Tax residency, corporate governance and directors' decision-making: update

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Corporate governance and directors' decision-making can affect the tax residency of an entity.

A series of UK judgments relating to a Jersey structure established by Development Securities plc (**DS plc**), including a UK Court of Appeal (**CoA**) judgment in **December 2020**, are likely to be of interest to anyone who is involved in international tax structuring or planning.

Summary of key points

- It is an established principle that:
  a. For tax purposes, a company resides where its central management and control (**CMC**) is exercised
  b. CMC is exercised where a company is actually managed, which is a matter of fact (but is usually where its board of directors makes decisions)
- A company's tax residency can be affected by management and control being exercised independently of (or without regard to) a company's board, or by a person who dictates decisions to the board
  a. That is not to say that CMC of a subsidiary will be taken to be exercised by its parent merely because directors of the subsidiary cause it to follow a tax planning scheme put forward by the parent – the key factor being where the decision to participate in that scheme was actually taken
  b. On the other hand, CMC is not necessarily exercised where the formal approval to authorise a company to take particular actions is given (ie where the relevant board meeting is held) – directors merely ensuring that what they are to approve is lawful (and authorising related actions such as execution of documents) may not, in and of itself, constitute making the decision to cause the company to take the relevant action(s)
  c. Care should be taken in directors relying on shareholder authorisations which, as a matter of fact, could be taken to be instructions and therefore the exercise of CMC by the shareholder
- Whilst the proper exercise of directors' duties and CMC are not directly connected, there remains some uncertainty as to the level of engagement required for directors to be taken to have actually made decisions
  a. It is clear that directors being fully appraised of relevant matters can go to evidencing that they actually made the relevant decisions
  b. Meetings of directors should be properly minuted, and those minutes should deal with the decision-making process and not just the decisions themselves

Background

Structure

The Development Securities judgments relate to a structure that was established in 2004 by DS plc, a UK tax resident company, to crystallise latent capital losses in UK real estate.

The structure involved three newly-incorporated Jersey companies acquiring assets from other members of the DS plc group at a time when the Jersey companies were intended to be Jersey tax resident. The Jersey companies then became UK tax resident and disposed of the assets at a loss, creating a tax benefit for the group.

Each Jersey company had a board consisting of two Jersey-resident professional directors and one UK-resident client director. All board meetings during the period that the companies were intended to be Jersey tax resident were held in Jersey.

HMRC determination and resultant litigation

HMRC formally challenged the structure, determining that the Jersey companies were UK tax resident at the time they entered into option agreements to acquire, and then acquired, the relevant assets, which was fatal to the success of the scheme in generating the intended tax losses.

DS plc unsuccessfully appealed, with the First Tier Tribunal (**FTT**) in its 2017 judgment[1] upholding HMRC's initial determination. However, the FTT decision was overturned in a second appeal by DS plc to the Upper Tribunal (**UT**) in 2019[2]. Our January 2020 briefing summarises the position following the 2019 UT decision.

HMRC itself then appealed, and in December 2020 the CoA found in its favour[3], reaffirming HMRC's initial determination that the Jersey companies were tax resident in the UK at the relevant time.

The Court of Appeal decision

Summary of corporate tax residency principles

The CoA's judgment provides a useful summary of the established principles applicable to corporate tax residency:

Principle	**Commentary**
A company may be tax resident in a place other than its jurisdiction of incorporation	Local tax laws will also be relevant to determining residency – for example, some jurisdictions (including Jersey) permit dual-residency, where certain conditions have to be met to "break" local residency
A company resides for tax purposes where CMC is exercised, being its place of actual management (rather than where it ought to be managed)	CMC is a matter of fact, not intention
Tax residency can be affected where: • *management and control is exercised independently of, or without regard to, a company's board of directors; or* • *a person dictates decisions to the board (as opposed to proposing, advising on or influencing decisions)*	• This highlights the importance of directors actually making decisions, rather than merely implementing decisions taken by others • It is not only shareholders taking decisions that can affect tax residency – other third parties who dictate decisions to the board can potentially exercise management and control for tax purposes
CMC of a subsidiary will not be taken to be in a jurisdiction other than that of its incorporation merely because: • *it is following a tax planning scheme put forward by its parent; or* • *its board takes decisions without full information, or even in breach of directors' duties*	• It is permissible for directors to take into account shareholder interests, intentions and desires when making decisions, without that affecting tax residency • The proper exercise of directors' fiduciary powers is not in and of itself determinative of management and control (although it is evident from *Development Securities* that it can be relevant in practice as it can evidence decision-making)
Events both before and after a particular action has been taken may be relevant in determining the position at the relevant time	• There is a heightened risk of challenge to tax residency when a company is established after a plan of which it is to form part has been formulated • In those circumstances, ensuring that directors actually make the relevant decisions, and that those decisions and the directors' decision-making processes are properly minuted, is of paramount importance

1. *Development Securities and others v HMRC [2017] UKFTT 0565 (TC)*
2. *Development Securities and others v HMRC [2019] UKUT 169 (TCC)*
3. *HMRC v Development Securities and others [2020] EWCA Civ 1705*

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Decision-making versus formal authorisation

A key theme one can draw from the CoA's decision is a distinction between decision-making and the mere formal authorisation of actions.

It is clear from the CoA's judgment that they agreed with the FTT that this is an active distinction in determining where CMC is exercised:

- CMC is exercised where decisions are actually taken
- That is not necessarily where the formal approval to authorise the company to take a particular action is given (ie where the relevant board meeting is held) – although ordinarily it would be
- Merely ensuring that causing a company to take particular actions is lawful (and authorising related actions such as execution of documents) may not, in and of itself, constitute making the decision to cause the company to take those actions

So, in the case of the Jersey companies within the DS plc structure, to quote from the FTT judgment (as endorsed by the CoA), the Jersey board:

> *"merely passed the formal relevant resolution for the Jersey companies to enter into the options and subsequently to exercise them on the basis of the instruction/certifications received without any engagement with the substantive decision albeit having checked (in tandem with DS Plc) that there was no legal bar to them carrying out the instruction".*

This, when viewed alongside evidence (including hand-written notes) that the directors considered a shareholder authorisation provided by DS plc as an "instruction" to enter into the relevant transactions (notwithstanding it being formally couched as an authorisation), caused the CoA to conclude that the relevant decision had been taken by DS plc in, and therefore the CMC of the Jersey companies was exercised from, the UK.

Level of engagement required to make a decision

The question of the level of engagement required for a board to be taken to have actually made a decision remains a point of uncertainty.

The main CoA judgment was given by Lord Justice Newey. Whilst not directly relevant to the CoA's decision, Lord Justice Nugee explained (*obiter*) that he had certain concerns with the FTT's suggestion that CMC can only be exercised by directors "actively engaging" in a decision if that means considering for themselves the merits and demerits of a proposal.

In Nugee LJ's words:

> *"The question is not why the directors made the decision they did, or how much thought they gave to 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?"*

Summary of key principles and risks

The following provides a more detailed summary of the key principles and risks highlighted by the Development Securities judgments and how they impact on corporate governance:

Principle/risk	**Commentary/risk mitigation**
Management and control takes place where decisions are actually made	• Simply being physically present in a particular place when a formal board meeting is held is not necessarily enough to establish CMC (particularly where there is evidence to suggest that, as a matter of fact, the decision was taken elsewhere) • To establish CMC the decisions taken at board meetings must be more than a mere formality • There remains some uncertainty as to the level of engagement required for directors to be taken to have actually made decisions, which can in part be mitigated through good corporate governance and record keeping (see further below)
Management and control does not vest in a company's parent merely because the company's board: • *carries out the purpose for which the company was established; and/or* • *takes decisions which align with the intentions or desires of the parent*	• When determining what is in the best interests of a company, it is proper for directors to look to the interests of its shareholder(s),[4] which may include their intentions and desires • However, in doing so it is imperative that directors then go on to actually make the relevant decisions, taking into account those interests, rather than simply implementing what they know or infer to be a decision taken by the shareholder(s) on the basis that it is an instruction (irrespective of how it was formally worded)

4. Where the company is solvent and not likely to become insolvent

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Principle/risk	Commentary/risk mitigation
A court may infer or conclude that directors were not making decisions where: • *they directors were not sent relevant emails or given sufficient time to consider relevant matters before meetings; and/or* • *their decision-making process is not properly minuted (even if the "decision" itself was)*	Whilst the proper exercise of directors' fiduciary powers is not in and of itself determinative of management and control, it is clear from *Development Securities* that it is relevant in determining whether and where decisions were actually made: • Directors should generally be copied in to relevant emails and given sufficient time to consider matters relevant to decisions (including to review steps papers, documents etc) • Where that is not possible, the company's advisers should attend board meetings to flag key transactional elements and risks to directors (which should be properly minuted) • Long-form draft minutes (or at least a detailed agenda) should be prepared in advance so directors are aware of those matters that they need to consider • Board minutes should: a. accurately record proceedings (including any additional matters not covered in, or deviations from, draft minutes / the agenda); and b. record the decision-making process as well as the decisions themselves
Where shareholders have pre-authorised directors' actions, a court may infer or conclude that the decision to take those actions was actually a shareholder decision (with management and control being exercised where the shareholder made its decision)	• A fundamental principle of company law, which is relevant to management and control and therefore tax residency, is that companies are managed by their directors • Shareholders should only be asked to authorise directors' actions where: a. there is no, or no clear, corporate benefit to the company, and the authorisation is to protect the board from potential claims for breach of directors' duties; or b. there is some other valid reason to seek such authorisation[5] • Where there is doubt as to corporate benefit, directors should take advice on their duties and apply that advice to the facts before relying on shareholder authorisations, to mitigate the risk of an argument that they had simply passed the decision to the shareholder(s) • It must be correct as a matter of fact, and clear from all relevant documentation, including any notes of meetings that are not formal minutes, that shareholder authorisations are not instructions and do not absolve the directors of the responsibility to make relevant decisions
A court may examine pre-incorporation planning as part of determining whether an entity's directors were: • *making actual decisions in relation to the entity's participation in the plan; or* • *merely implementing a plan agreed upon by another person (with the relevant decisions being taken by that other person, and management and control being exercised where those decisions were taken)*	• Proposed directors should be involved in pre-incorporation planning where possible • Where not possible, they should be quickly brought up-to-speed and appraised of all relevant factors, risks etc so that they are able to properly make decisions when required to do so

5. For example, where (a) it is a requirement of the company's constitutional documents, a shareholders agreement, investment agreement etc or market rules or (b) it is customary to obtain shareholder authorisation for the type of transaction concerned (for example certain Jersey financing transactions)

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