TaxTalk

Simplifying the complexities of Tax

May 2024

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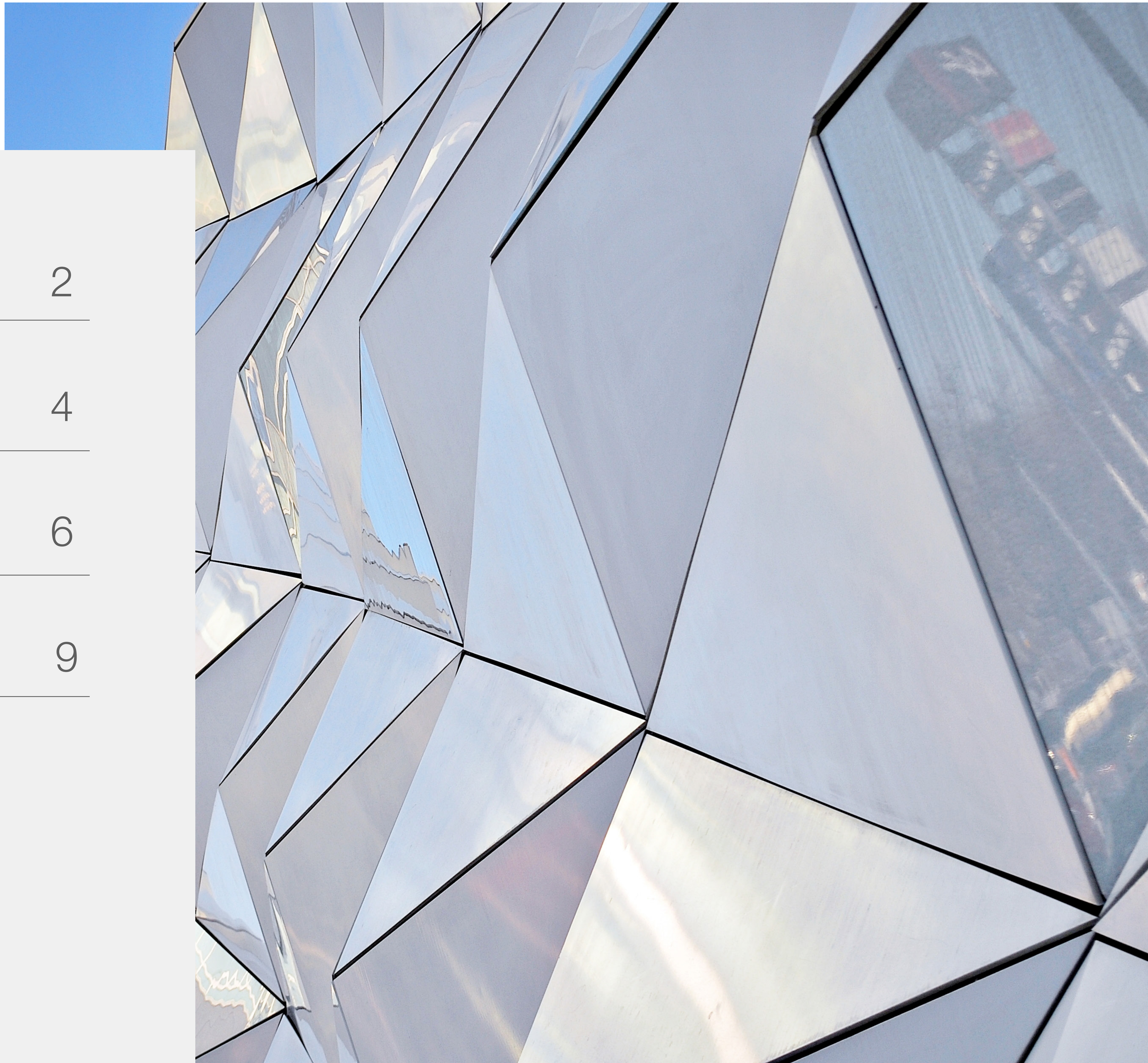

Company residence: where are you really?

The way we undertake business has substantially changed. Remote working creates numerous tax considerations and corporate residency is one of them. So how is corporate residency decided?

As technology allows businesses to operate from anywhere in the world, it's increasingly vital to understand the taxing rights of jurisdictions. So how does local law interact with international agreements in determining tax residency of companies?

An important and basic rule is that companies are taxed where they are resident. Historically, the residence test for companies followed principles established under case law. But that changed in 1988 when legislation introduced the incorporation test, now found in the Corporation Tax Act 2009.

Control and management

A company that is UK resident is taxed in the UK on its worldwide income. There are some general rules to consider when determining a company's tax residence:

- Incorporation: a company incorporated in the UK is considered to be tax resident in the UK
- Case law: a company which is centrally managed and controlled in the UK is considered to be tax resident in the UK.

It's worth noting that the case law test is only relevant for companies that aren't incorporated in the UK. The test to determine a company's residence has been considered through numerous cases over the years. Two of the most famous are De Beers and Calcutta Jute Mills. In these, and other cases, the courts have established that a company resides where its real business is carried on. And the real business is where the central management and control (CMC) is based.

In many cases the board of directors will meet where the company is resident, and where those meetings happen can be important in determining the place where the real business is carried on. But don't forget that, if the directors are dialling in to meetings remotely, their location is where they are physically based. And what if the directors are simply exercising decisions made by another person or if decisions have already been made before the meeting?

So whilst the principle may seem straightforward, it's true to say that CMC has been controversial in many cases. If there is uncertainty over a company's CMC, the directors should consider all the facts in determining where it resides.

Company residence: where are you really?

Place of effective management

Difficulties can arise when a company is deemed to be resident in the UK and also in another jurisdiction, under the laws of that country. For example, a company could be incorporated in the UK but centrally managed and controlled in a country where CMC is viewed as a test for residence. So that company could be considered resident in both countries: a dual resident.

Where this is the case, the company should consider if there is a double tax treaty between the UK and the other country. If so, the tie-breaker clause in the treaty explains how a dual resident company is only treated as tax resident in the country of its ‘place of effective management’ (sometimes known as POEM).

But beware. The place of effective management and the place of CMC are not the same.

That said, many treaties, are moving away from the place of effective management and instead implementing the mutual agreement procedure (MAP) clause. This requires that the competent authority in each country (HMRC in the UK) decides, by mutual agreement, which country will be the company’s ‘residence’. The concept of place of effective management is still relevant and is taken into account. But it’s just one factor.

The place of effective management is where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are made.

When trying to determine POEM, it’s important to understand that the decisions being considered are those made at the highest level of management which steer the direction of the company. It is often where the managing director, finance director and sales director are located. And it would make no difference if the board held their meetings in a different jurisdiction.

The tax authorities would consider all relevant facts and circumstances to determine the place of effective management, including:

- where the controlling shareholders are located and how much influence they exert on the decision-making process
- where the day-to-day management decisions are made
- where the board meetings (or equivalent) take place
- where the key and senior management personnel are located
- where are the commercial, strategic and policy decisions are made.

What should you do now?

If your company inadvertently ceases to be UK tax resident, this may lead to significant unexpected tax issues and professional fees. So it’s vital to do a risk assessment, in good time, of any significant transaction such as an investment round or exit. Companies should adhere to strong corporate governance that monitors residency positions and mitigates risk.

If you would like further guidance on any of the issues raised in this article, our Corporation Tax team can provide tailored advice based on your business’s specific circumstances. Please contact Ketan Shah.

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The importance of substance in location for transfer pricing

When it comes to tax and business planning, multinationals should focus on economic substance and how it links to location.

When UK-based multinationals trade with an overseas affiliate, or foreign groups trade with a UK affiliate, economic substance matters. Under transfer pricing rules, an entity’s level of economic substance in the location is important. This will affect its entitlement to income and profits, or its claim to tax deductions and losses. This means transfer pricing can drive the profit and tax reporting outcomes of multinationals across entities in key operating markets.

The meaning of substance

Substance is a fundamental concept in international tax and appears in domestic tax law, tax treaties, tax authority guidance, and court rulings. Substance refers to, and requires, genuine economic activity in an entity’s location, which supports a claimed (or denied) tax position.

In-country substance may take a variety of forms and typically includes:

- key personnel with the relevant skills and experience to perform the entity’s business activities (such as directors responsible for corporate governance and strategy)
- Tangible and intangible assets (for example, an office or facility, registered or internally generated IP)
- Contractual relationships (such as supplier or customer contracts)
- Legal requirements (for example, a regulatory licence).

In a multinational group, substance directly affects an entity’s potential tax residence, permanent establishment, legal and regulatory compliance, as well transfer pricing positions. When we think about the relevant tax or other legal provision, the level of substance is determined by a critical evaluation of the entity’s business and commercial arrangements.

In the recent case of BlackRock HoldCo 5, LLC -v- HMRC [2024] EWCA Civ 330, UK tax deductions claimed for interest costs arising on loans as part of a business acquisition structure were disallowed under the unallowable purpose rule in section 441 of the Corporation Tax Act 2009. The Court of Appeal ruled that there was no reason to include a UK based entity with the relevant loans in the structure other than seeking to obtain a UK tax advantage. The taxpayer lost due to a lack of commercial function and substance.

Substance in transfer pricing

The legal framework alone (legal ownership of IP or contracts, etc.) does not determine profit attribution to entities in a multinational group. To comply with transfer pricing rules and the OECD arm’s length principle, multinationals must meet certain criteria. Provisions (whether in goods, services, IP, or financing) between related parties should be on terms and pricing which are consistent with open market conditions. This mitigates the risk of tax enquiries, adjustments, and penalties by tax authorities.

The location of substance is critically important to the application of the arm’s length principle:

- When reviewing related party transactions, a critical step is a functional analysis. It focuses on the ‘economically significant activities’. This means the functions performed, assets used, and risks assumed by an entity. The allocation of risks requires the entity to have ‘control of risk’ and the financial capacity to bear the risk. For example, senior management teams decide market strategy and budgets, new product development, sales channels, and customer pricing frameworks

The importance of substance in location for transfer pricing

- In relation to intangibles, there should be a review of all the business activities which contribute towards the 'development, enhancement, maintenance, protection and exploitation' (or DEMPE) of IP. This could be, say, global marketing teams developing brand strategy and marketing collateral
- When it comes to attributing profits to permanent establishments, OECD guidance emphasises the importance of 'significant people functions'. This might include overseas sales personnel habitually exercising the authority to conclude the material terms and pricing of customer contracts
- When operating in the financial sector, an analysis of 'key entrepreneurial risk taking' (or KERT) functions can drive the profit and loss outcomes between affiliated entities. An example would be offshore asset managers making key investment and retention of risk decisions which have profit and loss potential.

Generally, the more important the business activities an entity performs at arm's length the greater its entitlement to income and profits (or risk of bearing losses). In other words, substance has a direct impact on the profit and tax outcomes of entities in a multinational group.

That's why a substance analysis is essential to determine the allocation of income and profits (or losses) between affiliates in a multinational group. Profit attribution will be attached to where, and to the extent that, there is substance.

Business and tax structuring

Business and tax structuring are intricately linked to substance, given that multinationals often adopt centralised operating models. Hubs may be set up on a global, regional, business division, product category or functional basis. Key personnel may be housed in a hub location for strategic and operational efficiencies.

It's also important to select location carefully when setting up a hub. Considerations include location-specific market attributes (such as access to skilled labour and proximity to customers), and tax attributes (including local tax rates and tax treaty networks). Multinationals should make sure that key personnel are working in the hub location; otherwise there may be unintended tax implications.

As businesses evolve, a mismatch may arise between income allocation and substance, where existing transfer pricing policies are no longer reflective of the business facts and circumstances. This can happen, for example, if there are developments in-country such as a new market strategy, creation of local intangibles, or hiring of new key personnel.

It's wise to conduct a transfer pricing analysis, including a substance review, every year. This will ensure that intercompany pricing policies are reflective of the latest economic reality. Transfer pricing documentation should also be prepared to support compliance with the arm's length principle.

Next steps

Multinationals should regularly assess transfer pricing policies. They should check that profit and tax outcomes align with substance, to mitigate the risk of misreporting and tax authority challenges.

For further guidance, please contact Farhan Azeem in the UK. He collaborates with local experts across PKF Global.

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What is 'business establishment' for VAT purposes?

Rarely does a definition matter so much and have so many implications for VAT. We look at the confusions often caused by misinterpretation of the term.

The term 'business establishment' is not defined in VAT law. But it was considered by the Court of Justice of the European Union (CJEU) in the VAT-related case of Planzer Luxembourg Sarl (C-73/06).

The CJEU ruled that 'business establishment' means the place where the essential decisions concerning the general management of a company are made, and where the functions of its central administration are carried out:

"Determination of a company's place of business requires a series of factors to be taken into consideration, foremost amongst which are its registered office, the place of its central administration, the place where its directors meet and the place, usually identical, where the general policy of that company is determined. Other factors, such as the place of residence of the main directors, the place where general meetings are held, the place where administrative and accounting documents are kept, and the place where the company's financial, and particularly banking, transactions mainly take place, may also need to be taken into account."

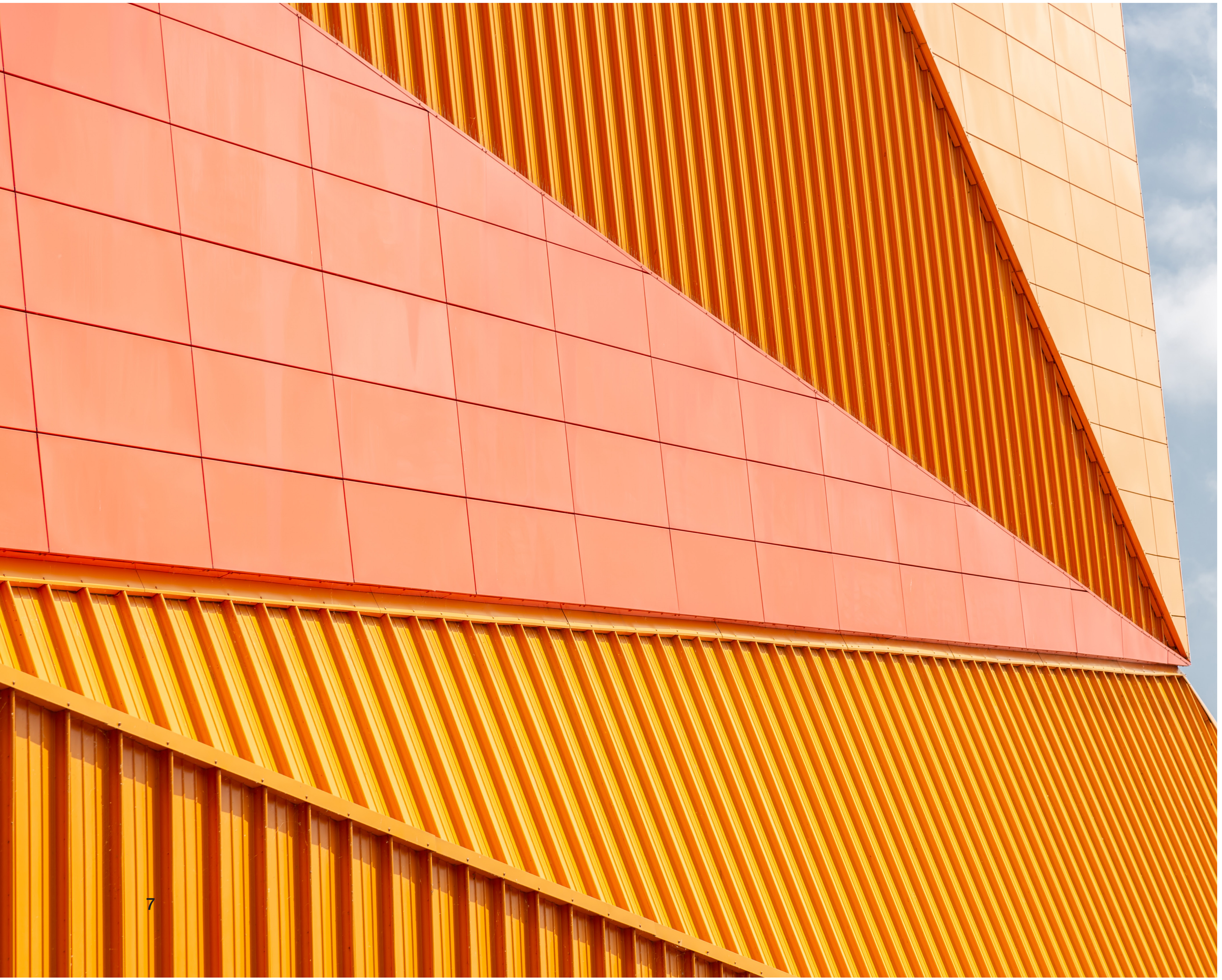
The HMRC definition

This ties in with HMRC's long-held interpretation of 'business establishment' for VAT purposes, as a company's principal place of business:

"The business establishment is the place where you have established your business and the main functions of the business' central administration are carried out. This will usually be the head office, headquarters or 'seat' from which the business is run. This is where essential day-to-day decisions concerning the general management of the business are taken. A registered office alone is not sufficient to create a business establishment."

It goes on to say that "an overseas company that registers or is incorporated at its accountant's address but has no other offices or staff in the accountant's country" is not considered a business establishment.

What is 'business establishment' for VAT purposes?



Business establishment: what it takes

So merely being incorporated in the UK and having a UK-registered office is not sufficient for a UK company, or branch of an overseas company, to have a business establishment in the UK for VAT purposes. What is required is at least one of the following:

- UK-resident employees and / or UK-resident self-employed contractors
- UK-resident directors
- a UK office which employees, directors or contractors use to conduct business for the UK company or branch
- physical in-person board meetings taking place in the UK.

What if a UK company or branch is not eligible to be UK VAT-registered by these criteria? The good news is that as well as not being UK VAT-registered itself, the UK suppliers of general services to that company should not charge UK VAT on their services.

If charges have been incorrectly made, the company should request refunds of the VAT on historic services from those UK suppliers. And VAT should not apply in future, unless a UK presence for VAT purposes (as described above) comes about for the UK company or branch.

But there's bad news too. If a non-UK company has UK-resident directors (as described above), it may be required to register for UK VAT. What's more, its UK suppliers may have to charge it VAT. And it may only be able to reclaim part of that, to the extent that it makes VAT-able supplies.

What knowledge does the supplier need?

From the perspective of a UK supplier of general business services, it needs to know where its customer is located so as to correctly charge (or not charge) UK VAT. It may be that it doesn't charge UK VAT to a non-UK company. But if that non-UK company has a UK business establishment to which the supplier supplies general business services, then the supplier should charge, and account to HMRC for, UK VAT.

What is 'business establishment' for VAT purposes?

Failure to charge, and pay on, that VAT means the UK supplier will owe HMRC VAT and interest (currently 7.75% p.a. on a straight line basis). There may also be a potential penalty of up to 30% of the VAT that should have been paid to HMRC.

If the UK supplier's contract with the non-UK company allows the supplier to pass on the VAT, interest and any penalty to the non-UK company, then the non-UK company has an additional cost. And only the VAT element of this may be partly or wholly recoverable from HMRC once the non-UK company has received a VAT invoice from the UK supplier.

If the supplier has a contract that says only that its fees are "exclusive of VAT" (or similar), with no mention of late VAT payment interest or penalties payable to HMRC, the supplier will have an interest or penalty cost for which it cannot obtain a tax deduction. VAT may have been paid late, for example, if the customer had not told the UK supplier about its business establishment in the UK.

When VAT is charged in error

So what about the opposite scenario? If a UK supplier incorrectly charges UK VAT to a UK company that does not have a business establishment in the UK, what then?

If the UK company is incorrectly UK VAT-registered and incorrectly reclaims some or all of the VAT charged via its UK VAT return, the company will incur an HMRC interest charge. It may also have to pay a penalty of up to 30% of the VAT that was incorrectly charged.

Real-life scenarios

Here are examples of the two situations:

- A UK group of trading companies had a Jersey-incorporated holding company. All the directors of the holding company lived in the UK. Its board meetings took place physically in the UK. The holding company was a member of a UK VAT group, together with the UK group of trading companies. This proved that HMRC considered the holding company to have a UK 'business establishment' for VAT purposes. A UK consultant did not charge VAT on its consultancy fees when it should have done and so incurred HMRC interest and also a 'careless error' penalty, neither of which could be passed on to its client and for which it did not obtain a tax deduction
- An Australian group of trading companies had a UK-incorporated holding company. All the directors of the holding company lived in Australia. All its board meetings took place virtually, with the directors at home in Australia. The holding company was registered for UK VAT – but HMRC then cancelled its registration retrospectively. A UK consultant charged VAT on its consultancy fees when it shouldn't have done. It had to claim back the incorrectly charged VAT from HMRC (it couldn't adjust the error on a current VAT return because its value was too large) and refund the VAT to its client. Meanwhile its client incurred an interest charge for reclaiming from HMRC the VAT that the UK consultant incorrectly charged, together with a 'careless error' penalty.

If you would like more guidance on VAT issues arising from 'business establishment' status errors, please contact Mark Ellis.

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About PKF
Simplifying complexity for our clients

PKF is one of the UK’s largest and most successful accountancy brands.

We provide a full range of audit, accountancy, tax and advisory services, and are experts at simplifying complexity – we’re particularly well-known for working with large, high-profile businesses with challenging issues in fast-moving and highly technical areas.

We are also an active member of PKF Global, an international network of legally independent accounting firms that gives us an on the ground presence in 150 countries around the world.

PKF in the UK

11th largest Tax practice in the UK

£153 million annual fee income

1450+ UK partners and staff

5th ranked auditor of listed companies in the UK

Our tax services At a glance

“By bringing together the extensive expertise and experience of our tax specialists we can provide a fully rounded service that offers excellent value for money."

We offer comprehensive tax compliance and advisory services to a range of clients, both in the UK and globally, helping them find their way in the increasingly complex world of tax.

We find practical solutions that we use to our clients’ advantage. Our team of experts supports individuals, and businesses ranging from start-ups and SMEs to large international groups, both listed and privately owned.

Where understanding of our clients’ sector makes the difference, our experts invest their in-depth industry expertise to provide invaluable support and insights.

We offer the following specialist tax services:

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Our Business Tax team will ensure that you are both tax compliant and efficient.

We provide specialist corporate and business tax advice on both a local and international level, which includes senior accounting officer and large business compliance, transfer pricing, transaction services, due diligence, R&D tax relief, employer solutions and global mobility. We also support both the personal and business affairs of partnerships and LLPs.

Read more

Personal tax and wealth management

Our team will guide you through the complex world of taxes, helping you meet all filing requirements and identifying risks and opportunities to help mitigate tax liabilities.

We advise individuals, the self-employed, partners, trustees and executors with their UK and international tax affairs. Our services include all aspects of tax, including Self Assessment, Capital Gains Tax, Inheritance Tax, property (both residential and commercial), trusts, family wealth and estate planning, residence and domicile issues.

Read more

VAT and Indirect taxes

Our indirect tax team will support you in meeting your VAT compliance objectives and advise you on any VAT issues that your business faces.

We can ensure that your VAT risk is assessed and managed, and that your VAT recovery is optimised. We can also provide advice and compliance services on other indirect taxes, such as Insurance Premium Tax, Customs duty, and Air Passenger Duty.

Read more

Tax disputes

HMRC is increasing the number and scope of tax investigations into both individuals and businesses, covering all aspects of potential underpayments of tax, including offshore investments, personal and corporate Self Assessment Tax Returns, PAYE and NIC compliance and VAT.

If an issue arises, our trusted advisors will match the right specialists with your needs to provide you the necessary support – whether for a routine HMRC enquiry or a more complex investigation.

Read more

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