CORPORATE RESIDENCE IMPLICATIONS OF THE DEVELOPMENT SECURITIES CASE

BUSINESS TAX ALERT

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A Review of Corporate Residence

It is of increasing importance that companies which are intended to be non-UK resident for tax purposes are indeed non-UK resident (and vice versa). Failure to achieve the intended tax status can result not only in unexpected tax liabilities but cause wider risk and reputational issues.

The recent decision of the Upper Tribunal in Development Securities and HMRC (2019) ("the DS case") provides important guidance on company residence and supports many of the approaches used by businesses for many years to manage their tax residence. In this alert we review the legal tests expounded by the Court and the practical issues arising from the decision.

We recommend that businesses regularly review their tax residence and we would be happy to assist you in reviewing and managing your UK or overseas corporate tax residence in the light of the DS case.

The facts of the case were relatively simple. Development Securities plc had entered into a tax avoidance scheme in 2004, which required the parent to incorporate subsidiary companies in Jersey and for these subsidiary companies to purchase shares and certain properties at an over-value. HMRC contended (and the First Tier Tribunal agreed) that the subsidiaries were UK resident. The Upper Tribunal ("the Court") reversed this decision.

The Law

The DS case provides a clear summary of the law in this area. The "starting point" for determining company residence remains the well-known central management and control ("CMC") test derived from the 1906 De Beers case where it was decided that "the real business is carried on where the central management and control actually abides". In the DS case the Court emphasised that the test is where CMC is actually exercised, not where it ought to be.

The Court termed the place of CMC the place of "paramount authority". If "paramount authority" is exercised offshore, certain corporate functions or lesser corporate decisions can then take place elsewhere. What is critical is the "locus" of CMC. The DS case is important in recognising that not all decisions need be taken by the directors of the non-resident company. The Court said "…We are concerned with identifying the locus of central management and control. The fact that other operations took place or other decisions were made away from this locus does not affect the locus of CMC unless in themselves they amount to CMC". (underlined in original).

Eighth Floor
6 New Street Square
New Fetter Lane
London EC4A 3AQ

And at

Q3, The Square
Randalls Way
Leatherhead
Surrey KT22 7TW

T +44 (0)20 7842 2000
F +44 (0)20 7842 2080

hello@rawlinson-hunter.com
www.rawlinson-hunter.com

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The CMC is equally applicable when determining the residence of a subsidiary. The Court said that there is no presumption that if a subsidiary "carries out the purpose for which it was set up, in accordance with the intention, desires and even instructions of its parents" that CMC lies with the parent.

The Court said it was necessary to distinguish between "influence over" a subsidiary and "control" of the subsidiary. Where a parent company merely "influences" the subsidiary, CMC remains with the board of the subsidiary. Provided the CMC of a company is robust, it is not lost simply because instructions are issued to the company by (for example) its parent.

In the DS case, the company claimed to be non-UK resident for a very short period (about six weeks) and had no employees. Moreover, its main acts were recognised by the Court as "uncommercial" and driven by tax avoidance motives. Despite these hurdles, the company was held to be non-resident. This emphasises that time and significant activity need not be critical. What is important is the directors and others paying attention to the legal tests and ensuring that sufficient attention, care and time is invested in the process. Interestingly, the Court did not examine the decision of the directors to move the residence of the Company to the UK.

The DS case also contains important guidance on the issue of companies being resident in more than one jurisdiction. The Court recognised that this was possible but considered that the norm would be for CMC to be located in one place and that "it will be necessary to identify specific exceptional factors to cause what is normally a unitary thing to fracture e.g. regular board meeting in one or more countries".

In a very significant development, the Court refused to extend the principle in HMRC v Smallwood (2010) (relevant to the residence of trustees) to corporate residence since to do so would "distort rather than elucidate the CMC test for corporate residence".

Where the residence of a company is under review a number of different "players" will often be involved, such as directors and professional advisers. In the following paragraphs, we consider the position and role of such people in the light of the DS case.

The Role Of Directors

The role of the directors of the company will be critical. The Court approved the following comments of Mr Justice Park in the case of Wood v Holden:

"In all normal cases, the central control and management is identified with the control which a company's board of directors has over its business and affairs, so that the principle almost always followed is that a company is resident in the jurisdiction where its board of directors meets"

The Court noted also, however, that the above will "not hold where there has been a usurpation of the board; a sham or, where the board acts as a "rubber stamp"".

This underlines the importance of having directors with the appropriate skills and (critically) time for their role, who are aware of all the facts, review all appropriate documentation, seek advice as appropriate and apply their minds to the position.

The directors must be careful not to abdicate their responsibility and as such while they can be given instructions (see above) they must not blindly follow them. There must be no suggestion that the directors acted as a "rubber stamp". Directors should ask questions and make informed decisions based on the exercise of their own judgement.

"Professional directors" (typically provided by trust companies or corporate service providers) often hold a large number of directorships. This need not prejudice the non-residence status of a company provided they can demonstrate they had the time to consider matters. HMRC can be expected to challenge cases where the directors did not have (and review) sufficient information to make their decision or there is evidence that the directors did not apply their minds to the transactions before them.

Provided directors review the position and think about it, they are entitled to rely on advice without questioning its validity. In the DS case the Court held that the Jersey directors could rely on the tax advice of the professional advisers without taking an independent view on the strengths or weaknesses of the UK tax planning. What is required is that the directors have sufficient insight to be able to consider if the transactions proposed are in the interests of their company.

One of the four directors of the subsidiaries was resident in the UK and was not a "professional" director but the company secretary of Development Securities. The Court noted that the company secretary in his capacity as a director of the subsidiary, "may have been prepared to carry out the transactions no matter what" but that the "professional" directors were not influenced by the company secretary. This is great credit to the professional directors and emphasises the importance of each director having his/her own opinion and the strength and authority to challenge views advanced or "instructions" purportedly given to the directors. The court noted that their decision may well have been different if the "professional" directors had acted as puppets. It is tempting for "professional" directors to miss a board meeting if a colleague is there. In some cases, there will be security in numbers where each director forms his or her own view.

The Company Secretary was also the only UK resident director. Having a director in a jurisdiction outside the jurisdiction in which the company claims to be resident need not be determinative of the position, but clearly extra care will be required in such circumstances. It would normally be unwise for the board to meet in the UK.

The directors should ensure their decisions are fully minuted, outlining discussions and not just decisions. Contemporaneous evidence always carries a disproportionate weight. Directors, trustees and advisers should proceed on the basis that their written communications, including emails, may be closely examined by HMRC and ultimately the courts. Careless correspondence can cost a residence status.

The Role Of Professional Advisers

Professional advisers will have an important role too. The advisers must ensure that they assist those involved in the offshore structure in understanding the nature of the CMC test and also ensure that the directors are aware of the need to seek advice where appropriate, and that the directors have sufficient detail (and have asked enough questions) to make informed decisions.

Advisers in particular need to be aware that the application of the CMC test can start before the first board meeting or indeed before the company is incorporated. It is clear from the DS case that a court may take into account events pre-dating the incorporation of a company and events outside the boardroom. Advice at this stage may prove to be particularly critical.

Finally, advisers should keep in mind that where they perform certain advisory functions in the UK (which, as indicated, the Court found to be consistent with non-residence) these functions are not allowed to grow in scope to such a degree that they usurp the role of the directors. The Court in the DS case considered that the delegation of functions such as audit, nominations and remuneration to committees would not usually result in CMC being exercised by the board committee.

The Role Of Trustees And Corporate Parents

In many cases, the "offshore" company will be held within a trust or foundation or within a corporate group with a UK parent. The Trustees or parent have an important role in ensuring that the directors are independent from the trustees or the parent company and do not "rubber stamp" instructions from the trustees, the settlors or the parent.

The trustees or parent must ensure they give the directors time to make their decisions, that they are fully briefed and have independent access (i.e. not just via the trustees or parent) to appropriate professional guidance.

Trustees and parents should recognise and accept that the decisions of the "offshore" company may be driven or determined by considerations or factors not relevant to the parent or the settlor/trustees. In the DS case it was noted that, the role of the directors of a subsidiary was to have regard "to what was in the best interest of [the parent] qua shareholder". In the DS case, the Court (in determining that the subsidiary was non-UK resident) noted that the directors of the subsidiary gave detailed consideration to the tax scheme they had been asked to execute – including its apparent uncommercial nature – and concluded that:

"the transactions were in the best interest of the shareholders and therefore in the best interest of the Jersey companies, there being no prejudice to either employees or creditors of the Jersey companies". (emphasis added in the Judgment itself).

Fact Specific

While the DS case provides a very helpful checklist of the "do's and don'ts" to ensure that a company is not resident in the UK, the Court was quick to emphasise that each case will depend on its facts. The DS case emphasises also that there are no "shortcuts".

Conclusion

In the modern tax world, correct administration is at least as important as correct tax advice. The DS case provides a practical guide of what to do and how to do it in order to ensure a company will be regarded as non-resident. Each case must, however, be looked at on its own facts.

We are happy to assist you in determining the implications of this recent judgment on your corporation structure.

Please do not hesitate to contact your usual Rawlinson & Hunter contact or James or David (contact details below).

James Randall
Partner

Direct Dial: (+44) 20 7842 2131
Email: james.randall@rawlinson-hunter.com

David Kilshaw
Senior Adviser

Direct Dial: (+44) 20 7842 2129
Email: david.kilshaw@rawlinson-hunter.com