Tax Topics

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# PARENTAL INFLUENCE OR ABDICATION? THE UK COURTS GRAPPLE WITH CENTRAL MANAGEMENT AND CONTROL[1]

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The UK Court of Appeal's decision in *HMRC v. Development Securities plc and others*[2] is noteworthy because it highlights the difficulties that may arise in determining the location of central management and control ("CMC") for wholly-owned subsidiaries/special purpose vehicles ("SPVs"), particularly where the SPV is transitory in nature or formed for the purpose of implementing a single transaction, and is controlled by a parent entity that also proposes the transaction. As part of the commonwealth, the decision may be instructive for Canadian tax purposes.

## Background: The Tax Plan and Lower Level Decisions

The tax planning at issue sought to use latent losses on certain subsidiaries and properties (collectively, the "Properties") within a UK group of companies to offset gains elsewhere within the group, while benefiting from indexation relief (i.e., factoring in inflation on a disposition to account for the "true" loss). The group stood to save £8 million.

The steps taken to implement the tax plan may be summarized as follows:

(1) The parent company ("Parent") incorporated new wholly-owned subsidiaries in Jersey (the "JerseyCos"). The JerseyCos had four directors — one was a UK resident and three were residents of Jersey (the "Jersey Directors").

(2) Call options (the "Options") were issued to the JerseyCos entitling them to buy the Properties at an overvalue (i.e., in excess of the fair market value) if certain conditions were satisfied (e.g., that the FTSE Real Estate Total Return Index closed at 2082 or above for at least five consecutive days in a specified period, and approval was obtained from Parent).

(3) The Options were exercised and Parent provided the funds needed to acquire the Properties through capital contributions and share subscriptions.

(4) The Jersey Directors resigned and were replaced by UK-resident directors.

(5) The Properties were transferred to other companies within the UK group.

The tax plan ultimately hinged on the JerseyCos being resident in Jersey when they exercised the Options.

Her Majesty's Revenue and Customs ("HMRC") argued that the JerseyCos' board of directors abdicated their responsibilities and that the relevant decisions for CMC purposes were made by Parent in the UK, such that the JerseyCos were resident in the UK.

[1] The authors wish to thank Mark Tonkovich for reviewing a draft of this article.

[2] [2020]EWCA Civ 1705, [*Development Securities*].

HMRC succeeded before the First-Tier Tribunal (the "FTT"),[3] which found that the JerseyCos' CMC was in the UK at the relevant time because the Jersey Directors merely followed Parent's instructions, acting as a rubber stamp. Central to the FTT's ruling was the finding that the Jersey Directors were not "actively engaging" in a decision to implement the tax planning by acquiring the Properties at an overvalue. In this regard, at paragraph 423, the FTT stated:

> The Jersey board were not, therefore, actively engaging in a decision to implement the tax planning by acquiring the assets at an overvalue in exercise of their discretion as directors. That decision was made by [Parent] and the directors merely gave their formal approval (as we would say they had undertaken to do from the outset) as they were instructed to do. The directors did not consider for themselves whether the transaction was for the companies' or the parent's benefit as part of a decision making process. There is no evidence that there was any discussion of that at any of the board meetings. Any discussion was confined to the legality position. That there was a benefit was certified to them simply as part and parcel of the "instruction" given to the board. Acting on the basis of such a confirmation is not the same thing as the board considering the issue independently in exercise of their own discretion in active engagement with the substantive decision to be made.
>
> [emphasis added]

The taxpayers appealed to the Upper Tribunal (the "UT"),[4] which reversed the FTT's decision on the basis that the FTT had erred in law in concluding that the Jersey Directors had abdicated their responsibilities. Among other criticisms, the UT determined that the FTT erred (i) in viewing the acquisition of the Properties (at an overvalue) as uncommercial, and (ii) in founding its decision on the Jersey Directors having failed to decline to do something that was improper or inadvisable (i.e., entering into uncommercial transactions by exercising the Options).

## The Court of Appeal's Decision

HMRC appealed to the UK Court of Appeal (the "CA") on the grounds that, *inter alia*, the UT mischaracterized the basis on which the FTT reached its conclusion on the JerseyCos' residence. The CA provided a lengthy (see paragraphs 72 – 84) criticism of the UT's reasons for judgment. Essentially, the CA concluded that the FTT properly understood the transactions at issue — its decision did not rest on the duties of the Jersey Directors and was rightly focused on the Jersey Directors' actions. As such, the UT's criticisms of the FTT's decision were not well founded and the CA allowed HMRC's appeal.

Although the decision rejects the UT's reasons for overturning the FTT's decision, it does not (fully) confirm the FTT's reasoning regarding CMC. For example, Lord Justice Nugee makes this clear in the following paragraphs (which were given as part of one of the three sets of concurring reasons, and with the following comments therefore appearing to be *obiter dicta*):

> 94. [. . .] I have very considerable reservations about the FTT's reasoning and would not want this outcome to be seen as an endorsement by me of the FTT's reasoning. [. . .]
>
> 101. Mr Grodzinski [counsel for the taxpayers] said that the FTT's decision was the first time in any case where the local board of directors of a company had actually met, had understood what they were being asked to do, had understood why they were being asked to do it, had decided it was lawful, had reviewed for itself the transactional documents, had been found not to have acted mindlessly, but had nevertheless been found not to have exercised CMC. He submitted that that was a significant departure from the previous case law. That seems to me to be right.
>
> 103. [. . .] I do not think the authorities establish that CMC can only be exercised by "actively engaging" with the decision if that means (as it appears the FTT meant) considering for themselves the merits and demerits of a proposal. The question is not why the directors made the decision they did, or how much thought they gave to it, or what they did or did not take, or should or should not have taken, into account. The question is a much simpler one, namely: did they make the decision? [. . .]

[3] [2017] UKFTT 565 (TC).

[4] [2019] UKUT 169 (TCC).

In contrast, Lord Justice Newey (who wrote the most detailed analysis allowing the appeal, and with whom the other two justices agreed for purposes of disposing of the appeal) did not express any views regarding Nugee LJ's reservations, given that full argument had not been made on those points. Further, Lord Justice Richards stated that he had no concerns with the FTT's decision or its reasoning.

## Comments

The potential disagreement between the three CA justices on the substantive aspects of the FTT's approach to CMC highlights select difficulties that may arise in applying the CMC test to SPVs, particularly where the SPV is transitory in nature or formed for the purpose of implementing a single transaction, and is controlled by a parent entity that also proposes the transaction. In this regard, there are three key takeaways.

First, the appropriate test for determining the CMC of an SPV remains that established by *De Beers*.[5] The test is premised on analogizing a corporation to an individual. This analogy typically works because a corporation and an individual follow a similar existence: They are born, live, and die. And, drawing from the words of Lord Chancellor Loreburn in *De Beers*:[6] Although a corporation does not eat or sleep, it can keep house and do business. Accordingly, a corporation is resident where its real business is carried on.

However, applying this analogy to SPVs can be challenging. For example, where there is influence from a parent corporation, it can be difficult to draw the line between a board of directors fulfilling its (limited) responsibilities and an abdication of those responsibilities. In this regard, at paragraph 401, the FTT stated:

> [. . .] it does not necessarily follow that CMC of an overseas group company, which has been formed for a specific purpose (whether as part of a tax plan or otherwise), is in the UK if it falls in with the plan of the parent of the group and does what is expected, <u>provided that proper consideration is given to the proposal</u> and the directors are in fact exercising their discretion to exercise CMC of the company.
>
> [emphasis added]

With the FTT's decision now reinstated, uncertainty may exist as to what constitutes "proper" consideration of a proposal or "actively engaging" in a decision when an SPV participates in a tax plan orchestrated by its parent. Accordingly, it will be important to produce evidence establishing that the directors turned their minds to the decision to be made, and then made the decision on behalf of the company.

Second, the FTT and UT confirmed that *HMRC v.Smallwood*[7] is irrelevant for determining CMC of a corporation because it deals with different issues: the residence of a trust under a tax treaty tiebreaker rule and the notion of "place of effective management".[8] As such, *Wood v. Holden*[9] remains the most recent decision from the CA on corporate CMC (prior to *Development Securities*).[10]

Third, this case reminds us that memories can fade and that directors may not be able to provide sufficient testimony as to their actions when questioned years later — stressing the importance of clear supporting documentation.

Following this decision, CMC best practices for SPVs include:

- Ensuring that the board of directors is aware of, and sufficiently understands, the legal test for CMC;
- Recognizing that the CMC test is a factual enquiry and that the courts will examine the surrounding facts (i.e., including before and after the relevant time);

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[5] *De Beers Consolidated Mines Ltd. v. Howe*, [1906] A.C. 455, [*De Beers*].

[6] *Ibid*, at page 458.

[7] [2010] EWCA Civ 778, [*Smallwood*].

[8] *Supra*, notes 2 and 3 at paras. 389 and 66 – 67, respectively.

[9] [2005] EWHC 547 (Ch) and [2006] EWCA Civ 26. This case involved an SPV that was wholly owned by a parent company. The England and Wales High Court (Chancery Division) concluded that the CMC rested with the corporation's board of directors even though it was a wholly-owned subsidiary that was created for specific purposes and carried out said purposes in accordance with the intentions, desires, and influence of its parent.

[10] For examples of the Tax Court of Canada referring to *Wood v. Holden* in regard to CMC, see: *Landbouwbedrijf Backx B.V. v. The Queen*, 2018 DTC 1104 (TCC), rev'd on other grounds 2019 DTC 5143 (FCA), and *Garron Family Trust v. The Queen*, 2009 DTC 1287 (TCC), aff'd 2010 DTC 5189 (FCA) (sub nom. *St. Michael Trust Corp. v. Canada*), aff'd 2012 DTC 5063 (SCC) (sub nom. *Fundy Settlement v. Canada*).

- Taking steps to retain other evidence that supports the consideration given to the decision by the directors, such as emails between directors and meeting minutes evidencing that the directors contemplated the proposals and actually engaged in the decision-making process; and

- Institutionalizing CMC best practices so that they are consistently followed.

Now that corporations have grown accustomed to modernizing their business practices and adopting new technologies in reaction to the COVID-19 pandemic, thought could also be given to how technologies can assist in facilitating and documenting a board's decision-making process. For example, board of directors' meetings could be recorded on video. If the revenue authorities challenge a corporation's residency, a video recording (demonstrating appropriate board activities) should help evidence whether the board gave the requisite consideration to a proposal and ultimately exercised CMC in making the decisions for the company. While this may be impractical for boards that meet regularly and conduct significant amounts of business, it could be useful in the context of an SPV where the board meets only once or twice.

Going forward, it will be interesting to see the treatment this case receives — particularly, to see what weight will be given to Nugee LJ's reservations.

# COVID-19 UPDATE

## Provincial

### Ontario

#### Province Launches New Ontario Tourism and Travel Small Business Support Grant (May 13, 2021)

The Ontario government is providing one-time payments of $10,000 to $20,000 to support eligible small tourism and travel businesses struggling to recover from the impact of the COVID-19 pandemic through the new $100-million Ontario Tourism and Travel Small Business Support Grant.

This grant will support eligible small tourism and travel businesses that did not receive the Ontario Small Business Support Grant ("OSBSG"), such as travel agents, hotels, motels, resorts, and bed and breakfasts. To qualify, businesses must have fewer than 100 employees and demonstrate they have experienced a minimum 20 per cent revenue decline between 2019 and 2020.

The program officially launched on May 13, 2021. Applications for this grant will close on Friday June 25, 2021.

# CURRENT ITEMS OF INTEREST

## Tax Relief for Livestock Producers

The Government of Canada released a list of prescribed drought regions in Nova Scotia, New Brunswick, Prince Edward Island, and Québec where livestock tax deferral has been authorized for the 2020 tax year.

The livestock tax deferral provision allows livestock producers in prescribed drought, flood, or excess moisture regions to defer a portion of their 2020 sale proceeds of breeding livestock until 2021, to help replenish the herd. The cost of replacing the animals in 2021 will offset the deferred income, which reduces the tax burden associated with the original sale.

A list and map of these designated regions is available here: https://www.agr.gc.ca/eng/agriculture-and-the-environment/drought-watch/livestock-tax-deferral-provision/2020-list-of-prescribed-regions/?id=1620138156975.

# RECENT CASES

## Appeals of assessments raised pursuant to s. 160(1) and GAAR application of the ITA allowed

The appeals of the five Appellants relate to the application of section 160 of the *Income Tax Act* (the "ITA") and of the General Anti-Avoidance Rule ("GAAR") to transactions undertaken to increase the after-tax return of the Appellants from a sale of farmland in Brampton (the "farmland") owned by five general partnerships (the "general partnerships"), which were in turn 99.99% owned by the Appellants. The transactions isolated the proceeds and income from the sale of the farmland in a newly incorporated subsidiary of each Appellant. Each Appellant then sold its subsidiary to Wilshire Technology Corporation ("WTC"), a corporation incorporated by an unrelated person to acquire the shares in all the subsidiaries. The Minister of National Revenue (the "Minister") assessed each Appellant under subsection 160(1) of the ITA for the income tax liability of that Appellant's subsidiary (the "underlying tax liability"), the assessments being determined without regard to a deduction for capital cost allowance claimed by each subsidiary that, if allowed, would have reduced each subsidiary's income to nil. The Appellants submitted that the Minister had not established the existence of the underlying tax liability of the subsidiaries for the taxation year, and that even if that liability did exist, three of the four conditions for the application of subsection 160(1) had not been met. In the alternative, the Minister assessed the Appellants under the GAAR. The Respondent submits that the transactions summarized above were avoidance transactions resulting directly or indirectly in an abuse of subsection 160 of the ITA.

The appeals were allowed. The Court found, bearing in mind that subsection 160(1) comprises two parts, that the questions raised by the positions of the parties are whether the events in issue fall within the scope of part one and, if so, what are the consequences to the Appellants under part two? This requires the interpretation of both parts of subsection 160(1). After a thorough analysis of the facts, evidence, and jurisprudence, the Court ruled that (1) there is a clear connection between the reduction in the property of the subsidiaries and the increase in the property of the Appellants. Consequently, the Judge ruled that the subsidiaries indirectly transferred approximately 82% of the Property to the Appellants. (2) The Court concluded that the Appellants and the subsidiaries were dealing at arm's length at the time of the transfer of the Property from the subsidiaries to the Appellants on December 31, 2006, and, therefore, the condition in paragraph 160(1)(*c*) for the application of paragraphs 160(1)(*d*) and (*e*) is not met. (3) The Court established that with respect to the assessment of the Appellants under subsection 160(2), the foregoing analysis establishes that since the Appellants are appealing the correctness of assessments under subsection 160(2), the burden of proof falls on the Appellants. (4) The Court found that the computer software was not acquired for the purpose of gaining or producing income as required by paragraph 1102(1)(*c*) of the *Income Tax Regulations* and therefore no capital cost allowance can be claimed by the subsidiaries in respect of the computer software. (5) The Court found that the GAAR does not apply to any of the Transactions. Accordingly, the appeals were allowed.

¶50,647, *Damis v. The Queen*, 2021 DTC 1020

## Whether corporate taxpayer entitled to deduct withholding tax on interest it received from a Delaware partnership

The issue in this appeal is whether Emergis Inc. ("Emergis") is entitled to a deduction for foreign non-business income tax claimed under subsection 20(12) of the *Income Tax Act* (the "Act") in its taxation years ending on December 31, 2000 and December 31, 2001, with respect to the US withholding tax paid in the equivalent of $3,808,456 and $5,051,276 Canadian dollars respectively on the interest income received from BCE Emergis General Partnership (the "USGP"), a US partnership formed under the laws of Delaware in which Emergis held a 99.9% participation. Emergis' claims under subsection 20(12) of the Act were disallowed by the Minister of National Revenue (the "Minister"). The structure was a "tower structure", with USGP holding 100% of a Nova Scotia Unlimited Liability Company ("NSULC"), which in turn held a 99.9% interest in a Delaware Limited Liability Company ("LLC"), all of which were hybrid entities that formed the "tower", which was set up to finance the acquisition of an arm's length US operating company.

The appeal was dismissed; costs were awarded to the respondent. The words "in respect of" in subsection 20(12) are to be interpreted broadly. The income from a share of a corporation other than the taxpayer should be considered. In the present instance, although subsection 20(12) does not include a requirement that the income on which tax was paid be taxable in Canada, the exemption obtained by the NSULC in the structure on the LLC dividend is the reason why Emergis is ultimately not taxable on it. The section 113 exemption, therefore, is related to the paragraph 20(1)(*c*) deduction Emergis was allowed to claim on the interest income on which US tax was paid. To the extent that the interest income will ultimately not be taxable in Canada because of the section 113 exemption, the US tax paid can reasonably be regarded as having been paid on the dividends paid out of the LLC because this is the foreign source of income Canada does recognize.

¶50,646, *Emergis Inc. v. The Queen*, 2021 DTC 1019

## Denial of taxpayer's application for relief was reasonable

The taxpayer filed returns for each of the 2007 – 2009 taxation years but did not immediately pay the amounts owing. In addition, he had unreported income of approximately $40,000. The CRA audited him and issued Notices of Reassessment. In addition to the tax amounts due, the Minister assessed interest and penalties, including penalties for gross negligence. Over the next few years, the interest and penalty components of the tax debt grew significantly. The taxpayer made instalment payments until the balance was fully paid. He did not contest the errors in his tax returns that resulted in the reassessment, but contended that the penalties and interest levied were excessive. He relied on a series of personal setbacks and incompetent professional representation in support of his requests for relief. After three refusals, the taxpayer submitted a fourth request for relief. This was also refused, and the taxpayer applied for judicial review of this decision.

The application was dismissed. The Federal Court dismissed the taxpayer's application for judicial review on the grounds that the new evidence he submitted in support of the application did not establish a causal link between his emotional distress and his failure to declare certain income for the taxation years in issue. The Minister's decision was subject to review for reasonableness. The Court does not have jurisdiction to order the Minister to waive taxes, penalties, and arrears interest. Its jurisdiction is limited to ordering the Minister to substantively reconsider his decisions not to waive the taxes and related interest and penalties. Although the Minister's decision did not set out detailed reasons, it was a reflection of the taxpayer's multiple prior requests for relief and the nature of the response required of the Minister upon receipt of a fourth request. The Minister undertook a review of the taxpayer's new evidence and of the processes and conclusions that resulted in the prior refusals. The taxpayer did not establish a basis for the Court's intervention in the exercise of the Minister's discretion.

¶50,651, *Cheeseman v. Canada (AG)*, 2021 DTC 5039

## Trial judge made no error in dismissing trustee's application for declaratory judgment and judicial review of formal demand from Minister of National Revenue

Following the audit of eleven French resident individuals by the French government, the Minister of National Revenue ("MNR") was asked under Article 26 of the Canada–France Income Tax Convention (the "Convention") to send formal demands of information to a Canadian trustee to obtain information about those individuals. The trustee was the trustee of many trusts whose beneficiaries were those individuals. The MNR forwarded fourteen formal demands of information to the trustee under subsection 231.7(1) of the *Income Tax Act* but received only some, not all, of the information requested on the identity of the trust beneficiaries, the value of their trust property, and the balance sheets and Forms T3 of the trusts. The trustee contended that Article 26 did not apply in this case and that, in any event, it was not subject to the French tax laws. The Federal Court dismissed the trustee's application for a declaratory judgment and judicial review of the formal demand received from the MNR, concluding that it did not have competence to make the decision and also that no French tax had yet been assessed on the above individuals. Furthermore, the conditions in subsection 231.7(1) were met, thus allowing the MNR to forward formal demands under subsection 231.2(1). The trustee then appealed the decision to the Federal Court of Appeal ("FCA").

The appeal was dismissed. The FCA held that the trial judge made no error in ordering the trustee to provide the information to the MNR and in dismissing its application for the declaratory judgment and judicial review of the MNR formal demand of information under subsection 231.7(1). The trial judge was totally justified to exercise his discretion to dismiss the above application. In the absence of any French legal expert, the trial judge did not have all the information to make a decision. The Court also dismissed the trustee's argument that the MNR had not ensured that the conditions of Article 26 of the Convention had been met before sending those formal demands of information to the trustee. In other words, the trial judge made no errors in his decision.

¶50,648, *Fiducie Blue Bridge Inc. v. Canada (MNR)*, 2021 DTC 5035

## Taxpayer's civil claim against CRA dismissed

The taxpayer was in the midst of a protracted dispute with the CRA. His appeals from income tax assessments were dismissed by the Tax Court of Canada and the Federal Court of Appeal. He subsequently sued the CRA in the Supreme Court of British Columbia for damages for negligence, wilful misconduct, and mental distress. The CRA moved to strike out the taxpayer's Notice of Civil Claim ("NOCC") without leave to amend and dismiss the proceeding, or alternatively dismiss the NOCC or strike out portions thereof.

The motion was allowed and the claim was dismissed. The facts alleged in the NOCC and the legal issues related thereto fell within the exclusive jurisdiction of the TCC and had been fully and finally determined under processes established under the *Income Tax Act*. To this extent, the NOCC was an abuse of process. The bare allegations in the NOCC of tortious conduct by the CRA were not supported by sufficiently pleaded material facts, and taken altogether disclosed no reasonable cause of action. Leave to amend the NOCC would not be granted as the tortious causes and remedies set out therein were statute-barred and bound to fail. The plaintiff's claim was dismissed.

¶50,650, *De Vries v. CRA*, 2021 DTC 5038

# INTERNATIONAL NEWS

## Austria Optimistic of a Mid-2021 International Digital Tax Deal

Austria's Ministry of Finance has said the country supports ongoing discussions for a global minimum corporate tax burden for multinationals.

In a recent statement posted on the Ministry's website, Finance Minister Gernot Blumel said he is confident that an agreement can be reached by the summer over new international tax rules for the digitalized economy, based on discussions being spearhedead by the OECD.

Blumel said:

> So far, Austria has taken the view that a universal international solution will be the most effective. Over the coming months, dealing with this issue will be given top priority, with frequent working group meetings.
>
> With the digital tax, Austria has taken a step forward on its own initiative. The most recent international statements of the new US administration, as well as the strong European approval of recent days, give me optimism that a comprehensive solution can now finally be found, one which is thus fair for Austrian trade.

Blumel said he discussed the issue when meeting with Liechtenstein's Prime Minister and Finance Minister Daniel Risch. Of these talks, Blumel said:

> I was able to exchange views on this issue with my colleague Mr Risch. We expect to see an agreement by the middle of the year. Corporations are profiting from the crisis, so now, of all times, they should finally also make a decent contribution, just as every other taxpayer in Austria is doing.

## Italy Publishes Pre-Filled Individual Tax Returns

Italy's tax authority released pre-filled individual income tax returns on May 10, 2021.

Taxpayers in receipt of employment or pension income have until September 30, 2021 to accept or modify their pre-filled form 730 ("modello 730"). This is possible from May 19, 2021. However, taxpayers may now view their returns online.

Comprehensive guidance has been released on the tax agency's website to support taxpayers in complying with the obligation.

Taxpayers due refunds will receive these through their pay slip starting from July, or through their pension from August or September. Otherwise, tax will be collected starting from the same dates.

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