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CORPORATE RESIDENCE NEW DEVELOPMENTS

HMRC WIN AGAIN

HMRC have continued their winning streak with victory in the First Tier Tax Tribunal in *Development Securities v HMRC*, a case concerning the tax residence of a number of Jersey companies.

WHAT WAS THE ISSUE?

Development Securities set up a number of Jersey subsidiaries in June 2004 in order to participate in a tax planning arrangement recommended by one of the big four firms of accountants.

The purpose of the planning was to increase available capital losses in relation to UK real estate which had gone down in value. It involved the Jersey companies acquiring assets at more than their market value and then becoming UK resident by the appointment of UK resident directors.

The mechanism for the Jersey companies to acquire the assets in question was for them to be granted a call option which could only be exercised if a particular real estate index reached a certain level. This was presumably included to try to prevent an attack on the basis that there was a preordained series of transactions.

HMRC, however, argued instead that the Jersey companies had always been UK resident (in which case the planning would not work) on the basis that the central management and control of those companies took place in the UK and not in Jersey, where the majority of the directors were based.

WHERE WERE THE COMPANIES RESIDENT?

Rather surprisingly, the Tribunal found that the Jersey companies were resident in the UK for tax purposes from the date of their incorporation.

Each of the Jersey companies had four directors: three representatives of a Jersey fiduciary company and one employee of Development Securities. The Jersey directors were all highly experienced individuals with appropriate knowledge of the real estate sector.

The employee of Development Securities was found not to be a decision maker and instead had more of an administrative and communication function.

The boards of the Jersey companies held at least four meetings between the date the companies were incorporated in June 2004 and the date the Jersey directors retired about six weeks later in July 2004.

Those meetings considered the steps which it was proposed should be taken, approved the entry into and subsequent exercise of the call option and all of the related administrative steps needed to complete the transactions as planned. There was very little input from Development Securities or from the accountants into the decision-making process of the boards of the Jersey companies.

SO WHERE DID IT ALL GO WRONG?

On the face of it, the facts are very similar to the situation in *Wood v Holden* which was decided by the High Court (in 2005) and the Court of Appeal (in 2006) in favour of the taxpayer. In that case, an overseas company had been set up to participate in a single UK tax planning project which took place over a relatively short period of time. Everything was orchestrated by an individual and a firm of accountants in the UK, but it was enough that the overseas directors had taken a positive decision to go along with the proposals and to implement the transactions even though, in that case, the directors had very little information on which to base their decision.

There were, however, some special features in *Development Securities* which were not present in *Wood v Holden*.

- The transactions were entirely uncommercial when looked at from the point of view of the Jersey companies, as what they were being invited to do was to acquire assets for significantly more than they were worth. The transactions only made sense in the wider context of the overall tax benefit to the group of increasing the tax losses.
- As a result of the fact that there was no commercial benefit to the Jersey companies, the transactions could only be carried out if they were approved by the UK parent company as the sole shareholder in the Jersey companies.

Bearing these factors in mind, the Tribunal came to the conclusion that, at the time the Jersey companies were incorporated and the directors were appointed by Development Securities, the decision to undertake the transactions had already been taken (by Development Securities) and that the directors of the Jersey companies, in agreeing to be appointed, in effect were also agreeing to carry out those transactions subject only to confirmation that it was lawful in Jersey for them to do so.

Rather unfortunately, the requirement for shareholder approval of the transactions (as a result of there being no benefit to the Jersey companies themselves) was referred to in one of the board meetings of the Jersey companies as an instruction.

This helped the Tribunal to find that the boards of the Jersey companies were just following the instructions of the parent company and were not really making their own independent decision as to whether to enter into the transactions.

It did not help that there was no evidence that the boards of the Jersey companies discussed at their board meetings in any detail as to whether they should enter into transactions which clearly had no benefit for the Jersey companies themselves, as opposed to the wider group, and instead focused mainly on whether the companies could lawfully enter into the transactions. Nor, it appears, did the directors of the Jersey companies take any advice on the merits of the tax planning proposal.

The Tribunal was therefore able to distinguish *Wood v Holden* on the basis that the directors in that case were presented with a transaction which had a clear commercial rationale for the overseas company whereas, in *Development Securities*, the transaction was clearly uncommercial and yet was not questioned by the board.

WHAT LESSONS CAN BE LEARNED?

The first thing to say is that this is an unusual case, involving a fairly aggressive tax planning arrangement which relied on the Jersey companies acquiring assets at a price which was significantly more than they were worth and which provided no commercial benefit to the Jersey companies. It is unlikely to be relevant in the context of most overseas companies which are set up for longer term, ongoing activities which do benefit the companies concerned.

It is also doubtful whether the decision correctly reflects the existing law. The boards of the Jersey companies may not have considered every point in detail but the directors clearly did apply their minds to the transactions in question, and were considerably more diligent than their counterparts in *Wood v Holden*. On the basis of the facts found by the Tribunal, it would not be surprising if an appeal court were to come to a different conclusion.

Despite this, there are some useful points for overseas directors which can be drawn from the decision:

- Try to get the terminology right – the loose use of words such as instruction or direction rather than advice, recommendation or request can have a significant impact.
- Make sure that the rationale for entering into a transaction is discussed and recorded in the board minutes.
- If the benefits of a transaction include tax benefits, obtain advice on the benefits and risks.
- If action is to be taken in the UK between board meetings, the offshore board should authorise this in advance and should still make a final decision on any significant aspects.
- Be prepared for a forensic analysis of company records. In this case, the review was conducted by the Tribunal in minute and painstaking detail. The level of disclosure required can come as a surprise.

Company residence is always a concern where there are UK shareholders, directors or possibly shadow directors. Despite the unusual facts of the case, HMRC will no doubt be looking more closely at company residence in other situations, and so it is vital to ensure the right processes are in place to ensure the best possible chance of withstanding any challenge.

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