

JERSEY PROPERTY COMPANIES LOSE TAX RESIDENCE CASE

INTRODUCTION

HMRC have successfully challenged the offshore residence of Jersey companies holding UK real estate. In the case of *Development Securities*, the First Tier Tribunal held that Jersey companies set up to hold UK real estate were resident in the UK for tax purposes. This case serves as a timely reminder of the care that must be taken to ensure the tax benefits of using non-UK entities to hold UK real estate are not lost.

BACKGROUND

Non-UK companies and unit trusts are commonly used to hold UK real estate, with the Channel Islands, Luxemburg, Cayman and the British Virgin Islands being popular jurisdictions for these vehicles. The key tax advantages of using non-UK vehicles to hold property are: (i) they are outside the scope of UK capital gains tax; and (ii) sales of the property can be structured by way of the transfer of shares in the vehicle without incurring a Stamp Duty Land Tax charge. With the extension of UK capital gains tax to vehicles holding residential property, and recent changes to the inheritance tax regime, there are limited benefits to using non-UK vehicles to hold residential property; however, they are still very popular as vehicles to hold commercial property, particularly among non-UK investors.

The exclusion from capital gains tax for these vehicles only applies where the vehicle is “centrally managed and controlled” outside the UK (this being the test for UK tax residence). The central management and control of a company is located in the place where key strategic decisions affecting the company are taken, and so will usually be where board meetings are held to consider major actions of the company. Although board meetings are generally where “central management and control” are located, this will not always be the case, particularly if there are dominant shareholders or “shadow directors” influencing the board. If HMRC can show that a company’s central management and control are located in the UK, rather than a jurisdiction outside the UK, the company will be UK tax resident and subject to UK capital gains tax, removing the tax benefits.

DEVELOPMENT SECURITIES

In this case three Jersey companies, ultimately owned by Development Securities plc, were used as part of a tax structure designed to increase the group’s available capital losses. HMRC were successful in their challenge to the Jersey companies’ residence, with the court finding that

although the relevant board meetings were held offshore, the directors were in effect doing no more than following instructions given by their UK parent. As a result the court found that the companies were centrally managed and controlled, and tax resident, in the UK, negating the tax benefits of the structuring. The result of the case (which may be overturned on appeal) is worrying because care had clearly been taken in the implementation of the structuring, and the steps commonly taken to ensure property SPVs are offshore resident had for the most part been followed.

In some ways, *Development Securities* is an extreme case, because the Jersey companies’ sole function was to acquire real estate assets at an artificially high price with a view to selling them on at a loss shortly afterwards. A company’s central management and control is where strategic decisions are taken and in most cases a company’s strategy will be underpinned by a general commercial objective to maximise value and realise profits. If that overriding commercial objective is wholly absent (as it was in this case) it will be easier for HMRC and the courts to decide that a company’s central management and control are exercised at a higher level, namely where the decision to use the offshore company for wider group purposes is taken.

PRACTICAL POINTS

Despite the unusual features of this case, groups using non-UK entities to hold real estate can draw some useful lessons from it:

- ◆ The ability to demonstrate that a non-UK entity’s key business decisions were taken by the board, outside the UK, will be pivotal in any challenge. Boards should consider not only whether a proposed action is lawful (a particular concern in the *Development Securities* case), but also the commercial benefits to the company. Board minutes often deal with the lawfulness aspects in some detail (e.g. declaration of conflicts of interest), but contain little record of discussion of the commercial benefits of a decision, often simply recording that “after discussion” the relevant decision was taken. Minutes that record key points made by the board during their discussion of the commercial aspects will stand up better to HMRC scrutiny.
- ◆ Any challenge by HMRC may not be made for several years after the relevant events occur. Memories fade and personnel move on, making it all the more important to keep a full contemporaneous record of board meetings and major decisions.

- ◆ Where challenges are raised, HMRC will go through the evidence with a fine-tooth comb. No email or hand written note escaped their (and the court's) scrutiny in the *Development Securities* case. Where tax advice has been given by accountants (as in this case) it will not be legally privileged and HMRC will have full access to this. Where advice has been given by lawyers the advice should be privileged and HMRC may not be entitled to see it; however, they will still have access to communications between directors and records of meetings. Records of all meetings and communications should be centrally stored and updated regularly, to make it easier to comply with a subsequent HMRC disclosure request.
- ◆ In the *Development Securities* case, reference was made, in a handwritten note of a meeting, to the parent company giving the Jersey companies an "instruction" to proceed with the transaction. This was damaging, as it suggested that the Jersey boards were merely following instructions from the UK rather than considering decisions independently. Where a UK shareholder's role is limited to advising and making recommendations to its non-UK subsidiaries, records should reflect this and shorthand expressions such as "instruction" should be avoided.
- ◆ Mindful of this case, buyers of offshore vehicles holding real estate may increase their due diligence in this area, as they will be keen to ensure that the vehicle they are acquiring is able to demonstrate its non-UK residence in the event of a future challenge. Insurers providing warranty and indemnity insurance on these transactions can also be expected to focus more on this area, and may be less willing to provide cover in cases where insufficient records have been kept.

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