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BENEFICIAL ENTITLEMENT IN HARGREAVES: IS INDOFOOD NOW PART OF UK DOMESTIC LAW?

In the recent *Hargreaves* judgment, the Upper Tribunal held that a UK company was not beneficially entitled to interest when it was obliged to pay similar sums to a non-UK entity. The decision effectively seeks to import the international fiscal meaning of 'beneficial ownership' into UK domestic law, in a way which is contrary to earlier Court of Appeal authority. Furthermore, once Hargreaves is applied to a few sample scenarios, the uncertainties it creates quickly become apparent.

The recent Upper Tribunal case of *Hargreaves Property Holdings Ltd* [2023] UKUT 120 (TCC) raises so many different withholding tax issues that it could be set as an exam question for future CTA students.

In an A* article in *Tax Journal* ('Withholding tax: *Hargreave-ances*', 23 June 2023), Deepesh Upadhyay and Sean Wright summarised the implications of the entire *Hargreaves* judgment. I don't intend to retread the same ground: in this article, I want to focus on the most difficult question in *Hargreaves*, on whether a UK company was 'beneficially entitled' to interest income, and therefore protected from withholding tax by ITA 2007 s 933, if that UK company paid 'what appeared to be very similar sums' to a non-UK person as consideration for acquiring rights to the interest income.

Beneficial ownership/entitlement are central concepts in tax codes around the world, and in many tax treaties. Over the last 20 years, there has been a general international trend towards interpreting 'beneficial entitlement' as an amorphous concept for fighting base erosion: in particular, by refusing to treat someone as beneficially entitled to income where they are required to pay away a similar amount of money to someone else.

For example, under the EU Parent-Subsidiary Directive, the 'Danish cases' (*T Danmark* (C-116/16), *Y Danmark* (C-117/16)) held that a company is not the beneficial owner of dividends if the transaction involves an 'abuse of rights', which could (arguably) be assumed if the company is a conduit. Similarly, in *Indofood v JP Morgan* [2006] STC 1195, the Court of Appeal held that, in tax treaties, beneficial ownership has an 'international fiscal meaning' which is not derived from domestic law, and that in this international meaning a beneficial owner must have 'the full privilege to directly benefit from the income'. Therefore, an obligation to pay away the income to a third party would defeat beneficial ownership for treaty purposes.

As I explain in this article, the Upper Tribunal in *Hargreaves* has effectively sought to import the *Indofood* concept of beneficial entitlement into domestic law. Surprisingly, it has done so without (expressly) recognising that this is the effect of its judgment, and without addressing any of the UK authorities which have, historically, created a very different definition of 'beneficial entitlement' in UK domestic law. Finally, I discuss some of the practical uncertainties which are created if Hargreaves is correct on the 'beneficial entitlement' point.

What did *Hargreaves* decide?

Hargreaves involved withholding tax on interest payments made from 2010 to 2015. Initially, those interest payments were made from the UK to a Guernsey entity. In 2012, an additional step was added, in which the Guernsey entity assigned its interest rights to a UK-resident affiliate, on terms under which, as consideration for the assignment, the UK company would pay Guernsey an amount equal to almost all of the interest which it received. It was clear that the UK affiliate had been inserted into the transaction solely for tax reasons. The taxpayer nevertheless argued that the interest payments were protected by ITA 2007 s 933, because the UK company which received those payments was 'beneficially entitled' to them.

At first instance ([2021] UKFTT 390 (TC)), Judge Beare held that *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, which made it obvious that the UK company was not beneficially entitled to the income. (Full disclosure: Judge Beare is a former partner in our firm.)

It is not immediately apparent to me that Judge Beare's reading of *McGuckian* was correct, not least as in a later House of Lords case, *Westmoreland* [2001] STC 237, Lord Hoffmann rejected the argument that one can always disregard a transaction 'simply on the ground that it was entered into solely for tax reasons'. (I make this point with some trepidation – experience suggests that, when I disagree with Judge Beare, I rarely win the argument.) In any case, this approach to beneficial entitlement, by definition, caused no collateral damage to transactions

which had a commercial purpose – and did not, therefore, cause any issues for the vast majority of taxpayers relying on ITA 2007 s 933.

On appeal, the Upper Tribunal took a different approach, suggesting that *McGuckian* did not compel the tribunal to ignore the tax-motivated assignment. Nevertheless, the Upper Tribunal upheld the decision that the UK company was not beneficially entitled to the interest.

This was because the Upper Tribunal 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 '(depending on the particular circumstances) 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, because in that situation there is the same underlying concern that tax on the income will not in practice be able to be collected' (para 28). So the UK company was not beneficially entitled to the interest income, because it was obliged to pay away 'very similar sums' to Guernsey. The Upper Tribunal held that the absence of a commercial purpose 'may be a relevant fact' in determining beneficial entitlement to the interest income (para 37), but did not explore when the lack of a business purpose might not be a relevant factor, or which other factors might be relevant in applying the *Hargreaves* definition.

The Upper Tribunal did not refer to the 'international fiscal meaning' of beneficial ownership in *Indofood* – though, somewhat bizarrely, they did refer to the (overturned) High Court judgment in that case. But the definitions of 'beneficial ownership' in Indofood ('full privilege to directly benefit from the income') and in *Hargreaves* ('substantively entitled to receive and enjoy the income') are almost identical. And, in each case, these definitions had the same effect: an obligation to pay on amounts received was enough to defeat beneficial entitlement.

Is *Hargreaves* consistent with UK case law on beneficial ownership?

Surprisingly, *Hargreaves* does not refer to the case law on the meaning of beneficial ownership/entitlement in UK domestic law. The leading cases here are the Court of Appeal judgments in *Wood Preservation v Prior* (1968) 45 TC 112 and *Sainsbury v O'Connor* [1991] STC 318, and more recently the Upper Tribunal judgment in *Bupa Insurance* [2014] STC 2615. (We advised the taxpayer in *Bupa Insurance*.)

Taken together, these three cases establish that:

- Beneficial ownership is not the same as equitable ownership. Ownership of a 'mere legal shell' deprived of 'all rights which would normally attach' to the asset is not enough.
- However, if a person retains any benefits in the asset or income, then this is enough to amount to beneficial ownership. In *Sainsbury*, Lloyd LJ rejected an argument from the Revenue that the court should form a 'balanced judgment' as to whether the retained rights were sufficiently important to confer beneficial ownership, noting that it would then be impossible to 'draw the [dividing] line'.
- An obligation to pay on 'very similar sums' to the interest/dividends received does not undermine beneficial ownership, so long as the recipient retains some risk and reward in the money received. In *Bupa Insurance*, the taxpayer was required to pay deferred consideration for the shares in an amount broadly equal to any dividends paid on those shares, with payments falling due two weeks after the dividend was received. But the Upper Tribunal had 'no doubt' that the taxpayer remained beneficially entitled to the dividends, because (for instance) it was entitled to retain any interest or FX gains generated on the dividend proceeds in that two-week period.

Putting it mildly, it is difficult to reconcile these principles with the Upper Tribunal's definition of 'beneficially entitled' in *Hargreaves*. It could, potentially, be argued that the earlier cases concern beneficial ownership/entitlement in the group relief rules, whereas *Hargreaves* concerns beneficial ownership in the withholding tax code; and that, under the 'patchwork blanket' theory of statutory construction in *Rangers* [2017] STC 1556, the term could have a very different meaning in the two different sets of rules. However, I can see no compelling reason why beneficial ownership/entitlement should have fundamentally different meanings in different parts of the Taxes Acts: the group relief rules are also intended to distinguish between the 'real' owners of assets/income and someone who owns them as a 'mere legal shell'. And, if the earlier cases were being distinguished, then you would expect the tribunal to refer to these cases and explain why they were distinguished, rather than ignoring them.

It seems to me, therefore, that the Upper Tribunal's interpretation of beneficial entitlement is likely to be inconsistent with *Wood Preservation* and *Sainsbury*, which would thus make it bad law (pending any further appeal).

Practical uncertainties from *Hargreaves*

Nevertheless, businesses will want to assess the practical implications of *Hargreaves* – not least as HMRC itself will surely argue that *Hargreaves*' vaguer definition of 'beneficial entitlement' is correct.

Once *Hargreaves* is applied to a few sample scenarios, however, the uncertainties it creates quickly become apparent:

- **Scenario A**: A company resident in a country with a 0% withholding tax rate in its treaty with the UK (Treaty Lender) lends to a UK resident company (UKCo1) on interest-bearing terms, which onlends to UKCo2 on broadly the same terms. Who is the beneficial owner of the interest paid by UKCo2? Is this UKCo1, even though it's obliged to pay away the interest to Treaty Lender? Or is this Treaty Lender – but then can UKCo2 get a direction to

pay interest gross to Treaty Lender, even though it doesn't actually pay Treaty Lender? And would UKCo1 still need its own direction to pay interest gross to Treaty Lender?

- **Scenario B**: UKCo1 issues listed debt on interest-bearing terms. It then onlends this to UKCo2 for broadly the same interest rate. Again, can UKCo2 treat UKCo1 as the beneficial owner of the interest? Or does UKCo2 need to trace through to the holders of the listed debt? And could this result in withholding tax due from UKCo2, even though UKCo1 could pay interest WHT-free under the quoted Eurobond exemption (ITA 2007 s 882)?
- **Scenario C**: UKCo1 issues unlisted zero-coupon bonds to a Guernsey lender at a discount to face value. UKCo1 onlends to UKCo2 at a fixed interest rate which, broadly, matches the discount element of the bonds issued by UKCo1. Again, can UKCo2 treat UKCo 1 as the beneficial owner of the interest? Or does UKCo2 need to treat the Guernsey lender as the beneficial owner, so that it needs to withhold tax, even though the Guernsey lender actually receives its finance return in a form which is not subject to withholding tax?

In practice, it seems unlikely that HMRC would want to collect withholding tax in these scenarios, as there is arguably no withholding tax avoidance if the eventual payment out of the UK is made in a form which is exempt from withholding. Indeed, after the *Indofood* judgment, HMRC released guidance which confirmed that the 'international fiscal meaning' would not apply where the payment to the 'ultimate' beneficial owner could itself have been made free from withholding (see HMRC's *International Manual* at INTM332060). But that guidance, of course, has no impact on UK/UK payments. Indeed, it now provides little comfort on cross-border payments if *Hargreaves* means that the international and domestic meanings of beneficial entitlement are the same!

It would, therefore, be helpful if HMRC could issue guidance confirming how it would apply *Hargreaves* in the scenarios above, just as it did after the *Indofood* judgment.

Ultimately, any guidance which defends the *Hargreaves* decision whilst protecting the 'good' scenarios above will, I think, need to conclude that 'beneficial entitlement' in ITA 2007 s 933 has different meanings depending on factors which have nothing to do with the nature of the recipient's enjoyment of the interest, but which turn solely on whether a transaction between the recipient and a third party is 'good' or 'bad' in UK tax terms. But if the effect of *Hargreaves* is that the same term, 'beneficially entitled', can have two different meanings in the same section, it's hard to see how this would be consistent with recent Supreme Court guidance on purposive construction, in *Project for the Registration of Children as British Citizens* [2023] AC 255, which emphasised that this exercise must focus, first and foremost, on the words which are actually used in the statute, so that citizens can 'understand … and rely upon what they read in an Act of Parliament'.

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