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Australia's proposal to reform company tax residence: legal fictions approaching truth?

Introduction

The Australian Government recently announced its intention to reform the statutory definition of "residence" for companies incorporated offshore, which has been in the Australian income tax statute for nearly a century.[1] The government has not yet released any Bill or draft legislation. This note explains the history of the statutory definition and the case law, administrative rulings and review that led to the proposal for reform. The note then explores some issues with the proposed reform, whether it will achieve the stated goal, and what it fails to address.

[1] Australian Government, *Budget 2020–21: Budget Paper No.2* (Commonwealth of Australia, 2020), *www.budget.gov.au* [Accessed 22 February 2021].

The concept of "residence" of a corporation has been described as "one of the cornerstones of corporate income taxation in domestic and international law".[2] Identifying corporate residence for this purpose involves layering the fiction of corporate location in geography onto the fiction of corporate personality in law.[3] As explained by Lord Loreburn in *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* (*De Beers*),[4] because a corporation "in a natural sense does not reside anywhere, some artificial test must be applied".[5] Lord Loreburn then stated the leading test of "central management and control" as follows:

> "The decision of Kelly C.B. and Huddleston B. in the Calcutta Jute Mills v. Nicholson (1) and the Cesena Sulphur Co. v. Nicholson (1)…involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides."[6]

The statutory definition of a "resident or resident of Australia" applicable to a corporation in the Income Tax Assessment Act 1936 (Cth) (the 1936 Act) is as follows:

> "a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia."[7]

Under this definition, a company incorporated outside Australia may be a "resident of Australia" if the company either:

1) carries on business in Australia and has its central management and control in Australia; or
2) carries on business in Australia and has its voting power controlled by shareholders who are residents of Australia.

The judicial formulation in *De Beers* was the foundation of the first limb of this definition of corporate residence of foreign companies. The Australian Parliament "adopted" the language of "central management and control" from judicial authorities.[8] The government proposes to amend this limb of the definition

> "to provide that a company that is incorporated offshore will be treated as an Australian tax resident if it has a *'significant economic connection to Australia'*. This test will be

[2] Edoardo Traversa (ed.), *Corporate Residence and Mobility*, EATLP International Tax Series No.16 (Netherlands: IBFD, 2017), p.1.
[3] John Prebble, "Ectopia, tax law and international taxation" [1997] B.T.R. 383, 389–390.
[4] *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* [1906] A.C. 455 HL is the origin of the "central management and control" test applied across common law jurisdictions; see John Avery Jones and Johann Hattingh, "De Beers Consolidated Mines Ltd v Howe (1906): Corporate Residence: An Early Attempt at European Harmonisation" in Dominic de Cogan and John Snape (eds), *Landmark Cases in Revenue Law* (Oxford: Hart Publishing, 2019), pp.67–90, Bloomsbury Collections, *http://dx.doi.org/10.5040/9781509912285.ch-003* [Accessed 22 February 2021].
[5] *De Beers* [1906] A.C. 455 HL at 458.
[6] *De Beers* [1906] A.C. 455 HL at 458.
[7] Income Tax Assessment Act 1936 (Cth) s.6(1) "*resident* or *resident of Australia* means:…(b)…".
[8] As observed by Gordon J in *Bywater Investments Ltd; Hua Wang Bank Berhad v Commissioner of Taxation* (*Bywater*) [2016] HCA 45 at [112].

> satisfied where *both the company's core commercial activities are undertaken in Australia and its central management and control is in Australia."*[9]

This change is intended to ensure that the treatment of foreign incorporated companies will reflect the corporate residency position prior to the 2016 High Court decision in *Bywater Investments Ltd; Hua Wang Bank Berhad v Commissioner of Taxation* (*Bywater*).[10]

The amendment will take effect on Royal Assent, but taxpayers will have the option of applying the new law from 15 March 2017. On that date, the Australian Taxation Office (ATO) withdrew its prior administrative guidance in Tax Ruling TR 2004/15[11] following the High Court decision in *Bywater*. The ATO then released a new ruling, TR 2018/5,[12] in which the long-standing administrative approach to "central management and control" was altered. The change of approach led to a review by the Board of Taxation,[13] and its recommendation will be implemented in this reform.

History of the statutory definition

The definition of corporate residence in section 6(1) of the 1936 Act was introduced in the Income Tax Assessment Act 1930 (Cth) (the 1930 Act).[14] Previously, there had not been any statutory definition of residence, for the main reason that the Australian income tax was territorial and applied only to income derived from sources in Australia, so a taxpayer's "residence" was not relevant to determining liability. However, the Income Tax Assessment Act 1915 (Cth) (the 1915 Act)[15] did extend tax jurisdiction to foreign companies selling goods into Australia through an agent in Australia. The agent was deemed to have taxable income of 5 per cent of the total price at which the goods were sold, and was required to pay income tax on that taxable income.[16] The 1915 Act also included a definition of an "Absentee" being a person "who does not reside in Australia".[17] This was designed to ensure that non-resident individuals would not benefit from personal deductions applicable for income from personal exertion or property. For administrative purposes, the 1915 Act required every company which "carries on business in Australia" to be represented by a person residing in Australia who was appointed as its public officer.[18]

The 1930 Act converted Australia's income tax from a territorial to a worldwide base, extending the definition of "assessable income" for "residents of Australia" to encompass "gross income derived from all sources, whether in Australia or elsewhere".[19] A definition of "residence" was

[9] Australian Government, *Budget 2020–21: Budget Paper No.2* (2020), p.13, emphasis added.
[10] *Bywater* [2016] HCA 45.
[11] ATO, TR 2004/15, *Income tax: residence of companies not incorporated in Australia — carrying on business in Australia and central management and control* (withdrawn 15 March 2017).
[12] ATO, TR 2018/5, *Income tax: central management and control test of residency* (released 21 June 2018).
[13] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (July 2020), *https://taxboard.gov.au/consultation/corporate-tax-residency-review* [Accessed 23 February 2021].
[14] Income Tax Assessment Act 1930 (Cth) s.2(i), re-enacted as para.(b) of the definition of "resident or resident of Australia" in the 1936 Act s.6(1).
[15] Income Tax Assessment Act 1915 (Cth).
[16] The 1915 Act s.15.
[17] The 1915 Act s.3, "Absentee".
[18] The 1915 Act s.51.
[19] The 1930 Act ss.13, 23.

duly introduced for both individuals and companies. The worldwide tax base was not overly ambitious, as it only applied to foreign source income that was not "chargeable with income tax" outside Australia.[20] Companies doing business in Australia and which had their "central management and control" or voting power controlled in Australia, were

> "taxable in Australia on the whole of their profits to the extent that those profits are not charged with income tax, or are derived from the sale of produce which is not taxed, outside Australia and the shareholders who are resident in Australia and who receive dividends out of those profits will be taxable on the dividends if, as dividends, they are not chargeable with income tax outside Australia to those shareholders."[21]

This exemption was the only means Australia had at its disposal to alleviate double taxation, as it did not have a foreign tax credit at the time and it entered into its first bilateral tax treaty (with the UK) in 1946.[22]

In *De Beers*, Lord Loreburn explained that the test of "central management and control" was required, in addition to identifying the place of incorporation or business, otherwise, a foreign corporation

> "might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad."[23]

The decision in *De Beers* had the effect that the UK Government could assert worldwide tax jurisdiction based on "residence" in relation to *outbound investment* by a company managed from the UK, into the (then) colony of South Africa. The Explanatory Notes for the 1930 amendment[24] reveal the opposite concern: the extent of tax jurisdiction in relation to *inbound investment* by a company incorporated offshore but that is both managed and trading in the (now independent) nation of Australia. The extension of "residence" to foreign-incorporated companies was "necessary because of the number of companies incorporated outside Australia whose sole or principal business is located in Australia."[25]

In contrast, the voting power test seems to be intended to prevent avoidance of the worldwide tax base by *domestic investors* who are resident in Australia and doing business in Australia, by the simple expedient of incorporating a company offshore, and holding the board meetings offshore. As it turned out, the voting control test was rather easily avoided, for example by interposing a foreign trust between Australian shareholders and a foreign corporation, and so it was ultimately not very successful in preventing such arrangements. Today, the controlled foreign corporation rules will apply to a foreign corporation with its voting power controlled by Australian

[20] Explanatory Notes to Income Tax Assessment Bill 1930 (Cth) cl.5, para.(q), p.15.
[21] Explanatory Notes to Income Tax Assessment Bill 1930 (Cth) cl.2(i), p.11.
[22] See C. John Taylor, "The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946" [2009] B.T.R. 201; Agreement between the Government of Australia and the Government of the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, with respect to Taxes on Income (London: 29 October 1946), Australian Treaty Series 1947 No.18, *http://www.austlii.edu.au/au/other/dfat/treaties/1947/18.html* [Accessed 8 March 2021].
[23] *De Beers* [1906] A.C. 455 HL at 458.
[24] Explanatory Notes to Income Tax Assessment Bill 1930 (Cth).
[25] Explanatory Notes to Income Tax Assessment Bill 1930 (Cth) cl.2(i), p.11.

resident shareholders.[26] In the Board of Taxation review, some stakeholders argued that the "voting power" test has little justification and should be repealed; however, the Board expressed caution about its removal without a thorough exploration of possible unintended consequences.[27] The Australian Government has not taken this step.

The Australian case law

A relatively small number of cases on corporate tax residence have reached the High Court in Australia.[28] One challenge with interpreting these cases is that many of them did not concern the statutory definition of corporate "resident" in section 6(1) of the 1936 Act. In the leading case of *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (*Koitaki*),[29] the High Court had to determine whether the company was a "resident" of Papua New Guinea (PNG) for purposes of a statutory exemption from Australian tax.[30] There was no dispute that the taxpayer company was a resident of Australia: it was incorporated in New South Wales. The Full Court affirmed the decision of Dixon J that the taxpayer company was not a resident of PNG because its central management and control was in Sydney, where all the strategic decisions were made, although the day to day management of the rubber plantations in PNG was carried out by a manager located there. Williams J, with whom the other judges agreed, citing *De Beers*, observed that

> "the crucial test is to ascertain where the real business of the company is carried on, not in the sense of where it trades but in the sense of from where its operations are controlled and directed. It is the place of the personal control over and not of the physical operations of the business which counts."[31]

Williams J observed in dicta that the definition in section 6(1) of the 1936 Act

> "follows substantially the principles for determining residence established by the English authorities. It is to be specially noted that the carrying on of business in Australia by a company incorporated abroad is not *by itself* sufficient to make such a company a resident of Australia."[32]

[26] The 1936 Act Pt X.
[27] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (July 2020), p.7.
[28] *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (*Koitaki 1941*) (1941) 64 CLR 241 (Full High Court) affirming the judgment of Dixon J in *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (*Koitaki 1940*) (1940) 64 CLR 15; *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (*Malayan Shipping*) (1946) 71 CLR 156 (Williams J); *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation* (*North Australian Pastoral Co Ltd*) (1946) 71 CLR 623 (Dixon J); *Waterloo Pastoral Co Ltd v Federal Commissioner of Taxation* (*Waterloo Pastoral Co Ltd*) (1946) 72 CLR 262 (Williams J); and *Esquire Nominees Ltd v Federal Commissioner of Taxation* (*Esquire Nominees 1972*) (1972) 72 ATC 4076 (Gibbs J); referred to approvingly (in dicta) in *Esquire Nominees Ltd v Federal Commissioner of Taxation* (*Esquire Nominees 1973*) (1973) 129 CLR 177 (Full High Court).
[29] *Koitaki 1941* (1941) 64 CLR 241.
[30] A similar issue, concerning an exemption for certain pastoral income if a company was "resident" in the Northern Territory of Australia, arose in *North Australian Pastoral Co Ltd* (1946) 71 CLR 623 (Dixon J) and in *Waterloo Pastoral Co Ltd* (1946) 72 CLR 262 (Williams J).
[31] *Koitaki 1941* (1941) 64 CLR 241 at 248–249.
[32] *Koitaki 1941* (1941) 64 CLR 241 at 251.

On this test, in the words of Dixon J, dual residence of a company is only to be found if

> "the control of the general affairs of the company is not centred in one country but is divided or distributed among two or more countries".[33]

The only High Court decision prior to *Bywater* that squarely raised the definition in section 6(1) of the 1936 Act was *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (*Malayan Shipping*).[34] The taxpayer company was incorporated in Singapore. Mr Sleigh, who was resident in Melbourne, held most of the shares, was managing director and had power to appoint or dismiss any other directors. All the activities of the company required his approval. The evidence demonstrated conclusively that Mr Sleigh controlled the business, and the taxpayer's counsel conceded that "central management and control" was in Australia. *Malayan Shipping*, therefore, only concerned the question of whether or not the company "carried on business in Australia". The difficulty in determining this arose from the fact that the company only did a small number of activities, mostly outside Australia, namely, chartering a Norwegian ship, and then sub-chartering it to Mr Sleigh himself, for 10 voyages.

The taxpayer in *Malayan Shipping* argued that, as a matter of statutory construction, "carries on business in Australia" was a separate requirement to "central management and control in Australia" and the former could not refer to the "control" of the company, but only to the underlying "operations" themselves. Williams J rejected this argument, citing Lord Parker in *Mitchell (Surveyor of Taxes) v Egyptian Hotels Ltd*:

> "Where the brain which controls the operations from which the profits and gains arise is in this country the trade or business is, at any rate partly, carried on in this country".[35]

His Honour explained the structure of the definition as follows:

> "The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situate or resident in Australia is, in my opinion, to make it clear that *the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient* to cause the company to become a resident of Australia. *But if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia.* If, on the other hand, a company incorporated elsewhere is merely trading in Australia and its central management and control is abroad, it does not become a resident of Australia unless its voting power is controlled by shareholders who are residents of Australia."[36]

[33] *Koitaki 1940* (1940) 64 CLR 15 at 19.
[34] *Malayan Shipping* (1946) 71 CLR 156.
[35] *Mitchell (Surveyor of Taxes) v Egyptian Hotels Ltd* (1915) A.C. 1022 HL at 1037.
[36] *Malayan Shipping* (1946) 71 CLR 156 at 159–160 per Williams J (citing *Koitaki 1941* (1941) 64 CLR 241), emphasis added.

Williams J concluded in *Malayan Shipping* that the company carried on business in Australia because all the operations of the company "from which the profits in substance arise"[37] took place in Australia:

> "The essence of the business was his decision in Melbourne to charter and sub-charter the tanker. It was this decision which in every substantial sense gave rise to the profits which the company made out of the sub-charters."[38]

A different issue was addressed in *Esquire Nominees Ltd v Federal Commissioner of Taxation* (*Esquire Nominees 1972*),[39] which involved, in the words of the High Court in *Bywater*, a "contrived tax avoidance scheme".[40] The taxpayer was a trustee company incorporated in Norfolk Island, acting in the capacity of trustee of a trust for the benefit of Australian residents. A finding that the taxpayer was a resident of Norfolk Island would (and, in the result, did) support an exemption from Australian taxation of distributions to beneficiaries in Australia out of income sourced in Norfolk Island (there was also no tax levied by the government of Norfolk Island). Gibbs J concluded that the central management and control of the taxpayer was exercised by the directors, who were resident in Norfolk Island, at board meetings in Norfolk Island, and not (as argued by the Commissioner) by a firm of accountants resident in Australia. The firm "had power to exert influence, and perhaps strong influence"[41] on the directors but the directors were found to have made decisions that applied the wishes of the firm

> "because they accepted that it was in the interest of the beneficiaries, having regard to the tax position, that they should give effect to the scheme."[42]

Tax Ruling TR 2004/15

These cases led to some confusion about the dual requirements of carrying on business, and central management and control in the statutory definition. In 2002, the *Review of International Taxation Arrangements* consultation paper[43] observed that the ATO

> "applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. However, the case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this."[44]

[37] *Malayan Shipping* (1946) 71 CLR 156 at 160 citing Atkin LJ in *F.L. Smidth & Co v Greenwood (Surveyor of Taxes)* (1921) 3 K.B. 583 CA at 593.
[38] *Malayan Shipping* (1946) 71 CLR 156 at 160.
[39] *Esquire Nominees 1972* (1972) 72 ATC 4076, referred to with approval in *Esquire Nominees 1973* (1973) 129 CLR 177.
[40] *Bywater* [2016] HCA 45 at [66].
[41] *Esquire Nominees 1972* (1972) 72 ATC 4076 at 4086 (Gibbs J).
[42] *Esquire Nominees 1972* (1972) 72 ATC 4076 at 4086 (Gibbs J).
[43] Australian Treasury, *Review of International Taxation Arrangements: A consultation paper prepared by the Commonwealth Department of the Treasury* (2002), *https://taxboard.gov.au/consultation/international-taxation-arrangements* [Accessed 22 February 2021].
[44] Australian Treasury, *Review of International Taxation Arrangements: A consultation paper prepared by the Commonwealth Department of the Treasury* (2002), pp.54–55 (Option 3.12 for consultation).

The *Review of International Taxation Arrangements* ultimately recommended removing the central management and control and voting power tests altogether and relying solely on a place of incorporation test.[45] However, this recommendation was not accepted by the government.

To address the continuing uncertainty, the ATO issued Tax Ruling TR 2004/15. The ruling stated that "the idea that a company both keeps house and does business",[46] as stated by Lord Loreburn in *De Beers*,[47] "is replicated in the two requirements of the second statutory test that the company carries on business in Australia and has its CM&C in Australia."[48] TR 2004/15 took a broad approach to "carries on business" but distinguished between two different kinds of company:

> "[T]he Commissioner's approach to this factual determination is to draw a distinction between a company with operational activities (for example trading, service provision, manufacturing or mining activities) and a company which is more passive in its dealings. It is appreciated that there will be some overlap in any particular situation."[49]

A company with significant operational activities would be carrying on business in any location where those operational activities took place. In TR 2004/15 the ATO accepted that this may not be the same location as central management and control, which

> "involves the high level decision making processes, including activities involving high level company matters such as general policies and strategic directions, major agreements and significant financial matters."[50]

Further, the location of central management and control would not necessarily indicate the location of carrying on business; however, in some circumstances, as demonstrated by *Malayan Shipping*, a company may carry on business at the same location as its "central management and control".

The approach taken in TR 2004/15 was illustrated by examples that were binding on the Commissioner.[51] One important example concerned an Australian parent company that has foreign subsidiary companies and therefore primarily concerned *outbound investment* by an Australian group controlled by a parent company resident in Australia. Consistent with *Esquire Nominees 1972*, the mere existence of a legal right in an Australian parent company to make voting decisions, or to remove a board of directors of a subsidiary company, would not amount to central management and control. However, if the parent board actually participated in high level decision making of the subsidiary "regarding the subsidiary's major contracts, finance and general policy and strategic direction", this would indicate central management and control in Australia.[52]

[45] Board of Taxation, *International Taxation: A Report to the Treasurer* (2003), Vol.1, p.109, para.3.135, Recommendation 3.12.
[46] TR 2004/15 (withdrawn 15 March 2017), para.47.
[47] *De Beers* [1906] A.C. 455 HL at 458.
[48] TR 2004/15 (withdrawn 15 March 2017), para.47.
[49] TR 2004/15 (withdrawn 15 March 2017), para.9.
[50] TR 2004/15 (withdrawn 15 March 2017), para.13 and see para.48.
[51] See especially TR 2004/15 (withdrawn 15 March 2017), Examples 7 and 8.
[52] TR 2004/15 (withdrawn 15 March 2017), paras 53–55.

Bywater: legal fictions and legal fakes

The *Bywater*[53] case decided by the High Court in 2016 presents an extreme example of an Australian resident individual seeking to avoid Australian tax jurisdiction by operating through a web of offshore legal entities, structures and processes. At first instance, it was found by Perram J that the taxpayer and associated companies carried on business in Australia by trading shares on the Australian Stock Exchange.[54] The case concerned assessed tax exceeding AUD$14 million during the years 2000 to 2007, related to profits on these share trades. Consequently, the case mainly concerned the question of whether the central management and control of the taxpayer companies was located in Australia. The conclusion of Perram J that it was, and hence that the companies were resident in Australia, was unanimously upheld by the Full Court of the Federal Court[55] and by the High Court.[56]

Perram J accepted that the directors of Bywater Investments Ltd, and associated companies, resided offshore and that the companies held board meetings (if any), retained books of account and minutes, and conducted any other formalities, offshore. In the words of Perram J, the taxpayer relied on *Esquire Nominees 1972* to argue "that its place of central management and control was in various overseas locations (Apia in Samoa, London or Neuchâtel in Switzerland) because, summarising it somewhat loosely, this is where their directors met or where the actual decisions about the share transactions in question were made"; moreover, "the issue is to be decided by reference to where the decisions of the taxpayers, as a matter of formality, were made", even if "it was Mr Gould who was pulling all of the strings in Sydney".[57] Perram J concluded that the "real business" of all the companies was conducted by Mr Gould, an accountant resident in Sydney, and further that the role of a Mr Borgas, who resided in Switzerland and was variously associated with each company, was "fake".[58] Indeed, Perram J "would have inclined to the view that Mr Borgas' actions were so false that it is likely they lacked any legal quality, i.e., they were a sham",[59] although sham was not alleged by the Commissioner in this case.

Concerning the legal test for "central management and control" and referring to various authorities, Perram J observed:

> "Throughout those decisions the principles to be applied have never once wavered. There are two:
>
> (a) a company is resident where its real business is carried on, and its real business is carried on where the central management and control abides; and
>
> (b) the question of where a company is resident is one of fact and degree."[60]

[53] *Bywater* [2016] HCA 45.
[54] *Hua Wang Bank Berhad v Commissioner of Taxation* (*Hua Wang*) [2014] FCA 1392 at [9].
[55] *Bywater Investments Ltd v Commissioner of Taxation* (*Bywater 2015*) (2015) 236 FCR 520.
[56] *Bywater* [2016] HCA 45. For some of the companies concerned in the matter, the court also had to consider the "place of effective management" of the company in applying the residence tie-breaker rule in the Australia–UK and Australia–Swiss double tax treaties; these issues are not addressed in this short note.
[57] *Hua Wang* [2014] FCA 1392 at [3](a).
[58] *Hua Wang* [2014] FCA 1392 at [405].
[59] *Hua Wang* [2014] FCA 1392 at [406].
[60] *Hua Wang* [2014] FCA 1392 at [393].

The Full Court of the Federal Court affirmed that Perram J had correctly applied the relevant authorities and "correctly identified…the question to be 'where was the real business of each of the taxpayers?'"[61] In the High Court, taxpayer's counsel argued that in determining central management and control, the focus of the inquiry should be on the location of formal decision-making of the board of directors and constitutional organs of the company. Therefore, the lower courts erred in seeking the location of the actual decision-making of the companies. The High Court reviewed the case law, including two UK authorities.[62] The plurality, comprising Chief Justice French and Kiefel, Bell and Nettle JJ, concluded that

> "none of those decisions supports the idea that a company is taken to be resident where its board meetings are held even if the meetings are mere window dressing comprised of rubber-stamping decisions actually made elsewhere by others and held in that place in the hope of avoiding tax liability in the place where the decisions are actually made."[63]

Their Honours distinguished *Esquire Nominees 1972*, concluding that Gibbs J found as a fact that the board of directors did make the decisions of the trustee company:

> *"Esquire Nominees* was a case where central management and control of the company was exercised through the company's constitutional organs in accordance with external advice and influence, but still in fulfilment of the constitutional organs' functions; as opposed to one in which the functions of the company's constitutional organs were usurped by an outsider who made decisions independently of or without regard to those constitutional organs."[64]

Somewhat surprisingly, the High Court in *Bywater* turned around the perception of *Esquire Nominees* as itself being overly formal. The High Court noted that its own

> "rejection of the appellants' formalistic approach [in *Bywater*], in favour of the test of fact and degree adopted in *Bullock* and *Esquire Nominees*, is fortified by the approaches adopted in other common law jurisdictions".[65]

Tax Ruling TR 2018/5

The ATO first responded to *Bywater* with a Decision Impact Statement stating that the High Court had "clarified" three matters relating to central management and control.[66] The ATO considered that as a result of *Bywater*:

> "The approach the Commissioner took in TR 2004/15 in relation to the earlier High Court decision in *Malayan Shipping…can no longer be sustained*. At [57] the majority of the

[61] *Bywater 2015* (2015) 236 FCR 520 at [11].
[62] *Wood v Holden (Inspector of Taxes)* [2006] EWCA Civ 26; [2006] S.T.C. 443; *Smallwood v Revenue and Customs Commissioners* [2010] EWCA Civ 778; [2010] S.T.C. 2045. The High Court found that these did not assist the taxpayer; or, if they did hold that formal arrangements were determinative, they should not be followed in Australia.
[63] *Bywater* [2016] HCA 45 at [66].
[64] *Bywater* [2016] HCA 45 at [83].
[65] *Bywater* [2016] HCA 45 at [84], citing cases including *Fundy Settlement v Canada* [2012] 1 SCR 520 at 526 [15]; *Hertz Corp v Friend* 559 US 77 at 92–93 (2010).
[66] ATO, *Decision impact statement: Bywater Investments Ltd & Ors v Commissioner of Taxation* (2016).

> court clearly agreed with Williams J's rejection of the contention that where a company has its central management and control in Australia it must, to be a resident of Australia, in addition also carry on its business operations in Australia. *Therefore if a company carrying on business has its central management and control in Australia it will necessarily carry on business in Australia.* That is so even when the only business carried on in Australia consists of that central management and control, and trading operations are conducted outside this country."[67]

This writer questions whether the High Court "clarified" any such view of *Malayan Shipping* in *Bywater*; a careful reading suggests that the High Court simply affirmed the approach taken by Williams J to the particular facts of that case, as briefly outlined above. However, the language of Perram J, and of the Full Court of the Federal Court, quoted above, together with the earlier authorities that ultimately cite *De Beers*, all emphasise that the "real business" of a company is where its central management and control is carried out.

In any event, TR 2018/5 carried through the change in administrative approach, stating:

> "It is not necessary for any part of the actual trading or investment operations of the business of the company to take place in Australia. *This is because the central management and control of a business is factually part of carrying on that business…A company carrying on business does so both where its trading and investment activities take place, and where the central management and control of those activities occurs….*"[68]

The non-binding Practical Compliance Guideline PCG 2018/9 accompanying TR 2018/5 presents the example of an Australian parent with a foreign subsidiary.[69] It concludes that if it were established that the central management and control of Sub Co was exercised by Aust Co's board in Australia (for example, if Sub Co's board merely "rubberstamped" decisions made by Aust Co's board), then "Sub Co is therefore a resident of Australia under the central management and control test of company residency",[70] regardless of where Sub Co carries out its business and trading operations.

The approach adopted by the ATO in TR 2018/5 implies an even greater emphasis on the location of decision-making by the board of a foreign-incorporated company, as this will now determine both elements of the definition of corporate residence. Acknowledging the need for compliance adjustment, the ATO provided an extended transition period, up to 31 December 2020 or 30 June 2021.

[67] ATO, *Decision impact statement: Bywater Investments Ltd & Ors v Commissioner of Taxation* (2016), emphasis added.
[68] TR 2018/5, para.8, emphasis added, citing support from the earliest authority, *Cesena Sulphur Co Ltd v Nicholson; The Calcutta Jute Mills Co Ltd v Nicholson* (1876) 1 Ex.D 428 and including *De Beers* [1906] A.C. 455 HL; *Malayan Shipping* (1946) 71 CLR 156; and *Bywater* [2016] HCA 45 itself.
[69] PCG 2018/9, *Central management and control test of residency: identifying where a company's central management and control is located* (2018), Example 7.
[70] PCG 2018/9, para.47.

The Board of Taxation review and recommendation

The change of approach in TR 2018/5 was the trigger for taxpayer advocacy leading to a Board of Taxation review, which reported to government in July 2020.[71] The Board recommendation, adopted in very similar terms by the government, as quoted at the start of this note, aimed to ensure

> "a *sufficient economic connection* between Australia and a company that has been incorporated overseas for that company to be considered an Australian tax resident. A sufficient economic connection will exist for these purposes where both the company conducts its core commercial activities in Australia and has its central management and control in Australia."[72]

The Board set out some policy criteria that it said formed the basis for this recommendation. These included

> "ensuring that a company's residency status is 'sticky', such that residency is not volatile and subject to short term changes; enhancing the veracity of the rules to ensure that a company's residency status is not determined solely or predominantly on the basis of board meetings being attended in person, as opposed to meetings being attended via internet based conferencing platforms; accommodating developments in modern corporate governance"[73]

as well as

> "lowering integrity risks brought to the Board's attention that arise from the potential for the current central management and control test to be manipulated; and removing unnecessary compliance costs and business inefficiencies in managing Australian tax matters."[74]

Requiring "core commercial activities" to be conducted (or "undertaken", in the words of the government announcement[75]) in Australia would, the Board said

> "[acknowledge] the real consequences of tax residency - Australia becomes able to tax a foreign company's income no matter where earned in the world (as opposed to only its income earned from Australia)".[76]

One might observe that this general statement ignores the largely territorial nature of the Australian corporate income tax today for foreign active business income and it also ignores the extension of taxing jurisdiction to foreign residents in the controlled foreign companies rules to foreign resident subsidiaries controlled from Australia.

[71] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (July 2020), *https://taxboard.gov.au/consultation/corporate-tax-residency-review* [Accessed 23 February 2021].
[72] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (2020), p.7, emphasis added. The language "sufficient economic connection" was changed to "significant economic connection" and "conducts" to "undertakes" in the government announcement: Australian Government, *Budget 2020–21: Budget Paper No.2* (2020).
[73] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (2020), p.13.
[74] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (2020), p.14.
[75] Australian Government, *Budget 2020–21: Budget Paper No.2* (2020).
[76] Board of Taxation, *Review of Corporate Tax Residency: Final Report* (2020), p.7.

The proposed reform has the aim of "walking back" the interpretation in TR 2018/5, and seeks to overcome the confusion around the phrase "carries on business in Australia". In addition, the Board recommended further guidance on the meaning of "central management and control". The Board's emphasis on certainty and long-standing practice bears some resemblance to a policy argument put by the taxpayer in *Bywater*, that

> "it had been commonplace throughout the more than 40 years since *Esquire Nominees* was decided for the directors of foreign subsidiaries of Australian companies to act as they were instructed to by their Australian parent companies, without fear that the central management and control of the subsidiaries would thereby be sited in Australia."[77]

The taxpayer argued that given this long practice, the best approach

> "was to retain a presumption, in effect, that boards of directors do the work which they are appointed to do and, consequently, that central management and control inevitably resides where the board of a company habitually meets."[78]

The argument was given short shrift by the High Court, which stated that concerns about an increase in litigation or uncertainty were exaggerated.[79]

The approach adopted by the Board, and the government, to the reform of corporate residence is to be commended for not taking the formalistic approach to "central management and control" advocated by the taxpayer in *Bywater*. Instead, it focuses on the other statutory requirement that the taxpayer "carries on business in Australia". However, what is meant by the novel phrase "core commercial activities undertaken in Australia"? How does this differ from "carries on business"? Are "core commercial activities" to be assumed to be trading, mining or manufacturing, or other such operational or physical activities, as alluded to in *Malayan Shipping* and in the language of former TR 2004/15?

We could inquire whether the company, De Beers Consolidated Mines Ltd, would be treated as resident in Australia under the proposed reform, if it were assumed that everything that was done in London were to be done in Melbourne today.[80] In *De Beers*, the underlying "physical" operations—diamond mining—and their day to day management were conducted in South Africa; however, the board meetings, strategic decision-making and some sales contracts were done in London. Following the approach of the ATO in TR 2018/5, De Beers would be a resident because its central management and control and, therefore, its business, would be carried on in Australia, regardless of the location of its physical operations. Applying the authorities *Koitaki 1941* and *Malayan Shipping*, and the earlier administrative approach in TR 2004/15, it might be concluded that the company was centrally managed and controlled in Australia, but because its mining operations were conducted in South Africa, it carried on business there—and therefore, it might *not* be a "resident" of Australia. The facts of *De Beers* are distinguishable from *Malayan Shipping* and are more similar to *Koitaki 1941*. However, in the latter case, the court did not have to address the separate statutory requirement of "carries on business".

[77] *Bywater* [2016] HCA 45 at [34].
[78] *Bywater* [2016] HCA 45 at [34].
[79] *Bywater* [2016] HCA 45 at [80].
[80] The writer thanks John Avery Jones for this suggestion.

Under the reform proposal, we must ask whether the "core commercial activities" of De Beers Consolidated Mines Ltd would refer only to its physical mining operations (in South Africa), or whether it would also include the strategic direction and diamond sales contracts (in London). The issue is not clear-cut. In this writer's view, it is doubtful whether the recommended reform is going to deliver greater clarity in the law.

The digital future of "central management and control"

It is also doubtful whether the proposed reform will address the other stated goals of the Board, including the goal of updating the definition of residence to accommodate new approaches to corporate governance, especially in an era of digital, geographically untethered corporate management. For companies that are found to undertake core commercial activities in Australia, the geographic location of central management and control—and whether it is offshore—may take on an even greater importance. The *Bywater* approach will assist in preventing egregious abuse of the concept, but it also leaves room for uncertainty, especially because *Esquire Nominees 1972* remains good law, indicating that even a "strongly influenced" offshore board may be found to have central management and control in the location where the board makes decisions.

The judicial emphasis on the physical location of decision-making, usually but not always by the board of directors, had already required pragmatic administration even before the mass expansion of online remote real time conferencing. In former TR 2004/15, the ATO observed that central management and control of a company would be found in the location where the "majority" of board meetings are held, and that where 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 rather than where the electronic facilities are based".[81]

Unfortunately, the issue of digital meetings between directors or managers in multiple locations was not addressed at all in TR 2018/5, and was only briefly acknowledged by the Board in its report of July 2020.

During the COVID-19 pandemic, the ATO has been cognisant of issues affecting the location of board meetings.[82] Where normal board meetings are suspended, where meetings are held in Australia that would normally be held elsewhere, or where some directors are in Australia because of travel bans, the ATO states that this alone will not alter the view taken on central management and control. The question remains, how long such administrative accommodation can last.

Conclusion

The Australian reform proposal that a "significant economic presence" in Australia be required to establish residence of companies that are incorporated offshore does less than appears on the surface. The reform has the rather limited goal of reversing a change of approach by the ATO, which may not in any event reflect a correct understanding of the *Bywater* case, and reverting

[81] TR 2004/15 (withdrawn 15 March 2017), para.15.
[82] ATO, *Working out your residency: Covid-19 effects on foreign-incorporated companies*, *www.ato.gov.au* [Accessed 23 February 2021].

to the generally understood previous practice. The proposed reform does not address other issues relating to corporate residence, including Australia's diverse approaches in its tax treaties to resolving disputes. These include the issue of Australia's approach to "dual residence" in the Multilateral Instrument, which has led to uncertainty about whether corporations will be able to access treaty benefits if competent authorities cannot agree on residence.[83]

The Board of Taxation report hints at the deeper challenges facing the "central management and control" concept which applies across the common law world. However, neither the reform proposal, nor the Board report properly addresses this issue. In a post-pandemic world, it seems likely that board meetings conducted by electronic means, with directors located remotely at various locations around the world, are here to stay. Consequently, reliance on the geographic location of decision-making for the central management and control test will become increasingly problematic. It may be impossible to adapt the long-standing judicial concept of "central management and control" to a future in which digital and remote corporate governance is the norm; we may need to jettison this way to locate a corporation for tax purposes in geographic space. Ultimately, the phrase "significant economic presence" evokes bigger questions, and reveals the close relationship between corporate residence and the existence of a permanent establishment which continues to be debated in the OECD-G20 BEPS project on the allocation of corporate tax jurisdiction between nation states.

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[83] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting 2016 art.4. See ATO, *Multilateral Instrument*, *https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/* [Accessed 4 March 2021].

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