Proskauer

June 2019

For more information, please contact:

Stephen Pevsner
Partner
t: +44.20.7280.2041
spevsner@proskauer.com

Robert E. Gaut
Partner
t: +44.20.7280.2064
rgaut@proskauer.com

Catherine Sear
Partner
t: +44.20.7280.2061
csear@proskauer.com

Welcome to this month's Proskauer UK Tax Round Up, which is a case law special. The last month has seen some interesting developments, with two cases concerning the interpretation and effect of share purchase agreements as well as a win for the taxpayer in a company residence judgment.

Guernsey SPV not resident in the UK

In *Development Securities plc and others v HMRC*, the Upper Tribunal (UT) has overturned the prior discussion of the First-tier Tribunal (FTT) in favour of the taxpayer in an important tax residence case relating to Jersey incorporated companies.

The FTT Decision

As we reported in our August 2017 UK Tax Round Up, the FTT found against the taxpayer and ruled that certain Jersey-incorporated companies were, in fact, UK tax resident through their central management and control being carried out in the UK.

By way of reminder, Development Securities plc (DS) (a UK company) had incorporated a number of Jersey subsidiaries intended to be Jersey tax resident as part of its implementation of a tax avoidance scheme which was intended to increase capital losses available to the DS group. The transactions involved the Jersey companies selling certain real estate assets for less than they acquired them for. The facts showed that all the board of directors of the Jersey subsidiaries had a Jersey-resident majority of directors (three were Jersey-resident and one was UK-resident), the board meetings all took place in Jersey and decisions were actually taken at those board meetings.

However, the FTT focused on the uncommercial nature of the transactions from the perspective of the Jersey subsidiaries themselves and that the transactions could only be justified in the context of the tax benefit to the DS group as a whole and that Jersey corporate law meant that the Jersey subsidiaries could only enter into the uncommercial transactions with the approval of their UK-resident parent company.

Consequently, the FTT had held that central management and control of the Jersey companies had been given up by the subsidiaries to the UK DS parent and, in taking on their director appointments, the Jersey directors were simply agreeing to implement what the UK DS parent company had already decided to do.

The UT's Decision

The UT has now overturned that decision and has ruled that central management and control of the Jersey subsidiaries was exercised in Jersey and not the UK.

The UT found that, while the relevant assets were indeed acquired at an overvalue, the overpayment by the Jersey companies was not funded by them but by DS. Subsequently, the FTT's decision that the transactions were "uncommercial" for the Jersey companies was doubtful.

The UT analysed Jersey company law in some depth, looking at how the directors were obliged to act in the best interests of the Jersey company. Jersey company law requires the company to consider the interests of shareholders, employees and creditors. In this case, given that the Jersey companies had no employees and that the transactions that the Jersey companies were to enter into, pursuant to the scheme, did not prejudice creditors, the UT decided that the primary consideration can only have been the interests of the sole shareholder (DS). The UT reported that the directors gave detailed consideration to the appropriateness of the scheme including the apparently uncommercial nature of the options and the acquisition by the Jersey companies of the relevant assets and concluded that the transactions were in the best interests of the shareholder and, therefore, in the best interests of the Jersey companies.

Although the UT agreed with the FTT that the single UK resident director had acted as a puppet or "rubber stamp" for DS, the FTT had not made a similar finding regarding the Jersey directors. The evidence pointed strongly to the Jersey directors properly applying their minds to the transactions. The UT noted that one board meeting lasted five hours and that the Jersey directors sought clarification on a number of points including the potential stamp duty liability arising and that they also noticed and raised with the advisers an inconsistency in the transaction documents.

HMRC tried to argue that the FTT had excluded from consideration material factor(s) going to the question of central management and control because they had occurred outside a board meeting. The UT rejected that argument and said that the FTT had, correctly, focused on the board meetings, but that it had also taken account of matters occurring outside these meetings appropriately.

Analysis

This is a welcome decision in favour of the taxpayer. It demonstrates again the importance of running offshore companies properly. The evidence as to what happened in the Jersey board meetings proved critical here. The board minutes showed that the three Jersey-based directors had met in Jersey and had spent considerable time analysing and discussing the terms of the deals over several board meetings. It was important to the UT's decision that the board minutes demonstrated that the directors had asked meaningful questions about the transaction and had called for explanations where necessary. Well-prepared contemporaneous minutes of such meetings are vital.

It shows also both that it is important for a non-UK resident company's directors to understand fully the scope and consequences of the transaction they intend to approve so that the transaction can be implemented properly and that it might be easier to implement effectively a narrower range of activities than to claim to carry out a broader range that it would be more difficult to consider and approve appropriately.

Was Peruvian VAT "payable" under the terms of a tax indemnity?

In *Minera Las Bambas SA and another v Glencore Queensland Ltd and others*, the Court of Appeal (CA) considered the terms of a sale and purchase agreement (SPA), which included a tax indemnity. It upheld the High Court's decision that certain assessments to Peruvian VAT were not "payable" for the purposes of the SPA, so the buyer could not claim for them under the tax indemnity.

The case concerned the acquisition of a Peruvian company in a large corporate transaction. The acquisition was made pursuant to the SPA, which was governed by English law and provided for disputes to be decided in the courts of England and Wales.

There was negotiated language in the SPA which gave a tax indemnity claim to the buyer in the case of specified taxes if and when they became "payable".

The target company developed a large copper mine in Peru over a four year period during which substantial sums were spent on goods and services purchased from third party suppliers. As a result, the company accumulated a large VAT credit balance and claimed and received various cash refunds of VAT credits.

The Peruvian tax authority (SUNAT) issued assessments which determined that the company had claimed tax credits for taxable supplies purchased from third parties for which it could not produce adequate supporting documentation and which, for this reason, were disallowed. Some of these rejected tax credits had been refunded to the company under the early refund scheme. SUNAT also assessed the company as having incurred a liability to pay VAT in connection with its construction of a new town in Peru.

Under Peruvian law a tax assessment issued by SUNAT becomes enforceable when the time allowed for filing an appeal expires, if no appeal has been filed within that time. If an appeal is filed, the tax debt cannot be enforced until after the appeal has been determined (and then, of course, only if and in so far as the appeal is unsuccessful). To encourage payment of sums which are the subject of an appeal, the Peruvian tax system operates a "graduality regime" under which the penalties charged by SUNAT (and interest on those penalties) are reduced if payment is made in full of the disputed tax liability before an appeal is filed.

The CA held, rejecting the buyer's appeal, that, if the existence and amount of a debt has been established but the indemnified person has not yet come under an enforceable obligation to pay the debt, it cannot be said that any loss has been suffered which the indemnifier has failed to prevent or to hold the indemnified person harmless against. To treat the seller's obligation to pay an amount of money to the buyer as a result of the tax becoming "payable" in such a situation would be inconsistent with the general nature and purpose of an indemnity.

In reality, the only way that the buyer could have enforced a valid claim under the tax indemnity under the SPA would have been to pay the assessed VAT early (which would have reduced the interest and penalties).

The CA also held, interestingly, that the loss of a right to receive repayment of a tax credit cannot, itself, be characterised as the incurrence of an obligation to pay tax. The parties had (anticipating this distinction) included a separate provision which protected the buyer against the loss of a VAT receivable that was taken into account in valuing the assets purchased under the SPA.

This case demonstrates that the wording in SPAs and tax indemnities needs to be considered carefully in the light of the machinery of the local tax laws and the tax obligation that a buyer is expecting protection against before the documents are finalised.

Failure of attempt to amend terms of share purchase agreement to change UK capital gains tax (CGT) result

In *Briggs & others v HMRC,* the FTT rejected arguments by the taxpayers that they had successfully amended the terms of a 2006 SPA to change the nature of certain receipts for tax purposes.

The taxpayers in the case were the sellers under a SPA under which they had sold shares for initial cash consideration plus a contingent right to loan notes to be issued by the buyer. The amount of the loan notes was unascertainable at the date of the contract and depended on the outcome of some litigation concerning the target. Under section 138A TCGA, the default treatment of that contingent part of the consideration (the earn-out right) was that there was no disposal for CGT purposes at the time of the sale and part of the base cost of the target company shares would be "rolled over" into the earn-out right constituted by the right to receive the loan notes. Although it is possible to elect out of that treatment and trigger an initial taxable disposal, the taxpayers had not done so.

The parties amended the SPA in 2013 to substitute the right to be issued loan notes for a right to receive cash. They argued that this was a minor variation of the SPA, and that no capital sum was taxable at the time of the variation. Moreover, they then sought to argue that the nature of the original transaction was changed for UK tax purposes, with the "rollover" treatment being replaced with tax in 2006-07 on the original value of the right to receive the loan notes and a further charge in 2013 when cash proceeds were received (applying what is referred to as the *Marren v Ingles* principle). It was not clear from the evidence what the motivation for the amendment had been and whether it was driven by particular tax considerations.

The FTT did not agree with the taxpayer's arguments that the deed of variation was only a minor change to the SPA. They were very clear that the 2006 transaction had resulted in a partial rollover of the target shares into the earn-out right to receive loan notes and that, when the deed of amendment was entered into and cash received, that cash was taxable at that point as a capital sum derived from the asset (being the right to receive the loan notes).

This is a very clear judgment, and is something of an enigma in that the motivation of the parties for the change to the SPA is unclear. That said, the attempts by the taxpayers to change the clear terms of the original agreement, and in so doing side-step the legislative machinery of section 138A TCGA, were firmly rejected.

Along with other cases where taxpayers seek to change the tax consequences of transactions after they are entered into (such as the *Klincke* case, considered by the UT in 2010), this case shows that taxpayers should consider carefully the costs and reason for doing so, as any such amendment might well be challenged by HMRC and rejected by the courts.