Tax residency of foreign incorporated companies - more attention required

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In brief

For many years, taxpayers and tax practitioners alike have considered that the principles relevant to establishing the tax residency of a company are well established in case law and through guidance issued by the Australian Taxation Office (ATO). However, an ATO draft taxation ruling issued last year dealing with the tax residency of companies, not incorporated in Australia, reversed historical practice supported by the ATO.

That draft ruling has now been finalised (TR 2018/5) and, in addition, a draft Practical Compliance Guideline (PCG 2018/D3) has been issued to assist taxpayers comply with the new ruling reflecting the new ATO view. Many taxpayers will be required to revisit their governance, systems and processes in relation to the management of foreign incorporated companies as a matter of urgency given the tight 13 December 2018 deadline that has been proposed.

In detail

In November 2016, the High Court of Australia handed down its decision in *Bywater Investments Limited and Ors v Commissioner of Taxation* and the related matter in *Hua Wang Bank Berhad v Commissioner of Taxation*[1] (the *Bywater case*). This case primarily concerned the residency of a foreign incorporated company. This is the first time the High Court has considered this issue in over 40 years.

By way of background, there are three different tests to determine if a company is a resident of Australia for tax purposes. Of these, two are relevant for companies that are not incorporated in Australia. Specifically, if either of the following tests is satisfied, the company will be a resident of Australia:

1. The company carries on a business in Australia and has its central management and control (CM&C) in Australia (the 'CM&C test').

[1] *Bywater Investments Limited & Ors v. Commissioner of Taxation*; *Hua Wang Bank Berhad v. Commissioner of Taxation [2016] HCA 45* (16 November 2016).

2. The company carries on a business in Australia and its voting power is controlled by shareholders who are residents of Australia (the 'voting power test').

Critically, both of these tests have traditionally been viewed as composite tests with the requirement to carry on business in Australia *considered separately* from either the CM&C requirement or the voting power requirement.

The Bywater case concerned the CM&C test of residency. Following the High Court's decision, the ATO released Draft Tax Ruling TR 2017/D2 concerning this test. At the same time, it withdrew TR 2004/15[2] which previously provided its view on this test. A key element of TR 2004/15 was that a foreign incorporated company trading outside Australian would not be a resident of Australia because it is not *carrying on business in Australia*. It was accepted by the ATO that its board of directors could hold the majority of its meetings in Australia where decisions on major contracts, finance, policies and strategic directions are made[3]. This approach, consistent with established law, simplified the management and corporate governance of foreign incorporated companies conducting trading business offshore. This "foreign trader" rule has been very helpful, for more than a decade, to Australian companies endeavouring to expand their operations offshore.

For further background regarding the Bywater case and Draft Ruling TR 2017/D2, please see our previous TaxTalk Alert.

ATO's final ruling on central management and control test

The 14 page final taxation ruling, Taxation Ruling TR 2018/5 *Income tax: central management and control test of residency*, released on 21 June 2018 sets out the Commissioner of Taxation's opinion about the way in which the CM&C test should be applied following the Bywater case. This ruling applies with retrospective effect from 15 March 2017 (being the date when TR 2004/15 was withdrawn and Draft Ruling TR 2017/D2 was first released). It does not deal with the voting power test or when a company carries on business.

After more than 12 months of consultation, the ATO's final taxation ruling includes few changes and no overall departure from the view outlined in its predecessor draft. In particular, the ATO rejected various submissions to the effect that the decision in the Bywater case did not require the withdrawal of TR 2004/15 and that the foreign trader rule continues to be supported by Australian case law. The final taxation ruling:

- Provides more detail on where a company's CM&C is located. For example, a foreign incorporated company will be directed and controlled, as a matter of fact and substance, at the place where those making the high-level decisions do so. It will not be where such decisions are recorded and formalised or where the company's constitution or by-laws or articles of association require the entity to be controlled and directed.

- Clarifies that the question of 'residency' will ultimately turn on the individual facts and circumstances and recognises that no single factor alone will necessarily determine where CM&C of a company is exercised.

  However, it now acknowledges that certain factors are more relevant and should be given greater weight in determining where high-level decisions take place and, in turn, CM&C exist. The final taxation ruling categorises the matters most likely to influence a court's decision (greater relevance) and matters the courts have considered of lesser importance.

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[2] TR 2004/15 *Income tax: residence of companies not incorporated in Australia - carrying on a business in Australia and central management and control* (withdrawn 15 March 2017).

[3] *TR 2004/15, paragraphs 71-73.*

Matters most likely to influence a court's decision	Matters the courts have considered of lesser importance
Where those who exercise the CM&C do so, rather than where they live.	Where those who control and direct the company's operations live.
Where the governing body of the company meets.	Where the company's books are kept.
Where the company declares and pays dividends.	Where its registered office is located.
The nature of the business and whether it dictates where control and management decisions are made in practice.	Where the company's register of shareholders is kept.
Minutes or other documents recording where high-level decisions are made.	Where shareholder meetings are held.
	Where shareholders reside.

- Makes it clearer that, as a starting point, where a company is run by its directors in accordance with its constitution and the company law rules applicable to that company which give its directors the power to manage the company, the company's directors will control and direct its operations. It follows that ordinarily it is a company's directors who exercise its CM&C. However, this is not the end of the enquiry as all facts and circumstances need to be considered and there is no presumption that the directors of a company will always exercise its CM&C.

Based on views expressed in the final taxation ruling, the ATO could reach different conclusions about residence if it was to reconsider the examples in the now withdrawn TR 2004/15. Therefore, taxpayers that have previously relied on this ruling, and in particular the examples, including the foreign trader circumstance outlined above, should revisit these positions as a matter of urgency.

The ATO's compendium that was released with the final taxation ruling explains that the general anti-avoidance provisions (Part IVA) would not apply to changes in how a company is managed merely in order to ensure the company remains non-resident after the withdrawal of TR 2004/15. Whilst not included in the final taxation ruling and therefore not legally binding on the Commissioner, these comments should provide some comfort for taxpayers that decide to make changes to corporate governance procedures for foreign incorporated companies. The transitional compliance arrangements discussed below signal that the ATO anticipates changes will be required.

ATO's proposed practical compliance approach

The ATO also released a 21 page draft PCG (PCG 2018/D3: *central management and control test of residency: identifying where a company's central management and control is located) w*hich is stated to provide practical guidance (with examples) to assist foreign incorporated companies and their advisers to apply the principles set out in the final taxation ruling, focusing particularly on the identification and location of a company's CM&C.

According to the draft PCG, 'Normally, a company's directors exercise its [CM&C] where they execute their duties and comply with the standards expected of directors under the applicable Australian or foreign company law. This will normally be where its directors make their decisions. Most companies

will have little difficulty identifying where it is located and little reason to consider the examples set out in this draft [PCG]'. The ATO also accepts in the draft PCG that 'Board minutes are the starting point for identifying who exercises and where a company's [CM&C] is exercised.'

To this point, the ATO accepts that the directors of a subsidiary company may act in accordance with the interests and wishes of its parent, and still exercise CM&C of that company, provided they exercise their own judgement and actually make the high-level decisions of the company.

However, the draft PCG highlights some exceptions to this general rule involving '… either some lapse in directorial standards or corporate governance, unusual facts such as the director's role being usurped by outsiders, or the company's control and direction being exercised in more than one place'.

In understanding this commentary, it is important to recognise that so-called practical compliance guidelines are not prepared for the primary purpose of expressing a view on the way a tax law provision applies. They represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws.

Highlighted below are some key observations from the draft PCG:

- **Relevance of companies activities** - the more extensive a company's business activities are, the more likely it is that high-level decisions that are an exercise of its CM&C will be distinct from day-to-day management decisions about business operations or transactions. The Commissioner accepts that boards may grant wide and extensive powers of management to employees, yet still retain and exercise CM&C of the company.

- **The keeping of board minutes -** if a company has board minutes showing a complete record of where all its high-level decisions were made and who made them, the Commissioner will accept them as prima facie establishing where the company's CM&C is located. These materials should include evidence supporting matters recorded by the board but does not necessarily need to include board deliberations, why decisions were made and whether alternatives were considered or rejected.

- **Merely influential or the real decision maker -** if a person is merely influential, even if that influence is strong, that influence will not of itself amount to an exercise of CM&C. It must be determined who makes the real decisions as opposed to being decision making influencers. This may require consideration of, for example, whether the subsidiary company directors:
  - independently consider directions given to it by its Australian parent/owner
  - obtain independent advice where necessary
  - decide not to implement proposals that are unlawful, illegal, improper or have adverse consequences for the company or the owner, or
  - consider the merits of a proposal, including the impact on the company's financial position, how it fits in with the broader business and whether it is in the company's best interest.

- **Decision making within a corporate group** - directors of a subsidiary company do not cease to exercise its CM&C merely because, in making decisions, they conclude that it is in the best interest of the company to:
  - facilitate the plans and policies of its parent
  - comply with proper proposals advanced to it by its parent that are also in the interest of the company group, or
  - make decisions only after receiving approval from its parent to do so.

A foreign incorporated subsidiary of an Australian resident company may also have employees of its parent as directors. This is not, of itself, conclusive of where the subsidiary's CM&C is exercised.

- **Decision making in more than one place** - decisions can be made in more than one place in two basic situations:
  - directors physically meet in multiple different locations where they exercise CM&C (e.g. board meetings regularly held in more than one country), or
  - directors do not physically meet in person to make decisions (e.g. decisions are made by phone or video conference, written circular resolution or by email where they are physically in different locations).

The Commissioner of Taxation does not accept that decisions are made in the place it is formalised, or where the last signature is placed on a resolution or a vote on it is cast.

Where board meetings are conducted via electronic facilities (rather than physical attendance), the focus is on where the participants contributing to the high-level decisions are located.

The question of where CM&C is located is determined by reference to how it is exercised over time. An occasional or one-off exercise of high-level decision making in a particular place outside the normal course of how a company's CM&C is exercised, does not cause it to be in that place for the purpose of the CM&C test, unless it is, by itself, 'substantial' in the context of the company, or it forms part of a 'regular pattern' of CM&C being exercised in that place that is substantial in the context of the company.

Transitional compliance approach - all companies

The draft PCG recognises that many foreign incorporated companies will be affected by the withdrawal of TR 2004/15, and provides a transitional period ending on 13 December 2018 to change governance arrangements so that CM&C is exercised outside Australia.

There are a number of strict conditions that must be satisfied before a foreign incorporated company can qualify for the transitional compliance approach, and it will be important for companies to document compliance with these requirements.

Ongoing compliance approach - public companies only

For subsidiaries of public companies only, the draft PCG also provides an ongoing compliance approach.

If certain conditions are satisfied, the risk of residency arising under the CM&C test will be considered low and the Commissioner will not normally apply his resources to review or seek to treat a foreign incorporated company as a resident applying the CM&C test merely because part of the company's CM&C is exercised in Australia because directors regularly participate in board meetings from Australia using modern communications technology.

There are a number of strict conditions that must be satisfied before a foreign incorporated company can qualify for the ongoing compliance approach. For example:

- a substantial majority of the company's CM&C must be exercised in a *particular* foreign jurisdiction - this means that, to sustain non-resident status, a company in the United Kingdom (UK) must be UK tax resident, hold board meetings in the UK and the majority of directors must attend board meetings whilst present in the UK, and

- the company must be an 'ordinary company', and cannot be a foreign hybrid for Australian tax purposes. This may mean that certain entities commonly used in the United States (US) that are transparent for US tax purposes will not qualify for the ongoing compliance approach.

It is important to recognise that these conditions must be satisfied to be considered low risk for the purposes of the draft PCG but are not necessarily representative of the law. For example, there is no Australian law requiring, using the example above, the majority of directors to attend board meetings whilst present in the UK - not being present in Australia for the board meeting should be adequate. Similarly, there is no special requirement in the Australian tax law that operates when testing the residency of a foreign hybrid. However, to qualify for the ATO's low risk compliance approach, it will be necessary to satisfy all of the conditions set out in the draft PCG and taxpayers will need to decide if that effort is necessary in all cases.

The takeaway

Determining tax residency of a company is a critical first step in working out its Australian tax liability as it means the difference between paying Australian tax on worldwide income (for a resident company) and paying tax only on the company's Australian sourced income (for a non-resident company). It is also relevant in applying many other aspects of Australian tax law, such as determining the members of a tax consolidated group, applying Australia's participation exemptions (i.e. for non-portfolio dividends, branch income or the sale of shares in an active company), tax treaties or Australia's controlled foreign company rules.

The change in views from the ATO on the application of the CM&C test will lead to uncertainty for many foreign incorporated companies. For example, we suggest careful attention where there are potential decision making 'influencers' in Australia, taxpayers have relied on the foreign trader rule for companies with active trading businesses, a majority of directors have not participated in decision making from the place of incorporation of a foreign company or decision making involved circular resolutions or other modern technologies.

Foreign incorporated companies will need, at a minimum, to review their governance arrangements to confirm whether CM&C is (and continues to be) exercised outside Australia. We anticipate that this will lead to additional costs and red tape for many Australian companies with offshore operations and aspirations. A very tight window of only six months is offered to taxpayers to consider the ATO's revised view on corporate residency, review existing governance protocols and, if required, make necessary changes. Public companies will need to decide if they should try to meet all of the conditions of the ongoing compliance approach.

It will become increasingly important to carefully manage all foreign incorporated companies, paying particular attention to the location of real decision makers and ensuring appropriate documentation and records are maintained of board meetings and key decisions made.

Although the taxation ruling is now finalised, submissions can be made to the ATO on the draft PCG by 13 July 2018.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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