

CORPORATE TAX RESIDENCE AND THE CASE OF ECONOMIC SUBSTANCE



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Publication Date: 01 July 2015
Subject Area: Tax

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1. Corporate Tax Residence

Corporate tax residence is currently a hot topic all over the world, as all countries seek to maximise tax receipts during the current difficult economic times. We have noticed an increase in corporate tax residency challenges in recent years in terms of both the number of challenges and their severity followed by a number of Governments around the world.

In some countries Special Investigations units have been established (UK, Israel, Ireland, Franc, Russia etc) to deal with these enquiries.

1.1 Why corporate tax residence is so important?

Corporate tax residence is the concept by which the taxing rights over a company's profits and gains are determined. Different countries have different ways of defining corporate tax residence, which creates further complexity for companies operating in more than one country.

Corporate tax residence is of importance as a company needs to ensure that it is only subject to tax in the jurisdiction it intends to be taxed in. If for any reason the company does not get this right, it can end up having multiple tax liabilities in multiple countries.

1.2 Definition of Corporate Tax Residence

Definitions of corporate residence for tax purposes vary considerably from country to country. Some countries determine the residence of a company based on its place of incorporation. Other countries determine the residence of a company by reference to its place of management and control. Some countries use both a place-of-incorporation test and a place-of-management and control test.



We state below a few countries and their respective criteria on Corporate Tax Residency:

UK

A company is resident in the UK for the purposes of the Taxes Acts if

- It is incorporated in the UK (with certain exceptions), or
- The central management and control of its business is in the UK.

Israel

Section 1 of the Israeli Tax Ordinance provides that a corporate entity is considered an Israeli resident, if it fulfils one of the following:

- Was incorporated in Israel. Or,
- The control and management of its business is performed from Israel.

New Zealand

A company is resident in New Zealand if it meets any one of the following criteria:

- It is incorporated in New Zealand. Or,
- The central management and control of its business is carried out in New Zealand.

Singapore

In Singapore, the tax residence status of a company depends on where the control and management of its business is exercised.

A company is tax resident in Singapore if the control and management of its business is exercised in Singapore.

Cyprus

In Cyprus, the tax residence status of a company depends on where the control and management of its business is exercised.

A company is tax resident in Cyprus if the control and management of its business is exercised in Cyprus.

Russia

In Russia, the Federal Law № 376-FZ has established rules since the beginning of 2015, in relation to the taxation of controlled foreign companies by Russian tax residents. A company incorporated overseas is to be regarded as tax resident in Russia if:

- i. It is tax resident in Russia under an international taxation agreement. Or,
- ii. Its place of effective management is in Russia.



2. Place of Central Management & Control

The place of central management and control as a test of residence is becoming in a number of countries as the first rule that companies need to satisfy in order to avoid any tax adverse consequences. The mere fact that the company has been incorporated in a particular Jurisdiction does not automatically make the company to be tax resident in that particular Jurisdiction. The worldwide financial crisis has led governments to seek mechanisms to protect or increase their tax base, outside their jurisdictions by disputing the tax residency of companies located in countries that are considered as low tax jurisdictions.

In most of the countries around the world there is no statutory definition of the meaning of “central management and control” but nevertheless court judgements on the meaning of central management and control can be treated and can be used as guidance on how the courts in a particular jurisdiction will interpret its meaning.

On how court judgments are to be applied in a particular case involves a question of fact. That cannot be too heavily emphasised.

2.1 Common Law Countries

According to most common law countries, a company is resident in the country where the central management and control of the company is carried out. The mere fact that the company has been incorporated in a particular country does not automatically make the company to be tax resident in that Country.

UK court decisions can be easily applied and to similar situations involving other countries that are based on common law.

2.2 The Power of the Directors

In seeking an answer to the question where the exercise of management and control lies, the first natural step is to ask who, in law, has the right and duty to exercise it. A company being an abstraction cannot itself do any real acts at all. The abstraction can act only through the agency of other people. In practice the constitution of the company, its Articles that is, will provide that the power of management lies with the board of directors; the power of management is delegated to the directors as a board.

Of course the shareholders in the General Meeting have rights and duties. They can appoint and dismiss the directors, they can approve the accounts and pass a dividend, they have a voice in such matters as issuing new capital, reduction of capital and in changes of the objects clause of the Memorandum or changes in the Articles. These things do not constitute the management and control of the business. They are rather keeping a critical eye on the interests of the shareholders.

It follows that the power of management and control lies in the hands of directors and not with the shareholders.

The board is thus emerging as something more than an agent and it is becoming in its own field the company. Of course the board of directors can still appoint agents and as long as they are mere agents they do not, by the bare fact of being there and fulfilling their agencies, detract from the management and control of the board. However if the board assign all its powers to a person, i.e. by issuing a general power of attorney, or in reality that person exercises all of the powers of the board in such a way that that person purports to confer exclusive powers without expressly reserving a right of supervision, then that person is the Board and the management and control of the company is carried out by that person. It follows then that a company's residence status should be where that person resides. That is the place where he takes all decisions concerning the administration of the company.



2.3 UK Court Decisions

Although management and control of a company will generally reside at the place where the directors meet and where the main functions of a company are carried out, there are cases in which these factors are not determinative of the place of central management and control.

For example, the House of Lords held in the case of *Bullock v The Unit Construction Co Ltd* (1960) 38 TC 712 that, because it was quite clear from the stated case that the boards of directors of the UK company's African subsidiaries were standing aside in all matters of real importance, real control and management of those subsidiaries was being exercised by the board of directors of the parent company in London.

In another famous court case *De Beers Consolidated Mines Ltd Vs Howe*, Lord Loreburn stated:.....the principle that a company resides for the purposes of income tax is where its real business is carried on....I regard that as the true rule, and the real business is carried on where the central control and management actually abide.

In another decision of the Special Commissioners' of the UK Inland Revenue has, however, highlighted how important it can be for the directors of a company to make informed decisions, rather than merely "rubber-stamping" resolutions, if they are to demonstrate that they are exercising effective management and control of their company. In their decision in *Mr. R and another v Holden (Inspector of Taxes) SpC 422*, the Special Commissioners stated:

"We do not consider that the mere physical acts of signing resolutions or documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum level of information. The decisions must at least to some extent be informed decisions. Merely going through the motions of passing or making resolutions and signing documents does not suffice. Where the geographical location of the physical acts of signing and executing documents is different from the place where the actual effective decision that the documents be signed and executed is taken, we consider that the latter place is where 'the central management and control actually abides'."

This case emphasises how important it can be for the directors of a company that is being managed and controlled in a jurisdiction, to be fully involved in any proposed transaction from the earliest stages and for them to have full knowledge and a thorough understanding of the transaction, including the anticipated benefits and liabilities. It certainly is not good practice for the directors to be presented at a late stage with a fully worked-out set of proposals and documentation that they are asked to sign off on without any prior involvement in negotiations on the transaction; indeed, that is likely to put the company's tax residence in jeopardy.

In our experience, the position can be improved by appointing directors who have knowledge and experience in the area of business in which the company is engaged and who are thus better qualified to take decisions on matters affecting the company.

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

In brief, the *Laerstate* case concerns corporate tax residence, in particular, the meaning of acts of central management and control and the circumstances in which it should be concluded that a company's directors are not exercising that central management and control themselves.

The tribunal concluded that *Laerstate*, a Netherlands incorporated company, was UK tax resident for the period in dispute, because the company's shareholder, who was himself residing in the UK during the period in question, exercised central management and control. The case is now finally decided in favour of HMRC following the recent decision by the taxpayer not to appeal against the First Tier Tribunal's decision.



Laerstate had two directors, Mr B (who was also the sole shareholder) and Mr T. Neither Mr B nor Mr T were themselves UK residents. Directors' meetings were held on a reasonably frequent basis and were always held outside the UK. Both Mr B and Mr T were persons of substance who would be capable of conducting the company's strategic business in an informed manner.

However, on examining the substantive facts as to how the company was managed, the Tribunal held that the company was, in reality, being managed solely by Mr B outside the formal directors' meetings and that Mr B was managing the company to a substantial extent whilst in the UK, notwithstanding that he was not himself UK resident. As a result, the Tribunal found that the company was UK tax resident during the relevant period and, therefore, that the profits which the company realised from its share transactions during this period were subject to UK corporation tax.

In particular, it was clear that Mr T's role was very much secondary to that of Mr B and was limited to assisting and concurring with Mr B. For example, there was a substantial period during which management activity was being carried on (by Mr B), although no directors' meetings were held and the role of Mr T in relation to significant transactions was limited to the signing of agreements that he had not previously seen, did not know the details of and was not in a position to make informed decisions as to whether or not they were in the company's best interests. Although Mr T had the necessary expertise, his role was simply to implement decisions taken previously and independently by Mr B.

2.4 Establishing effective management and control of a company in a particular Jurisdiction

In our experience to establish effective management and control of a company in a particular Jurisdiction we need to show this manifested in the below general guideline list. The below list is not exhaustive and obviously it does not mean that all the below should be followed in all cases. The below list is just a broad guideline model to be used and depending on the Jurisdictions involved, the activities of the company and a number of other factors the below list can be shortened or expanded accordingly:

- All or the majority of the board of directors should be residents in the jurisdiction the company intends to be taxed in. If only the majority of directors reside there the majority should be enough to form a quorum for the conducting of the board meetings under the articles of association. The minority directors who are not resident(s) should consider traveling to country of company residence for occasional board meetings.
- Board meetings should be actually held in the country of residence and must be properly documented.
- The general policy of the company should be formulated in the country of residence. The place of effective management is generally understood to be the place where the Head Office is: the Head Office in the sense of - not the registered office - but the central directing source. That is major/important decisions such as the provision of loan facilities, the purchase of a significant interest in other companies etc should be taken by the board in the country of residence.
- The appointed directors of the company should be fit to hold office or be employed in the administration of the Company's affairs. When appointing a board of directors, the individual members are persons of high caliber, such as successful business men, Chartered and Certified accountants, lawyers, or persons with a relevant background in relation to the company's proposed activities. The directors should really have the knowledge and expertise to really understand and know the business activities of the company and they are actually part of the strategic decision making process of the company. They are not just rubber stamping any decisions taken by the shareholders or their advisors. They should formulate and implement the strategy of the company.



- With regards to decision making at Directors level, a minimum level of information should always be provided, that would enable the directors of a company to consider whether or not they should make a decision. The directors should be given sufficient time to consider the implications of any contracts to be signed and take advice where necessary. It is also prudent to ensure that board minutes properly document the information the directors have used to consider and then make decisions. In relation to negotiations with third parties directors should have a say in the negotiation process and should be kept abreast of developments during negotiations and should be given the opportunity to provide their input. At the stage of actually signing the contract, the directors of the company should actually sign the contract in the chosen place of effective management of the company. It may be possible however, that very occasionally, the company grants a specific power of attorney to an agent, to sign the contract in question on its behalf;
- Related to the point above, care should be taken to ensure that the board meetings are properly documented, i.e. detailed notes taken contemporaneously, outlining the matters for consideration of the board, the information provided in the board pack to enable them to make their decisions.
- Company bank accounts should be controlled and operated by the resident directors. This entails that money movements in the accounts are properly documented, so that they are seen to be done under the Control of the directors.
- Day to day management is actually carried out in the country of residence.
- Any issuance of POAs to third parties should be limited and when this is done the scope of the services assigned should be limited and specific. Of course the board of directors can still appoint agents and as long as they are mere agents they do not, by the bare fact of being there and fulfilling their agencies, detract from the management and control of the board. However if the board assign all its powers to a person, i.e. by issuing a general power of attorney, or in reality that person exercises all of the powers of the board in such a way so that the person purports to confer exclusive powers without expressly reserving a right of supervision, then that person is the Board and the management and control of the company is carried out by that person. It follows then that a company's residence status should be where that person resides. That is the place where he takes all decisions concerning the administration of the company.

Physical Presence

It may also be advisable to show a physical presence in the country of residence. This will make the case for demonstrating management and control stronger. The company should not be just a "paper" company.

This can be achieved by:

- The company renting an office.
- Applying for telephone and fax lines to be installed and subscribing for a listing in the local telephone directories.
- Employing people and paying monthly salaries and social insurance contributions
- Ensuring that all corporate, accounting, human resource and other records are prepared and kept in servers located in the country where the company is resident.
- Last but not least, the company should have a valid commercial reason for its existence. Even though this can sometimes be a tax oriented reason, there should also be commercial benefits for setting up a company in a particular jurisdiction and the decision to establish a company in a particular jurisdiction should not be taken solely based on tax considerations.



3. Conclusion

3.1 Effective Management & Control

A company can very easily inadvertently become tax resident and subject to tax in a different jurisdiction from the one it intends to be taxed in and thus incorporated. Basically it is essential that the structure does not fall foul of the abovementioned concepts. It is not sufficient to only have the directors (management and control) sitting in the chosen jurisdiction such as Cyprus, rather it is essential that the day to day (effective control) activities are also conducted by the directors from a “permanent establishment” in Cyprus.

Our experience has shown us that many companies seek tax advice on corporate tax residence matters prior to establishing an offshore business, however, few seek further advice on implementation and maintenance of these structures. It is often during the implementation phase and thereafter that mistakes are made with regard to residence.

At Centaur Trust our focus is on the effective implementation of international tax structures related to the use of Cyprus or other companies, as standalone vehicles or as part of an international tax structure. When we act as directors we take our role very seriously and have an unprecedented depth of insight in relation to our clients’ activities. We appoint directors that are fit to hold office or be employed in the administration of a company’s affairs. When appointing a board of directors, the individual members are persons of high calibre, such as successful business men, Chartered and Certified accountants, lawyers, or persons with a relevant background in relation to the company’s proposed activities. Our directors are able to rely on the assistance and support of 7 specialised and distinct departments within our firm, enabling them to genuinely have the knowledge and expertise to understand and know the business activities of the company. They are actually part of the strategic decision making process of the company. They do not just “rubber stamp” any decisions taken by the shareholders or their advisors. They are involved in formulating and implementing the strategy of the company, and they make sure that the company is fully compliant and operates within the myriad of laws which apply in the jurisdiction of residence.

Our integrated, client-focus oriented approach essentially combines insight and innovation from multiple disciplines:

- Legal, Tax, Accounting, Banking, IT, Secretarial, Compliance, Human Capital

Our aim is to have the appropriate business and client industry knowledge, so as to recognise the specific needs of our clients, and then to identify and create practical solutions in relation to specific administrative, regulatory, compliance and other corporate processes. We do this by streamlining the key processes, so that together with our clients to be in a position to generate and maintain the kind of ordered, accurate, consistent and timely financial and non-financial data about all aspects of their business.

Physical Substance

We have so far discussed the first criterion, namely the location of effective management and control by way of the appointed directors and all the factors relating to their location and fulfilment of their powers, duties and responsibilities. The second major criterion relates to physical substance.

We have recently completed the process of expanding our business centre, The Idalion Business Centre, through which we offer all our physical office services. The new extension is constructed on two floors, and has doubled our capacity, having been built according to the latest specifications for comfort, as well as IT & communication facilities.

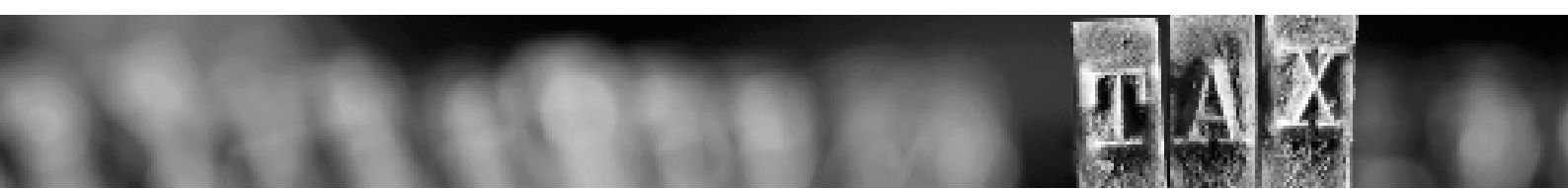
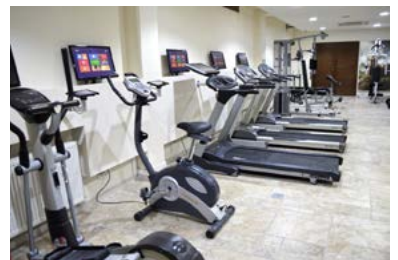




The Idalion Business Centre is situated in over 4,500 sq. meters of landscaped gardens, providing an ideal stress free environment for our staff and clients. In addition to the 1,200 sq. meters of office space, the Idalion Business Centre also offers an in-house gym, a swimming pool, a small chapel, a large kitchen and dining area, a fully interactive auditorium, as well as recreation and barbeque area.

For clients who require a real physical presence in Cyprus, with individual offices of a very high standard, in an ideal location we have the ability to accommodate their requirements to relocate management and staff to Cyprus, and to work from fully equipped and established offices.





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