SQUIRE PATTON BOGGS

Tax Strategy & Benefits
Development Securities – A New Line in the Sand

The UK rules for determining the tax residence of a company are relatively straightforward, and yet their application by HM Revenue and Customs (HMRC) and the courts has generally been anything but. There is no such thing as absolute confidence when it comes to where the line in the sand between UK and non-UK residence has been drawn.

A new decision, recently emerging from the First-tier Tribunal (FTT), called *Development Securities (No. 9) Limited and others [2017] UKFTT 565 (TC)*, continues the theme. It is, at the same time, both comforting and cautionary.

The Plan

The Development Securities group (DSG) implemented a "plan" (or, perhaps more accurately, a tax avoidance scheme) designed to inflate the value of latent capital losses on certain UK property-related assets by adjusting them to include the effect of inflation (or indexation).

In broad terms, the plan was composed of the following steps:

- DSG incorporated three new companies in Jersey (the "JerseyCos")
- UK-based members of DSG granted the JerseyCos options to acquire certain assets (shares or UK property) at a price equal to:
  - The asset's historic base cost *plus*
  - Indexation accrued to that time

  This resulted in a price that was considerably in excess of each asset's market value.
- The JerseyCos exercised the options (no tax charges arise to the UK-based members of DSG on the disposal intragroup)
- The JerseyCos (now holding the assets) were brought onshore (that is, they became resident in the UK for tax purposes)
- The JerseyCos disposed of the assets, triggering a capital loss (as inflated by the indexation amount)

For the plan to work, it was critical that the JerseyCos were tax resident in Jersey, from the time of their incorporation until the time (after they had acquired the assets) that they were brought onshore. If, as HMRC argued before the FTT, the JerseyCos had actually always been resident in the UK for tax purposes, the plan would fail.

Corporate Residence

As companies incorporated in Jersey, the JerseyCos could only be UK tax-resident if they were centrally managed and controlled (CMC) in the UK.

The concept of CMC is not one that is defined in the UK tax code – it is one that has evolved over more than 100 years of case law. It is likely, whether the decision of the FTT is appealed or not, that this case will signal a further milestone in that evolution.

Normally, to identify the CMC of a company, one looks for where the "real business [of the company] is carried on" (*De Beers Consolidated Mines v Howe* [1906] AC 455). The "real business" of a company can normally be found where the highest level of decision-making (i.e. control) being exercised in the company takes place.

Although always a question of fact, of substance rather than legal form, the necessary control will, in the vast majority of cases, be found at the level of the company's board of directors (*Bullock v Unit Construction Company* [1959] Ch 147 and *American Thread Company v Joyce* (1912) 6 TC 1). That said, there is an important nuance here. Looking narrowly at specific instances of management will not be enough. It will also be vital to assess the business of the company as a whole (*Laerstate BV v HMRC* [2009] UKFTT 209).

Other persons may influence the board – that is, others may suggest a course of action, and they may even fully expect that their suggestions will be followed by the board. This alone will not affect the CMC of a company provided the actual decisions, affecting the real business of the company, are still made by the board.

However, in exceptional circumstances, the power of the board can be usurped. This happens where the real decisions are actually made elsewhere such that the board is not merely influenced, it is effectively by-passed. In such exceptional cases, the CMC of a company will be found where the usurper is found (*Wood v Holden* [2006] EWCA Civ 26).

Outsider Influence and Usurpation

The *Development Securities* case redraws the dividing line between influence and usurpation.

In *Wood v Holden,* the dividing line between these two concepts was found by distinguishing between:

- **Influence**: Directors *making* an actual decision, however heavily influenced by an outsider; and
- **Usurpation**: Directors *not making* any decision at all (i.e. where the board is actually or effectively by-passed).

In *Development Securities*, DSG argued that the control of the board had not been usurped and, therefore, the CMC of the JerseyCos was in Jersey. To support their contention, DSG pointed to a plan that was carefully designed and meticulously carried out. Although the parent company clearly exercised some influence, ultimately (so DSG argued) the decision to implement the plan rested with, and was taken by, the boards of the JerseyCos.

The plan, and DSG, did everything possible to ensure that the JerseyCos would be tax resident in Jersey. This included ensuring:

- The board of the JerseyCos was composed of a majority of Jersey-resident directors
- All board meetings took place in Jersey
- The key decisions (i.e. to enter into and exercise the options) were taken, after due consideration, at those meetings

None of these facts were contested. HMRC argued, however, and the FTT eventually agreed, that despite all of this, the CMC of the JerseyCos had still been usurped and the real decisions affecting the real business had been taken by the UK resident parent company of the JerseyCos. Of course, simply looking at what happens at meetings of a board alone is never enough, but what becomes crucial in the FTT decision in *Development Securities* is the level of engagement required for a board to be considered to be "applying their minds" to the decision in need of being made.

Fact Specific?

Following *Wood v Holden*, the FTT decided that the fact that:

- The JerseyCos had been incorporated to perform a single function
- It was clear that DSG and its advisors had devised the plan in the UK and decided to implement it even before the JerseyCos had been incorporated
- DSG confidently expected that board would implement the plan

were not enough to dislodge the presumption that the CMC of the JerseyCos should be found, with the board of directors, in Jersey. Operationally at least, therefore, everything happened as it should in Jersey and without undue pressure from the UK.

However, the FTT identified three unusual features that allowed it to distinguish this case from the *Wood v Holden* decision.

- First, and perhaps critically, the only transaction to be undertaken by the JerseyCos, whilst they were intended to be Jersey tax-resident, was an *uncommercial* one – the JerseyCos decided to carry out a single act (to be contrasted with a single, ongoing function), namely to acquire assets, for a substantial amount in excess of their market value, not for their own benefit but for the benefit of the UK DSG group.
- The uncommercial nature of the proposal could only be justified (for corporate law purposes) on the basis that DSG specifically approved it and the JerseyCos were adequately funded by DSG in order to be able to overpay for the assets. The implication here being that the JerseyCos did not have any real discretion in making the decision – even if the corporate law impediment could be resolved it did not necessarily follow that the companies should, as a matter of commerciality, exercise the options.
- The plan envisaged the JerseyCos would become UK tax resident shortly after the asset acquisition – that is, the existence of the JerseyCos as Jersey resident companies was only ever intended to be very short-term (on the facts of the case, just under six weeks in total).

Based on these three, fact-specific findings, the FTT was able to conclude that:

- The "real business" of the JerseyCos was not property investment, but, rather, simply to implement the plan to enhance capital losses for the benefit of DSG
- The decisions representing the strategic management of that real business of the JerseyCos (i.e. those representing the CMC of the JerseyCos) were those relating to the design and implementation of the plan

In light of those two factors, "from the outset, in the very act of agreeing to take on the engagement, the Jersey directors were in reality agreeing to implement what the parent had already at that point in effect decided to do" – presented, as it was, with a very specific plan, which made no commercial sense for the JerseyCos, the board could only possibly agree to undertake it because DSG wanted it to do so and, therefore, it was DSG that was, in effect, exercising the CMC of the JerseyCos.

On this basis, the FTT decided the JerseyCos were, therefore, resident in the UK for tax purposes.

A New Line in the Sand

Subject to the possibility of an appeal, the *Development Securities* case subtly moves the borderline between UK and non-UK corporate residency. Taxpayers and, perhaps even more so, their advisors, will need to review and tighten processes and controls in light of the decision to ensure non-UK resident companies remain non-UK resident for tax purposes.

Alongside the normal safeguards (including, for example, a proper composition of a non-UK company's board of directors, protecting the genuine autonomy of that board, and ensuring that all decisions relation to the business strategy and activities of the company are actually taken at meetings of the board outside the UK), consideration should now also be given to:

- Whether or not there is a *commercial* (as opposed to tax) justification for making any particular decision (however perfectly that decision has been considered, actually made, and documented by a board).
- Ensuring that formal board minutes accurately reflect the *actual* discussions conducted at meetings of the board. In evidence laid before the FTT, contemporaneous, handwritten notes made at the time of the meetings of the JerseyCos Boards indicated that the decision to implement the plan was based on "instructions" and "orders" from the parent company irrespective of the fact the formal resolutions and minutes referred to "authorisations" and "approvals".
- The use and status of non-UK resident, single-purpose companies. There is now authority to distinguish between, on the one hand, offshore companies established to perform a limited, single *function* for a group of companies (e.g. a finance function) and, on the other, offshore companies established to perform a single act for the benefit of a group of companies.

As a practical matter, the decision also raises difficult issues in respect of identifying potential, historical, tax residency issues when, for example, conducting a due diligence exercise in anticipation of a share acquisition. Clearly, on the basis of this decision, the formal records represented by a target company's board minutes will not, necessarily, always accurately reflect the reality of where a company's CMC has been exercised – substance will always outrank form where the evidence is strong enough.

That said, the decision in *Development Securities* is also equally reassuring. Although it acts as a timely reminder to ensure advice and processes are robust, there is no implication that the use of a non-UK resident company in a group's commercial operations is about to be challenged. This is good news for those businesses that routinely adopt such structures as part of a long-term strategy, including, in particular, real estate investment companies that use Luxembourg companies to hold UK assets.

Corporate tax residency looks set to continue to be a potential battleground in the future over the true extent of the UK tax base. It is entirely possible that, given the revenue challenges the UK will face in the coming years, HMRC will consider analysing, and challenging, corporate residency more aggressively. Taxpayers with offshore operations and structures might like to double-check they are still standing on the right side of the line in the sand.

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