Analysis

An evolving approach to corporate residence

Speed read

HMRC is currently active in challenging corporate residence, often deploying arguments which seek to move the debate beyond the terms set by *Wood v Holden*. Despite a recent HMRC victory in *Development Securities*, the law in this area has not fundamentally changed (or at least not yet). Given the current focus on offshore matters, however, overseas companies may find they need to improve their governance processes if they are going to preserve their residence outside the UK.

Gideon Sanitt
Macfarlanes
Gideon Sanitt is a partner and head of the tax disputes and investigations team in Macfarlanes LLP. He specialises in complex disputes with HMRC, in all aspects of direct and indirect tax for both private clients and companies. Email: gideon.sanitt@macfarlanes.com; tel: 020 7849 2123.

Gregory Price
Macfarlanes
Gregory Price is a senior solicitor in the tax and structuring group at Macfarlanes LLP. He advises on the full range of corporate tax issues, with a particular focus on group tax planning and corporate tax advice for substantial privately owned businesses. Email: gregory.price@macfarlanes.com; tel: 020 7849 2754.

HMRC has a range of tools that it can deploy to ensure that the UK gets its 'fair share' of taxable profits from offshore arrangements that have a UK nexus. Potential lines of attack include transfer pricing, diverted profits tax and the controlled foreign company rules. The implementation of the recent BEPS related changes provides further ammunition, such as the interest barrier and anti-hybrid rules.

But, there is another – and much older – type of challenge that can be effective for HMRC in the right circumstances: challenging the tax residence of a non-UK incorporated company.

In our recent experience, HMRC will routinely enquire into the residence position of non-UK companies where there is a significant UK connection. Given the current focus on offshore matters, this is likely to be a live issue for many groups in the medium term. The challenge is, first, to understand where the law of residence now stands (and where it may be heading); and second, to address any practical shortcomings in the management of offshore entities that might otherwise leave them vulnerable to a residence enquiry.

Central management and control

It has been settled law for more than a century that a non-UK incorporated company will be resident in the UK for tax purposes if it is centrally managed and controlled in the UK. In the most famous example, a company registered overseas which operated diamond mines in South Africa was resident in the UK because its board of directors held their meetings in London and exercised real control of the company's most important business at those meetings (*De Beers Consolidated Mines* [1906] AC 455).

The rule stated in *De Beers* is that a company is resident 'where its real business is carried on ... and the real business is carried on where the central management and control actually abides'.

In the leading modern case on corporate residence – *Wood v Holden* [2006] EWCA Civ 26 – the Court of Appeal endorsed the proposition that a company will be resident in the place where decisions are made by its board of directors (or other appropriate 'constitutional organs'), subject to one exception. This is where an 'outsider' has 'usurped' that function and exercises management and control independently of, or without regard to, those constitutional organs (such that the board has stepped aside altogether). The court considered that there was a high threshold for usurpation: an 'outsider' may propose, advise and influence the decisions of the board without usurping its function. The line is crossed only where the outsider 'dictates' the decisions which are to be taken.

Since *Wood v Holden*, there have been two examples in the UK courts of an 'outsider' (operating in the UK) overstepping the mark, such that a non-UK incorporated company with a non-UK board has nonetheless been found to be UK tax resident.

In *Laerstate BV v HMRC* [2009] UKFTT 209 (TC), a controlling shareholder and one of two directors, Dieter Bock (of Tiny Rowland fame – the case relates to the disposal of shares in Lonrho), resigned from the board of the company. However, Bock continued (in practice) to exercise central management and control of the company from the UK, notwithstanding the fact that he was no longer a director. While some board level activity was carried out by the one remaining director (at least on paper) in the Netherlands, the company was held to be UK resident.

More recently, and perhaps more troublingly in the context of corporate groups, a UK parent company, operating on the advice on its UK tax advisers, was found to have usurped the function of the directors of certain offshore subsidiaries when it 'instructed' them to enter into a transaction that was of no commercial benefit to those individual subsidiaries. (This is the *Development Securities* case, to which we return below.)

A couple of traps

Where a company inadvertently becomes UK resident, it will bring with it any latent gains on its assets, as there is generally no step up in base cost at the time of migration. (One exception is for intangibles taxed under CTA 2009 Part 8.) This issue can be compounded if the company then ceases to be UK resident – perhaps without appreciating that it had temporarily moved central management and control to the UK. In those circumstances, there is a market value exit charge, capturing gains which accrued before migration to the UK, as well as any increase in value while the company was UK resident.

A further point to watch is that the protection afforded by double tax treaties – which generally prevent a company from being treated as resident in two contracting states at the same time – is likely to be watered down as the implementation of the OECD multilateral instrument begins to remove the traditional 'place of effective management' tie breaker test from treaties. In those circumstances, a company incorporated overseas but centrally managed in the UK is likely to be treated as resident in both jurisdictions, unless and until the tax authorities of the two states decide otherwise by mutual agreement.

Taxpayer attitudes to corporate residence

Since *Wood v Holden*, the rules on corporate residence have been seen – rightly or wrongly – as an area in which HMRC would find it difficult to make inroads.

As long as directors applied their minds to what they were signing, they would be treated as exercising central management and control, even though, in practice, they were unlikely to depart from the recommendations they had been given.

Whether the hurdle in *Wood v Holden* is quite as low as some have thought, however, is questionable and it is an area that is being tested by HMRC.

Formal initiatives from HMRC include the Offshore Property Developers Task Force, which has been running since early this year and has been investigating (among other issues) the corporate residence of certain offshore developers.

Less formally but no less significantly, there has been considerable activity from HMRC in investigating companies where they are managed by offshore trusts.

HMRC's view of the case law

HMRC counterbalances *Wood v Holden* by referring to *Laerstate* as an example of a board being usurped by an individual. The comments in *Laerstate* that it is necessary to consider where central management and control 'abides' give HMRC some latitude to look beyond where the board resolutions are made and where documents are signed, in favour of a more general 'scrutiny of the course of business and trading'. However, the circumstances of *Laerstate* are unusual: for most of the period, the individual in question was a director. Although he then ceased to be a director, it was relatively straightforward for the court to conclude that he was still exercising central management and control, with the directors rubber-stamping his decisions.

HMRC has also looked to a decision of the High Court in Australia at the end of last year. In the joined cases of *Bywater Investments* and *Hua Wang Bank Berhad* [2016] HCA 45, it was held that the relevant companies were centrally managed and controlled from Australia, despite the fact that the director was located in Switzerland.

The court concluded that the 'real business' of the company was being carried out by an individual in Australia, with his decisions rubber-stamped by the director in Switzerland. HMRC has relied on this decision when running the argument that it is necessary to look at the wider course of business, beyond the board.

However, quite apart from the fact that *Bywater* is an Australian case, it is an extreme example. In blunt fashion, the court concluded that the ownership and directorial structure was 'fake', the actions of the directors were a 'charade' and all that happened in Switzerland was the 'generation of pieces of paper'. In reality, therefore, the case does not advance matters beyond *Wood v Holden*. Although the court ultimately concluded that the board had been usurped, on the relatively extreme facts of the case that was not surprising.

HMRC had success earlier this year in *Lee and Bunter v HMRC* [2017] UKFTT 279, when arguing that an offshore trust was effectively managed in the UK (under the test in the double tax treaty). The court concluded that the trustees were merely executing a pre-planned tax arrangement and the 'shots were called' from the UK. Again, however, the case is unlikely to have significant consequences: it concerns a trust, rather than a company, and follows the decision in *HMRC v Smallwood* [2010] EWCA Civ 778, which concerned a similar hardwired tax scheme.

Development Securities: a new approach?

Wood v Holden has recently been considered in *Development Securities v HMRC* [2017] UKFTT 565.

In that case, Jersey companies were incorporated in order to implement a tax avoidance plan that would allow the wider group to realise latent capital losses.

The arrangement involved the companies exercising an option (whilst tax resident in Jersey) under which assets were acquired for more than market value and then becoming UK tax resident, at which point the assets would be sold, triggering the loss.

The arrangements were superficially similar to *Wood v Holden*, in which a company was established to avoid a tax charge. It was claimed that although the Jersey companies had a prescribed role and were influenced by a tax plan formed elsewhere, the directors properly turned their minds to the (limited) decisions they had to take.

The tribunal disagreed, concluding that by agreeing to act as directors, the individuals were effectively agreeing to implement a decision that had already been taken.

The tribunal was particularly concerned by the lack of benefit to the Jersey companies: 'The question arises as to why directors of a company would agree to undertake a project which is not for the benefit of that company.'

The answer from the tribunal was clear: it 'can only be that it was because the parent wanted them to do so'. The companies were formed solely to perform a single, wholly uncommercial act, following which control was immediately handed back.

There is a tricky point here about transactions which are for the benefit of a group, but not necessarily (or not directly) for the company which is implementing a particular step. It is not usual for a subsidiary to rely on guidance from its parent company that such a step is in the wider group interest. Is *Development Securities* telling us that the decision to enter into such a transaction will always, in reality, be made by the parent and not the board of the subsidiary? We think that is going too far. The facts in *Development Securities* are somewhat extreme and should be distinguished from more routine questions of corporate benefit that arise in practice. That said, it is incumbent on directors to give some thought to the commerciality and benefit of decisions as far as their own company is concerned, if they are to be respected as the real decision makers.

In the case, HMRC's arguments included those noted above; namely, that the test is where central management and control 'abides', which means it is necessary to consider the general course of the business, and not just particular actions (such as the signing of documents or the making of board resolutions).

Although the tribunal did not disagree with the proposition that board meetings are not conclusive, the tribunal still followed the same type of reasoning as was pursued in *Wood v Holden*. Directors could follow another person's plan but still exercise central management and control.

In the end, the decision turned on the circumstances of the case. In *Wood v Holden*, the directors were acting on positive recommendations to enter into a transaction that made commercial sense. In this case, individuals were taking on the role solely in order to carry out a pre-arranged plan that would not even benefit the company.

Future of *Wood v Holden*

Outside of one-off tax schemes (as in *Development Securities*) and extreme facts (as in *Bywater*), we have not seen especially convincing attempts by HMRC to move the test for residence away from the boardroom.

As it stands, therefore, taxpayers may take some confidence that *Wood v Holden* continues to be the relevant test. However, as can be seen from the cases above, residence is being tested and it is worth approaching such issues with great care.

Development Securities highlights a particular issue that will apply to many. The tribunal noted that there were errors in the minutes, that changes were made to minutes to reflect matters that had not taken place, and that the language used suggested that the tax plan would inevitably take place.

These issues were not conclusive but they represent the types of errors and inconsistencies in documentation that will concern professional directors and that HMRC has become adept in finding. In some quarters, there may be a worrying complacency that offshore companies are protected by *Wood v Holden*. Quite apart from ignoring what *Wood v Holden* actually concludes, that view fails to appreciate the shift in attitudes regarding offshore matters.

The reality is that there are likely to be offshore companies that will offer an opportunity to HMRC to challenge residence (and possibly reframe the *Wood v Holden* test) because the documentation is cursory and processes are not always followed.

What should companies do?

If a company is to preserve its non-resident status, it needs to have a board of directors that actively engages with what is important (and beneficial) to the company.

Companies should ask themselves how carefully they follow reporting lines to and from the board and pursue the proper decision making procedures.

This is particularly important where there is an individual or company in the UK closely associated with the offshore company and its business. Activities can be delegated and advice sought, but the board will still be expected to oversee those activities and to apply its mind to the decisions that need to be taken.

Otherwise, companies may one day find that HMRC's challenges are not limited to one-off tax schemes, but to the proper functioning of their business from overseas. ■

For related reading visit www.taxjournal.com

- *Development Securities*: a new reality for company residency? (Julian Feiner, 1.9.17)
- Cases: *Development Securities (No. 9) and others v HMRC* (25.7.17)
- Corporate residence: lessons from *Wood v Holden* (Jonathan Levy & Andrew Watters, 13.2.06)

Briefing

Tax and the City briefing

Jeanette Zaman
Slaughter and May
Jeanette Zaman is a partner with Slaughter and May, specialising in corporate tax. She has considerable experience advising on mergers and acquisitions, demergers and corporate reconstructions, as well as advising clients on all stages of HMRC enquiries. Email: jeanette.zaman@slaughterandmay.com; tel: 020 7090 5041.

Zoe Andrews
Slaughter and May
Zoe Andrews is a senior tax professional support lawyer at Slaughter and May, covering all aspects of UK corporate tax and international tax developments affecting the UK. Email: zoe.andrews@slaughterandmay.com; tel: 020 7090 5017.

Speed read

The difficulties faced by taxpayers in bringing judicial review claims is highlighted in two recent cases. The High Court's judicial review in *Dickinson* considered HMRC's decision to issue an APN, even though HMRC had expressly promised not to enforce payment pending the resolution of the disputes. The Court of Appeal in *Hely-Hutchinson* considered whether HMRC could abandon its position in its published guidance on *Mansworth v Jelley*. The corporate residence test is examined by the FTT in the *Development Securities* case, a useful reminder that simply going through the motions of having offshore board meetings is not in itself enough to achieve non-UK residence. The Upper Tribunal rules in *McQuillan* that zero dividend redeemable shares are ordinary share capital as defined in ITA 2007 s 989.

Judicial review

Several recent judicial review cases demonstrate the uphill battle taxpayers face in seeking to challenge actions taken by HMRC on public law grounds.

Dickinson: accelerated payment notices (APNs)

J Dickinson v HMRC [2017] EWHC 1705 (reported in *Tax Journal*, 14 July 2017) is the latest in a line of cases in which the exercise of HMRC's discretionary power to issue APNs has been challenged in the High Court. HMRC had agreed to postpone the payment of a disputed tax liability pending the resolution of the substantive dispute before the FTT, but then reversed the arrangements and issued APNs. The issue for judicial review was whether it was an abuse of power for HMRC to resile (abandon its position) from its express promise not to enforce payment pending the resolution of the disputes relating to the validity of HMRC's assessments.

In this case, it was agreed by HMRC that a clear and specifically directed promise was made to the taxpayer to postpone the payment of the disputed tax. Even so, the High Court (Charles J.) rejected the taxpayer's claim on the basis that one of the purposes of the APN regime was to 'change the goal posts', such that the reasonable grounds test for postponement of disputed tax is no longer determinative of the question where disputed tax relating to a DOTAS arrangement should lie pending determination of an appeal. Postponement agreements and clear promises are not ignored, but their force has been significantly undermined. In keeping with the general law on legitimate expectations, a change in macro political considerations was sufficient for HMRC to resile from its original promise.

The issuance of APNs and partner payment notices (PPNs) has previously been challenged in *Rowe* [2015] EWHC 2293, *Walapu* [2016] EWHC 658 and *Vital Nut* [2016] EWHC 1797. In *Rowe* and *Walapu*, an argument was advanced that, despite HMRC making no express promise to the contrary, the issuance of an APN/PPN constituted a breach of a legitimate expectation. In *Vital Nut*, a related argument was made (also before Charles J.) that the APNs were issued in breach of the principles of natural justice and were unreasonable and unfair. None of the arguments were successful before the High Court.

In July, the Court of Appeal heard the joint appeals of *Rowe and others* (in relation to PPNs) and *Vital Nut and another* (in relation to APNs). The Court of Appeal decision is eagerly awaited.

Reversal of *Mansworth v Jelley* policy

In *Hely-Hutchinson* [2017] EWCA Civ 1075 (reported in *Tax*