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International Tax | Large Corporate

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David Hughes examines the recent case of *Development Securities v HMRC* and considers what the decision means for corporate residence issues

Key Points

What is the issue?

Development Securities (No 9) Ltd and others v HMRC [2017] UKFTT 565 (14 July 2017), involved the determination of the corporate residence position of three Jersey incorporated companies.

What does it mean to me?

The First tier Tribunal set out a very detailed review of the facts and the key matters affecting central management and control.

What can I take away?

The uncommercial nature of the key transaction each Jersey incorporated SPV was intended to enter into, together with the relatively short time they were required to be Jersey resident, were key elements used as a basis for the tribunal's finding the companies were UK resident.

Development securities: a tale of life before incorporation

Development Securities (No 9) Ltd and others v HMRC [2017] UKFTT 565 (14 July 2017), involved the determination of the corporate residence position of three Jersey incorporated companies. These companies were subsidiaries of the DS plc group (DSG) and were formed to acquire group property assets as part of a tax scheme devised by PwC.

The board of each of the Jersey companies comprised of three Jersey-based and tax resident directors provided by Volaw, a Jersey trust company, and a UK based and tax resident director, Mr Stephen Lanes who was DSG's company secretary.

We don't intend to dwell on the detailed machinations of the tax scheme which required the Jersey incorporated companies to be non-resident for a short period, other than to note that it was designed to generate tax losses through the

acquisition of certain properties at an overvalue and that as part of the scheme the Jersey companies were to enter into call options, their exercise conditional on the movement of the FTSE Real Estate Total Return index.

The condition was met and the options duly exercised, whereupon shortly thereafter the Jersey directors of each company resigned and were replaced by UK resident directors so that the companies all became UK resident. The Tribunal noted that this whole exercise took place in a little under six weeks.

The first tier tribunal set out a very detailed review of the facts and circumstances to establish the roles of the main protagonists and the key matters affecting Central Management and Control (CMC).

Certain key facts

It was not disputed that PwC devised the tax scheme in the UK and liaised closely with Mr Marx, a UK resident director of DS plc, to implement the planning.

PwC's advice went to great pains to emphasise the importance of the Jersey based directors making the strategic decisions of the companies at board meetings held in Jersey (see para 20.) DSG demonstrated awareness of the necessity of ensuring that the Jersey directors were not given instructions. This protocol appears to have been for the most part rigorously followed by DSG although the tribunal did identify one incident where adherence was arguably overlooked. At para 21 it was noted that Mr Lane was admonished by Mr Marx for the language he used to communicate on the project as 'careless notes could prove expensive'.

A key element of PwC's strategy was to advise that the Jersey directors have minimal direct contact with PwC so that PWC could not be alleged to have issued instructions to the Jersey directors from the UK.

In paras 109–129 the tribunal reviewed the reliability of written evidence of board meetings. It concluded at para 129 that although the typed minutes were important evidence, they were secondary to the notes of meetings made by an employee of Volaw as contemporaneous evidence. The practical effect of the tribunal's favouring of the notes of meetings was that these suggested that there were instances of the Jersey directors receiving 'instructions'. However, the tribunal also accepted that the relevant directors' meetings were held and that 'the directors took the actions

stated to occur at those meetings.’

An unfortunate error?

In applying the CMC test of corporate residence the tribunal used as its starting point the *De Beers* case (5 TC 198) and Lord Loreburn’s oft quoted formulation. However in a bizarre error the tribunal *rewrote* Lord Loreburn’s test to include an entirely new requirement, to consider the course of business informed by what had taken place immediately prior to incorporation (shown as the text that is underlined).

‘The test is where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the [CMC] actually abides. You reach that conclusion based on a scrutiny of the course of business over the relevant period, informed by what had taken place immediately prior to incorporation.’

The seriousness of the tribunal’s error becomes apparent when one considers what the text should have read: ‘It remains to be considered whether the present case falls within that rule. This is a pure question of fact to be determined, not according to the construction of this or that regulation or by-law but upon a scrutiny of the course of business or trading’.

Unfortunately for the tribunal this error is pivotal to their decision, since at para 410 (see below) they find that a matter occurring immediately before incorporation demonstrates that the directors had surrendered their independence by accepting the assignment to act as directors. Further, Para 412 reiterates ‘It is inherent ... that the board were undertaking to implement the necessary steps from the outset on the “say so” of the parent ...’

The Acts of CMC

Practical examples of the ‘real business’ of a company (CMC) include strategic decision making such as acquisition and divestment decisions, the declaration of dividends, the raising of finance etc.

Notwithstanding the tribunal’s misstatement of the case law test of CMC, they correctly identify the characteristics of CMC.

At Para 407 the tribunal set out its view as to the decisions pertaining to CMC.

‘The only decisions to be made by the Jersey board which can be described as of a strategic or management nature, in the context of that “real business”, are those to implement the planning by acquiring the assets at overvalue under the call option arrangements at a point when the companies were intended to be resident outside the UK and then to move the residence of the companies from Jersey to the UK.’

The tribunal found all other acts including the banking arrangements and payment of the price for the assets as merely incidental.

It is not clear to the author that certain of these other acts were not acts of CMC, particularly given the circumstances surrounding the appointment of Mr Lanes as a director, i.e. at para 76 ‘one reason to have a representative from DSG on the board of the Jersey companies was because they would be receiving not just assets but substantial sums of the group’s money …’

What were the Jersey board engaged to do

As explained above the misstatement of the *De Beers* test which was repeated at para 404 distorted the tribunal’s focus on the pre-incorporation activities, which whilst relevant have in the author’s view been given exaggerated effect. This is particularly apparent in the paragraphs determining what the Jersey board were engaged to do.

At para 410: ‘[W]e consider the rather unusual circumstances in this case evidence that 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, subject only to checking it was lawful for them to do so’.

At para 411 this point was reiterated: ‘We find it difficult to see that, in reality, in those circumstances, in agreeing to act as directors as regards a very specific sole project which was inherently uncommercial for the Jersey companies themselves, the Jersey directors were doing anything other than thereby agreeing from the outset to implement specific steps required to acquire the assets for their client, DS Plc.’

At para 430 it was concluded that the Jersey Board merely passed the resolutions to enter into and subsequently exercise the options 'without any engagement with the substantive decision …'. This was on the basis that earlier the Tribunal had considered that there was no evidence that the directors had discussed or considered the matter.

Regarding 'commerciality' the author would merely note that group companies may sometimes be expected to enter into transactions for the greater good of the group. Transfer pricing rules demonstrate that group companies do not necessarily have a proclivity to charge arm's length prices.

Notwithstanding the issue of commerciality, it is difficult to reconcile the tribunal's view with those expressed in the judgments given by Park J in the High Court [2005] STC 789 and Chadwick LJ in the Court of Appeal [2006] STC 443 in *Wood v Holden*. Clearly Park J envisaged situations in which a Special Purpose Vehicle (SPV) might exist solely to discharge a single purpose set out in a 'proposal' ('described in some … judgments as instructions') from the parent. The only significant distinguishing feature in *Development Securities* perhaps being the perceived lack of commerciality.

At para 307: '[Park J] noted that it should be borne in mind that it is possible (and is common in modern international finance and commerce) for a company to be established which may have limited functions to perform, sometimes being functions which do not require the company to remain in existence for long. He noted that such vehicles may fulfil important functions, they usually have board meetings where they are considered to be resident but the meetings 'may not be frequent or lengthy'. He said the reason for that is that in many cases although the things such companies do are important they 'tend not to involve much positive outward activity. So the companies do not need frequent and lengthy board meetings.'

The tribunal went on to reproduce Park J's analysis of four cases involving SPVs before noting at para 309.

At [27] he said although not identical these cases had some 'common features' which he thought were relevant to the present case being: 'They all involved persons based in one jurisdiction (commonly a high tax jurisdiction) causing companies to be established in other jurisdictions (commonly low or no tax jurisdictions)…. the companies so established were intended to fulfil particular

purposes which were ancillary to the activities of the persons who caused them to be established…the local managements did not take initiatives, but responded to proposals (described in some passages in the judgments as instructions) which were presented to them…they did implement the proposals, and it is obvious that, when the foreign companies had been established, the confident expectation was that they would implement the proposals. In general, although large amounts of money may have been involved, the functions which the companies were established to fulfil did not involve much regular activity, so there was no great need for frequent exercises of [CMC].'

Decision

At paras 422 and 433 the tribunal set out key findings: 'We conclude that, as is clear from ... notes of board meetings, in agreeing to execute the documents required to enter into the option arrangements and subsequently to exercise them, the Jersey directors were acting under what they considered was an "instruction" or "order" from the parent in the form of the resolution approving the transactions'. ... From the terminology used in ... notes of the meetings the approval resolution was viewed as an instruction for the directors to enter into the option.' (Para 422.)

'The Jersey board were not, therefore, actively engaging in a decision to implement the tax planning by acquiring the assets at an overvalue in exercise of their discretion as directors. That decision was made by DS Plc and the directors merely gave their formal approval (as we would say they had undertaken to do from the outset) as they were instructed to do.' (para 423)

The role of the UK based director

The tribunal accepted that Mr Lanes' role within the group was administrative and that he was not 'decision-making' as far as determining the strategic decisions of the group. At para 432 the tribunal found that 'Mr Lanes was acting primarily as a communicator, co-ordinator and facilitator in his largely administrative role.'
Mr Lanes therefore did not exercise CMC. He had been appointed purely to safe guard the group's assets and perform a coordination function.

Dual residence

The tribunal did not consider the question of dual residence in detail as at para 435 it found that the only acts of CMC took place in the UK.

Conclusion

The tribunal's decision determining the UK residence status of the Jersey incorporated subsidiaries seems to have as its cornerstone, a misstatement of the *De Beers* rule which acted as a prism through which certain facts and circumstances were obscured, while others were given undue prominence, such as the mere fact of assenting to act as directors.

The uncommercial nature of the key transaction each Jersey incorporated SPV was intended to enter into, together with the relatively short time they were required to be Jersey resident, were further key elements used as a basis for the tribunal's findings. Indeed at para 424 the tribunal attempts to distinguish the facts and circumstances being considered from those prevailing in *Wood v Holden* on the basis that *Wood v Holden* centred around a commercial decision being made by the directors in contrast to an uncommercial one.

Although I agree that blindly entering into an 'uncommercial' transaction may indicate that directors of a company are failing to exercise CMC, this may perhaps be distinguished from circumstances where a parent company has clearly considered that it is appropriate for the subsidiary to enter into that transaction, and informed the subsidiary of that fact, particularly where the directors of the subsidiary have demonstrated that they understand the proposed transaction and have expended much effort to ensure that they may legally enter into it.

The words of Chadwick LJ at the Court of Appeal in *Wood v Holden* may perhaps have some resonance: 'On a true analysis the position was that there was no reason why [AA] should not decide to accept (on behalf of Eulalia) the terms upon which the Holdings shares were offered for sale by CIL; and ample reason why it should do as it was expected it would.'