Australian National University

Crawford School of Public Policy

TTPI

Tax and Transfer Policy Institute

The proposed changes to "Corporate Residence" for Australian income tax law

TTPI – Policy Brief 1/2021
February 2021

John Taylor
Emeritus Professor
UNSW

Tax and Transfer Policy Institute
Crawford School of Public Policy
College of Asia and the Pacific
+61 2 6125 9318
tax.policy@anu.edu.au

The Australian National University
Canberra ACT 0200 Australia

www.anu.edu.au

CRICOS Provider No. 00120C

POLICY BRIEF

THE PROPOSED CHANGES TO "CORPORATE RESIDENCE" FOR AUSTRALIAN INCOME TAX LAW

John Taylor, Emeritus Professor, UNSW

One announcement in the 2020-21 Federal Budget that received less publicity than others was the intention to change the definition of resident company for Australian income tax purposes. The proposal is to implement a recommendation by the Board of Taxation in its July 2020 Report to the Treasurer on this issue.

The review of the residence of companies arose because of disquiet, particularly among multinational enterprises, about the interpretation of the present definition of resident company in Taxation Ruling TR 2018/5 issued following the decision of the High Court in *Bywater Investments Ltd v Commissioner of Taxation*[2016] HCA 45.

The Current Definition of Resident Company and the Board of Taxation's Recommendations

The current definition of resident company for income tax purposes is contained in *Income Tax Assessment Act* 1936 s6(1) and has been unchanged since it was added in 1930 to s4 of the *Income Tax Assessment Act* 1922. Prior to 1930 Australia only taxed income it if had an Australian source.

Under the definition, a company will be an Australian resident for income tax purposes if:

(a) It is incorporated in Australia; or
(b) It carried on business in Australia and either:
    (i) Has its central management and control in Australia; or
    (ii) It voting power is controlled by shareholders who are residents of Australia.

The principal recommendation for change made in the Board of Taxation's July 2020 Report to the Treasurer is that test (b)(i) above be modified to ensure that 'for a foreign incorporated company to be an Australian tax resident there needs to be sufficient economic connection to Australia'. The Board further recommended that, except in the case of certain holding companies, 'sufficient economic connection' is best demonstrated when both the company's core commercial activities are undertaken in Australia and its central management and control is in Australia. Consequential recommendations concern the development of legislative and administrative guidance on what 'core commercial activities' might entail and the development of further administrative guidance on the meaning of the expression 'central management and control' to provide greater alignment with modern business practice.

Longstanding concerns about interpreting the definition

Concerns about how to interpret and apply the 'central management and control' test are longstanding, dating at least to an earlier 2003 report of the Board of Taxation,

International Taxation: A Report To The Treasurer, https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/international_taxation_arrangements_report_volume_1.pdf, which recommended its removal and establishment of 'place of incorporation' as the sole test of corporate residence (recommendation 3.12, p100 That report referred to the decision of Williams J in *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156 as holding that a company 'which is managed in Australia is likely to carry on business here'. This arguably mis-stated the effect of the *Malayan Shipping* decision and did not account for Williams J's explanation of the dual requirement that a company: (a) carry on business in Australia; and (b) have its central management and control in Australia. The explanation of Williams J of the dual requirement was that it aimed to make it clear that mere trading in Australia, without the presence of central management and control, would be insufficient to make a company an Australian resident. In response to the board's 2003 report the ATO issued Taxation Ruling TR 2004/15, which regarded the carrying on business in Australia as being, in most but not all cases, a separate and additional requirement from the presence of central management and control.

In the recent case of *Bywater Investments Ltd v Commissioner of Taxation*[2016] HCA 45 the High Court reaffirmed a long line of authority to the effect that where central management and control is located is a question of fact and is not necessarily determined by where the formal requirements of corporate law (such as board meetings) are carried out. The issue considered in *Bywater Investments* was whether several companies incorporated in foreign jurisdictions were Australian residents on the basis that they were centrally managed and controlled in Australia. In the High Court the taxpayers did not argue that the presence of central management and control in Australia was not enough for the taxpayer companies to be Australian residents in the absence of satisfying a separate and additional requirement of carrying on business in Australia. All the taxpayers had conceded before the primary judge (Perram J) that their share trading activities on the ASX amounted to carrying on business in Australia.

In the High Court, the plurality of judges briefly discussed the judgment of Williams J in *Malayan Shipping*, stating that they regarded it as 'unsurprising' that Williams J rejected a contention that a company that was centrally managed and controlled in Australia was not an Australian resident unless it were also carrying on business in Australia. The High Court in *Bywater* also selected several quotations from the 1906 House of Lords judgment in *De Beers Consolidated Mines v Howe* CITE, which were consistent with a view that the exercise of central management and control was necessarily part of carrying on the business of a company. These quotes included the statement that the 'real' business of a company was carried on where it was centrally managed and controlled. This thinking is entirely in line with the historical development of the concept of central management and control, dating back to the 1876 Exchequer Court decision in *The Calcutta Jute Mills Co Ltd v Nicholson,* heard with *The Cesena Sulphur Co Ltd v Nicholson* (1878) 1 ExD 428; (1876) 1 TC 83.

The presence of the apparently dual requirement of "carrying on business" and "central management and control", dating from the introduction of the statutory test in 1930 is

curious. While Williams J's explanation in *Malayan Shipping* (discussed above) is one possibility, the Explanatory Notes on Amendments contained in a Bill FOR AN ACT TO AMEND THE Income Tax Assessment Act 1922-1929, https://www.legislation.gov.au/Details/C2004B03133 issued when the definition was inserted may point to a different explanation. The *Notes* explained:

> 'The definition of " resident " would not be complete without a reference to companies. Paragraph (b) therefore causes the definition to apply to companies incorporated in Australia wherever the head office of control may be situated, and to other companies whose central management and control is in Australia, or whose shareholders controlling the voting power of the company are residents of Australia. Such a definition is necessary because of the number of companies incorporated outside Australia whose sole or principal business is located in Australia. The companies - will be 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. The definition will embrace those companies which have been incorporated in Australia to operate outside Australia.'

This statement in the *Explanatory Notes* is ambiguous. A distinction is drawn between companies incorporated in Australia and those that are not so incorporated. In relation to companies not incorporated in Australia, two distinct types: those centrally managed and controlled in Australia, and those whose voting power is controlled by Australian residents, are conflated. In the next sentence, the explanation given for both types being defined as Australian residents is that, despite their foreign incorporation, the sole or principal business of the company is located in Australia.

The mere control of voting power in a company does not necessarily mean that a company has its sole or principal business where its voting power is controlled. The *Explanatory Notes* might imply that the presence of a company's sole or principal business in Australia was required for either type of company to be regarded as an Australian resident. If so, then this would explain the 'carries on business in Australia' requirement in the definition of 'resident' as it applies to companies.

On the other hand the statement in the *Explanatory Notes* can also be seen as consistent with Williams J's explanation of the definition in *Malayan Shipping*, on the basis that mere trading was not enough but that the presence of either central management and control or control of voting power in addition to trading indicated that the principal business of the company was in Australia. In any event, the *Explanatory Notes* appear to establish that the 'mischief' sought to be overcome by the definition arose where the sole or principal business of a foreign incorporated company was in Australia.

The 1930 insertion of the definition of 'resident' in relation to companies also has to be seen in the context of the 1915 decision of the House of Lords (or lack of decision as the House of Lords was equally divided) in *Mitchell v Egyptian Hotels Ltd* [1915] AC

1022. The House of Lords was evenly divided on the issue of whether a company, incorporated in the United Kingdom, which owned and operated hotels in Egypt was subject to United Kingdom tax on the basis that, although all operational decisions in relation to the Egyptian hotels were made by an local Egyptian board, certain limited financial decisions were made by the United Kingdom board of the company.

The judgments in *Mitchell v Egyptian Hotels* are not really concerned with whether the company was a United Kingdom resident, the company admitted that it was a United Kingdom resident, but rather with whether the limited degree of control exercised by the United Kingdom board meant that the Egyptian Hotel business was not wholly carried on outside the United Kingdom. As the House of Lords was evenly divided on the issue, the decision of the Court of Appeal, that the Egyptian Hotel business was wholly carried on outside the United Kingdom, stood. It is possible that the drafter of the 1930 definition was cognisant of the possibility that, although the exercise of central management and control was necessarily part of carrying on business, its exercise did not mean that all a company's business was carried on where central management and control was exercised. The facts of *Mitchell v Egyptian Hotels* could be regarded as a situation where the principal business operations of the company were located in a place other than where its central management and control was exercised. It is possible that the drafter by using the dual requirement of 'carries on business in Australia' and the exercise of central management and control in Australia was trying to avoid a company in the same position as in *Mitchell v Egyptian Hotels* being an Australian resident.

None of these possibilities entirely solves the puzzle that we are left with by the drafter of the 1930 amendment. With the drafting history and drafting instructions not available in the National Archives of Australia we can only speculate.

Governance and communications developments make the definition problematic

The Board of Taxation's 2019 report pointed to developments in corporate governance and communications technology that make the operation of the central management and control test problematic. The powers of corporate boards are frequently delegated to committees of executive management, while communications technology today enables board and other meetings to be held on-line with participants potentially being resident and joining the meeting virtually from a number of different jurisdictions.

In fact, these developments are not new: the delegation of powers to subcommittees or local boards is at least as old as *Mitchell v Egyptian Hotels* and the possibility of remote meetings with board members joining from different locations is at least as old as telephone conference call technology. Australian cases such as *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 623 had long recognised that central management and control may exist where important business decisions of the business are actually undertaken, not necessarily where the board meets. However, the frequency of the use of remote and delegated meetings has increased over the years and, in the case of communications, been exacerbated by the COVID19 pandemic.

Despite the awareness of modern governance practice in the Board's report there is a lingering legalistic view that boards run major companies notwithstanding considerable empirical evidence that employed executive directors develop policy proposals that are often merely approved by the board as a whole.

Factors to be considered for a "sufficient economic connection" to Australia

The Board of Taxation recommended that the central management and control test be modified to ensure that a foreign incorporated company has a sufficient economic connection to Australia, in order to be an Australian tax resident. The Board saw this as being demonstrated where both the company's core commercial activities and its central management and control were in Australia.

The Board provided the following inclusive list of factors that the Board considered could be taken into account in determining whether the core commercial activities of a company were undertaken in Australia:

- The nature of the business carried on by the company
- The location of staff and assets employed in the conduct of the core business activity both in Australia and abroad
- The size of the company
- The sophistication of the company's corporate governance practices
- The separation between strategic management and operational control of the business
- The composition of the company's board and any additional roles held by directors; and
- The distinction between activities that are core to the conduct of the business and those that are preliminary or ancillary, such as general support functions.

The Board recommended that the ATO produce administrative guidance to align the term 'central management and control in Australia' more closely with modern business practice. Factors additional to the location of board meetings that should be taken into account included:

- The composition of the board and any additional roles directors may hold
- Any impact of the ultimate ownership of the company
- The impact of regulatory requirements
- The residency and/or physical location of directors in exercising their duties

The absence of any express reference to the role of executive management and governance structures in the factors listed for guidance on 'central management and control' is surprising. Many of the factors listed as being relevant in determining 'core commercial activities' go to issues of strategic management and hence arguably fit within what the courts have traditionally regarded as the core feature of central management and control. Hence, arguably, there is circularity in the Board's recommendations as the factors it considers relevant in determining core business

activities overlap with those that courts could conceivably take into account in determining the existence and location of central management and control.

The Board's examples of current problems

The Board of Taxation's report included several examples where the current ATO interpretation of the central management and control test was regarded as problematic.

One Example concerned a New Zealand incorporated company with manufacturing assets and operations wholly located in New Zealand and owned by a New Zealand incorporated holding company with underlying Australian shareholders and with some Australian resident directors. The concern with this Example was that it was possible, under current ATO guidance that the attendance by the Australian directors at board meetings via video conferencing might mean that the New Zealand incorporated companies were Australian residents and if the Australian directors were flown to New Zealand for board meetings then the company's residence would switch back to New Zealand.

Another example concerned senior management of a group being located in an Australian parent company and confirming that decisions are consistent with overall group strategy before boards of subsidiary companies in foreign jurisdictions make those decisions. The Board's report indicated that, under the current ATO approach, it was uncertain whether the central management and control of the subsidiaries would be in Australia or in the countries where the boards of the subsidiaries met.

A third example concerned a United States subsidiary of an Australian company. The United States subsidiary manufactured and sold specialist equipment. The Australian parent set global policies detailing operational and trading policies that the United States subsidiary was obliged to follow. The board of the United States company met in the United States but simply followed the directions from the Australian parent. Here the Board considered that there was little doubt that the Australian parent was exercising central management and control over the United States subsidiaries and hence would be an Australian resident under the current ATO approach.

In all these examples, the Board evidently considered the result undesirable with an explicit concern being to favour rules that are stable and predictable. A sub-text in the Board's consideration of the examples was a view that regarding a foreign incorporated company as being an Australian resident was inappropriate when that company did not have any production or trading operational activities in Australia. Such a concern would be consistent with current Australian policy on taxation of foreign active income of Australian resident companies. If an Australian resident company is conducting active business through a foreign branch then, provided the branch passes an active income test, Australia treats the foreign branch profits as non-assessable non-exempt income. Similarly, if foreign subsidiary of an Australian resident company passes an active income test then a dividend funded from its foreign profits will be non-assessable non-exempt income to its Australian parent. Given these rules, it makes little sense to regard a foreign incorporated company with only active foreign business operations as an Australian resident. Under current Australian

rules the Australian corporate tax in relation to active business income is basically a source tax.

The need for conceptual coherence in a redrafted definition

A legislative reform of the definition of resident company will need to take into account:

(a) the need for increased operational certainty and administrative workability;

(b) the need to protect the integrity of the Australian corporate tax base; and

(c) the need for conceptual coherence.

The Board of Taxation is clearly aware of the need to address the first two considerations. Introducing a factor-based approach to determining the core commercial activity of a company should assist in meeting these two needs. This approach, however, will not necessarily produce conceptually coherent legislation.

The requirement that a company have its core commercial activity in Australia and then, in addition, be managed and controlled in Australia runs the risk of a conceptual inconsistency between the notion that the 'real' business of a company takes place where it is centrally managed and controlled and the proposed legislative requirement that the core commercial activity of the company be carried in on Australia before any need to consider central management and control arises.

One possible solution to the conceptual inconsistency is to alter the order in which the central management and control requirement and the core commercial activity requirement appear in the legislation. This could be supported by rephrasing the factors to be taken into account. If the legislation were to define a company as being resident in Australia if it is centrally managed and controlled in Australia **and** has additional, specifically identified, significant business activities in Australia then the conceptual inconsistency disappears.

On this approach, mere trading would not make a company an Australian resident but central management and control coupled with a specified level and type of business activity would. On the other hand, central management and control without specified the specified level and type of business activity would not make a company an Australian resident. The activities specifically identified in the legislation could take account of particular types of business structure such as holding or mere investment companies. The core commercial activities would need to be defined to be revenue-generating operational activities, such as production, trading, the provision of services or the licensing of intellectual property.

If we apply this approach to the three examples summarised above, this produces the result that *none* of the foreign subsidiaries would be regarded as being Australian residents

On the other hand, this approach should ensure that the foreign subsidiaries in the *Bywater Investments* case, which were centrally managed and controlled in Australia and had all their significant share trading activities in Australia, would be regarded as Australian residents.

Arguably, the same results would arise under the approach suggested by the Board of Taxation but, given the long standing case law on central management and control as 'the real business' of a company, there is a serious risk of conceptual inconsistences, particularly if 'core business' is to be determined with regard to the factors listed in the Board's report. This leaves room for litigation and uncertainty. If the real concern is to ensure that foreign incorporated companies are not Australian residents if they do not have active trading or productive business operations in Australia, then that should be the emphasis of the factors for identifying core commercial activities in the definition.

References

Australia, Board of Taxation, (2003) *International Taxation: A Report To The Treasurer,* https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/international_taxation_arrangements_report_volume_1.pdf

Parliament of Australia, House of Representatives, (1930), Explanatory Notes on Amendments contained in a Bill FOR AN ACT TO AMEND THE Income Tax Assessment Act 1922-1929, https://www.legislation.gov.au/Details/C2004B03133