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CLIENT BRIEFING

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The Court of Appeal in *Beard* concludes the foreign dividends received by the taxpayer were not 'dividends of a capital nature' as the mechanism for payment of the dividends left the corpus of the foreign shares intact. The Upper Tribunal's decision in *Rettig* shows how difficult it is to win a judicial review case of HMRC's decision not to exercise discretion to extend the time limit for a claim to set off a NTLRD against profits. HMRC publish significantly revised guidance on the loan relationships unallowable purpose rule following last year's Court of Appeal decisions. The proposal to increase US taxes on non-US individuals and entities in retaliation for 'unfair foreign taxes' on US persons (including DSTs, the UTPR and diverted profits taxes) causes concern for UK investors.

Beard: whether dividends were of a capital nature

The Court of Appeal in *A Beard v HMRC* [2025] EWCA Civ 385 had to interpret the meaning of 'dividends of a capital nature' in ITTOIA 2005 s 402(4). For income tax purposes there is a distinction between payments received from UK-resident and non-UK resident companies. UK income taxpayers are subject to income tax on any distribution (whether or not capital in nature) from a UK resident company but only on dividends not of a capital nature, or other income received, from a non-UK resident company.

Alexander Beard, a UK tax resident shareholder, argued that the distributions (in cash and in shares) he received from the share premium of Glencore, a Jersey company, were of a capital nature and so not caught by s 402. At the relevant time, Jersey law provided two alternative mechanisms for paying distributions out of share premium. Although the 'Part 12' mechanism was available for capital reductions, Glencore used the 'Part 17' mechanism which had less onerous condition and was the same mechanism as would be used for paying a dividend out of trading profits. This choice of mechanism proved critical to the UK tax analysis.

Beard failed to convince the FTT and the UT that the distributions he received were not within s 402 and appealed to the Court of Appeal where he lost a third time. Although no new ground is broken is this case, the Court of Appeal's review of the case law and application of that case law to the facts of the case is helpful to anyone analysing how a particular payment to UK individual shareholders from a non-UK resident company should be classified which is something advisers drafting shareholder documents for London-listed non-UK resident companies are often required to do.

The Court of Appeal confirmed the focus of s 402(4) is the character of the dividend and not the funds from which the dividend is paid. The test to ascertain the character of the dividend is whether the corpus, or capital, of the asset remains intact after the distribution. The mechanism by which a dividend is paid is an essential element in determining whether the corpus of the asset remains intact. The mechanism will generally be determinative but in some cases, it might be necessary to look behind the mechanism to identify the 'true substance'. In this case, however, the Court of Appeal found that under the Part 17 mechanism, the corpus of the Glencore shares remained intact in the hands of the taxpayer after the distributions and so the dividends were income in nature and not capital. This conclusion applied equally to the cash dividends and the distribution of shares (a dividend in specie of a 'fairly minor asset') which for tax purposes had the same income character as a Part 17 distribution of an equivalent amount of cash.

Rettig: judicial review of HMRC's decision not to extend time limit

The Upper Tribunal in *R (oao) Rettig Heating Group UK Limited (in liquidation) v HMRC* [2025] UKUT 143 (TCC) dismissed the claim for judicial review of HMRC's refusal to exercise discretion to extend time for a claim to set off its non-trading loan relationship deficit (NTLRD) against profits from overseas dividends.

There is a two-year time limit to set-off NTLRD against profits but HMRC have discretion to extend this time limit. The profits in this case were from dividend income from an Irish subsidiary received in the accounting period ended

31 December 2002 so the time limit for NTLRD set-off expired on 31 December 2004. Rettig originally filed a corporation tax return which included the dividend income as taxable profits and offset part of its NTLRD against this with the balance of the NTLRD then being surrendered by group relief to Purmo. That return was then amended (in time) to treat the foreign dividends as exempt and to withdraw the NTLRD offset, instead surrendering all of the NTLRD to Purmo.

At the time of expiry of the two-year time limit, Rettig's position that the foreign dividend income was exempt was on the basis that the UK's domestic provisions, which exempted UK dividends but taxed foreign dividends, were in breach of EU law. This argument ran (slowly over decades) through the CJEU and the UK courts in the *Franked Investment Income (FII)* group litigation. The final outcome was that the foreign dividend income was chargeable to UK tax but with credit for foreign tax at the foreign nominal rate (which for manufacturing income for the Irish subsidiary was 10%). This meant that even after the credit for the foreign tax, the taxpayer would have further UK tax to pay on the dividend income if the NTLRD could not be offset. It was 2020 before HMRC put out a Business Brief setting out HMRC's views on the statutory claims to double tax relief following the result of the *FII* and other litigation and there followed various communications between HMRC and Rettig about the correct amount of foreign tax credit and how that could be given. HMRC had opened an enquiry into the relevant CT return which, at the time of the Upper Tribunal's decision, remained open although HMRC indicated they intended to make amendments.

So it came to be that in March 2021, just over 16 years after the two-year time limit expired, Rettig made a claim to reduce the amount of group relief of NTLRD surrendered to Purmo and instead offset part of the NTLRD against the Irish dividend but HMRC refused to exercise their discretion to extend the two-year time limit for the NTLRD offset – although it did permit the amendment to the group relief surrender. Rettig sought judicial review of HMRC's decision (issued in January 2024) to refuse the late claim.

SP 5/01: discretion to grant time extensions

HMRC are guided as to the use of their discretion to grant time extensions by *Statement of Practice 5 of 2001* (SP 5/01) and accordingly applied SP 5/01 in this case which resulted in the decision not to allow the out-of-time claim. Rettig brought the judicial review application arguing that HMRC had made errors of law in interpreting SP 5/01, had failed to take into account relevant considerations and had reached an irrational decision. The Upper Tribunal concluded that HMRC had correctly interpreted SP 5/01 and that the decision to refuse the late claim was not irrational.

SP 5/01 provides that generally HMRC will admit claims which could not have been made within the statutory time limits 'for reasons beyond the company's control'. The taxpayer failed to persuade the Upper Tribunal that its circumstances came within either example of reasons beyond the company's control. According to the Upper Tribunal, disputes as to legal chargeability do not bring the taxpayer within these examples: '*It is entirely within a taxpayer's control to make the correct assessment of the relevant legal position. The fact that view may prove to be wrong does not mean it was out of their control to make that assessment, just that they got it wrong*.'

Considering the first example in SP 5/01, the Upper Tribunal found that the taxpayer had an awareness of the profits (the Irish dividends) but a lack of awareness that the profits should be brought into tax. The Upper Tribunal concluded this meant that it was actually possible for the taxpayer to have made a claim to offset the NTLRD before the end of the expiry period even though HMRC could not give effect to that claim until those profits were brought into charge. On the second example, the Upper Tribunal decided that discussions with HMRC about the chargeability of the dividends to tax were not the type of 'discussions' with HMRC to which the second example referred: '*If it had been intended that Example Two should extend to a situation where the chargeability of profits to tax was subject to an unresolved legal challenge, different wording would have been required*.'

Declaratory theory of case law

This case highlights the practical problems time limits pose for the declaratory theory of case law. The decisions of the CJEU in the *FII* litigation declared what the law had been at all relevant times, so they were retrospective in effect. But should that retrospectivity enable HMRC to make amendments to the return to add in the taxable amount of foreign dividends for a period without letting the taxpayer make use of reliefs which it would have used at the time had it filed the return on the basis of the law later determined in *FII*? This seems like a prime scenario for HMRC to use their discretion so it is a shame that the Upper Tribunal took such a narrow construction of SP 5/01.

High bar of irrationality test

The test of irrationality has an extremely high bar: to be an irrational decision, it has to be one that no reasonable decision-maker in the position of the relevant decision-maker, and otherwise acting lawfully, could have made. It is not sufficient to show that the taxpayer acted reasonably in delaying the claim because it does not follow that if a taxpayer acts reasonably, HMRC must be irrational in not allowing the late claim.

What next?

This case shows how difficult it is to win a judicial review case of HMRC's decision not to exercise discretion. But it sounds like the taxpayer is not giving up just yet. Once HMRC have issued a closure notice, counsel for the taxpayer suggested it intends to put in a claim under the FA 1998 Schedule 18 consequential claims provisions and if HMRC do not accept the validity of such a claim, the taxpayer could lodge a substantive appeal arguing that

HMRC's view that the consequential claims provisions would not apply to the NTLRDs is incorrect.

HMRC's revised guidance on unallowable purpose

Following last year's Court of Appeal decisions in *Kwik-Fit* [2024] EWCA Civ 434, *BlackRock* [2024] EWCA Civ 330 and *JTI* [2024] EWCA Civ 652, all of which are now final, HMRC have significantly revised their guidance in the *Corporate Finance Manual* at *CFM38100 to CFM38200*. The revised guidance draws out the principles from the unallowable purpose cases whilst noting that in any given case, whether there is a main unallowable purpose will ultimately be a question of the specific facts to be determined by the fact-finding tribunal. We have highlighted three of the areas where HMRC have expanded their guidance. It is important to remember that the views set out in the guidance are based on HMRC's interpretation of the law and cases which may not necessarily be the same as how a taxpayer or a court would interpret them. The guidance does, of course, form part of HMRC's known position for the purposes of the notification of uncertain tax treatment rules that apply to large businesses.

Whose purpose do HMRC consider is relevant?

Referring to *BlackRock*, the guidance states the test is the company's subjective purpose in being party to the loan relationship in question. It is the purpose of the relevant decision-makers, usually the directors of the company, which must be determined. Based on *BlackRock* and *JTI*, where the loan relationship in question is part of wider group arrangements, the purposes of the group '*are likely to be relevant in assessing the application of the unallowable purpose rule*'. The relevance of the group purposes to the directors in influencing their decisions would then need to be assessed on the facts.

Even if the directors of the taxpayer company are ignorant of the scheme's tax purpose it may still bear on the company's tax purpose. The guidance states '*In such circumstances, the company may well be a party to the loan relationship for the purpose of securing the tax advantage*.' This is based on the quote from *JTI* that '*[i]t may suffice that those promoting the scheme have that intention*'.

Assessment of the significance of a purpose to see whether securing a tax advantage is a main purpose

HMRC set out a number of specific factors which may be relevant but are not determinative including:

- the extent to which the tax advantages are known or expected;
- the degree of attention paid to securing the tax advantages;
- the size of the tax advantages in absolute terms and/or relative to the size of the commercial benefits;
- the impact on net UK tax benefits and/or net global tax benefits; and
- the 'but for test' - whether or not the arrangements would have happened anyway, or would have happened in a different way, but for the tax advantage.

HMRC note that many of these factors were established in case law on the wholly and exclusively test or other purpose or object tests but have been confirmed as applicable to the unallowable purpose rule.

Apportionment where there are mixed commercial and unallowable purposes

There is no prescriptive method of just and reasonable apportionment of the debits to the relevant (subjective) purposes and again, what is just and reasonable depends on the facts and circumstances. It is important to note that the test of attribution on a just and reasonable apportionment is an objective one and so any proposed forms of apportionment that reintroduces subjectivity will not be appropriate. HMRC work through various possible approaches including attribution on the basis of a clear causal link and asking a 'but for' question (both of which find favour with HMRC). HMRC then list approaches which HMRC consider to be 'very difficult' (such as considering what attribution would result in a counteraction of a net UK tax benefit achieved; or using relative weight of purposes) or 'highly unlikely to be an appropriate approach in most circumstances' (in the case of an approach based on seeking to counteract net global tax benefit).

Section 899: US enforcement of remedies against unfair foreign taxes

The Trump Administration's One Big Beautiful Bill is currently working its way through the US legislature. It includes a provision (s 899) to increase US tax rates (including withholding tax rates) on residents of 'discriminatory foreign countries' imposing 'unfair foreign taxes' on US persons. S 899 would also modify the application of the Base Erosion and Anti-Abuse Tax (or BEAT) to corporations owned directly or indirectly by certain non-US persons with sufficient nexus to a discriminatory foreign country.

The increase in withholding tax under proposed s 899 is understandably causing concern to non-US persons with US investments. The legislation is very broadly drafted and includes the Pillar 2 undertaxed profits rule (UTPR), digital services taxes and diverted profits taxes. The UK has the complete hat-trick of these 'unfair taxes' and so is likely to be classed as a discriminatory foreign country. Section 899 also picks up other taxes '*with a public or stated purpose indicating the tax will be economically borne, directly or indirectly, disproportionately by United States persons*.' Where applicable, s 899 would increase the statutory rate of tax (or, where applicable, the treaty rate) on certain US-source income by 5% for each calendar year, up to a maximum of 20% above the statutory rate.

It is market practice for loan agreements, derivative contracts and certain note offerings to include a provision requiring a gross-up for certain withholding taxes. For existing agreements with a US borrower or counterparty, it should be considered whether the application of s 899 could trigger such gross-up obligations or consequential termination provisions. Where an agreement or offering is currently being negotiated, parties should consider the allocation of the risk of withholding taxes that would become payable under s 899, if enacted.

The s 899 withholding tax increase will begin at the earliest in the calendar year 2026 if the provision is enacted by the 30th of September 2025, or in 2027 if enactment is after the 30th of September 2025. This leaves a period of time for deals to be done to remove such unfair taxes which is what this measure is really intended to achieve.

What to look out for:

- The consultation on advance tax certainty for major projects closes for responses on 17 June.
- The Supreme Court is due to hear the appeal in *HFFX LLP and others v HMRC* on the remuneration of members of an LLP between 17-19 June.
- The consultation on the draft legislation reforming transfer pricing, permanent establishment and diverted profits tax closes on 7 July.

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