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HARGREAVES IN THE COURT OF APPEAL: A RETURN TO ORTHODOXY ON WITHHOLDING TAXES?

The Court of Appeal has dismissed Hargreaves' appeal against the Upper Tribunal's decision and determined that tax should have been withheld from interest paid on loans advanced to the group. The judgment provides taxpayers and their advisers with helpful certainty on the meaning of 'beneficial entitlement' for withholding tax purposes and a great re-cap of key case law and their relevance for considering 'beneficial entitlement' and 'yearly interest' in the context of UK withholding tax.

Hargreaves Property Holdings Ltd v HMRC [2024] EWCA Civ 365 ranks among the most important withholding tax cases in many years. Certainly few, if any, recent cases have raised quite so many withholding tax points for the tribunal to decide.

In both the First-tier and Upper Tribunals ([2021] UKFTT 390 (TC) and [2023] UKUT 120 (TCC)), the taxpayer lost on all of these points. But, particularly on the question of whether a UK company was 'beneficially entitled' to the interest payments, the Upper Tribunal adopted what, in our view, was a radical extension of the 'beneficial entitlement' concept in UK domestic tax law. We each wrote articles for this journal last year discussing the impact of the Upper Tribunal decision ('Withholding tax: *Hargreave*-ances' (Deepesh Upadhyay and Sean Wright), Tax Journal, 23 June 2023; 'Beneficial entitlement in *Hargreaves*: is *Indofood* now part of domestic law?' (Dominic Robertson), Tax Journal, 7 July 2023, republished on Slaughter and May's website on 17 July 2023).

The Court of Appeal has now upheld the decisions of the tribunal, but has done so on a narrower basis than the Upper Tribunal: it has decided the case based on long-standing caselaw, and rejected the Upper Tribunal's more expansive view of 'beneficial entitlement'. Rather than writing two separate articles again, we've joined forces to assess the implications of the Court of Appeal judgment.

What was Hargreaves all about?

The case concerns a UK resident company, Hargreaves Property Holdings Ltd ('Hargreaves') which had historically borrowed from connected overseas lenders to fund the group's commercial activities. In 2004, Hargreaves restructured its loan agreements for the sole purpose of switching off UK withholding tax, whilst still obtaining corporation tax relief for its interest expense. The changes included:

- Amending the governing law and jurisdiction clauses in the loans, and the place of payment, to refer to Gibraltar rather than England.
- The loans were made repayable on 30 days' notice by lender or borrower.
- Shortly before interest payments were due, the original lender would assign the right to interest and principal for consideration – initially, the assignments were made to Guernsey residents, but from 2012 onwards the right to interest was further assigned to a UK resident company, Houmet Trading Ltd (Houmet).
- Very shortly after the assignment, the borrower would pay interest and principal to the assignee.
- The original lender would advance a new loan to the borrower, using the consideration received from the assignment, to fund the borrower's payment to the assignee.

(We do wonder why Hargreaves did not simply list the debt, which would have been a far simpler way of disapplying withholding tax. But perhaps the borrowings fluctuated too much and the need to document the debt in the form of bonds together with the additional on-going listing costs meant that a listing was not considered to be feasible.)

HMRC considered that the planning did not work, and that Hargreaves should have withheld income tax, under ITA 2007 s 874, from interest payments. Hargreaves appealed this on four grounds, centred around whether (i) the interest was UK source, (ii) the interest was 'yearly interest', (iii) double tax treaty relief was available under the Guernsey-UK tax treaty and (iv) a UK resident company (Houmet) was beneficially entitled to the interest.

Hargreaves lost on all four points before the First-tier and Upper Tribunals. The tribunals held that the interest had a UK source, holding that *Ardmore Construction Ltd v HMRC* [2018] EWCA Civ 1438 required the tribunal to carry out a fact-sensitive, multi-factorial analysis – and held that the most material factors (the residence of the debtor

and the location of its assets) pointed to a UK source. The tribunals also held that the treaty argument failed for procedural reasons: treaty relief required a direction from HMRC enabling interest to be paid free from WHT, and no direction had been obtained.

The source and treaty points were not appealed to the Court of Appeal, and are not discussed further here (see Deepesh's article last year for further details). This left only two issues for determination: was Houmet beneficially entitled to the interest which it received, and was the interest yearly interest?

Beneficial entitlement

ITA 2007 s 930 switches off withholding tax on interest paid by a company if the company 'reasonably believes' that the interest is an 'excepted payment', and s 933 confirms that a payment is 'excepted' 'if the person beneficially entitled to the income in respect of which the payment is made is a UK resident company'. (Incidentally, as Falk LJ pointed out in this case, the 'reasonable belief' requirement in s 930 is, in reality, redundant: if the payer held a reasonable but incorrect belief that a payment was 'excepted', then s 938 means that withholding tax is still imposed.)

At first instance, Judge Beare held that the assignment to Houmet had no commercial purpose (which must be right), and that *IRC v McGuckian* [1997] STC 908 (a House of Lords case which is not about beneficial entitlement) 'compels the conclusion' that, where a step in a transaction has no business purpose, that 'artificial step' had to be disregarded, such that Houmet was not beneficially entitled to the income.

The Upper Tribunal queried this reliance on *McGuckian*, but nevertheless upheld the decision that Houmet was not beneficially entitled to the interest. They held that 'beneficial entitlement' is intended to refer to 'UK companies who are substantively entitled to receive and enjoy the income' (para 29), and that it therefore may 'exclude situations where the commercial and practical reality of the matter is that the interest … is then paid on to an entity outside the UK' (para 28). So Houmet was not beneficially entitled to the interest income, because it was obliged to pay away 'very similar sums' to Guernsey.

As Dominic noted in his article last year, it was surprising that neither judgment referred to any of the leading UK cases on the meaning of 'beneficial entitlement' – and indeed the Upper Tribunal judgment effectively applied the 'international' meaning of beneficial entitlement, from *Indofood International Finance v JP Morgan Chase Bank* [2006] STC 1195, rather than its domestic meaning.

In the Court of Appeal, by contrast, Falk LJ's leading judgment contains a long analysis of the UK caselaw on beneficial ownership/entitlement (including *Parway Estates Ltd v IRC* (1957) 45 TC 135; *Wood Preservation v Prior* (1969) 45 TC 112; *Ayerst v C & K (Construction) Ltd* [1975] STC 345; *J Sainsbury plc v O'Connor* [1991] STC 318; and *Bupa Insurance Ltd v HMRC* [2014] UKUT 262 (TCC)). She derived six principles from these cases:

- Beneficial ownership is a well-established concept and 'means ownership for the benefit of the person'. (Are there shades of 'Brexit means Brexit' here?)
- Beneficial ownership and the (non-tax) concept of equitable ownership normally, but not always, mean the same thing.
- Beneficial ownership, as a statutory concept, must be construed purposively in the context of the legislative scheme in question. (Falk LJ strongly rejected a submission that the phrase should be interpreted literally and not purposively: in her view, there is 'no special category of statutory concept that is immune from purposive construction.' It is a shame that the Supreme Court case *R (O) v Home Secretary* [2022] UKSC 3 was cited as support for a literal interpretation of the term. In our view, *R (O)* does not support Hargreaves' submissions, but it remains an important case on how purposive construction should be carried out – in particular, it emphasises that the focus must remain on the 'statutory words' and that courts should be reluctant to impose a strained meaning on the statutory words, as citizens and their advisers 'are intended to be able to understand parliamentary enactments'.)
- Crucially, a legal owner of property will not be its beneficial owner 'if they do not in fact have *any of the benefits* of ownership, such that they hold only a "mere legal shell"' (emphasis added.) Falk LJ therefore rejected the Upper Tribunal's suggestion that an obligation to pay away 'very similar sums' would necessarily defeat beneficial ownership; what matters is whether the recipient retains 'any of the benefits' of the sums.
- It is possible for nobody to be the beneficial owner of property for tax purposes.
- The caselaw on beneficial ownership applies to cases on beneficial entitlement, and vice-versa.

For good measure, Falk LJ also confirmed that *Indofood's* 'international fiscal meaning' of beneficial ownership/entitlement is irrelevant for domestic purposes.

Applying these principles, Hargreaves lost the 'beneficial entitlement' issue for a prosaic reason: they had produced 'extremely limited' evidence on how the assignments to Houmet worked, and therefore they had simply failed to prove that Houmet had 'any of the benefits' derived from the interest payments. In coming to this conclusion, the Court placed emphasis on the fact that the arrangements were entirely tax-motivated, the artificial steps did not give rise to any meaningful risk or reward and not only did Houmet's involvement have no commercial purposes but also (based on the evidence) had no practical or real effect.

Falk LJ's approach to Hargreaves has removed many of the uncertainties created by the Upper Tribunal judgment, as outlined in Dominic's article last year: it is now clear that beneficial entitlement in s 933 is determined based on

long-standing principles, and that a legal owner of interest is the beneficial owner if it retains 'any of the benefits' of that interest. However Falk LJ's approach has also re-emphasised that advisers considering financing arrangements and in particular, intra-group arrangements, should consider whether the tax motivations, relevant steps and purpose (or indeed lack thereof) could cut across the position that the relevant lender retains any of the benefits of the interest payable to it.

There are still some uncertainties to resolve in future, of course. For example, if someone entitled to receive £100 of interest is obliged to pay on £95 of that interest to a third party, is the recipient beneficially entitled to all of the interest, or only to £5 of the interest? (Presumably HMRC will say the answer is only £5.) Would it then make a difference if the recipient was obliged to pay the £95 after a two-week gap, and retained any profits and losses which it made on the £95 in the interim? (Presumably this would secure beneficial entitlement to the interest, based on *Bupa*.)

Yearly interest

On this issue, the Court had to decide whether interest was 'yearly' interest if it arose on loans with a duration of under a year, 'but which were routinely replaced by further loans from the same lenders'. Unsurprisingly, the Court of Appeal agreed with the lower Tribunals' conclusion that this was yearly interest, for the reasons which they gave, i.e. that this question is determined by a 'business-like rather than dry legal assessment' of a loan's likely duration. This decision was based on longstanding precedent – in this case, going back to 1889, *Goslings and Sharpe v Blake* (1889) 2 TC 450. (Reflecting the very different tax system at the time, in *Blake* it was the Revenue who argued that the interest was 'short' interest, and the taxpayer who argued that it was yearly interest.)

Although each loan was, legally, advanced as a separate loan (and always existed for less than a year), Judge Beare had found that the lender's decision to renew the short-term loans was merely a formality. That inevitably meant that the payments were yearly rather than short interest.

Hargreaves is, therefore, a helpful reminder to advisers that there is no easy, and certainly no formalistic, way of converting longer-term debt into short-term debt which does not generate yearly interest. However, if a borrower funds itself through short-term debt from a series of different (and unrelated) lenders, each of which makes an independent decision to lend, then it seems to us that the facts are much closer to those in *Blake*, and that the interest could therefore be treated as exempt from withholding tax.

Conclusion

As the taxpayer has lost at all three stages of the appeal, we suspect that *Hargreaves* is unlikely to proceed to the Supreme Court. (Indeed, if the Supreme Court agreed to hear the case, that would suggest to us that the judges wanted to look again at the UK domestic concept of 'beneficial entitlement', to test whether it should move closer to the *Indofood* international meaning – which is hardly likely to assist the taxpayer in this case.)

If the Court of Appeal judgment is the final word, then ultimately the case merely endorses long-standing existing authorities in respect of withholding tax on interest and serves as a helpful reminder to advisers that context (including tax motivations, purpose, timing and steps) is everything. That said, most taxpayers (and their advisers) will welcome the greater certainty provided by the Court of Appeal – and the judgment remains well worth reading as an authoritative analysis of the law on beneficial ownership and yearly interest.

This article was co-authored by Deepesh Upadhyay, tax partner in the London tax team of Eversheds Sutherland (International) LLP, and was first published in the 21 May edition of Tax Journal.

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