

CASE COMMENT

***HMRC v Development Securities:* An Unwelcome Development in the UK Corporate Residence Test?**

Jessica Kemp and Joseph Sheldrick*

In *HMRC v Development Securities*, the United Kingdom Court of Appeal ('CA') reinstated the first-tier decision that Jersey-incorporated subsidiaries of a UK parent were UK tax resident by reason of having their central management and control in the UK on the basis that they were simply following the instructions of a UK parent without themselves considering the merits of entering the transaction. This arguably constitutes a widening of the test of corporate residence for UK tax purposes.

Practical application

While this case should be read in light of its unusual fact pattern, and the possibility of appeal to the Supreme Court should be taken into account, there are still some helpful practical lessons that can be taken from it for directors of non-UK subsidiaries or special purpose vehicles (SPVs):

- Directors should ensure that they carefully consider and discuss the merits (or otherwise) of the subsidiary entering into any relevant transaction or proposal.

* Jessica Kemp is a partner in the Tax Department at Travers Smith, London, and the Newsletter Editor of the IBA Taxes Committee. Joseph Sheldrick is a senior associate in the Tax Department at Travers Smith, London.

- Care should be taken that the correct language and terminology are used in records and minutes (eg, the incorrect use of words such as ‘instruction’, ‘order’ or ‘direction’ should be avoided).
- Detailed and accurate records and minutes should be kept. Draft minutes can be prepared in advance of meetings (as a guide to discussions), but drafts must be updated afterwards to reflect the actual discussions accurately.
- Individuals who are directors, employees or representatives of a UK parent should ideally not be directors of the subsidiary/SPV.
- Corporate governance policies should be reassessed in light of changing working arrangements as a result of the Covid-19 pandemic.

Background and summary of decision

In *HMRC v Development Securities* [2020] EWCA Civ 1705, the UK CA allowed HMRC’s appeal, overturning the decision of the Upper Tribunal (UT), and reinstating the decision of the First-tier Tribunal (FTT) that certain Jersey-incorporated subsidiary companies of a UK parent were UK tax resident by reason of being centrally managed and controlled in the UK.

Very broadly, the case involved some tax planning designed to increase available capital losses for Development Securities plc and its subsidiaries. This relied on Development Securities plc incorporating three new Jersey incorporated companies, which were tax resident in Jersey. To defeat the scheme, HMRC argued that the Jersey subsidiary companies were UK resident on the basis that their central management and control (CMC) took place in the UK and not in Jersey. The FTT held that CMC took place in the UK, but the UT overturned this decision on appeal.

The CA overturned the UT decision on the basis that the UT was not justified in setting aside the FTT decision for the reasons given by the UT. In particular, the CA considered that the UT had mischaracterised the primary reason for the FTT’s decision as being that the directors had failed to decline to do something improper or inadvisable by entering into uncommercial transactions. Instead, the basis for the FTT’s decision was that the directors were acting under what they considered to be an ‘instruction’ or ‘order’ from the UK parent company to carry out the transaction, and that the directors followed these instructions (subject to checking their lawfulness) without engaging with the substantive decision.

For procedural reasons, it was not open to the CA to consider whether the FTT decision might have been wrong for other grounds. However, the CA judges appeared to be divided as to the validity of the FTT’s reasoning. One judge expressed ‘very considerable reservations about the FTT’s reasoning’,

while another judge did ‘not have any concerns about the decision of the FTT or their reasons’.

The UK test for corporate residence

The CA provided a useful overview of the relevant authorities regarding the UK test for corporate residence, including a summary of some of the key points.

- The overarching principle is that a company resides for tax purposes where its real business is carried on, and that is where CMC actually abides.
- The principle applies in relation to subsidiaries, including SPVs.
- It is the actual place of management, not that in which it ought to be managed, which fixes the residence of a company.
- A company may be resident in a jurisdiction other than that of its incorporation not only where a ‘constitutional organ’ (eg, a board of directors) exercises management and control elsewhere, but if the functions of the company’s constitutional organs are usurped, in the sense that management and control are exercised independently of, or without regard to, its constitutional organs, or if an outsider dictates decisions (as opposed to merely proposing, advising and influencing decisions).
- On the other hand, CMC of a subsidiary will not be taken to be in a jurisdiction other than that of its incorporation just because it is following a tax planning scheme propounded by its parent. Nor need it matter that a company’s board takes decisions without full information or even in breach of the directors’ duties.
- Events before or after the particular date in question may be relevant as casting light on the position on that date.
- Where a company is resident is essentially a question of fact.

The CA’s decision in *Development Securities* was limited to overturning the UT’s decision, and it was not open to the CA to consider whether the FTT decision might have been wrong on other grounds. In light of the divided opinions of the CA judges about the reasoning of the FTT, it is therefore questionable to what extent (if any) *Development Securities* extends the scope of the UK test for corporate tax residency (as summarised above). *Development Securities* certainly reiterates the point that CMC is essentially a question of fact, and care should be taken in trying to extract broader principles from the reasoning of the FTT (as applied to the particular facts and circumstances in this case).

If the FTT’s reasoning were to be followed, then the scope of the test could potentially be interpreted as being extended broadly as follows:

Where the directors of a non-UK incorporated subsidiary or SPV:

- (1) act under the ‘instruction’ or ‘order’ from a UK parent (as distinct from an ‘authorisation’ or ‘ratification’), and
- (2) do not consider or discuss the merits (or otherwise) of the company entering into an arrangement (whether from the perspective of the company or the wider group), and merely check the legality of the arrangement, the directors could be regarded as simply administering a decision they were instructed to undertake, without any engagement with the substantive decision, in which case CMC may be regarded as being in the UK (where the UK parent has issued the instructions).

However, it should be noted that one of the CA judges (Nugee LJ) expressed ‘very considerable reservations’ about the FTT’s reasoning, and rejected the apparent extension to the CMC test:

‘I do not think the authorities establish that CMC can only be exercised by “actively engaging” with the decision if that means (as it appears the FTT meant) considering for themselves the merits and demerits of a proposal. The question is not why the directors made the decision they did, or how much thought they gave it, or what they did or did not take, or should or should not have taken, into account. The question is a much simpler one, namely: did they make the decision?’

It is hoped that *Development Securities* will be appealed to the UK Supreme Court, which should provide the opportunity for further guidance in relation to the UK test for corporate tax residence. Pending any such appeal, it is uncertain to what extent the FTT’s reasoning in *Development Securities* can be applied more broadly, but taking a prudent approach it should be assumed that HMRC may seek to apply similar arguments in the future.

What practical lessons can be learned?

While the *Development Securities* CA decision should be read in light of its unusual fact pattern, there are still some helpful practical lessons that can be applied to help prevent non-UK companies being treated as UK tax resident.

HMRC is known to be scrutinising corporate residence more generally, particularly where companies lack real substance in their local jurisdiction. Corporate residence should remain a particular concern for non-UK companies with a UK parent, or which have UK shareholders, directors or some other nexus with the UK. It is important that such companies take steps to ensure that proper corporate governance policies and processes are in place, and are followed in practice, to reduce the risk of HMRC asserting that there is UK CMC.

These corporate governance policies and processes should be revisited in light of any changes or modifications that have been required to be made as a result of the ongoing Covid-19 pandemic. While HMRC has stated that it is 'very sympathetic' to the disruption being caused by the pandemic, its view is that the existing legislation and guidance on corporate residence already provide the flexibility to deal with changes in business activities necessitated by the pandemic. This leaves open the door for HMRC to challenge the tax residency of non-UK companies in the future, at a time when it may be less sympathetic, and motivated to increase tax revenues.

Some particular lessons that can be drawn from the *Development Securities* case are summarised below (but it should be noted that this is not an exhaustive list).

- The directors of non-UK subsidiaries or SPVs should ensure that they carefully consider and discuss the rationale for (and the merits, or otherwise, of) the company entering into any relevant transaction or proposal, and that the directors actively engage with the decision. It is recommended that the board should consider this from the perspective of the subsidiary company only (focusing on the commercial rationale), as well as taking into consideration any benefits to the wider group.
- It should be ensured that the correct language and terminology are used when describing transactions and communications. The use of words such as 'instruction', 'order' or 'direction' rather than 'advise', 'request' or 'recommend' could have a significant impact on the question of CMC, based on the *Development Securities* FTT decision.
- Company records and board minutes should be detailed and accurate. The FTT conducted a very thorough review of all the board minutes and other relevant documents. Companies should be prepared for everything to be scrutinised in minute detail by HMRC (and the FTT). Draft board minutes can be prepared in advance of a board meeting (as an agenda, or guide to discussions), but it should be ensured that the drafts are updated afterwards to reflect accurately the actual discussions at the meeting (including details of any disagreements).
- Care should be taken when determining the scope of the engagement of any local directors, that the local directors are not (in effect) agreeing to follow the parent company's instructions from the outset. It would be advisable for the engagement to be clear that local directors are not pre-agreeing to any such instructions and that their power as directors of the subsidiary company are not being fettered in any way.
- It is recommended that the directors of a non-UK subsidiary/SPV should not include individuals who are directors, employees or representatives of a UK parent. It would also be preferable for no representatives of the UK

parent to be present at the subsidiary board meeting, but if this is necessary then care should be taken to ensure that the observer does not participate in discussions, or otherwise influence the decisions of the board.

Conclusion

While it is hoped that *Development Securities* will be appealed to the Supreme Court, pending any such appeal it would be prudent to assume that the FTT's reasoning could be applied to future cases involving non-UK subsidiaries or SPVs. Particular care should therefore be taken to ensure that non-UK subsidiaries or SPVs do not simply follow the instructions or orders of a UK parent (or other UK persons) without themselves properly considering the merits of entering into any transaction.