Proskauer

Court of Appeal decides that Jersey companies were UK tax resident

Tax Talks Blog on **December 23, 2020**

In *HMRC v Development Securities*, the Court of Appeal (the "**CA**") has overruled the Upper Tribunal and agreed with the First-tier Tribunal that the relevant Jersey incorporated subsidiaries of a UK parent were resident in the UK for tax purposes by reason of being centrally managed and controlled in the UK.

While of considerable interest, it should be remembered that the question of where a company is centrally managed and controlled is principally one of fact and so different facts might yield a different conclusion.

What the CA's decision shows is that the line between non-UK and UK residence can be a fine one when it depends on whether the overseas company's directors gave due consideration to the transaction as a whole or just to a small element of it, and that, accordingly, non-UK company boards should always make sure that they give proper consideration to the transaction as a whole, albeit informed by advice or recommendations that they might have received from the UK, to minimise the risk of being treated as UK resident.

By way of background, in this case the UK tax resident parent company of a group, Development Securities plc ("**DS**"), wished to implement a tax planning scheme whereby the group would use latent losses incurred on the acquisition of some of its subsidiaries and properties (the "**Relevant Subsidiaries and Properties**") to offset other gains in the group.

In order to implement the scheme, three new companies were incorporated in Jersey as subsidiaries of DS and granted call options that entitled them to buy the Relevant Subsidiaries and Properties if certain conditions were satisfied. The options were exercised at a price in excess of the market value of the assets, and so not in the best interests of the Jersey subsidiaries considered in isolation. The Jersey-based directors of the Jersey subsidiaries approved the transactions on advice from DS and were then replaced by UK-resident directors so that the companies became UK tax resident. The Relevant Subsidiaries and Properties were transferred to other group companies and losses were crystallised on the transfer. Those losses were treated as accruing to DS as a result of an election made under section 179A of the Taxation of Chargeable Gains Act 1992.

HMRC challenged the tax residency of the Jersey subsidiaries arguing that the significant director level decisions as to whether to enter into the transaction were taken in the UK and not by the companies' boards of directors in Jersey and that all that the Jersey companies' directors considered was whether the transaction was legal under Jersey law.

The First-tier Tribunal decision

As was reported in the UK Tax Round Up in August 2017, the FTT accepted that all board meetings of the Jersey subsidiaries had a Jersey resident majority (three directors were Jersey resident and one director was UK resident), the board meetings were held in Jersey and the decisions were actually taken at those board meetings.

However, the FTT also found that given the uncommercial nature of the scheme transactions, the Jersey corporate law required the transactions entered by the Jersey subsidiaries to be approved by DS, the UK company.

Accordingly, the FTT had held that the central management and control of the Jersey companies was exercised in the UK by DS because the directors of the Jersey subsidiaries were approving the decisions that had already been taken by DS. Thus the Jersey companies were UK tax resident.

The Upper Tribunal decision

As reported in the Tax Talks on 19 June 2019, the UT overturned the FTT's decision, ruling that the Jersey subsidiaries were resident in Jersey because the central management and control was exercised in Jersey and not in the UK.

Contrary to the FTT's conclusion, the UT did not find that the transactions that the Jersey companies entered into were uncommercial because the subsidiaries were not disadvantaged due to the acquisition being funded by DS. Having analysed the Jersey corporate law, the UT concluded that the directors of the Jersey companies had only to satisfy themselves that the interests of the group's parent were taken into account.

The UT agreed with the FTT's finding that the single UK resident director acted by "rubber stamping" the decisions. However, the UT also found that the Jersey directors properly exercised their directors' duties by considering the transactions in detail and concluding that they were in the interests of DS and therefore the Jersey companies.

The Court of Appeal

The CA has now overturned the UT's criticism of the FTT's findings and reinstated the FTT's decision that the Jersey companies were UK tax resident. In particular, the CA noted that there was a misunderstanding by the UT as to the importance of the uncommercial nature of the transactions when considering that this issue was not a determining factor in the case.

Noting that the key test for where the central management and control of a company is exercised is set out in *De Beers Consolidated Mines Ltd v Howe* the CA agreed with the FTT in that the question of where the Jersey companies were tax resident required answers to (1) who was making the strategic and management decisions regarding the company's business and (2) where were those decisions made. Both are a question of fact.

The CA noted that an important finding by the FTT was that the Jersey directors were, as a matter of fact, acting under instructions or orders from DS in confirming the lawfulness of their decision but without considering the merits of the decision. This led to a conclusion that the decision to enter into the relevant transactions was, in fact, taken by DS and not by the directors in Jersey.

All the Jersey directors were trying to ensure was that they were acting lawfully in implementing the instructions from DS, but this question was separate from the FTT's key findings as to who made the decision to enter into the transactions and where that decision was made.

Analysis

This is an important decision in the line of cases considering the tax residence of overseas incorporated companies.

In *Wood v Holden* in 2006 it was held that mere influencing of the decision of the directors by a third party (e.g: a parent or third party adviser) does not necessarily lead to a conclusion that the central management and control is removed from the non-UK company's directors.

In this case, it has now been held that the UK parent could be taken to effectively take the decision for the non-UK company by giving instructions to proceed with the specific transactions notwithstanding that the non-UK's directors considered (or satisfied themselves of) the legality of the relevant transactions but did not give any decision to the merits of the transactions. This led to a conclusion that the central management and control was conducted by the parent and therefore in the UK and not in Jersey.

This case serves a reminder that the important line between (i) a decision taken by a non-UK resident board that is being influenced by a third party on the one hand and (ii) a decision that is being dictated by a third party on the other hand can be a fine one and will depend on a detailed analysis of the facts in each case.

Particular attention should be paid to foreign subsidiaries that are under the control of UK parent companies. Each case in which it is important to ensure that the central management and control is exercised outside the UK needs to be considered on its facts.

Careful consideration would need to be given to the overall pattern of decision-making by directors of a foreign subsidiary, analyzing any instructions, directions or guidance given by the parent entities in order to determine whether the level of control exercised over the subsidiary is such that it would inadvertently remove the control from the hands of its directors. It is also important to ensure that the board of a non-UK resident company does actively engage in the decision making process and in fact makes the relevant decision rather than follows a decision that was already taken by a third party.

It is possible that this case can be confined to its facts as it is likely that it was influenced by a number of unusual elements such as (i) uncommercial nature of the transactions, (ii) short period of incorporation of the Jersey subsidiaries, (iii) change of Jersey-based directors to UK resident directors and (iv) the single decision that had to be taken by the board in relation to specific transactions.

It remains to be seen whether the decision will be appealed to the Supreme Court.

View Original