# Laerstate: the dangers of the UK corporate residence test

OFFSHORE CORPORATE STRUCTURES HAVE been, and will remain, an important tool in corporate tax planning. However, there has been a renewed interest in the taxation of offshore corporates, highlighted by the recent emigration of certain high-profile listed companies from the UK. Although relating to a disposal back in 1996, the decision in *Laerstate BV v HM Revenue & Customs (HMRC)* [2009] has therefore arrived at an opportune time.

## FACTS

Laerstate BV (Laerstate), a Dutch company, was the vehicle used by Dieter Bock to acquire and subsequently dispose of his interests in Lonrho plc (Lonrho). The case considers the residence of Laerstate between 1992, when it acquired its interest in Lonrho and at which time Bock was one of its directors, and 1996, when Laerstate disposed of shares in Lonrho to Anglo American, at which time Bock was no longer a director.

*Laerstate* therefore considers the application of the corporate residence test in two scenarios, as Bock resigned as a director of Laerstate in 1996 prior to the disposal of the Lonrho shares. Laerstate had another director, Johannes Eduard Trapman, who was in office throughout the relevant period.

*Laerstate* considers in great detail the events between 1992 and 1996, specifically in relation to the conduct and location of Bock during that period. The evidence showed that:

- the constitution of Laerstate was such that each director of Laerstate could represent and bind the company with third parties;
- there was no formal requirement under Dutch law for a formal record of board meetings to be kept;
- although some board meetings of Laerstate were held, most related only to minor ministerial matters and not to the policy or strategy of the company;
- the negotiation and financing of the acquisition of Lonrho shares and their subsequent disposal was conducted by Bock, (although this was, on occasion, with the 'assistance, co-operation and concurrence of Trapman', Trapman's involvement was very much 'secondary' to that of Bock, who was ultimately responsible for the strategy of the transactions at all times);
- inconsistencies in Bock's and Trapman's evidence, and the timing of certain events, implied that Bock effectively retained and controlled the decisions made by Laerstate, both during the period in which he was a director and after he resigned;
- Trapman was not provided with drafts of the relevant documentation that he signed and there was no contemporaneous evidence that he considered or reviewed the relevant documentation prior to signing; and
- travel records showed that the management activities performed by Bock were undertaken substantially in the UK.

## APPLICATION OF THE 'CENTRAL MANAGEMENT AND CONTROL' TEST

Both parties agreed that the residence of Laerstate should be determined by reference to where its central management and control (CMC) abides, being the location where the high-level strategic decisions of the company were made. The decision turned, however, on how the CMC test should be applied to the facts.

Counsel for Laerstate argued that CMC should be identified by reference to the resolutions of the board that approve the relevant transactions and documentation,

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or, where there is no resolution, where the relevant document is signed. Counsel argued that as all meetings were held and material documents signed outside the UK, Laerstate's CMC was outside the UK, and therefore Laerstate could not be resident in the UK for tax purposes.

Counsel for HMRC accepted that where a company is run at board meetings, the location of CMC is likely to be where the board meets. However, they contended that in this case Laerstate was not, at least to a material extent, run at board meetings. Counsel argued that the evidence showed that it was Bock who made the strategic and policy decisions on behalf of Laerstate, both during the period in which he was a director and after he resigned.

### TRIBUNAL'S DECISION

The First-tier Tribunal (Tax), in interpreting the CMC test, held that there is no assumption that CMC must be found where the board of directors meet. It is purely a question of fact where the CMC of a company abides, it being the location where high-level strategic and policy decisions are made. Although the location of board meetings is relevant, the test is not confined to certain acts of a company, such as this or the signing of documents. To establish CMC, it is necessary to look at a general overview of how a company is run, and in particular whether the course of trading and business of a company demonstrates that CMC is exercised in the UK.

During the period in which Bock was a director, it was extremely unfortunate for the taxpayer that Bock was authorised to represent and bind the company in his own right. The body of evidence demonstrated that Bock arranged, negotiated and made the crucial decisions in relation to the relevant transactions, with Trapman only becoming involved after the negotiations had been completed, if at all. The fact that Bock could individually represent Laerstate meant that, throughout the period between 1992 until 1996 when he resigned, the course of trading and business of Laerstate was such that the CMC of the company was to a large extent directed solely by Bock.

The fact that sporadic board meetings were held outside the UK did not give rise to a change in residence, as the residence of a company 'will not fluctuate merely by reason of individual acts of management and control taking place in different territories'. The Tribunal therefore rejected the taxpayer's argument that CMC should be determined by reference to the location of board meetings and the signing of documents.

In relation to the period after Bock resigned from Laerstate (and only then), the Tribunal held that it was necessary to consider the decision in *Wood & anor v Holden (HMIT)* [2006]. In *Wood* the board meetings of the company could not be disregarded as, without the decisions made by the managing director in the Netherlands, the relevant agreements would not have been made.

As Mr Bock was no longer able to represent and bind Laerstate, the residence of Laerstate during that period turned on whether Trapman was, at that time, in possession of the minimum information necessary to make an informed decision.

Again, the Tribunal concluded from the available evidence that it was Bock, rather than Trapman, who was making the decisions in relation to the disposal of Lonrho shares. The timing of events leading up to the disposal also led the Tribunal to conclude that it must have been Bock who made the high-level decisions. Trapman then signed the relevant documents, which he did without considering whether or not to do so, and without the necessary information to make an informed decision. At one stage Bock even referred to Laerstate's shares in Lonrho as 'my shares'.

> ***'The fact that Laerstate's constitutional documents allowed Bock to represent the company individually, while he was a director, was extremely unhelpful to the taxpayer's argument.'***

### CONCLUSIONS

*Laerstate* re-affirms that to determine the residence of a company, it is necessary to determine where the high-level strategic decisions of the company are made. This will not necessarily be where the board of directors meet, as it is necessary to consider the overall governance of the company and the behaviour of the board. It is an important reminder that the CMC of a company will not be determined by the location of board meetings, if, through the course of business and trading of a company, it is evident that such decisions are not made at board meetings.

The fact that Laerstate's constitutional documents allowed Bock to represent the company individually, while he was a director, was extremely unhelpful to the taxpayer's argument. It allowed the Tribunal to treat all of Bock's actions, while present in the UK, as creating an overall picture that the CMC of Laerstate was located in the UK. To avoid this pitfall, constitutional documents of offshore companies should be drafted so as to ensure strategic and policy decisions of the company can only be made by the board at a meeting held outside the UK.

Even if this is the case, it is still necessary to ensure that the corporate governance of an offshore company is such that the CMC of the company is not brought onshore by the behaviour of the board. *Laerstate* highlights the following points in relation to the governance of an offshore company:

*Laerstate BV v HM Revenue & Customs [2009] UKFTT 209 (TC)*

*Wood & anor v Holden (HMIT) [2006] EWCA Civ 26*

- the board should meet regularly to consider all strategic and policy decisions to be made by the company;
- documentation should be tabled at board meetings, and information provided to allow all members of the board to properly consider the matters discussed at the meeting and the execution of relevant documentation;
- where possible, minutes of meetings should accurately record the discussions by the board and any issues or questions raised by its members;
- all meetings should be held and all documents signed outside the UK, and attendance by telephone from within the UK should also be avoided (travel documentation should be kept to evidence attendance at meetings and where documentation is signed); and
- any UK resident directors (or directors conducting business from within the UK) should not conduct themselves in such a way that may lead third parties to assume that they are authorised to negotiate on behalf of and bind the company (where possible, any duties carried out on behalf of the company, such as the negotiation of documents, should be delegated by the board at a meeting, and the entry into of all documentation should remain subject to the board's approval).

Such corporate governance procedures will be well known to anyone dealing regularly with offshore corporate structures. The question, however, is how well such procedures are followed in practice, particularly when the reality of a corporate transaction may mean that such governance proves impossible or simply too inconvenient to follow, usually at the most crucial time. Where a particular individual could be seen to have influence over a company, *Laerstate* provides a warning of the consequences of straying from best practice.

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# Yet another change of heart

ALTHOUGH IT MAY GO UNNOTICED BY THE world at large, HM Revenue & Customs (HMRC) recently issued a further release on the subject of the correct tax treatment of unapproved options. While this may appear a fairly dry subject at first, the history to the recent announcement is illuminating and highlights issues that are of concern to all taxpayers (and not just those who are affected by the recent announcement).

### *MANSWORTH (HMIT) v JELLEY* [2002]

Back in the late 1980s and the early 1990s, Colin Jelley exercised some options he had been granted a few years earlier and immediately sold the shares. A dispute arose between him and the Inland Revenue (the Revenue), as it then was, on the correct method of calculating his gain (and in particular on the amount he was entitled to deduct from the proceeds on account of the cost of acquisition of the shares). The dispute centred on the interaction between two provisions of the capital gains code:

- the first provided that where an asset was sold and acquired otherwise than by way of bargain at arm's length, the consideration treated as paid for the asset was to be the market value of the asset; and
- the second provided that where an option was exercised, the grant and exercise should be treated as a single transaction.

The Revenue accepted that the grant of the option, being in respect of past service, was a bargain otherwise than at arm's length. It contended, however, that the exercise of the option was a bargain at arm's length. The result was that the cost of the shares, for tax purposes, was the amount paid on exercise (which, as is common, was in this case less than the shares' market value).[1] On the other hand, Jelley argued that both the grant and exercise were otherwise than by way of bargain at arm's length and that the acquisition cost was therefore to the market value of the shares at the time of exercise (with the result that no gain arose to Jelley). Both the High Court and the Court of Appeal agreed with the taxpayer and rejected the Revenue's arguments.

The decision might well have never been heard of again. After all, in the Court of Appeal, Chadwick LJJ expressed the view that:

> 'It is, perhaps, pertinent to note that the particular issue raised by this appear is unlikely to be of widespread concern.'[2]

*Mansworth (HMIT) v Jelley EWCA Civ 1829*

However, the decision was raised again by the statement of practice issued by the Revenue following its defeat.

Shortly after the publication of the Court of Appeal, the Revenue issued guidance on the effect of the decision. It started, uncontroversially enough, by stating that the acquisition of the cost of the shares is their market value at the time of exercise. However, paragraph 3 dropped the proverbial bombshell by stating that the cost of the shares for tax purposes is their fair market value plus the amount on which income tax is charged on exercise of the shares. This throwaway comment, for which no justification was given and which appeared unsupported by the case itself, ensured that, at the stroke of a pen, most employees exercising an option would realise a capital loss that they could use to reduce their tax bill. The Revenue's guidance was met with something approaching incredulity. Numerous commentators pointed out that the position produced a perverse economic result and seemed unsupported by both legislation and precedent.

Undeterred, the Revenue expanded on its guidance a couple of months later and even amended it to take account of some criticism of it made in *Taxation* magazine.[3] The net effect was that several taxpayers were able to amend their tax returns to claim the benefit of the loss that the Revenue's guidance had created.

Readers might be excused for thinking that this was all a bit of a storm in a teacup. The law was changed soon after the Revenue's guidance was issued in 2003, with the result that the exercise of an option no longer gave rise to a completely artificial loss. And there things might have remained had it not been for a rather extraordinary release by HMRC earlier this year.

The release stated that HMRC had taken legal advice on the effect of *Mansworth*, which advice had confirmed what most people had realised some time ago: the Revenue's interpretation of *Mansworth* was wrong. One wonders what led HMRC to seek advice on this subject and publish it more than six years after original press release. The recent release did beg the question of how the old guidance had been arrived at; presumably no advice was taken at the time.

For those not completely *au fait* with the complexities of the self assessment system, this release might be of interest in that it highlights the position they find themselves in where they make a self-assessment return that is regarded as correct, but subsequently turns out to have been made on an incorrect basis, eg because a court decision goes against what was understood to be the correct interpretation of a statutory provision. In general, where the time limit for the opening on an enquiry of the taxpayer's return has not expired, the taxpayer will be free to amend it. However, where that time limit has passed, the taxpayer is prevented from re-opening their return if the return was made on the basis of the practice generally prevailing at the time. HMRC will also be free to amend the return where there is a current enquiry into it, even if that enquiry has nothing to do with the correct tax treatment of the exercise of an option.

## COMMENT

HMRC's repeated change of heart on the meaning and correct interpretation of *Mansworth* will no doubt have caused some embarrassment at HMRC. Some taxpayers will have benefited by being able to claim wholly artificial losses against real gains. For others, the change of heart will be an annoyance as they will be required, yet again, to amend their self-assessment returns. However, there is a more ironic postscript to all of this: HMRC is in the process of consulting with interested parties on the role of tax agents. The most recently published paper from HMRC deals at some length with the standard of competence that HMRC expects from tax agents and how HMRC will enforce such standards;, its preferred method at the moment being to have a right to review the work of agents that it considers fall below the expected standard. Will it now be necessary to set up an agents' representative body to review HMRC's reaction to decided cases?

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## NOTES

1) This article criticises HMRC for various changes of position. It is therefore only fair to point out that the arguments advanced by HMRC in *Mansworth* were consistent with long-held positions of HMRC that were known to taxpayers and their advisers.
2) His view was based on the fact that some years before *Mansworth*, the law had been changed to provide that the acquisition of the option should not be treated as by way of bargain otherwise than at arm's length, a view that seems to have got lost in the commotion following the guidance issued by HMRC.
3) 'Jelley Wobbles', Sue McDonald, p141, *Taxation*, 8 May 2003.