim pleaded that:

> "Had the Portfolio Companies been UK residents then the requirement upon [Prudential] to pay … ACT … would have been reduced because the Dividend Income would have attracted tax credits… and would have amounted to franked investment income."

84. In our view this made it clear that Prudential's case was that the foreign- sourced dividends ought to have been treated as though they were UK- sourced dividends by the attribution of a tax credit. Although the precise amount of the tax credit for which

Prudential argued has varied from time to time, that basic principle has been clear. For reasons that have not (or have not adequately) been explained, HMRC did not plead anything in response to paragraph 34. Once again the absence of any pleaded case obscured what was in issue. Prudential adduced evidence at trial in support of its case under paragraph 34, and the point was also flagged in skeleton arguments and oral submissions made on its behalf. Paragraph 8 of Mr McCullough's tenth witness statement contained the assertion that:

> "Portfolio dividend income received from companies resident beyond the UK should have been treated as FII."

85. In essence the case was that foreign-sourced dividends should be fed into the domestic regime governing ACT at the water's edge, treating them as FII to the extent required by EU law. The consequences of that treatment would then be governed by the domestic regime.

86. We were not shown anything that HMRC placed before the judge at or before the main trial which advanced any alternative treatment. The method upon which HMRC wished to rely would have required adducing evidence for which the judge's directions for the second stage of the case made no provision. The materials which HMRC did try to present to the judge at that stage did not permit the method to be properly tested.

87. In our judgment, the judge was fully entitled to conclude as he did that it was too late to raise the point.

88. We also consider that the judge was right to hold that the point was in fact covered by the declaration that he made in paragraph 2 of his order made following the main trial, namely that section 231(1) of ICTA should be construed so as to grant a limited credit for foreign-sourced portfolio dividends of the amount needed to secure compliance with EU law. Since section 231(1) is the gateway to the domestic system of dealing with FII, that declaration can only have meant that foreign-sourced dividends had to be treated as a modified form of FII.

89. It follows that the judge's ruling, namely that foreign-sourced dividends must be treated as having been fed into the domestic ACT system at the water's edge carrying the tax credit to the extent required by EU law, stands. The unlawful ACT is thus identified by operating the domestic ACT system on the assumption that the foreign-sourced dividends would have carried the tax credit required by EU law, and would have been franked investment income to that extent.

90. The judge also said that, even if it were open to HMRC to run their counter-argument, he would have rejected it on the merits for reasons given in his judgment in *FII (Quantification),* in which the same issue arose (see para. [33] of the Second Judgment and paras. [164]-[171], read with [116]-[121] and [141]-[155] of the judgment in *FII (Quantification)).*

91. Since the first two reasons given by him, at paras. [29] and [30]-[32] of the Second Judgment, respectively, are essentially lawful case-management decisions made by him, we have considered whether it is appropriate for us to address the merits of the underlying point of principle in this judgment or leave them for consideration by this

court when the appeal from *FII (Quantification)* is heard in June 2016. We have concluded that it is necessary and appropriate for us to address the merits on the underlying point of principle regarding the methodology for quantifying the Prudential's restitutionary claims. We heard full argument about this and are as well-placed as this court will be in June to decide this question. As the arguments on the various issues in this appeal have developed, in our opinion it is necessary for us to do so as part of our reasoning to explain why in the context of this case the judge was right to make the case-management decisions he did and also as part of the foundation for our decisions on the further issues we have to decide, labelled Issues 21, 22 and 23: see below. So far as the judge's case-management decisions are concerned, a proper understanding of the underlying point of principle is necessary to explain why the judge was right to rule as he did.

92. The competing arguments are as follows. Prudential says that the effect of the decision of the Court of Appeal in *FII (CA)* at paras. [97]-[109], in determining that an interpretation of section 231(1) of ICTA which conformed with EU law could and should be given to that provision, and the judge's declaration regarding the proper interpretation of section 231(1) at paragraph 2 in his order of 28 January 2014 made after the Main Judgment is that section 231(1) of ICTA should be construed in such a way as to grant a tax credit for foreign-sourced portfolio dividends of the amount needed to secure compliance with EU law. The effect of this is to create a modified FII system in relation to foreign portfolio dividends, in which the tax credit for foreign portfolio dividends will be treated as part of the franked investment income under section 238(1) of ICTA in the same way as payments of ACT by a UK company paying a dividend create a tax credit and are treated as part of the franked investment income under those provisions. Prudential made the same submission in *FII (Quantification)*, where the judge summarises it at para. [118].

93. HMRC, on the other hand, propose a very different methodology. The judge summarised this at para. [119] of *FII (Quantification)* as follows:

> "The Revenue's methodology, by contrast, starts from the proposition that it is only when ACT was actually paid that it is necessary to determine whether any of it was unlawful. It is therefore necessary to begin by identifying the EU source income comprised in the dividends which trigger the actual charge to ACT. Since the charge was usually imposed at the top of the group, after payment up of all or part of the EU income originally received by the water's edge company through one or more intermediate holding companies, and since all the UK companies involved usually had other sources of income, the Revenue have to devise a mechanism for tracing the original EU income as it passed up the group until the stage when ACT became payable. This is an exercise which has no analogue in the UK ACT system, and it involves the making of a number of sometimes arbitrary assumptions, as well as calculations of very considerable complexity."

94. The HMRC methodology does not apply the FII system in relation to foreign portfolio dividends. Instead, HMRC propose a completely different system to calculate the amount of overpayment of tax by Prudential, involving the identification of different

income streams between UK companies and adoption of a pro-rating approach to determine how much of the profits of any UK company in fact derive from UK-sourced portfolio dividends and how much from foreign-sourced portfolio dividends.

95. Section 231(1) of ICTA, headed "Tax credits for certain recipients of qualifying distributions", provides in relevant part as follows:

> "… where a company resident in the United Kingdom makes a qualifying distribution and the person receiving the distribution is another such company or a person resident in the United Kingdom, not being a company, the recipient of the distribution shall be entitled to a tax credit equal to such proportion of the amount or value of the distribution as corresponds to the rate of advance corporation tax in force for the financial year in which the distribution is made."

96. Section 238 of ICTA sets out definitions for interpretation of terms relevant to the collection of ACT. Section 238(1) and (1A) provides in relevant part as follows:

> "(1) In this Chapter –
>
> 'franked investment income' means income of a company resident in the United Kingdom which consists of a distribution in respect of which the company is entitled to a tax credit (and which accordingly represents income equal to the aggregate of the amount or value of the distribution and the amount of that credit) …;
>
> 'franked payment' means the sum of the amount or value of a qualifying distribution and such proportion of that amount or value as corresponds to the rate of advance corporation tax in force for the financial year in which the distribution was made …
>
> …
>
> (1A) For the purposes of this Chapter, a company has a surplus of franked investment income in an accounting period if the amount of the franked investment income of the company in that period exceeds the amount of the franked payments made by it in that period."

97. Section 241 of ICTA sets out the calculation for ACT where a company receives FII. It provides in relevant part as follows:

> "(1) Where in any accounting period a company receives franked investment income the company shall not be liable to pay advance corporation tax in respect of qualifying distributions made by it in that period unless the amount of the franked payments made by it in that period exceeds the amount of that income.

> (2) If in an accounting period there is such an excess, advance corporation tax shall be payable on an amount which, when the advance corporation tax payable thereon is added to it, is equal to the excess.
>
> (3) Where a company has a surplus of franked investment income for any accounting period, the surplus shall be carried forward to the next accounting period and treated for the purposes of this section … as franked investment income received by the company in that period.
>
> …"

98. Where a UK company pays a dividend up to a UK receiving company (i.e. a "qualifying distribution" within the meaning of section 231(1)), the paying company pays ACT by way of what the CJEU regards as an advance payment of the corporation tax payable by that company in relation to its underlying profits, and the nominal rate of ACT applicable to its payment is used to quantify a tax credit for the benefit of the UK receiving company. That tax credit becomes part of the franked investment income of the receiving company, as defined in section 238(1): the franked investment income of the receiving company is the amount of the dividend it received plus the relevant tax credit in respect of ACT. Where the UK receiving company then makes a dividend payment itself (i.e. a "qualifying distribution" of its own), the amount of that payment plus an amount derived by applying the nominal rate of ACT in respect of that dividend qualifies as a franked payment made by that company, as defined by section 238(1). Section 241 then sets out the calculation of ACT which actually falls to be paid by the UK receiving company, arrived at by a comparison of the franked investment income received by the UK receiving company in an accounting period with the franked payments made by it in that period.

99. Where a foreign company pays a portfolio dividend up to a UK receiving company (what has been referred to in this case and in the FII litigation as the UK water's edge company), the effect of the rulings of the CJEU is that the foreign dividend should be afforded equivalent treatment, taking the form of the imputation method according to which credit should be given for the relevant foreign tax at the effective rate or the nominal rate (whichever is the higher), subject to a cap at the rate of the UK's nominal rate of ACT.

100. The question then arises how that credit should be given. As outlined above, Prudential contends that this should be done by a simple modification of the UK's existing system for allowing for tax credits to be brought into account in calculating the ACT payable by a UK receiving company when it distributes onwards dividends which it has received. It says that when foreign portfolio dividends are received by a UK water's edge company, it is possible to work out the relevant underlying foreign tax (at either the effective rate or the foreign nominal rate) for which credit should be given; that this credit should be treated as a tax credit for the purposes of section 231(1) by giving that provision a modified construction to conform with the requirements of EU law; and that it then follows from the ordinary interpretation of section 238(1) that this tax credit becomes part of the calculation of the UK receiving company's franked investment income and hence by application of section 241 falls to be set off (i.e. to be taken into account as a credit) against any franked payments

made by the receiving company, thereby reducing its liability to pay ACT in the relevant accounting period.

101. In our judgment, the decision of this court in *FII (CA)* has given the answer to this question. The answer which has been given bears out Prudential's submission on this point.

102. At first instance in *FII (High Court)* neither side suggested that a conforming interpretation of the ACT provisions in national legislation could be achieved ([see [144]). Instead, each side focused on arguments regarding disapplication of the legislative provisions and giving direct effect to the underlying rights of the claimants under the article in the Treaty providing for free movement of capital, Article 63 TFEU (ex 56). The claimants successfully argued for an approach which treated the UK territorial limitation on FII contained in section 231(1) as being of no effect: see paras. [147] and [150]. This would equiparate the treatment of UK-sourced dividends and foreign dividends so that the claimants would get a tax credit for the full UK ACT rate even in relation to foreign dividends.

103. HMRC appealed to this court against that ruling, among others: see *FII (CA)*. The arguments on this point on the appeal were categorised in a different way from how they had been analysed at first instance. This court took the parties in fact to have argued for different conforming interpretations at first instance (see *FII (CA)* at para. [100]), rather than for disapplication of the provision. We do not think that is right, but nothing now turns on the difference in the categorisation. On the arguments in this court in *FII (CA)* issue clearly was joined between the parties regarding whether a conforming interpretation could be given to the ACT legislative provisions by reference to the strong interpretive obligation in EU law (see e.g. Case C-106/89 *Marleasing SA v La Comercial Internacional de Alimentacion SA* [1990] ECR I-4135 and the discussion in *R (IDT Card Services Ireland Ltd) v Customs and Excise* [2006] EWCA Civ 29; [2006] STC 1252 and *Vodafone 2 v HMRC* [2009] EWCA Civ 446; [2010] 2 WLR 288) and if so what that interpretation should be.

104. This court held at [97]-[109] that a conforming interpretation of the ACT legislative provisions is possible to ensure that they give effect to the relevant rights under Article 63. (We should draw attention to the fact that, due to some corrections made to paras. [98], [105] and [107] after the judgment in *FII (CA)* was handed down, the text of those paragraphs as they appear in the published report in Simon's Tax Cases at [2010] STC 1251 is inaccurate: we have used the officially approved transcript of the judgment which, we believe, is now available on the BAILII website. The correct version is that dated 19 March 2010). This court overruled the judge on the solution he had given and held that:

> "a conforming interpretation can be achieved simply by reading in words that make it clear that resident companies can claim a credit under section 231 in respect not only of qualifying distributions made by resident companies (domestic-source income) but also distributions made by other companies (foreign-source income) to the extent that Community law requires a tax credit to be given in respect of that income too. The extent of that entitlement can then be investigated when the section falls to be applied. …" ([107])

105. This means that the relevant conforming interpretation of the ACT provisions is achieved by modifying the interpretation of section 231 by application of the *Marleasing* interpretive obligation so as to create a tax credit of the relevant amount in respect of foreign dividends assessed by reference to the relevant foreign nominal or effective rate of tax (whichever is the higher), capped at the UK nominal rate of tax. No other change to the interpretation of the ACT provisions in accordance with their ordinary meaning was suggested by the court and none is necessary to give effect to the requirements of EU law. It may be observed that although HMRC succeeded in overturning the more generous approach (from the taxpayer's point of view) favoured by the judge in *FII (High Court)*, the solution arrived at leads to the conclusion that Prudential is correct in its submissions on this question in the present appeal.

106. To take a simple example: a UK water's edge company (X) holds 5% of the shares in company Y, a company in another Member State. Y pays corporation tax on its profits of 2000 at the nominal rate in that Member State of 15% (so its effective rate and nominal rate of tax are the same, at 15%) and then uses the balance to pay a dividend of 1700 to its shareholders, of which 5% (i.e. 85) goes to X. The 15% foreign rate of tax is below the UK nominal rate of ACT. X is entitled under section 231(1) to a tax credit of 15 (the amount of foreign tax paid attributable to the dividend received by X) in respect of the dividend it receives. According to section 238(1), therefore, X has franked investment income of 100 which falls to be applied in any relevant accounting period as set out in section 241. The effect is that X should receive a credit of 15 against a relevant ACT liability when it makes a qualifying distribution of its own.

107. This way of according protection in domestic law for Prudential's rights under Article 63, by a conforming interpretation of section 231(1) of ICTA, was underlined in the present litigation by declaration 2A made by the judge in his order of 28 January 2015 after the main judgment, in which he answered the relevant issue as follows:

> "Section 231(1) should be construed in such a way as to grant a limited credit for foreign-sourced portfolio dividends of the amount needed to secure compliance with EU law. No question of disapplication therefore arises."

108. In our view, the judge was bound to make the declaration in these terms by this court's reasoning in *FII (CA)* at [97]-[109].

109. On this appeal Mr Ewart seeks to contend that the question of the correct methodology to use to determine the amount of credit in respect of foreign tax Prudential should have been allowed against its liability to pay ACT and hence the extent of its *San Giorgio* restitutionary claims was left at large by this court in *FII (CA)* and also by the judge's declaration. We do not agree. Once the conforming interpretation of section 231(1) given by this court in *FII (CA)* and by the judge's declaration is applied, the other ACT provisions simply apply in accordance with their ordinary meaning, precisely as Prudential submits on the present appeal.

110. Mr Ewart sought to suggest that this court's ruling at [107] in *FII (CA)* was not tied to interpretation of section 231(1) but produced a sort of power of amendment which roamed at large across all the ACT provisions, leaving it open to HMRC to propose a

different methodology within the interstices of those provisions taken as a whole for giving effect to the requirements of EU law. In substance, he wished to introduce a distinct crediting methodology into section 241.

111. In our view this is an unsustainable submission. It rests on a misconception regarding the operation of the *Marleasing* interpretive principle and of the ruling given in *FII (CA)*. Application of that principle does not make it irrelevant which particular statutory provision in a group of provisions is being interpreted. On the contrary, it is a principle of interpretation which is applied to give a specifiable and specific meaning to a particular provision (or series of provisions, taken one by one), even if it allows considerable latitude as to the wording which may be read into the provision (or provisions). In considering whether a particular conforming interpretation can be given to a particular provision, the court has to check to see that that proposed interpretation does not go against "the grain" of the legislation in question or conflict with its cardinal features. This was the exercise performed by this court in *FII (CA)* to arrive at the particular conforming interpretation it identified for a specific section, namely section 231(1) of ICTA. That interpretation was sufficient to give effect in domestic law to taxpayers' rights under Article 63 precisely because section 238(1) and section 241 continue to operate alongside section 231(1) (as so interpreted) in the usual way. Nothing was left at large so far as concerns the meaning of the ACT provisions in a way which could now accommodate HMRC's proposed alternative methodology.

112. In his judgment in *FII (Quantification)* the judge examined the working through of the HMRC methodology in some detail at [164]-[171]. He found it to be of enormous complexity, based on numerous and unverifiable assumptions and bearing no relationship at all to the actual system of dividend taxation in force in the UK. He also found HMRC's methodology to be open to practical objections of such seriousness "as to make it impossible to implement in a coherent and verifiable manner". It is unnecessary for us to review these findings for present purposes. We note, however, that these matters would tend to indicate that, even if it were now open to HMRC to contend that section 241 or some other provision should be given a distinct new conforming interpretation, the HMRC's methodology might well be said to go against "the grain" and against cardinal features of the ACT legislation.

ACT Sub-issues

113. The first of these issues, labelled Issue 21, was identified by the parties as follows:

> "Where a corporation tax liability is in part unlawful and against which ACT was utilised which incorporated unlawful ACT, is the unlawful ACT to be regarded as utilised first against the unlawful corporation tax (the Claimant's view) or is the lawful and unlawful corporation tax to be regarded as having been met pro rata by the utilisation of lawful and unlawful ACT?"

114. The judge addressed this issue at paras. [35]-[37] of the Second Judgment. At para. [35] he said this:

> "In the absence of any special reason to the contrary, my inclination would be to adopt a pro rata approach throughout, as HMRC submit. The question is what factual assumptions it is appropriate to make, in a situation where everybody at the time assumed the whole of both the ACT and the MCT [Main Corporation Tax] to have been lawfully charged. It therefore seems natural, now that the true position has emerged, to treat the relevant payments of ACT and MCT as composed proportionately of lawful and unlawful tax. I would not be dissuaded from taking this approach by the fact that the ECJ has consistently treated (lawful) ACT as a prepayment of (lawful) MCT, because that seems to me to have nothing to do with the question of attribution of historical payments with which I am now concerned."

115. However, at [36]-[37] the judge held that an anomaly had been identified if the HMRC approach were used, arising from the ruling of this court in *FII (CA)* at [148], such that Prudential could end up being over-compensated. This gave good reason to depart from the *pro rata* approach which he would otherwise have preferred.

116. On this appeal Mr Ewart contends on behalf of HMRC that the judge was wrong to reject the pro-rating methodology on this point, whereas Mr Bremner on behalf of Prudential contends that the judge was right for the reasons he gave. Mr Bremner contends that if the credits from a foreign dividend which relieve ACT are not associated with the credits which relieve the corporation tax on that foreign dividend, then there is a risk that the same credits are used more than once, and gave the same worked example which had impressed the judge. Mr Bremner also contends in his skeleton argument that the reverse is also the case: if the component of lawful ACT and lawful corporation tax on the same income are not linked then more than the composite lawful charge is imposed. However, the judge did not accept this submission when it was made to him and despite the court's request for worked examples to support the submissions of the parties on this part of the case none was provided to support this aspect of Mr Bremner's submissions.

117. There is an oddity regarding both arguments: Prudential argues for an approach which would increase its tax liability and HMRC argue for an approach which would reduce it. When pressed by the court as to why they were adopting their respective positions, both parties indicated that they simply wished the court to identify the correct principle to apply, whatever impact it might have on them.

118. In our judgment, on this issue it is HMRC's methodology which is correct in principle, essentially for the reasons given by the judge at [35], quoted above. We would add that the correctness of that methodology is further supported by consideration of the nature of the issue to be addressed and the context in which it arises.

119. The issue is how to determine the extent of the benefit for HMRC in money terms of a payment or bringing into account of an unlawful charge to corporation tax (alongside a lawful charge to corporation tax arising at the same time as part of an undifferentiated overall apparent liability to pay a total amount of corporation tax) so as to become unjustly enriched thereby, having regard to the way in which that

unlawful charge was satisfied by being set off against an undifferentiated fund comprising a mixture of lawful and unlawful ACT. As HMRC submit, what is needed is a fair way of determining what is in principle a factual question (the extent of the relevant unjust enrichment), but one which arises in a situation where everyone concerned at the time thought that all the corporation tax (both lawful and unlawful) was in fact properly due and that all the ACT (both lawful and unlawful) was properly due.

120. The context in which that question arises is one in which no-one is to blame for the unfortunate situation which, unbeknown to all, had arisen. HMRC did not know, and due to the uncertainty at the relevant time regarding the meaning and effect of EU law could not reasonably be expected to have known, that the unlawful elements of these charges were in fact unlawful, any more than Prudential knew or should have appreciated this. The judge found in *FII (High Court)* that there was no "sufficiently serious breach" of EU law by HMRC to ground a claim in damages, precisely because of the uncertainty regarding its meaning and effect. Mr Aaronson emphasised in the context of debate about the operation of section 32(1)(c) of the Limitation Act that Prudential could not reasonably have been expected to appreciate that they might have a claim for recovery of ACT until the judgment in *FII (ECJ) 1.*

121. There is thus no justification, in terms of fairness when addressing the quantification of a simple restitutionary claim, for adopting any approach to framing the counter-factual scenario necessary to determine the amount of any unjust enrichment which favours one party over the other: a fair balance should be struck between their competing interests. The fair balance should be struck by using an objective standard, since both parties were disabled by their ignorance about the true state of affairs from actually applying their minds at the time to how to allocate the lawful and unlawful elements of ACT as between the lawful and unlawful elements of corporation tax.

122. In our judgment, this analysis indicates that the presumption in favour of applying the pro-rating approach proposed by HMRC correctly identified by the judge at para. [35] of the Second Judgment has greater normative force than he gave it in that judgment. In fact, we consider that the judge was correct in the corresponding part of his judgment in *FII (Quantification)* dealing with utilisation of unlawful ACT (in a mixed fund of lawful and unlawful ACT) by setting it off against a mixed amount of lawful and unlawful corporation tax, to adopt a pro-rating approach in line with that proposed by HMRC on this appeal rather than an approach of setting off unlawful ACT first against unlawful corporation tax (the approach proposed by Prudential in these proceedings and the primary contention of the claimants in the *FII* case): see [191]-[206]. At [204] the judge found the justifications for the approach proposed by the claimants in those proceedings and now proposed by Prudential to be unconvincing; and at [205] he said:

> "[A *pro rata*] approach, on the other hand, reflects the indisputable fact that lawful and unlawful ACT were both mingled in a single pot in every accounting period, with no way of distinguishing one component from the other. In those circumstances, I think the only rational solution to the problem is to regard all the payments, surrenders and applications of ACT which actually took place as having been comprised of both lawful and unlawful ACT on a pro rata basis …"

123. We do not consider that the supposed “anomaly” presented by Mr Bremner’s worked example and based on the implications of this court’s judgment in *FII (CA)* at [148] is of a character or such weight as to warrant the displacement of what on the face of things seems clearly to be the fair approach in the circumstances, namely the pro-rating approach proposed by HMRC.

124. This court in *FII (CA)* held that, following *FII (ECJ) 1*, taxpayers are entitled to reimbursement of, among other things, lawful ACT set against unlawful corporation tax “since the jurisprudence of the ECJ treats ACT as an advance payment of MCT [main corporation tax]”. Although we note that HMRC has on foot an application for permission to appeal to the Supreme Court on this and other points, we, like the judge, are bound by this ruling.

125. However, in our view it simply represents one relatively peripheral aspect of how practical justice could be achieved in the complicated circumstances of this case, in the view of this court in *FII (CA)*. As the judge noted and Mr Bremner accepted, the particular example works by making some strained and factually unrealistic assumptions. This example does not constitute a fundamental criterion for a just resolution of all the quantification issues between the parties applicable across all other fact scenarios to which the present litigation might give rise. It is unrealistic to expect perfect harmony of result across all aspects of the present litigation and it is unsurprising that at various points this court has made adjustments to reflect practical rather than perfect or logical justice, just as the judge has done at points in his judgments. In this context it is questionable that the Prudential’s worked example can properly be characterised as giving rise to an anomaly. More importantly, we do not think that it can be used to deflect the considerable force of the underlying argument of principle relied upon by HMRC and articulated by the judge in the passages from the Second Judgment and the judgment in *FII (Quantification)* quoted above.

126. Further, we think the simplicity of the clear and principled approach to bringing credits for foreign tax paid or payable in relation to foreign dividends into account which we have found above to be correct in relation to the issues about the treatment of foreign dividends as a form of FII supports the adoption of a clear and principled pro-rating approach to utilisation of unlawful ACT by offsetting in relation to unlawful corporation tax. The simplicity of the approach in working out the extent of unlawful ACT levied at identified points of time provides a sound platform for applying the fair pro-rating approach. In a complex and murky area of the law, where the practical ramifications of every twist and turn in the legal analysis are sometimes difficult to foresee, we consider that the approach most likely to work justice overall between the parties is one which is in both respects clear and supported by basic principles which are themselves readily comprehensible and workable as a matter of practical application.

127. Accordingly, we would allow HMRC’s appeal in this very limited respect and set aside the judge’s ruling in relation to Issue 21.

128. The agreed formulation of the second sub-issue, labelled Issue 22, is as follows:

> "Where a quarterly return has been made of franked payments and ACT has been paid in respect of those payments and the company receives excess FII after the end of that quarterly

> return period but before the end of the accounting period, is the resulting repayment of ACT:
>
> (i) attributable to the offsetting of actual FII against franked payments so that unlawful ACT only arises from the offsetting of the section 231 credits which should have accompanied foreign dividend income against the net amount of ACT not repaid (the Claimants' case); or
>
> (ii) a repayment of lawful and unlawful ACT in the proportions in which that ACT payment was made up of lawful and unlawful ACT (HMRC's case)?"

129. The judge helpfully summarises the relevant legal position at [41] of the Second Judgment and at [42] he explains his initial reaction to it in *FII (Quantification)*:

> "41. The relevant statutory provisions which enabled surplus FII to be carried back within the same accounting period (but no further) were contained in paragraph 4 of schedule 13 to ICTA 1988. In *FII (High Court) II* [i.e. *FII (Quantification)*] I set out these provisions at [209], and summarised their general effect in this way:
>
> > "The effect of these rather densely worded provisions may be summarised by saying that FII received in a later quarterly return period must first be applied in franking any dividends paid by the company in that period, but that any surplus may then be carried back to frank unrelieved dividends paid in an earlier quarter, thus generating a repayment of ACT. If there has been a change of ACT rates in the meantime, the repayment is not to exceed the amount of the tax credit comprised in the FII which is carried back."
>
> 42. Issue 12 in *FII (High Court) II* was, I think, essentially the same as the issue which I now have to consider: see the formulation of Issue 12 in [210]. As I recorded in [207], the question had been barely touched upon in the numerous written submissions presented to me, and had not been mentioned at all in oral argument. I therefore dealt with it very briefly, concluding as follows in [211]:
>
> > "In my judgment the Revenue are correct on this point. Although the repayment is generated in its entirety by the receipt of actual FII, I can see no good reason why that fact should alter the characterisation of the ACT which is repaid, or create an exception to the general pro rata approach to utilisation which I have held to be appropriate."

130. However, in this case the judge was persuaded by Mr Bremner to take a different view, albeit he did so "with considerable hesitation": see [43]. He summarised Mr Bremner's submission thus:

> "… The central point, if I have correctly understood Mr Bremner's submissions, is that the FII carried back is by definition entirely lawful, as it was generated exclusively by the receipt of UK-source dividends. Any repayment of ACT paid in an earlier quarter to which the carried back FII gives rise must therefore be treated as far as possible as a repayment of lawful ACT. If that is not done, FII generated by UK income ends up being used so as to cancel out part of the credit which EU law requires on foreign income. By taking me through some sample computations, Mr Bremner was able to persuade me that this would be the result of applying HMRC's approach, and that any apparent timing anomalies thrown up by Prudential's approach are appropriately dealt with by interest adjustments."

131. In our view, the judge's initial reaction to the point in *FII (Quantification)* was correct. The arguments appear to us to be similar to those which arise in relation to Issue 21 above, which we have determined in favour of HMRC. In the context of Issue 22 it is correct to say that *ex hypothesi* the FII comprises tax credits generated by receipt of UK-source dividends, but it does not follow that these should be treated as being set off only against lawful ACT. No-one appreciated at the time that in fact the ACT against which the FII was carried back might comprise an element of lawful ACT and an element of unlawful ACT and no-one was to blame for that state of affairs. The fair course is therefore to treat the FII payment as attributable pro rata to the unlawful ACT element and the lawful ACT element.

132. In relation to the unlawful ACT element, the application of the FII credit attributable to it will bring to an end the primary period of unjust enrichment of HMRC by reason of the payment of that unlawful ACT, but there will then need to be an interest calculation on a compound basis under the common law, following the decision of this court in *Littlewoods Retail Ltd v HMRC* [2015] EWCA Civ 515, [2015] STC 2014: see below. There is no injustice to Prudential by proceeding in this way and it accords with the proper principles to be applied in working out the extent of unjust enrichment of HMRC in this area. We cannot see that this cancels out any part of the credit which EU law requires on foreign income. There is no reason of principle why the ordinary pro-rating approach which fairness would ordinarily require should be disapplied here, particularly since the judge accepted that Prudential's own approach would create apparent timing anomalies.

133. Therefore, for reasons similar to those in relation to Issue 21, we would allow HMRC's appeal in this very limited respect as well and set aside the judge's ruling in relation to Issue 22.

134. The final sub-issue under this head relates to the carry back of excess FII within the same accounting period. This was labelled Issue 23.

135. Although the judge recorded at [44] that the issue was not argued before him, Mr Ewart and Mr Bremner agree that it was argued before him and the judge acknowledged in his permission to appeal ruling that he had overlooked the fact that Mr Ewart did briefly allude to the topic. At all events, the judge did rule on the issue and it falls to be decided in this court.

136. Issue 23 is a variant of Issue 22 above which arises in the context of life assurance business such as is carried on by Prudential because, so we were told, it is more difficult for life assurance companies to work out the ACT due from them in an accounting period. Accordingly, a life assurance company may only come to know the true extent of its liability to pay ACT some time after the end of the accounting period in which it is taken be to be due. Issue 23 reads as follows:

> "In the 1993 accounting period franked payments were only made in the second quarter. Excess FII arose in the fourth quarter and the return for that quarter claimed a corresponding repayment of ACT. However the ACT liability in the second quarter was met by a number of ACT payments some made before the fourth quarter and some after it. Is the repayment of ACT arising from the fourth quarter return to be regarded:
>
> (i) as a repayment of each of those payments made towards the second quarter liability on a pro rata basis whether those payments were made before the fourth quarter or not (the Claimant's case); or
>
> (ii) a repayment of only those payments of the second quarter liability which had been made before the fourth quarter on a pro rata basis (HMRC's view)."

137. The parties agree that the answer to this question would apply in other cases where the same circumstances arise.

138. The judge ruled on this at [45] as follows:

> "Since I have received no submissions on this question, I take it that the parties are content for me to provide a short answer to it. It seems to me that either solution would be a reasonable one to adopt, and there are no obvious reasons for preferring one to the other. My slight preference, however, is for the former solution, because it better reflects what actually happened, as can now be seen with the benefit of hindsight. I would therefore answer the question accordingly."

139. The judge was given little assistance by the parties on this rather abstruse issue. The effect of the judge's ruling is to allow Prudential to treat the later excess FII in Q4 as being used so far as possible to set off against lawful ACT paid in Q2, rather than pro-rating the later excess FII in Q4 between the unlawful ACT paid in Q2 and the lawful ACT paid in Q2.

140. However, in our view, this approach is incorrect, for reasons similar to those given in relation to Issues 21 and 22 above. There is no good reason in principle to attribute the excess FII arising in Q4 other than on a pro rata basis between the unlawful ACT and the lawful ACT paid in Q2, and that is the fair treatment in the circumstances.

141. We accept HMRC's submission on this point by reference to its worked example. Assume 1000 ACT liability arises in Q2 of 1993. It is paid in two tranches: 600 on 14

July 1993 (the due date for payment of the ACT) and 400 on 31 December 2000. Of the 1000 of ACT, 750 was lawful and 250 was unlawful, and the parties agree that 75% of the ACT paid on each date was lawful and 25% was unlawful. (We note in passing that on this point Mr Bremner accepted the fairness of using a pro-rating approach in a context where it was not known at the time that any part of the ACT paid was unlawful, which accords with our own analysis under Issues 21 and 22 above). In Q4 of 1993 surplus FII arises, leading to repayment of 400 of the ACT paid in Q2. It is agreed by the parties that the lawful and unlawful ACT for Q2 is paid as follows: at 14 July 1993, 450 lawful ACT is paid and 150 unlawful ACT is paid; at 31 December 2000, 300 lawful ACT is paid and 100 unlawful ACT is paid.

142. The parties differ on the correct way to treat the 400 ACT repaid. Prudential submits that the ACT repaid as a result of the surplus FII in Q4 consists so far as possible of lawful ACT paid in Q2 and the repayment refers to the ACT paid on 14 July 1993 and 31 December 2000 in the same ratio as the ACT payments. Therefore it says that 60% of the repayment of 400 is of lawful ACT paid on 14 July 1993 (i.e. 240) and 40% is of lawful ACT paid on 31 December 2000 (i.e. 160). So following the repayment the total ACT for the year would be, as at 14 July 1993, total lawful ACT paid less ACT repaid of 210 (450 – 240 = 210), total unlawful ACT paid of 150 (since none repaid), and total ACT paid less ACT repaid at 360; and as at 31 December 2000 the respective figures would be 140 (300 – 160 = 140), 100 and 240. Thus the lawful ACT paid is reduced to 350, made up of 210 paid on 14 July 1993 and 140 paid on 31 December 2000, and the unlawful ACT remains the same.

143. We do not accept that this is the correct approach. There is no good reason to prioritise the notional repayment of lawful ACT as compared with unlawful ACT. A fair and principled approach requires that the excess FII in Q4 should be treated as repayment of the lawful and unlawful ACT in Q2 on a pro rata basis, much as under Issues 21 and 22 above.

144. Accordingly, we accept that the proper approach to this example is that given by HMRC, as follows. The ACT repaid as a result of excess FII in Q4 consists of lawful and unlawful ACT in the same ratio as the ACT paid in Q2, and is only of the payment made on 14 July 1993 because the repayment was made before the later payment of ACT made on 31 December 2000. Therefore the 400 repaid through application of the excess FII is treated as a repayment of 300 lawful ACT and 100 unlawful ACT paid on 14 July 1993. Following the repayment, the total ACT paid for the year would be, as at 14 July 1993, total lawful ACT paid less ACT repaid of 150 (450 - 300 = 150), total unlawful ACT paid less ACT repaid of 50 (150 – 100 = 50), and total ACT paid less ACT repaid of 200; and as at 31 December 2000 the respective figures would be 300, 100 and 400.

145. As HMRC point out, on both approaches the same overall amount of ACT is paid and repaid in the year but on HMRC's approach the repayment will reduce both the lawful and the unlawful ACT paid on 14 July 1993. That is correct as a matter of principle. No repayment is set against the payment made on 31 December 2000 because, as a fact, the repayment would have been made before that payment. Again, for the purposes of identifying and quantifying unjust enrichment of HMRC, this is correct in principle.

146. For these reasons, we would allow HMRC's appeal in this further limited respect as well and set aside the judge's ruling in relation to Issue 23.

The change of position defence

147. The judge considered a number of legal questions under this head. He considered that a change of position defence was not an available defence in EU law in the face of a *San Giorgio* claim for repayment of unlawfully levied tax.

148. The change of position defence is tersely pleaded in HMRC's defence as follows:

> "… [HMRC] have changed their position in consequence of the payments made by the Claimants… such that it would be inequitable and/or unconscionable to require [HMRC] to make restitution of those sums. The sums in question formed part of the United Kingdom's tax revenue for the relevant years in which they were paid. Those sums have been irretrievably spent, in some cases many years ago."

149. Even as a matter of English law the mere fact that the defendant has spent the money does not of itself give rise to a defence of change of position: *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548, 580. He might have made the expenditure anyway in the ordinary course of things; or he may have spent the money on acquiring an asset with a realisable value; or he may have spent the money in discharging indebtedness thus ameliorating his net asset position. Accordingly, taking this plea at its highest it does not, in our judgment, disclose a viable defence of change of position.

150. Quite apart from that HMRC adduced no evidence and gave no disclosure in support of the pleaded defence, as the judge recorded at [190]. Without an evidential basis, the pleaded defence was bound to fail for that reason too. HMRC attempted to salvage the position by arguing that it was seeking a decision in principle, but as the judge pointed out at [191] there had been no direction for a split trial; so that argument was hopeless. The judge was therefore correct to rule at [193] that it was not open to HMRC to rely on that defence in these proceedings.

151. On appeal HMRC wished to raise a new and unpleaded defence of change of position or absence of enrichment, despite the fact that in their skeleton argument at trial they asserted that the pleadings were adequate to deal with all change of position defences; and that they disavowed reliance on "passing on" and "fiscal chaos", both of which had been briefly mentioned in the agreed list of issues. This was one of the issues that we excluded from the appeal. We therefore say no more about it.

152. Nor do we need to deal with any of the legal questions, which are better left to a case in which they matter.

Interest: compound or simple?

153. The judge discussed the question of interest at [241] to [247]. His discussion in these paragraphs dealt with the recovery of compound interest as a matter of domestic law. Based on a detailed analysis of *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v*

IRC [2007] UKHL 34, [2008] 1 AC 561, he concluded that Prudential was entitled to compound interest for all relevant periods.

154. He returned to the theme in *Littlewoods Retail Ltd v HMRC* [2014] EWHC 868 (Ch); [2014] STC 1761, in which he said at [417]:

> "It is also convenient to deal here with another point which I have not yet separately addressed. On the assumption that my primary conclusion is correct, should compound interest continue to run to the date of judgment, or should it stop running when the relevant repayments of principal sums were made and be replaced at that point by simple interest under s 35A of the Senior Courts Act 1981? Neither side addressed me at any length on this question, because I have recently considered it, and resolved it in the taxpayers' favour, in *Portfolio Dividends (No 2)* [2014] STC 1236, [2014] 2 CMLR 312 at [245] to [246]. In short, it seemed to me that although there had been no appeal in Sempra from the decision of Park J that interest should run pursuant to s 35A for the period from utilisation of ACT until judgment, the logic of the majority speeches in the House of Lords showed that compound interest should also be available in respect of the post-utilisation period. I confirm that I remain of the same opinion, and I would therefore answer the comparable question in the present case in Littlewoods' favour. The Revenue did not, of course, concede the point before me, but recognised that it would be more sensible to reserve it for a higher court since I had so recently considered it myself and decided it against them."

155. *Portfolio Dividends (No 2)* is this case. *Littlewoods* went to the Court of Appeal which, in the judgment of the court, expressly approved this paragraph: see [2015] EWCA Civ 515, [2015] STC 2014 at [203] and [204]. There is a pending appeal from that decision to the Supreme Court. However, the decision of this court in *Littlewoods* is binding on us; and we follow it.

Limitation

156. In their defence to Prudential's claim HMRC pleaded that Prudential were not entitled to any relief in relation to any cause of action which accrued more than six years before the issue of the claim form (8 April 2003). It was alleged that any such claim was barred by the Limitation Act 1980. HMRC also pleaded reliance on section 320 of the Finance Act 2004 and section 107 of the Finance Act 2007.

157. By section 320 of the Finance Act 2004 Parliament attempted to cut down retrospectively a taxpayer's right to rely on an extension of the limitation period in cases of mistake. However, in their third ruling given after the judge's decision, the CJEU ruled that that attempt was unlawful under EU law.

158. The judge therefore had to decide (on the assumption that section 320 was valid) whether the amended claims relating to ACT arose out of the same or substantially the same facts as the claims already pleaded. He decided that they did. However, he said

that his decision on that point was of little practical consequence because if section 320 was invalid, as was likely, Prudential would be entitled to rely on an extension of the limitation period under section 32 (1) (c) of the Limitation Act 1980 which extends the limitation period in cases of relief from the consequences of a mistake. It was clear from the transcript that this was common ground. HMRC wished to appeal on the question whether the judge was right in what he decided; and also wished to argue that Prudential could with reasonable diligence have discovered the mistake earlier than it did. This was not an allegation that had been pleaded or raised before. Since the question of extending the limitation period under section 32 (1) (c) was common ground before the judge, we refused to permit HMRC to argue the latter point. In the light of that an appeal against the judge's decision on the question whether the amended claims arose out of the same or substantially the same facts as the pleaded claims could have had no practical effect on the judge's order; so we excluded that issue from the appeal as well.

Result

159. We allow the appeal on Issues 21, 22 and 23 but otherwise dismiss it.