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# ***Tax residency of a company – has the status quo been changed?***

31 March 2017

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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, a decision of the High Court of Australia handed down late last year dealing with the tax residency of companies that were not incorporated in Australia, and a subsequent ATO draft ruling purporting to following this judgment, threaten to upset the status quo, and may require taxpayers to revisit the issue of residence once more.

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## ***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*<sup>1</sup> (the *Bywater case*). This case primarily concerned the residency, for Australian tax purposes, of a company that was not incorporated in Australia. 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 in Australia (the 'central management and control test').
  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').
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<sup>1</sup> *Bywater Investments Limited & Ors v. Commissioner of Taxation; Hua Wang Bank Berhad v. Commissioner of Taxation* [2016] HCA 45 (16 November 2016)

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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 central management and control test or the voting power test.

The Bywater case concerned the central management and control 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 which previously provided its view on this test.

### ***The Bywater case***

As noted above, the dispute between the Commissioner of Taxation and the relevant taxpayers centred on the issue of whether each taxpayer, being a company that was not incorporated in Australia, had its place of central management and control in Australia.

The Commissioner's position was that the central management and control of each company was located in Australia, since the business decisions of each company, such as decisions to buy and sell off shares listed on the Australian Stock Exchange and the lending of monies, were made in Australia by an individual residing in Australia.

The taxpayer's position was that the central management and control of each company was where the directors of each company held their meetings and, in accordance with authority provided to them under the 'constitutional organs' of each of the companies, approved the transactions brought to the board by the Australian resident individual for consideration. Since this location was outside Australia, the taxpayers argued that they were not resident of Australia under the central management and control test.

At first instance in the Federal Court, it was found that, in respect of three companies (Bywater Investments, Chemical Trustee and Derrin Brothers Properties), it was the individual in Australia who made the decisions about the business activities of the relevant company and the only activity that occurred in the overseas jurisdiction was the generation of documentation which was intended to support the proposition that the companies were in fact managed and controlled from outside of Australia. Similar findings were made in respect of Hua Wang Bank Berhad. The Full Federal Court subsequently dismissed the appeals brought by the taxpayers against the decision of the single judge in the Federal Court in relation to application of the central management and control test.

The appeal to the High Court concerned the question of whether, in view of the finding of fact by the Federal Court that the substantial decision making for each company was by an individual in Australia, central management and control should be taken to be at the place where the boards of each company held meetings of directors.

In dismissing each of the appeals, the High Court cited the decision of Justice Gibbs in *Esquire Nominees Ltd v Federal Commissioner of Taxation*[1973] HCA 67 and agreed with his Honour's statement that –

*"there is a long line of authority that makes clear that, for the purposes of s6 of the 1936 Act, a company has its central management and control where the central management and control of the company actually abides, that being a question of fact and degree to be determined according to the facts and circumstances of each case".*

The High Court added that the central management and control will usually be where the meetings of the board of directors are conducted. This is because ordinarily *"the board of directors of a company makes the higher-level decisions which set the policy and determine the direction of operations and transactions of the company"*. However the Court went on to say that *"it does not follow that the result should be the same where a board of directors abrogates its decision-making power in favour of an outsider and operates as a puppet or cypher, effectively doing no more than noting and implementing decisions made by the outsider as if they were in truth decisions of the board"*.

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Since in the cases under consideration, it had been found that it was the individual in Australia who made the substantive business decisions for each company, the place of central management and control was where that individual resided and made those decisions. Since this was in Australia, each company was a resident for Australian tax purposes.

It is important to note that the facts of both cases involved elements of contrivance with the Court summarising Perram J's findings at first instance that the individual's actions "*suggested the presence of dishonesty*" and that the evidence was that "*was overwhelming*" that the individual controlled every aspect of the relevant entities' business. Arguably the contrived nature of these facts may limit the precedential value of the decision more broadly.

### ***Draft Tax Ruling TR 2017/D2***

Draft Tax Ruling TR 2017/D2 *Income tax: Foreign Incorporated Companies: Central Management and Control test of residency* (the Draft Ruling), was released on 15 March 2017 setting out the Commissioner's "preliminary but considered view" on how to apply the central management and control test following the Bywater case. The Draft Ruling is proposed to apply from its date of issue of 15 March 2017.

On the same day, the Commissioner withdrew his previous ruling on the central management and control test set out in TR 2004/15 *Income tax: residence of companies not incorporated in Australia - carrying on a business in Australia and central management and control*.

The Draft Ruling generally quite closely follows the decision in the Bywater case and references the High Court judgment extensively. Some key points of interest include:

- The Draft Ruling states that it is not necessary for any part of the actual trading or investment operations from which a company's profits are made to take place in Australia, as the central management and control of a business is factually part of carrying on that business. That is, if a company carries on a business and has its central management and control in Australia, it will be resident of Australia. The Draft Ruling states that this is in accordance with the High Court's judgment in Bywater.

This is a notable change from the ATO's previous position reflected in TR 2014/15.

The Bywater decision makes reference to *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156 ('Malayan Shipping') which was referenced extensively in TR 2004/15. However, in TR 2004/15, the facts of *Malayan Shipping* were cited (at paragraph 20) as being an example of a special circumstance where central management and control could also constitute carrying on a business. The Draft Ruling appears to extend this to be a broad statement of general principle.

- The nature of a company's activities and business define which acts and decisions are an exercise of its central management and control (see table 1 for some examples). Central management and control is the control and direction of a company's operations, a key element of which is the making of high level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter. The conduct of the company's day to day activities and operations is not an act of central management and control, nor is managing those activities under the authority and supervision of higher level managers or controllers.
- Identifying who exercises central management and control is a question of fact in each case, and mere legal power or authority to manage a company is not sufficient to establish exercise of central management and control. Normally a company's directors will control and direct its

operation, however there is no presumption that the directors exercise central management and control. An “outsider” who does more than influencing those with legal power to control the company, who actually dictates or controls the decisions made by directors will exercise central management and control of the company.

- Documents evidencing decision making (i.e. who has made the decision and where the decision is made) remain relevant provided that they evidence what actually did in fact take place.

*Table 1: Examples of activities in context of central management and control*

<b>Acts of central management and control:</b>	<b>Matters of company administration which are not acts of central management and control:</b>
Setting investment and operational policy including: <ul style="list-style-type: none"> <li>• setting the policy on disposal of trading stock, and/or the use and development of capital assets</li> <li>• deciding to buy and sell significant assets of the company</li> </ul>	Keeping a company’s share register, including registering transfers of shares
Appointing company officers and agents and granting them power to carry on the company’s business (and the revocation of such appointments and powers)	Keeping a company’s accounts
Overseeing and controlling those appointed to carry out the day to day business of the company	Where a company pays dividends
Matters of finance including determining how profits are used and the declaration of dividends	The minimum acts necessary to maintain a company’s registration

The Draft Ruling is unique in both its format and content. Unlike its predecessor TR 2004/15 and other recent rulings published by the ATO, it does not contain any examples illustrating the application of views contained within, nor does it contain a non-binding “explanation” of the views expressed in the ruling (this is one of only a few rulings that does not contain an explanation).

Based on the views expressed in the current Draft Ruling, it appears that the ATO would reach different conclusions about residence if it was to reconsider the examples in now withdrawn TR 2004/15. Taxpayers that have previously relied on this ruling, and in particular these examples, should revisit these positions as a matter of urgency.

It is disappointing that the ATO has not sought to provide a similar level of guidance and explanation in the new Draft Ruling as was previously available, and this is likely to result in increased uncertainty for taxpayers. The ATO has, however, indicated that it is consulting on both the format and substantive issues in the Draft Ruling, and may consider providing additional guidance and examples through Practical Compliance Guidelines.

### ***The takeaway***

Determining the 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) versus only Australian sourced income (for a non-resident company). It is also relevant in applying many other aspects of Australian income tax law, such as determining the members of a tax consolidated group or in applying Australia’s controlled foreign company rules.

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The change in views from the ATO on the application of the relevant test is most likely to lead to uncertainty for companies that are not incorporated in Australia where there are potential decision making 'influencers' in Australia. Should the ATO views in the Draft Ruling ultimately hold, it may be difficult to draw the line in many cases - for example, does an Australian parent of a foreign subsidiary merely influence the decision making of the board of directors of the foreign subsidiary, or do they actually dictate and control the decision making?

Affected taxpayers should revisit existing positions - "watch this space" for future developments and consider whether to make a submission on the draft ruling. Submissions are due by 12 May 2017.

### ***Let's talk***

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

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