

‘Companies are tax resident where the directors meet, Right?’

The recent case of *Laerstate BV v Revenue and Customs* [2009] UKFTT 209 (TC) was heard on 11 August 2009 and primarily concerns the place of central management and control of a company, Laerstate, and hence its residence for tax purposes. This case, which was an uncommon win for HMRC, brings to the fore the risks of commercial pressure overriding corporate governance, which, in the offshore world, is not an uncommon occurrence.

In addition, what is surprising about the case is that it was heard some 15 years after the relevant transactions took place!

Background

The facts of the case are as follows.

- Laerstate BV was a shell company incorporated in the Netherlands and consequently resident there under Netherlands domestic law. Its sole director was Eduard Trapman.
- On 9 December 1992 the entire issued share capital was acquired by Dieter Bock, a German National and business associate of Mr Trapman, as a corporate vehicle through which Mr Bock intended to invest in Lonrho plc. Mr Bock joined Mr Trapman as a director of Laerstate from that date.
- On the same day Laerstate BV entered into agreements to subscribe for up to 100m new shares in Lonrho and to acquire approx 43.5m Lonrho shares from Yeoman Investments Ltd, a Bahamas company controlled by Tiny Rowland, then CEO of Lonrho, using finance arranged by Mr Bock. The agreement also provided for put and call options between Yeoman and Laerstate over a further 45.5m Lonrho shares. Following Laerstate’s investment in Lonrho, Mr Bock became a director and joint CEO of Lonrho on 10 February 2003, subsequently taking over as sole CEO from Mr Rowland in 1994.
- Mr Bock remained a director of Laerstate until 30 August 1996. In the period in which he was a director various agreements relating to the acquisition and financing of further Lonrho shares from Mr Rowland were entered into. In March 1996 Yeoman exercised its put option and Laerstate acquired the 45.5m shares. It then entered into an agreement to sell those shares to SBC Warburg and entered into an option agreement with Anglo American over the remaining 143.5m Lonrho shares. Following Mr Bock’s resignation Laerstate exercised its put option over the 143.5m shares in October 1996.
- During the period in question Laerstate held 9 board meetings, all offshore, of which 4 were attended by Mr Trapman alone. No meetings took place between November 1994 and March 1996. Mr Bock travelled extensively throughout the period, spending the majority of his time outside UK. However, in relation to decisions involving Laerstate, the Tribunal found that the key decisions were by Mr Bock during periods when he was present in the UK and dealing with UK based lawyers, Lonrho and the subsequent purchasers of the shares. The

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Tribunal made the following finding in relation to the period during which Mr Bock was a director of Laerstate.

“We find.... that Mr Bock conducted the business of the appellant [Laerstate]. We accept that on occasion he did so with the assistance, co-operation and concurrence of Mr Trapman and that acts of management took place in various locations, including the Netherlands and Germany, but throughout the period during which Mr Bock was a director we find that he carried out activities of the appellant of a strategic and policy nature and managed the business of the appellant, and that he did so to a substantial extent in the UK. For a considerable time during this period there were no board meetings of the appellant, even though there were significant management activities taking place. These management activities were undertaken by Mr Bock, substantially in the UK.” They found that in the period to 30 August 1996 central management and control was exercised in UK.

- Thereafter, in the period following Mr Bock’s resignation from the board they looked at three key issues and found that in each instance Mr Trapman did not make the requisite decision in any of them, merely signing documents on the instruction of Mr Bock. “We did not detect any change in the way the appellant was managed before and after Mr Bock ceasing to be a director of the appellant (or before he became a director). Mr Bock predominantly made those decisions in the UK.”
- The company therefore continued to be centrally managed and controlled in the UK.

The case also considered the place of effective management of Laerstate under the UK-Netherlands Double Tax Treaty: this matter is not discussed further in this article.

What evidence was considered?

The Tribunal not only took oral evidence from the directors but also examined travel schedules, diary entries, letters, notes, emails and notes of telephone calls. From this evidence they concluded that the minutes of the company, which appeared to be in good order, could not be an accurate reflection of what actually took place, so this evidence was rejected.

What can we learn from this decision?

In the first instance HMRC went to town regarding the evidence it gathered in presenting the case. HMRC not only looked at the usual evidence, such as the minutes of the offshore company but put great weight on the evidence of the parties and witnesses to support what was set out in such minutes. This perhaps provides an indication of how far HMRC are prepared to go and their ability to do so is now enhanced by the availability of a network of Tax Information Exchange Agreements.

Secondly it emphasised that it is the taxpayer that has to prove that the board of directors is the actual decision making organ of the company. It is very common for the articles of association of a company to be drafted to ensure, as far as possible, that the decision making ability of the company is limited to the directors; however, in this case despite the articles being carefully drafted, this wasn’t sufficient. What appears to have happened is that Mr Bock was running the investment and

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other transactions for Laerstate as if he were a party to them, with Mr Trapman occasionally displaying a lack of understanding of what was going on.

This case confirms that we need to look at the actions, not just of the board of directors, but of any person making strategic decisions regarding a company when determining its residence. The Tribunal confirmed that there was a scale of behaviour which started with the director who mindlessly signs documentation without even reading it or knowing its contents to a director who is aware of what he is signing, has full information available to him to make a fully informed decision and has the necessary expertise to make that decision based on the information to hand. There are clearly those directors who fall in between these two ends of the spectrum. The Tribunal commented that 'mere physical acts of signing resolutions or documents do not suffice to actual management': what matters is that an actual decision is taken even though this may be heavily influenced by recommendations. At first blush this may appear to be a fine line, but as can be seen HMRC are minded to look at all the relevant factors and look at what happens between the meetings of the directors to assess who is really making the high level, strategic decisions.

It is therefore of the utmost importance to making sure that strategic decisions are actually made by the directors who purport to make them and it is fundamental that those decisions are based on information to enable a fully informed decision to be made.

It is also important to note that the Tribunal said that the board may take into consideration the wishes of a shareholder but should not follow such recommendations blindly. This of course may be difficult for any offshore board of directors to do when they are deal with an active business man who regards an offshore company as being under his control.

Corporate residence: what are HMRC doing right now?

This is a relatively rare win for HMRC and is likely to encourage them to challenge offshore residence more frequently and in more depth: the factual material in this case was extensive.

It is our understanding that HMRC are actively looking for other cases to take where they believe the central management and control of a company takes place in the UK. It is also clear from comments made by Dave Hartnett, the Permanent Secretary for Tax to HMRC, in the Financial Times on 14 October 2009 that HMRC intend to use this case where companies have migrated to countries outside the UK. He said that while board meetings may be taking place in other countries, there is evidence to suggest that key company decisions are still being made from the UK in some instances and he said "investigation and litigation in the UK" will establish whether a company had truly redomiciled.

How does this decision differ from Wood v Holden?

In *Wood v Holden*, (78TC01) the Special Commissioners also found for HMRC, but the High Court and Court of Appeal reversed their decision on the basis that they had misapplied the authorities to the facts. The Tribunal has attempted to navigate its way around the pitfalls that the Commissioners were said to have fallen into. It remains to be seen whether the company will appeal and therefore how successful the Tribunal has been in that.

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However, *Wood v Holden* can be distinguished on a number of key grounds. Firstly, unlike Mr & Mrs Wood, Mr Bock was both the sole shareholder and a director of the company and personally found to be actively involved in making the key decisions. Unlike *Wood v Holden* where there were only 2 transactions that the directors of Eulalia had to consider, in this case there were a number of events over a four year period which could be considered to evidence how central management and control was being exercised. That in turn opened the way for the Tribunal to review the course of the company's business and trading as advocated by Lord Loreburn. The effect was that there was far more scope than in *Wood v Holden* for activities of substance to take place outside formal board meetings, to the extent such meetings took place at all, and therefore far more scope for prejudicial material to taint the evidential trail. In *Wood v Holden* without the decisions taken at meetings in the Netherlands the relevant agreements would not have been made. The Tribunal found that that was not the case here and that Laerstate was not run through its board meetings.

The Tribunal distinguished between the period when Mr Bock was a director and was therefore legally entitled to bind the company in his own right and those periods before and after he was a director. Whilst he was a director they found that, in contrast to the position in *News Datacom Ltd v Atkinson*, [2006] STC (SCD) 732, his activities in the UK were concerned with policy, strategic and management matters amounting to the exercise of central management and control. This was not a case of the board being usurped, as in *Bullock v The Unit Construction Co. Ltd (38TC712)*, but of a dominant director (who was at all relevant times the 100% shareholder and hugely in debt in the interests of the company) making the decisions. They found that Mr Trapman did not make decisions as to what happened with Mr Bock's company.

After Mr Bock resigned from the Board the Tribunal found that the running of the company did not change. In these circumstances the *Unit Construction* case and the test in *Wood v Holden* would be relevant. Did the Board (Mr Trapman) stand aside and let others (Mr Bock) make the decisions or did Mr Bock exhort or persuade Mr Trapman to make certain decisions? In the former case central management and control would lie with Mr Bock; in the latter with Mr Trapman. The Tribunal found that Mr Trapman could not have made the relevant decisions because he had less than an absolute minimum of information on which to do so. This gets very close to the reasoning of the Commissioners in *Wood v Holden* and it will be interesting to see whether the Tribunal's finding is challenged on this point, particularly given the fact that Mr Trapman was a businessman of some substance and standing. Their decision amounts to a statement that he acted on Mr Bock's instructions without considering their merits. The fact that they reached this conclusion through inferences drawn from selective facts may also support a possible appeal.

How will this decision affect funds?

It is not uncommon for many offshore funds to have a mixed board comprising individuals who are resident in many jurisdictions. Many UK focussed funds do have UK based directors who have either been instrumental in the establishment and promotion of the fund or are appointed to the board to provide greater credibility to the markets. Such funds also have other interested parties in the UK who exert influence over the funds. The lessons we learn from Laerstate and *Wood v Holden* is that we must look at the activity of fund itself and the decision making process and ask the questions: Does the board have the necessary technical expertise to make the relevant decisions? Do the members of board have the requisite information available to them to make decisions on each

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occasion? Are there other parties in the UK who are instrumental in making the strategic decisions of the fund? And lastly, Does the non-resident board actually make the strategic decisions?

It will have become increasingly clear in recent times who is really making the decisions associated with offshore funds: many funds may have had to restructure or change direction as a result of liquidity problems and it should have been the board who have really made such decisions.

How will this decision affect companies managed by trustees?

HMRC will be encouraged by this decision in that they may now spend more time looking behind the activities of the board itself to try and find the real decision maker (s). It is perhaps particularly important to consider the impact of this decision in the context of companies with controlling shareholders who are based in the UK.

In the context of both funds and companies owned by trustees some comfort can be gained of the company in question is undertaking activities which are akin to those carried out in *Wood v Holden*; however, where activities become more involved and require a great deal more regular strategic decision making, the board of directors will need to be mindful of the *Laerstate* decision (especially in the context of the historic activities) and actually make sure they are not merely puppets for a controlling shareholder or other party who is based in the UK in the future.

Recommendations

As indicated above this decision has not established new law but it does reinforce the need to get it right: it is simple, the decisions of a strategic nature must be made by the directors, they must have the relevant expertise and they must have sufficient information to make those decisions. The following matters are also very relevant.

- In establishing residence it is critically important that if a company is intended to be run through its board at board meetings then that is evidenced through regular, well minuted meetings, attended by all the directors in the appropriate jurisdiction. Evidence of decisions should be created and retained to support the minutes (and even be embodied in such minutes) with such minutes being contemporaneous rather than pre-prepared.
- Non-UK directors should have the relevant expertise and necessary skills to make the decisions and the board should comprise a majority of non-UK directors.
- There should be no telephone attendance of meetings from the UK and physical attendance of meetings offshore should be normal practice.
- It is important to note the approach to building up the fact pattern which was adopted by HMRC and followed by the Tribunal and to note that oral evidence can be valuable in putting documentary evidence into the proper context, but a Tribunal will not ignore prejudicial documents and will attach the weight they think appropriate to each.
- It is normally easier to argue that an individual has stood aside rather than several individuals and therefore boards of one or two directors should be avoided.

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- Where one director is likely to be dominant, whether through their shareholding or otherwise, it is important to ensure that he or she acts within well defined and understood guidelines and is not able to (and does not in fact) commit the board through their individual actions.
- It is perhaps unsurprising that the Tribunal favoured HMRC on grounds of principle as not only was the taxpayer seeking to avoid UK tax by arguing it was non-resident, it was also trying to obtain a windfall from the UK Treasury. The UK tax at stake was on three separate issues related to the residence of the company:
 - CGT on the share sale.
 - ACT due on dividends paid by the appellant company.
 - The refund available to the appellant company on UK dividends it received under the dividend article of the UK/NL treaty.

Conclusion

The Laerstate decision is a significant win for HMRC and whilst the fact pattern was complex it nevertheless highlights the importance of a properly constituted, well informed and technically competent board of directors when it comes to strategic decision making. I am sure HMRC are fully aware that many offshore companies are not run through their boards and it is perhaps only a matter of time, with the advent of a plethora of Tax Information Agreements, the proposed EU Savings Directive II and the push for global fiscal transparency, before HMRC start challenging companies on a more extensive basis. So, it is not sufficient for directors to merely turn up to meetings, receive their director's fee and not be actively involved in the management of a company's business: failure to do so may mean a company's tax residence is not where the directors actually meet but where the individuals who exert strategic influence over the company are based.

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