COVID-19 ALERT:
IMPACT ON CORPORATE TAX RESIDENCE AND SUBSTANCE: INVESTMENT FUNDS AND MULTINATIONALS

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Snapshot

- Travel restrictions and social distancing measures imposed as a result of the crisis mean that non-UK companies are at risk of becoming tax resident in the UK or breaching substance requirements if board meetings are held or decisions taken without careful forethought. This could have long term consequences.
- Similar issues were encountered, albeit on a significantly smaller scale, during the Icelandic volcanic ash cloud episode of 2010 when many planes were grounded and directors could not travel. If it is imperative that board meetings are held during the current crisis when directors cannot travel and attend in person then any resulting tax risks will need to be carefully managed.
- Emergency measures to relax board meeting and substance requirements, for example in Luxembourg and the Channel Islands, do not automatically mean that all tax risks are avoided.
- While there has been a concession announced in the UK in relation to the statutory residence test for individuals, HMRC has not yet made any similar announcements in relation to the residence test for companies.
- Businesses are asking various questions about what they should do now to manage residence and substance risks in view of the crisis. For example, what happens if a director is unable to travel to a board meeting in person due to the travel restrictions and instead dials in from their home jurisdiction? Would that result in the company becoming tax resident in the director's location? What steps should be taken to mitigate tax risks if board meetings need to be held? Can directors based in the UK and other taxing jurisdictions sign documents? These, and other questions commonly being asked, are set out below.

Introduction

The COVID-19 pandemic and measures taken by national governments to restrict its spread have given rise to a whole host of issues for business. Except to the extent relevant to cash management, tax may not be as front of mind for businesses. That being said, the global steps being taken to stop the spread of the virus may have direct tax consequences for business, including the possible impact on corporate tax residence and maintaining offshore substance.

For sponsors operating offshore funds and platforms, for example in Luxembourg, Channel Islands and Cayman/BVI, the boards of offshore GPs and asset holdcos will typically include (in the minority) directors who are usually based in the UK or other major asset management centres such as New York, France or Germany and who fly to attend board meetings. Similarly, multinational groups may have elected to the boards of internal financing and other group companies individuals who travel to relevant locations for board meetings. The suspension of travel for "non-essential" purposes poses a risk that such arrangements may now be undermined.

Corporate tax residence – background

Corporate tax residence refers to the jurisdiction in which a company is treated as tax resident (and so subject to tax). Different jurisdictions have different tests for corporate residence but in most cases (for example the UK and Luxembourg) a company will be treated as tax resident in its jurisdiction of incorporation or jurisdiction from which "central management and control" (or "place of effective management") is exercised. Where a company is dual tax resident (e.g. incorporated in country X but centrally managed and controlled from country Y) an applicable double tax treaty may allocate exclusive taxing rights to one jurisdiction or another applying a "tie-breaker" test; if not, the company will be subject to tax on its profits in both jurisdictions and may well suffer negative tax consequences, such as restrictions on accessing tax reliefs and benefits.

Taking the UK specifically, a company will be UK tax resident if it is either incorporated in the UK or centrally managed and controlled from the UK. The latter is often equated with

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the location of the directors and, in particular, where their meetings take place and effective strategic decision-making is undertaken. Where a company is not incorporated in the UK but has directors who live or spend time in the UK, it needs to be careful to make sure that its directors attend board meetings in the jurisdiction of intended residence and, among other measures, avoid dialling in to board meetings from outside that jurisdiction so that the company does not inadvertently become tax resident in the UK. Restrictions on how board meetings are organised may be found in protocols or embedded in the articles themselves. Similar concerns arise in a number of other jurisdictions including Luxembourg, France and Germany.

The section at the end of this article contains some background on substance.

The impact of COVID-19

Tax residence and substance requirements will now be placed under great strain by the closure of borders, and various travel bans across the globe, as well as requirements to "self-isolate". Of course, at present, it is unclear for how long these restrictions will remain in place. The magnitude of the crisis and impact on business invariably means that board meetings will be needed, perhaps, more so than ever. However, what happens if a director is unable to travel to a board meeting in person due to the travel restriction and instead dials in from their home jurisdiction? For instance, a director of a Luxembourg or Jersey company is "stuck" in the UK but an important board meeting must take place – would that result in the Luxembourg or Jersey company becoming UK tax resident?

Equally, although perhaps less common, corporate structures may have non-UK companies that they want to be centrally managed and controlled from the UK and so UK tax resident. Here the concern is the inverse: non-UK based directors are unable to travel to the UK for board meetings with a risk of the company not being centrally managed and controlled from the UK.

This problem has not gone unnoticed, and jurisdictions such as Guernsey, Jersey and Luxembourg have already started to relax their own rules around corporate residence and substance. However, these reassurances aside, the tax authorities of the major financial jurisdictions (including the UK) are yet to issue comfort that the rules around residence will be relaxed in the face of the coronavirus pandemic, albeit we understand requests for guidance have been made. Absent such comfort, unwary companies may now risk having their global profits fall into another country's tax net, losing access to tax reliefs and benefits and/or triggering "exit" tax charges as a result of a change in their tax residence, among other adverse consequences.

Below are some examples of the types of questions being asked at present. Although the points raised are specific to the UK, the considerations may equally apply to other jurisdictions that have a "central management and control" / "place of effective management" residence test although, of course, advice from the relevant jurisdiction should be sought to confirm what steps may assist in managing the corporate residence risk and substance requirements in that jurisdiction.

Is the absence of an intention for a non-UK company to become UK tax resident sufficient to prevent it from becoming UK tax resident?

Absent any change in law or other relaxation of the rules, no. The test is not one of intention but is a question of fact and degree: the reasons why UK based directors are unable to travel to the non-UK jurisdiction to attend board meetings in person are irrelevant. The question is whether the non-UK company is in fact being "centrally managed and controlled" from the UK or not.

Can a board meeting be held by telephone or video and will that avoid tax risks?

The articles of association or incorporation of the company need to be checked to ensure board meetings may be held other than in person and what the requirements are (if any). This is subject to any emergency

measures that have been initiated relaxing the requirement to follow meeting protocols. Provided telephone or video meetings are permitted, they should be initiated by a director in the company's country of intended residence. Ideally, the UK directors would not attend from the UK by telephone or video but, if they do, they should be in the minority. Provided this is on an exceptional basis the risks may be mitigated but see the next Q&A.

Would one-off emergency meetings with directors dialling in from the UK result in a non-UK company becoming centrally managed and controlled from the UK?

In short, having UK based directors dialling in to board meetings from the UK on an exceptional "one-off" basis is unlikely to result in a non-UK company becoming UK tax resident. However, this is a matter of fact and degree. If the number of "exceptional" board meetings increases, or if the most senior directors are participating from the UK, then there is a real risk of the non-UK company becoming UK tax resident (regardless of the intentions or reasons as noted above).

There may be other non-tax factors to consider such as, for instance, whether decisions taken by boards in those circumstances are *ultra vires* in that they may be inconsistent with internal protocols and/or articles of association which require board meetings to be held, in person, in the non-UK company's jurisdiction of incorporation and place restrictions on directors dialling in from outside of that jurisdiction. In those circumstances, the appointment of proxies may be helpful and could be considered.

Luxembourg and other jurisdictions have announced emergency measures relaxing residence and substance requirements. Will that prevent a Luxembourg or Jersey company from becoming UK tax resident if UK directors make decisions when in the UK?

No. Emergency measures in the company's jurisdiction do not automatically mean that the company will not be brought onshore in another jurisdiction for tax purposes notwithstanding that it complies with those emergency measures.

Luxembourg has introduced emergency measures to enable companies and other legal persons to hold shareholders and board meetings without having to be physically present. Similarly, the Jersey Comptroller of Revenue has confirmed that, subject to conditions, if companies need to adjust their operations as a result of the crisis then it will not fail the economic substance test under Jersey law. Therefore, if virtual board meetings need to be held while directors are prevented from travelling due to restrictions being in place then Jersey economic substance should not be affected for Jersey domestic law purposes. Guernsey has also introduced similar measures.

However this does not mean that UK tax risks are avoided, for example where directors in the UK join a virtual board meeting for a Luxembourg or Jersey company. Whether relaxing physical presence for board meetings works from a tax perspective also depends on how other relevant countries (e.g. where a director dials in from) will view this, and HMRC have not (yet) relaxed any rules around UK corporate residence.

What steps can realistically be taken to mitigate the risk of a non-UK company becoming UK tax resident?

Where a board meeting is due to cover "normal" matters, then the safest approach might be for it to be postponed. However, these are not "normal" times and postponing board meetings indefinitely may not be practical given the continually evolving nature of this pandemic and its impact on business. Equally, there may be legal, regulatory or commercial reasons why board meetings cannot simply be postponed. For example, an investment fund sponsor ready to push the button on a fundraising closing will want to seize the opportunity to close and arrange for the relevant board meetings to make this possible.

Where board meetings need to take place, non-UK companies should consider changing the composition of their boards to ensure that there are sufficient local (i.e. non-UK) directors on the board of the non-UK company

to make decisions in person at board meetings held in the non-UK jurisdiction. When changing directors, there may be local or internal company requirements for the directors to be suitably qualified and be able to make informed decisions. In all cases, although local directors may be "briefed" by UK persons (and those persons could even join board meetings purely as observers in exceptional cases provided that the minutes reflect that and any calls are initiated from outside the UK) it will be important to ensure that in all circumstances the people actually making the strategic decisions are the local directors in the jurisdiction of incorporation of the non-UK company, and that any strategic decisions taken by those directors are genuine and are not simply the "rubber stamping" of decisions actually made by UK based persons.

Further mitigation steps may include the use of committees or proxies. However, again, as with local directors, it is important that proxies and committees make the strategic decisions and are not simply "rubber stamping" decisions made by UK based persons.

Would it help if UK based directors resign from the non-UK company and are replaced by local directors?

As noted above, changing board composition temporarily to remove UK based directors is one mitigating step that could be taken by non-UK companies. However, simply removing UK based directors will not, in and of itself, be sufficient to mitigate the risk if those same persons are still, behind the scenes, taking the strategic decisions on behalf of the non-UK company with local directors "rubber stamping" those decisions. In other words, it is the substance, rather than the form, of the governance position that matters.

Assuming that it is possible for the UK based directors to resign or stand aside and not be involved in any strategic decision making of the non-UK company then that will certainly mitigate the risk of the non-UK company becoming UK tax resident. However, there may be (non-tax) practical issues in changing board composition with other legal factors, such as director duties, needing to be considered. For instance, if the non-UK company is, or is at risk of becoming, distressed, it would seem more difficult to remove existing UK based directors and replace them with new local directors (who would then assume those duties).

Can a UK based director sign documents on behalf of the non-UK company from the UK?

Where it concerns simple execution of a document then, subject to the articles and any local requirements, that execution should not in and of itself be sufficient to make the non-UK company UK tax resident on the basis that execution of a document is the formal ratification of a decision that has previously been taken. Of course, for the reasons set out above, it is important that the actual decision to enter into any strategic agreement or arrangement is not made in the UK but, rather, made by the board outside of the UK. And all cases need to be considered on their facts.

There may of course be other consequences – e.g. stamp taxes issues – of signing documents in the UK. In addition, if a person in the UK habitually enters into contracts on behalf of a non-UK company then this can, depending on the circumstances, give rise to a taxable permanent establishment in the UK for that company. These issues are outside the scope of this article.

Is there a risk of creating a UK permanent establishment if a non-UK company has UK based directors dialling into board meetings?

Subject to various territorial extension rules, a non-UK company will be subject to UK corporation tax if it is trading in the UK through a permanent establishment. Although fact dependent, it is unlikely that director level decision making would amount to carrying on a trade. As such, dialling into board meetings from the UK is unlikely in and of itself to result in the non-UK company being treated as trading in the UK through a permanent establishment, although each scenario needs to be considered on its facts.

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Substance – background

Substance for tax purposes has become increasingly important over the last few years, particularly for investment fund GP, financing and holding entities. So called "letterbox" or "brass plate" jurisdictions have long come under scrutiny by tax authorities in certain contexts, but the last few years have seen enhanced substance requirements more generally (and challenges to substance under existing anti-conduit / beneficial ownership rules).

In the funds market, for example, regulatory and other developments have seen sponsors make increasing use of Luxembourg structures over the last few years, while the UK, Channel Islands, Cayman and BVI remain widely used by UK and US based sponsors. In any case, an appropriate level of substance in the jurisdictions involved is important to avoid tax inefficiencies and also because of investor requirements.

Tax substance is the extent to which an entity has real "presence" in its home jurisdiction, and takes into account, among other things, factors such as the identity of the directors and degree of regularity with which they meet and where they meet.

In any given case, there may be several reasons why local substance is needed, for example to satisfy local substance requirements in the company's home jurisdiction, to satisfy source payment requirements to avail of relief from withholding tax or relief from capital gains tax on an exit, to achieve a particular VAT treatment of fees (e.g. management or advisory fees) paid by the company and to comply with any local transfer pricing rules or guidance.

Following a 2017 investigation by the EU Code of Conduct Group, the Channel Islands, the BVI, Bermuda and the Cayman Islands, among others, were included in a list of jurisdictions which were required to address 'economic substance' concerns. As a result, new legislation, effective from, broadly, 1 January 2019, has introduced new economic substance requirements for relevant entities in those jurisdictions.

Our tax team is available to discuss any of these issues with you and answer any specific questions you may have. If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below.

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