

Chapter 1

Corporate Residence

INTRODUCTION

1.1 This book examines how the tax residence of a company is determined under UK law. It explains the statutory rules applying to company residence and sets out the case law test of central management and control. It also considers the residence requirements which a company must meet in order to be treated as resident for treaty purposes and thus qualify for treaty benefits. It proceeds to describe the role played by the treaty residence tiebreaker provisions, in resolving conflicts of dual residence that arise where a company is a resident under the domestic laws of both states.

1.2 Up until 15 March 1988, a company's tax residence was determined solely by the application of case law. This case law had developed over a period of more than one hundred years. The genesis of the case law test can be discerned in the landmark judgements of Chief Baron Kelly and Baron Huddleston in the *Calcutta Jute*¹ and *Cesena*² cases heard together in 1876. The case law test itself was enunciated by Lord Loreburn in 1906 in the famous *De Beers*³ case. This test focuses on determining the location of where high level strategic decisions affecting the business of the company are made. It is often quoted as the rule that a company is resident where its directors meet provided they carry on the real business of the company at those meetings.

1.3 From 15 March 1988, the UK has taken a two-pronged approach to company residence. On the one hand, it applies a simple incorporation rule which operates to treat all companies incorporated in the UK as UK resident. On the other, the case law test has been retained as an entirely separate test, which is applied to foreign incorporated companies and UK incorporated companies excepted from the incorporation rule.

1 *Calcutta Jute Mills Co Ltd v Nicholson (Surveyor of Taxes)* 1 TC 83.

2 *Cesena Sulphur Co Ltd v Nicholson (Surveyor of Taxes)* 1 TC 88.

3 *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* 5 TC 198.

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1.4 A further statutory provision overrides both the incorporation rule and the case law test, and operates in circumstances where, under the tiebreaker provision of a tax treaty, the residence of a company is awarded to the ‘other state’. This provision was introduced in the Finance Act 1994 (FA 1994) to deal with a perceived weakness inherent in basing a test of residence solely on an incorporation rule. The incorporation rule created opportunities for tax avoidance, since a company treated as UK resident under that rule could nevertheless be dual resident and claim relief under a relevant tax treaty. From 30 November 1993, FA 1994, s 249, now enacted as the Corporation Tax Act 2009 (CTA 2009), s 18 removed this opportunity for avoidance by providing that where, under a tax treaty, residence was awarded to the ‘other state’ the company ceased to be UK resident for all purposes.

1.5 Modern UK tax treaties closely follow the Organisation for Economic Co-operation and Development (OECD) Model treaty.⁴ Article 4 of that Model treaty contains the treaty residence tiebreaker provisions. This article uses the criterion of ‘place of effective management’ as its favoured determinant. The test is elaborated upon in the Commentary on the OECD Model treaty. However, the courts have had difficulty in distinguishing its characteristics from those of central management and control. Therefore, from a UK perspective, this test may, for most purposes, be taken to equate with the case law test. This is subject to the rider that, since the OECD Commentary states that there may only be one place of effective management, that where central management and control is divided between countries,⁵ the place of effective management is normally found in the country in which the characteristics of central management and control are most dominant. In *Wood v Holden* decided in 2006 Chadwick LJ at the Court of Appeal stated:

‘It is not clear – at least not clear to me – whether the [place of effective management] test differs in substance from the *De Beers* test; and, if the two tests are not, in substance the same, I find it very difficult to see how in the circumstances which the Special Commissioners had to consider they could lead to different answers.’⁶

A SUBSTANCE OVER FORM APPROACH

1.6 The UK tax system is based on the principle of residence taxation, so that, a UK resident company is subject to UK tax on its worldwide income. The determination of residence status is therefore crucial in determining a company’s exposure to UK tax. In this regard, the case law test which applies to foreign incorporated companies and also the statutory residence tiebreaker

4 OECD, Income and Capital Draft Model Convention (1963) and subsequent updated versions.

5 *Union Corporation Ltd v Commissioners of Inland Revenue* 34 TC 207.

6 78 TC 01 at 71.

rules which apply regardless of where a company is incorporated, both reflect a substance over form approach to the determination of residence. Indeed, the central management and control test operates primarily as an anti-avoidance provision to prevent companies from manipulating their residence status.

1.7 It is interesting to note that the statutory residence tiebreaker provision set out in CTA 2009, s 18 may be engaged to prevent a company manipulating its residence status in favour of the UK. Consider, for example, a foreign group resident in a country with a tax treaty with the UK containing an appropriate treaty tiebreaker provision based on 'place of effective management'. If the group wished to migrate its holding company to the UK to avail of the UK's lower corporation tax rate, it might arrange for a UK company to be incorporated for this purpose. However, it would be very unwise for that group to rely solely on the incorporation rule to argue that its newly incorporated UK holding company is UK resident. This is because under the residence tiebreaker provision of the relevant tax treaty, the place of effective management criterion will award residence to the other state and CTA 2009, s 18 will operate so as to treat that company as non-UK resident.

1.8 Lord Loreburn made clear when first promulgating the case law test of central management and control in the *De Beers* case more than a century ago, that the main alternative test of company residence, ie incorporation, was simply too open to abuse. The judge underscored the main weakness of the incorporation test, ie it would leave the UK's tax base highly vulnerable, as it would be relatively easy for UK resident persons to incorporate an offshore company and not pay any UK tax on that company's profits.

1.9 The case law test of central management and control, by way of contrast, did not exhibit this weakness. Instead in most instances, this test looked at where the directors of a company make the key decisions affecting the business of the company.

DOUBLE TAXATION

1.10 A main feature of the case law test is that it creates a liability to UK corporation tax where the directors of the company are UK resident and hold board meetings in the UK even where the economic substance of the business is located offshore.

For example, in the *De Beers* case, the company ran a business trading in diamonds. The mines were being operated under the supervision of a local board of directors which was responsible for the day to day running of the business. However, the London board made the key strategic decisions affecting the company's business, ie finance, the acquisition and disposal of subsidiaries, the payment of dividends, etc. The company was held to be UK resident, since

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the key strategic decisions affecting the company's business were taken by the directors sitting in London.

1.11 Clearly, the operation of this rule creates the possibility of double taxation. It is unlikely that a treaty residence tiebreaker provision would assist in these circumstances, since under the 'place of effective management' concept often used as the tiebreaker criterion, the top level management which that test focuses on is likely to lie with the UK board. Relief for double taxation at the corporate level is now given in these cases by providing credit against UK corporation tax for foreign tax paid on the profits of the company.

1.12

The taxation of foreign profits by reference to the residence of a corporation may perhaps be justified if the shareholders of the company also reside in the residence state. The argument being that the exercise of strategic decision making in the residence state, generates the economic benefits arising in the source state, all of which may potentially be repatriated to the residence state, by way of dividends etc.

1.13 This argument does not pretend to rehearse economic principles, but perhaps with regard to English jurisprudence, merely reflects colonial attitudes to the relations which flow between the residents of the mother country and the territories she held sway over.

1.14 Whilst the taxation of foreign profits arising to a company whose shares were held by UK shareholders was problematic, an even more delicate matter was justifying the taxation of such profits where foreign shareholders held a majority of the company's shares. Kelly CB recognised this difficulty and its implications for international law in the *Calcutta Jute* and *Cesena* cases.

'They are both cases of great importance, because they raise, and I believe for the first time, a very important question – important in the extent of its operation as well as in its nature and involve most important principles of great weight as affecting the law of England, and I may almost say as affecting the international law of the world; ... because it is quite in vain to deny that whatever may be directly the terms or effect of our decision, the result in both cases is that the Parliament of this country tax foreigners, not natives of this country, not inhabitants of this country.'⁷

The judge then went on to consider the particular facts of the *Calcutta* case:

'I only say in conclusion, and I say it with regret, that there can be no doubt that, inasmuch as this is a tax upon what is called, and truly called, the earnings of this Company, and as two-thirds of those earnings, ... belong to persons not within this country, and not subject to the taxation and the laws

7 1 TC 88 at 93

of this country, it certainly is an infringement upon one of the principles on which taxation is levied by the laws of any country, that those two-thirds should be thus taxed.⁸

1.15 Rather confusingly, whilst clearly considering that the company was a separate legal person subject to tax in its own right, the judge appears also to have considered that the shareholders effectively suffered the imposition of UK taxation. Perhaps this confusion reflects the fact that, at the time this case was decided, the characteristics of a limited liability company and the consequences of legal personality had not yet been fully elaborated. The landmark case of *Salomon v Salomon*⁹ being decided more than two decades later.

1.16 If it is accepted that the entity itself is entirely separate from the persons who, from time to time, happen to be its shareholders, the issue becomes less controversial.

1.17 The judge went on to justify what may be perceived as the taxation of foreigners on foreign sourced income, by alluding to the fact that those foreigners benefitted from the exercise and protection of English laws:

‘[I]f a foreigner residing abroad, and having no property, or interest in this country, and no connection with this country, thinks fit to come and invest his money in this country, and so to obtain the broad shield of protection of the law to his property, he must take it with the burdens belonging to it.’¹⁰

SHAREHOLDERS

1.18 The case law test asserts UK taxing rights based on the exercise of high level management and control. Where the shareholders are UK based, there will be a natural tendency to appoint UK directors to oversee the running of the company, this is regardless of the fact that local directors may also be appointed to run the foreign operations. Therefore, in many scenarios the central management and control test replicates the results of a shareholder test. Notwithstanding this, the central management and control test is conceptually distinct, and capable of giving a different result, to that which would have obtained had the residence of the shareholders been the determinant.¹¹ This is particularly true in the case of subsidiaries which, in most circumstances, will be tax resident under the case law test in the country where their board meets and makes decisions. Thus ‘overseas’ subsidiaries are not inevitably resident where their UK parent, ie the main shareholder is resident. This is so

⁸ 1 TC 88 at 103

⁹ *Aron Salomon (Pauper) v A Salomon and Company* [1897] AC 22 (HL).

¹⁰ 1 TC 88 at 103.

¹¹ *Stanley v Gramophone and Typewriter Ltd* 5 TC 358.

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even though the subsidiary may be complaisant to do the wishes of its parent company.¹²

1.19 The day-to-day impact of the residence status of the shareholders described above may be distinguished from the influence they exert at shareholder meetings, which may take place in a location other than their residence state. The location of shareholder meetings has long been established as a factor relevant in determining the residence status of a company.¹³ Indeed in *John Hood & Company*, Madden J considered that on the particular facts which involved an omnipotent director:

‘[T]he central management and control of this company abides with the general meeting of the shareholders in Belfast, where the registered office of the company is situated and where the meetings of the company are held.’¹⁴

1.20 HMRC have dealt with the potential lacunae regarding subsidiary companies by enacting controlled foreign company legislation.¹⁵ This legislation broadly seeks to ensure that, where subsidiaries are resident in low tax jurisdictions, their profits may in certain circumstances be taxed on their UK resident parent company.

AN INTERNATIONAL COMPARISON

1.21 The UK’s residence rules, whilst complex, provide a framework to protect the UK’s tax base from abuse. Indeed, many other jurisdictions take a broadly similar approach to that adopted by the UK and apply, at least as one element of their respective residence rules, a test based on control. The following description of certain features of the residence rules of a small selection of other countries is meant as illustrative only.

1.22 In relation to the control element of their tests, Canada, Australia, and the Republic of Ireland use the central management and control test as part of their respective rules determining corporate residence. Similarly, Germany, Poland, and the Czech Republic use a place of management criterion, while Belgium, Spain, Denmark, and Luxembourg use a place of effective management criterion. Each country may interpret these concepts differently, even where they are given the same nomenclature. Nevertheless, they all share the key characteristic of defining a company’s residence by identifying control.

1.23 Turning to consider those countries using the central management and control test, Canada, Australia and Ireland all also treat a company as

12 *Unit Construction Co Ltd v Bullock (Inspector of Taxes)* 38 TC 712.

13 *Calcutta Jute* 1 TC 88 at 98.

14 *John Hood & Co Ltd v W E Magee (Surveyor of Taxes)* (1918) 7 TC 327.

15 Controlled Foreign Companies, Taxation (International and Other Provisions) Act 2010, Pt 9A.

resident where it is incorporated in that jurisdiction. Taking as an example the Republic of Ireland, in 1999, an incorporation rule was introduced that provided that generally a company incorporated in Ireland was resident there. This rule is not surprisingly, subject to a number of exceptions. For instance, the incorporation rule is disapplied to companies carrying on a trade in Ireland where that company is under the direct or indirect control of a person who is; resident in a treaty country, or in an EU Member State, or whose shares are traded on a recognised stock exchange. The case law test of central management and control applies to determine the residence status of foreign incorporated companies.

1.24 The countries using place of management as their control criterion all use legal seat as their formal criterion. In many jurisdictions this phrase may be taken to refer to registered office.

1.25 Finally, of the countries using place of effective management as their control criterion, Luxembourg and Portugal both use the legal seat criterion, as their formal criterion. Belgium provides that a company is Belgium tax resident if it has its legal seat or main establishment in Belgium, whilst Spain uses the incorporation criterion as its formal criterion.

1.26 It should be noted that the US takes a different approach to that outlined above and bases its residence test on incorporation, so that a company that is not incorporated in a state of the US is treated as foreign resident.

ANTI-AVOIDANCE FRAMEWORK

1.27 It is important to emphasise that, although the residence rules form an important part of the framework protecting the UK's tax base, they do not operate in isolation and there are various other measures that may also apply. For example, even where it is possible to demonstrate that a company is non-UK resident, if it carries on its business in the UK through a UK permanent establishment, any income attributable to that permanent establishment may be subject to UK corporation tax. The meaning of the term 'permanent establishment' is set out in the Corporation Tax Acts¹⁶ and includes a fixed place of business, such as an office or factory, through which the company's business is wholly or partially carried on.

1.28 Where an UK resident individual has the power to enjoy the income of a non-resident company, that individual may be subject to UK tax under the transfer of assets abroad legislation¹⁷ on that income. Similarly, where that individual has an interest in the share capital of a non-resident company, any

¹⁶ CTA 2010, s 1141.

¹⁷ See Inheritance Tax Act 2007, s 714 *et seq.*

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gains made by that company may be attributed to that individual under TCGA 1992, s 13. This apportionment is made on a *pro rata* basis by reference to the scale of the interest held.

1.29 As previously mentioned, controlled foreign companies (CFC) legislation may also apply to tax the income of non-resident subsidiaries of a UK parent company, if these subsidiaries are resident in countries with a low rate of corporation tax. A country's corporation tax rate is considered low for these purposes if it is less than 75% of the main UK corporation tax rate. Similarly, the Taxation of Chargeable Gains Act 1992 (TCGA 1992), s 13 may be applied to attribute gains of non-resident companies to their UK resident corporate shareholders.

1.30 It should be noted that certain elements of the UK's anti-avoidance legislation to which reference is made above, may not be compatible with EU law, and that this legislation is in the process of being rewritten in an effort to achieve compliance.

1.31 Nevertheless, HMRC has, at its disposal, heavy and diverse artillery to attack the use of offshore companies where they perceive their use to be abusive.

TOMORROW'S TEST TODAY?

1.32 Given that the *De Beers* test was first enunciated over 100 years ago, well before the dawn of the digital communications revolution and the consequent increasingly frenetic internationalisation of business, the question arises as to whether the rule remains functional. Obvious issues include the perceived inability to deal satisfactorily with peripatetic boards and scenarios where the central management and control is split between various geographic locations. These issues are considered later in this book.

1.33 It should however be pointed out in defence of the case law rule and in praise of the ingenuity of the judges, that it has proved remarkably apt at evolving to adapt to its new environment. Witness its application to Special Purpose Vehicles in the cases of *Untelrab*¹⁸ and *Wood v Holden*.¹⁹ Ironically, the greatest weakness of the case law rule, subjectivity, may yet turn out to be its greatest strength. In particular, the test sits very comfortably in the context of the General Anti-Abuse Rule to be introduced in the Finance Act 2013. The case law test therefore functions not only as a determinant of residence in relation to foreign incorporated companies, but also as a highly effective anti-avoidance measure.

¹⁸ *Untelrab Ltd v McGregor (Inspector of Taxes)* [1996] STC (SCD) 1.

¹⁹ 78 TC 01.