

**Dewey & LeBoeuf London**

Dewey & LeBoeuf's London office is a full-service English law practice with extensive US law capabilities. With over 140 lawyers in London, the office handles complex, challenging international work for a global client base.

UK Redomiciliations – What is the Risk of a Successful HMRC Residence Challenge?

20 January 2010

After a run of corporation tax residence cases in which the UK tax authorities have lost, the First-Tier Tax Tribunal decided last August that a Dutch-incorporated company was, in fact, UK tax resident on the “central management and control test” (*Laerstate BV v. HMRC*¹).

Their success is likely to encourage Her Majesty's Revenue & Customs (“HMRC”) to challenge the residence status of certain non-UK-incorporated companies with UK commercial links. In particular, Dave Hartnett, permanent secretary for tax at HMRC, is reported to have warned that particularly careful scrutiny will be given to so-called corporate “inversions” or “redomiciliations” – in other words, reorganisations of UK-headquartered listed groups such that the group parent company is no longer UK tax resident. In the last few years, several UK-listed groups have redomiciled to a variety of jurisdictions, including the Irish Republic, Switzerland, Bermuda and the Netherlands.

Mr Hartnett is reported to have said “Some companies claim to have changed their residence and left the UK. Investigation and litigation in the UK will establish that.” The UK press last month quoted a senior HMRC source as saying: “We will be looking for substantial evidence that a move has taken place and is genuine. We will want to see emails to establish there has been a physical relocation and that the brains of the company has (*sic*) moved.”

The UK Corporate Tax Residence Test – Who is Exercising Central Management and Control, and Where?

Long-standing HMRC published interpretation of the case law sets out the following approach to determining a company's residence status²:

- i. [HMRC] first try to ascertain whether the directors of the company in fact exercise central management and control;
- ii. if so, they seek to determine where the directors exercise this central management and control (which is not necessarily where they meet);

¹ [2009] UKFTT 209 (TC).

² A UK tax resident company is liable for UK corporation tax on its world-wide profits and, in the case of a holding company, on the distributed profits of any of its low-tax subsidiaries which fall within the UK-controlled foreign companies regime.

- iii. in cases where the directors apparently do not exercise central management and control of the company [HMRC] then look to establish where and by whom it is exercised.³

In *Laerstate*, the company in question was a private investment holding company, wholly owned by a single individual shareholder, who, for part of the period in question, was also one of the two directors. The decision that the company was UK tax resident was based on the conclusion that, in fact, the company's affairs were being managed by that sole shareholder (/director) outside formal board meetings, and not by the board of directors as a whole through formal meetings/resolutions – step (iii) in the analytical approach outlined above.

Thus the decision turned on an analysis of the same question as arose in two of the other key reported cases of recent years, *Untelrab v. MacGregor* [1996] STC (SCD) 1, *Wood v. Holden* [2006] STC 443; namely whether the board of the relevant company was genuinely exercising central management and control or whether that function was really being performed by someone else, such as a parent company or professional advisers.

In the case of a widely held listed company, it would be highly unusual to find that central management and control was being exercised by someone other than the full board of directors (in other words, in breach of the company's constitution and the corporate governance codes of practice for listed companies).

So, in the case of those listed groups which have redomiciled away from the UK, it is probably not so much a question of *who* is exercising central management and control, but rather *where* they are doing so.

In other words, although it may be accepted that the full board of the parent company are indeed running the company, the question is whether they are doing so through the forum of formal board meetings in its chosen place of residence – step (ii) above. Where appropriate, HMRC will investigate whether the directors are doing so instead through informal discussion in the UK.

So, how vulnerable to such an attack is a UK-listed group which relocates abroad?

- *Constitutional Restraints:*
 - One protective mechanism commonly employed is to build requirements and restrictions into the new

³ Statement of Practice 1/90.

holding company's constitution - as to the composition of the board, the quorum and location of board meetings, the methods of attendance and so on. Such provisions undoubtedly serve as helpful reminders (and brakes on careless behaviour). A hoped-for additional benefit is the opportunity to argue that non-compliant management activity is ultra vires and should be ignored.

- However, the case law clearly states that an entirely objective assessment of the facts and circumstances is required in order to determine *who* is exercising central management and control. For example, in the leading case of *Unit Construction Co Ltd v. Bullock* [1960] A.C. 351, the functions of the local boards of various subsidiaries had been usurped by the parent company board. This concept is further illustrated in *Laerstate* – in the earlier period under discussion, the controlling shareholder, as one of two directors, did have legal authority to take unilateral binding decisions on behalf of the company (and it was held that he exercised that authority). However, in addition, the Tribunal decided that he continued to do so, during the later period, even after he had formally stepped down from the board and even though the sole director was a highly experienced businessman in his own right and a business partner of the shareholder in other ventures (and not merely a trustee/professional director).
- Just as the identity of the person(s) exercising central management and control may conflict with the constitutional authorisations, so, too, may the place *where* that authority is exercised. Indeed, if anything, the courts may be less reluctant to find that the directors are fulfilling their responsibilities in the “wrong” place, than to find that they are in breach of their fiduciary duties and have ceded decision-making power to others. So, it is hard to take refuge in the company's constitution.
- *Key Strategic and Policy Decisions:*
 - The case of *Laerstate* illustrates the long-standing case-law position that the concept of central management and control is substantive (not purely formal) and qualitative (examining the nature, and not just the pure number, of relevant decisions). The

Tribunal emphasised that the central management and control test does not confine itself to a consideration of particular actions of the company, such as the signing of documents or the making of certain board resolutions outside the UK if, in a given case, a more general overview of the course of business and trading demonstrates that, as a matter of fact, central management and control abides in the UK. In particular, a series of formal board meetings outside the UK, some of which are devoted to handling routine administrative decisions, will not outweigh the taking of several key business decisions in the UK. This echoes the comments by the courts in earlier cases to the effect that merely going through the motions of passing or making resolutions and signing documents does not suffice – it is the place where the actual effective decision that the documents be executed is taken which counts.

- A particular situation where care needs to be taken to ensure that management is not taking place outside formal board meetings is in the context of urgent decision-making. The ratification at an offshore board meeting of decisions already taken in the UK or contracts already agreed in the UK is unlikely to assist.
 - Particular pressures can be placed on a listed company in an emergency, when the logistics have to take into account the demands of numerous stakeholders, stock exchange rules/timetables and so on.
 - On the other hand, case law shows that residence is tested over a period of time, so that an occasional UK board meeting of a company which is intended to be non-resident is not necessarily fatal.
- *Board Packs and Minutes:*
 - The Tribunal in *Laerstate* said that “mindless” execution of documents/signing of resolutions without even thinking what the documents/resolutions are about, does not constitute the exercise of central management and control because no true decision-making takes place.

- Furthermore, nor does execution of a document/passing of a resolution where the directors know what they are signing/resolving but have not considered the merits at all – evidence of this would be the directors not having the absolute minimum of information that a person would need to have in order to be able to make a decision.
- On the other hand, in line with earlier case law (such as *Untelrab v. McGregor*, *Wood v. Holden*), decision-making still constitutes effective decision-making even if a lack of complete information or understanding means that the decision is ill-informed or ill-advised. It still constitutes central management and control.
- The Tribunal in *Laerstate* noted that the minutes were thin and/or inaccurate as regards significant details of the transactions being approved. Detailed and accurate minutes recording the factors taken into consideration and the debate at the meeting are important evidence of the board meeting being the true forum for decision-making.
- However, a listed company will typically benefit from a high-quality company secretarial function which prepares and circulates board packs and accurate detailed board minutes to a much higher standard than in *Laerstate*.
- Moreover, the board of a UK-listed company are typically very mindful of their personal responsibilities and highly unlikely to be party to decisions without full and accurate information.
- *Choice of Directors:*
 - The fact that the sole shareholder was personally UK tax resident was not, in itself, determinative in the *Laerstate* case. Having decided that his activities constituted the real top-level management of the company, the Tribunal then considered in detail his physical movements, based on his diary, travel arrangements, correspondence and so on, in order to find where that management activity took place.
 - Nevertheless, it is common practice to ensure that a company which is not intended to be UK tax resident

does not have a majority of UK personally resident directors. This is not because this is a test, as such, for corporate tax residence status. Rather, as a practical matter, if a majority of the (key) directors are based in the UK, then HMRC will suspect that they discuss the affairs of the company whilst physically in the UK and there is obviously a clear temptation for them to do so.

- At the same time, bearing in mind the importance of identifying true decision-making, the appointment of some local service providers in the relevant non-UK jurisdiction to a board made up of UK resident individuals may not be effective on its own to locate the decision-making in that jurisdiction – although not “mindless,” if the local “professional” directors lack the commercial expertise to assess the information made available to the board, there is a risk that their input is not sufficient to ensure that board meetings are the true forum for central management and control.
- Accordingly, a listed group which wishes to relocate outside the UK but has a significant number of UK-resident executive and/or non-executive main board directors, will be well-advised to re-balance the board, and perhaps add some non-UK-based heavy-weight non-executives with relevant industry experience, whose participation in the decision-making process is difficult to overlook.
- *Frequency of Board Meetings:*
 - In *Laerstate*, there were some long gaps between formal board meetings. The company nevertheless engaged in significant commercial activity in between times – this clearly implied that someone somewhere was taking strategic decisions. The absence of board meetings made the company more vulnerable to an HMRC challenge that such decisions were being made on behalf of the company in the place where the controlling shareholder was based.
 - UK-listed companies will normally hold regular formal board meetings. Such companies which redomicile still need to be careful to hold meetings sufficiently often to handle the volume of business for the company in question.

- This might necessitate increasing the frequency of board meetings after the reorganisation because there is less flexibility for “informal” discussions amongst the directors between meetings.
- *Commercial Motive:*
 - The case is also a reminder that whether or not there is a genuine commercial reason for a certain activity to take place in a particular geographical location does not “excuse” that behaviour from affecting UK corporate tax residence.
 - On the other hand, because the test is totally objective, the fact that one of the reasons for a group reorganisation may be tax efficiency, or that the tax savings are significant, are not relevant to the legal outcome (even if they may affect HMRC’s attitude).
- *Careless Communications:*
 - It is worth noting the HMRC spokesman's reference to a trawl of emails. However perfect the set of board meeting minutes which can be produced to HMRC, contradictory communications within the company and with external advisers/counterparties (indicating actual decision-making by one or more people located in the UK) could seriously undermine their evidential weight. In *Laerstate*, for example, HMRC cited the behaviour of external advisers/counterparties which treated the sole shareholder as if he were the sole decision-maker, in terms of the addressing of advice, taking of instructions and so on.
 - In the context of a sizable listed group holding company, the greater practical risk is probably that internal emails or pre-emptive action imply that key decisions have already been taken and are being implemented (albeit that “formal” approval at the next board meeting is awaited) or that inconsistent statements appear in the group’s Web site, press releases, marketing materials and so on. (However inaccurate in themselves, they could put the company on the back foot in its defence of its tax status.)

- *Group Support Functions:*
 - A group which relocates may still retain a significant presence in the UK by way of "head office" group support functions – finance, IR and communications, legal and HR, IT. The relative size and sophistication of the UK presence may increase the practical risk of an HMRC challenge, but the legal significance is doubtful.
 - In quite an old House of Lords decision (*Swedish Central Railway Company Limited v. Thompson* 1925 A.C. 495) it was held that a UK-incorporated company (this was in the days when UK incorporation did not automatically mean that a company was UK tax resident), the directors of which met regularly in Sweden to manage the principal business of the company, was nonetheless resident in the UK because of the mere presence in London of a committee of the board to sign cheques, seal documents and deal with share transfers and of the company secretary, registered office, company seal and share register together with the performance of certain administrative functions. These features were regarded as sufficient to make the company resident in the UK as well as Sweden. This case is difficult to reconcile with the rest of the case law.
 - Moreover, certain ongoing UK-based "day to day activity" by a holding company relating to its UK listing (such as shareholder presentations, meetings with rating agencies and so on) should not affect residence status.
 - Nevertheless, the mere existence of such human and technical resources in the UK, especially if a number of the directors are personally based in the UK, may tempt directors into the convenience of discussing those matters in the UK, which ought to be reserved for decision-making in the chosen home jurisdiction.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

Pursuant to US Treasury Department Circular 230, unless we expressly state otherwise, any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed herein.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2010 Dewey & LeBoeuf LLP
All rights reserved.

Conclusion

The main area for redomiciled UK groups to watch so far as UK tax residence is concerned is probably not so much *who* is exercising central management and control, but *where*.

In that respect, the Tribunal's interpretation of the law in *Laerstate* is useful, as an illustration of a set of facts which was held to fall on the wrong side of the line. It is a timely reminder of the substantive nature of the central management and control test. But the facts are not directly comparable.

Moreover, a well-advised group, which takes care to follow its internal management guidelines, should be able to avoid falling into the same trap as *Laerstate*.

For more information, or specific advice relating to any of the above, please contact Judith Harger at +44 20 7459 5185 or jharger@dl.com, Graham Brough at +44 20 7459 5230 or gbrough@dl.com, or Farheen Raza at +44 20 7459 5130 or fraza@dl.com, or your Dewey & LeBoeuf relationship attorney.