TAXATION UPDATE

Australian Tax Residence for Companies Revisited by High Court after 43 years

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For the first time in 43 years, Australia's ultimate appeal court (the High Court of Australia) has decided a case on the issue of "central management and control" of certain foreign incorporated companies: *Bywater Investments Limited v FC of T; Hwa Wang Bank Ltd v FC of T* [2016] HCA 45. Central management and control is a common law concept, so UK case law is important. We reported on the decision at first instance in our 4 Feb 2015 Taxation Update.

As the appellant companies had conceded that they were carrying on business in Australia, the companies would be Australian tax residents if their "central management and control" was in Australia.

The last time the High Court dealt with that issue was the decision of Gibbs J in *Esquire Nominees Limited v FC of T* [1972] 129 CLR 177 affirmed as to the central management and control point by the full High Court. There the Norfolk Island board of the Norfolk Island company actually considered recommendations of the Australian accountants to the Australian parent company, considered and implemented them. However, because their decisions were found have been in the best interests of the company and they would not have done anything which would be unlawful, the central management and control was found to be in Norfolk Island.

For present purposes it should be noted that the plurality in Bywater said at [82], the appellants contended that, since *Esquire Nominees* was decided, that "there has been a general accepted understanding in Courts and within the academy that the central management control of a company is taken to be an exercise where the company's board meets to exercise its constitutional functions, and therefore that the company will be taken to be residents abroad even if the board does no more than mechanically implement instructions given by residents of Australia". (The writer understands the unusual expression "academy" in this context was intended to refer to academics as a group).

The High Court in *Bywater* found that all decisions of the foreign incorporated companies in that case were in fact made by Mr Vanda Gould in Sydney, on the basis that the offshore directors where simply "rubber stamping" his instructions, or that no board meetings were held at all.

Whilst based on the authority of *Esquire Nominees*, the decision in *Bywater* is not surprising given the original findings of facts about Mr Gould, the applicants' submission as to the threat of uncertainty and litigation if its understanding of *Esquire Nominees* was not accepted, which the High Court said at [80] were "exaggerated", the case still sends a clear message that the question of "central management control" is always a question of fact not answered by simply holding board meetings outside Australia.

UK Wake Up Calls

Indeed it may have been assumed that the status quo following *Esquire Nominees* was as the applicants submitted in Bywater, at least until the UK Inland Revenue started to test the tax residency status of foreign companies that claim to be tax residents outside the UK in the mid-1990s. Perhaps this first became apparent with the decision of the Special Commissioner in *Untelrab Limited v McGregor (Inspector of Taxes)* [1996] STC (SCD) 1. Whilst the Special Commissioners held that the company in that case was resident in Bermuda and applied *Esquire Nominees*, what was noteworthy was the depth of analysis of the evidence of the activities of the company over a six year period, including cross-examination of the offshore directors. It is noted that the decision in *Untelrab* was footnoted by the High Court in *Bywater* at footnote [132].

The next "wakeup call" coming from the UK was the criminal prosecutions in *R v Dimsey; R v Allen*, [2000] QB 744 where the defendants were jailed for "conspiracy to cheat the Public Revenue" in circumstances where Mr Dimsey (a solicitor in Jersey as a director of Jersey and other haven companies) acting on the instructions of his client Mr Allen in the UK, who was not an actual director, but rather a "shadow" director. *R v Dimsey; R v Allen* were not referred to by the High Court in *Bywater* as those cases were criminal cases.

Subsequently, in *Wood v Holden (HMIT*) [2006] EWCA Civ 26, the *Esquire Nominees* principle was confirmed, that the place where a board of directors exercises its duties (properly), will be the place of its "central management and control" (in that case, The Netherlands), even where the controlling shareholders, or advisers recommend or even expect the board to reach certain decisions, and those persons are elsewhere (UK). In that case, the directors carried out their duties responsibly.

Another UK case which if sufficient attention had been paid to it, might have sent a further warning about complacency in the corporate governance of offshore subsidiaries of Australian resident parties, was the UK First Tier Tribunal decision in *Laerstate BV v Revenue & Customs* [2009] UKFTT 209 (TC), where a Dutch company was found to be tax resident of the UK again, demonstrating the detailed enquiry into the decision making process of the directors (and for a period, a "shadow" director), and again referring to *Esquire Nominees* with approval, but with a somewhat more detailed emphasis on whether the director who did not own the company, had sufficient information before him to be able to make an informed decision. Note, *Laerstate* was not footnoted in *Bywater*.

The High Court also distinguished trading and finance companies from special purpose companies, in relation to the impact of the authority of *Esquire Nominees*, which company only had to implement one transaction. What that probably means is that trading and finance companies' boards will have to meet far more often to make the high level decisions of the company. However, the High Court couldn't be taken to be suggesting that the delegation of day to day decisions to management (or indeed to one director) would invariably mean that the board's authority had been usurped. However, having a board protocol and a clear rule as to delineation of day to day management from high level board type decisions, should make it clear to management that they need the board's authority to carry out other than day to day operations. So in essence, an offshore company needs to be governed in the same fashion as a listed company (with a clear delineation between the functions of the board compared to managers), rather than the fusion that takes place in an owner run small private Australian company.

The reality is that as the ATO had not apparently challenged the tax residence of foreign subsidiaries of Australian companies (at least as is apparent from reported Court and Tribunal decisions after 1972 and before 2011 (in *Crown Insurance*)), the UK warnings after the UK Inland Revenue became active in the area, sounded by *Untelrab*, *R v Dimsey; R v Allen*, *Wood v Holden*, and *Larestate,* may not have been sufficiently heard in Australia, and so a sense of complacency may have developed.

Some Suggestions

Whilst pure formalistic responses will not be enough, it is certainly the case that ensuring that directors do met to consider proposals put forward by the parent company or individual owners (rather than have an Australian resident director or "shadow" director bind or act on the company's behalf and only inform the board after the fact), and the directors have sufficient information in front of them to make an informed decision (as well as the *Esquire Nominees* baseline- only acting in the best interests of the company and not doing anything which would be unlawful), will go a long way to solving the problems that may flow from more vigorous ATO enquiry as to the "central management & control" of foreign companies doing business in Australia or which are majority owned by Australian residents.

As the onus of proof will always be on the company that claims it is a non-resident, ensuring that the persons chosen to be directors of such companies have the knowledge, skill and diligence to carry out their duties, and have sufficient credibility that they can give evidence in an Australian Court or Tribunal (which may not be permitted to be by video-link, but by travelling to Australia), of how they have fulfilled that role, will be extremely important if the foreign company is challenged. At a practical level, this will invariably increase the cost of having that function performed by a non-resident director.

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If you have any queries in relation to this tax update, please contact the writer Robert Gordon, or Tony Pointon.

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