

DOUBTS ABOUT THE CENTRAL MANAGEMENT AND CONTROL RESIDENCY TEST FOR COMPANIES?

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ABSTRACT

This article critically examines the Australian Taxation Office (ATO) interpretation of the second statutory test for company residence found in the definition of 'resident' in sub-section 6(1) of the Income Tax Assessment Act 1936. The statutory test consists of three components: first, if the company is incorporated in Australia then it is a resident; second, if the company is not incorporated in Australia but the company is carrying on a business in Australia and has its central management and control in Australia then it is a resident; and third, it is not incorporated in Australia but it is carrying on business in Australia and has its voting power controlled by shareholders who are resident in Australia then it is a resident of Australia for taxation purposes. The central management and control test contained in the public Taxation Ruling TR 2004/15 has been the subject of considerable conjecture and confusion for many years. The ruling states that the test of residency for a company not incorporated in Australia consists of two requirements: the company must be carrying on business in Australia and it must have its central management and control located in Australia. A company not incorporated in Australia and thus not satisfying the first test of residency must have its central management and control in Australia or have the majority of shareholders resident in Australia coupled with the carrying on of a business in Australia before it is held to be a resident. The contrary view is that the central management and control test on its own may be sufficient to deem a non-Australian incorporated company to be a resident for taxation purposes. It is contended that there is no need to demonstrate that the company is also carrying on a business in Australia. This article contends that the approach of the Commissioner of Taxation contained in TR 2004/14, is open to serious doubt.

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I. INTRODUCTION

The main objective of this article is to critically examine the central management and control test contained in the definition of a resident company in sub-section 6(1) of the *Income Tax Assessment Act 1936* (ITAA36). Sub-section 6(1) provides the definition of 'resident or resident of Australia' and in terms of a company the following definition is provided:

[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.

In particular this article critically assesses the Australian Taxation Office's (ATO) interpretation of the second statutory test for the residence of a company found in the above definition of 'resident' in sub-section 6(1) of the ITAA36. The central management and control test contained in the public ruling TR 2004/15¹ has been the subject of considerable conjecture and confusion for many years. The ruling states that the test of residency for a company not incorporated in Australia consists of two requirements: first, the company must be carrying on business in Australia and second, it must have its central management and control located in Australia. In particular, this article addresses the vexed issue of whether the test of residence contains one requirement or two requirements.

The second part of this article looks at the definition of company residence, in particular the central management and control test and its origins. In Part three the article examines the judicial interpretation of this statutory provision and asks the question, is the test one limb; namely, central management and control is where the business is carried on, or does it contain two separate limbs; namely, requiring both the carrying on of a business in Australia and at the same time having its central management and control in Australia?

Part four examines in detail the approach taken by the Commissioner of Taxation contained in Taxation Ruling TR2004/15. In essence that ruling argues that both requirements, namely the carrying on of a business in Australia and having its central management and control in Australia need to be satisfied before a company is a resident of Australia for taxation purposes. In Part five of the article the risk management issues are examined from the perspective of foreign companies complying with the tax ruling. This analysis will determine the likely risks that may arise for companies relying on the ruling and then later finding that the Australian courts have taken a different approach.

Even if all these issues can be resolved, there are practical problems associated with applying the central management and control test. Part six of the article raises, among other things, the vexed question of where central management and control is actually located. In Part

¹ Australian Tax Office, *TR2004/15 Income tax: residence of companies not incorporated in Australia—carrying on business in Australia and central management and control*
<<http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR200415/NAT/ATO/00001>>.

seven the article poses the question of whether it is time for a change. If so, what would the alternative tests contain given how difficult any change would be in a world of cross-border complexity and tax avoidance, especially with the challenges facing countries with large Multi-National Entities (MNE's) engaged in Base Erosion and Profit Shifting (BEPS). For example, the Apple Corporation was a non-resident of both Ireland and the US because of the definition of residence.² Prior to Ireland amending its definition of corporate residence in 2013, a company that was incorporated in Ireland was not a resident unless it had its central management and control in Ireland.³ A company was not a resident of the US unless it was incorporated in the US. Apple Corporation had its central management and control in the US but the company was not incorporated in the US thus avoiding being neither a resident of the US nor Ireland.⁴ This situation was exploited by many other MNE's such as the caterpillar Corporation.⁵

The article concludes that, on balance, the central management and control test has only one requirement and that corporate residency exists in Australia where some part of the company's central management and control takes place in Australia. There is no requirement to be carrying on a business in Australia. This conclusion is at odds with the Commissioner's approach in TR2004/15. It is also the contention of this article that the ATO's current views on the central management and control test, incorrect in law as it has been interpreted by the courts, neither addresses the changing nature of commerce across the globe nor enables Australia to protect in part its company tax base. While this article raises the problems associated with the central management and control test and its different interpretations, Part eight of this article provides some solutions. However, it is ultimately the responsibility of the Commonwealth Parliament of Australia or the courts to provide a robust answer to this potential problem.

II. THE DEFINITION OF RESIDENT IN SUB-SECTION 6(1) OF THE ITAA 36

Sub-section 995-1(1) of ITAA 1997 says that a person, which includes a company, is an 'Australian resident' if that person is a resident of Australia for the purposes of the ITAA 1936. For companies, sub-section 6(1) of the ITAA36 provides three statutory tests, the fulfilment of any one being sufficient to deem a corporate entity to be a resident or resident of Australia. They are the 'incorporation test', the first statutory test; the 'central

² Antony Ting, 'iTax-Apple's International Tax Structure and the Double Non-Taxation Issue', (2014) *British Tax Review* 40, 46.

³ Antony Ting, 'Current Notes – Old wine in a new bottle: Ireland's revised definition of corporate residence and the war on BEPS', (2014) 3 *British Tax Review* 237, 239.

⁴ Ibid.

⁵ Ibid, 237.

management and control' test; the second statutory test and the 'voting power' test which is the third statutory test.

The first statutory test deems a company to be a resident for Australian income tax purposes if it is incorporated in Australia. This test is unequivocal in its operation. The second statutory test deems a company, not being incorporated in Australia, to be resident if it 'carries on business in Australia, and has ...its central management and control in Australia.' The third test deems a company, not being incorporated in Australia, to be resident if it 'carries on business in Australia... [and] its voting power is controlled by shareholders who are residents of Australia.'

It is with the second test that most controversy arises. By a normal reading, the test appears to have an unambiguous two-element construction. The first element requires a company to be carrying on business in Australia and the second element requires that the company has its central management and control in Australia. On this reading, only satisfaction of both elements would deem a corporate entity to be a resident of Australia. However, this interpretation seems to be at odds with the decision in *Malayan Shipping Company v Federal Commissioner of Taxation*.⁶ Many commentators hold to the view that the general principle emanating from the *Malayan Shipping* case is that where a company has its central management and control in Australia, then, ipso facto, it is also carrying on business in Australia thus satisfying both elements in one.⁷ This outcome raises the question of why the original drafters of the legislation would have intended this interpretation given the construction they employed. If this interpretation was to hold in a general sense then foreign companies would be residents simply by having their central management and control in Australia.

However, Professor Dirkis observes that there are those who believe that to be resident under the second test, central management and control must be accompanied by acts which constitute the carrying on of a business.⁸ This is the general view expressed by the

⁶ (1946) 71 CLR 156. This case is discussed in detail in Part III of this article.

⁷ See for example Kerri Sadiq, 'Double Tax Agreements and International Allocation of Business Income in Australia' (1999) 4 *Int'l Trade & Bus L Ann* 151, 155; Taxation Review Committee, Commonwealth, (1975) (Asprey Report), 255; NE Challoner and JM Greenwood *Income Tax Law and Practice (Commonwealth)* (2nd ed, 1962), 42; Uta Kohl, 'The Horror-Scope for the Taxation Office: The Internet and its Impact on 'Residence'' (1998) 21 *University of New South Wales Law Journal* 436, n 45; Tom Magney, 'Australia-Singapore Taxation Aspects of Carrying on Business in Singapore - Part II' (1975) 4 *Australian Tax Review* 67, 69; Kerrie Sadiq, 'Jurisdiction to tax and the case for threshold reform' (2005) 1 (2) *Journal of the Australasian Tax Teachers Association* 162, 169-170, and Richard Vann and Ross Parsons 'The foreign tax credit and reform of international taxation' (1986) 3 *Australian Tax Forum* 131, 148.

⁸ Michael Dirkis, 'The same old same old: Corporate residency after RITA, (2006) 21 *Australian Tax Forum* 27, 38, footnote 48, where he says: 'See e.g. Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.190. Similarly, AJ Baldwin and JAL Gunn, *Income Tax Law in Australia*, (1937) 168, note that 'if the business of the company carried on in Australia consists of or includes its central management and control,' then the company is a resident.'

Commissioner in the Taxation Ruling, TR2004/15.⁹ The doubt about the manner in which the test applies is of concern in government quarters due to the problems associated with the collection of taxation revenue. The Review of International Taxation Arrangements (RITA)¹⁰ consultation article, prepared by the Australian Federal Treasury, expressed significant misgivings about the application of the test. In Option 3.12 for consultation, the RITA article requested consideration of clarification of the test so that ‘exercising central management and control alone does not constitute the carrying on of a business’.¹¹

A. *Origins of the Second Statutory Test*

The origins of the second statutory test are derived from the common law of the United Kingdom. In respect of individuals and companies, resident status was a key determinant of a State’s taxation rights. A resident, enjoying the benefits of the infrastructure and the protection of the state, was required to provide something in return. This something was tax payable on taxable income from all sources, not just the country of residence. In respect of a business enterprise, as Adams says: ‘...[a] large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.... Business is responsible for much which occupies the courts, the police, the army and the navy.’¹² The quid pro quo for maintaining this environment is the payment of income tax. As Justice Oliver Wendell Holmes said: ‘taxes are what we pay for civilized society’¹³

For individuals, the English courts linked a resident to some enduring physical quality of a person’s presence in the United Kingdom. Although a question of fact, prime indicators of whether an individual was a resident included things like maintaining a settled or usual place of abode or being present in a place for a considerable time. In *Levene v Commissioners of Inland Revenue*¹⁴, Viscount Cave found that on most occasions there was no particular difficulty in determining ‘where a man has his settled or usual abode.’¹⁵

However, in the early twentieth century in respect of companies, the English courts had to wrestle with a legislatively created entity in determining where a company was a resident

⁹ Australian Tax Office, above n 1.

¹⁰ The Federal Treasury, Review of International Taxation Arrangements, (Canberra, 2002) <http://www.taxboard.gov.au/content/reviews_and_consultations/international_taxation_arrangements/consultation_paper/downloads/international_taxation_arrangements_consultation_paper.pdf>.

¹¹ Ibid 55.

¹² Adams, T.S., *The Taxation of Business*, 11 National Tax Association Proc. 185, 186 (1917) cited in Sprague et al., *Permanent Establishments and the Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, Tax Council Policy Institute, 2003.

¹³ *Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue* (1927) 275 US 87, 100.

¹⁴ [1928] 1 AC 217.

¹⁵ Ibid, 222–223.

for tax purposes. In *De Beers Consolidated Mines Ltd v Howe*,¹⁶ Lord Loreburn found it convenient to draw an analogy with individuals in ascertaining where a company was resident. In that case, he said:

In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...¹⁷

In *Egyptian Delta Land and Investment Company Ltd v Todd*,¹⁸ Lord Sumner acknowledges the difficulty of applying the natural resident concept to companies and in the end he concludes that it can only be artificially applied. However he said:

The analogy that is really possible between a natural person and a company is that of carrying on business at a place...and in my opinion, for the purposes of income tax, both on the words of the Acts and on the cases, the residence of a foreign company is preponderantly...determined by this kind of fact.¹⁹

The question therefore to be addressed by the courts was where does the company keep house and do business? In *De Beers*, Lord Loreburn answered this question by stating that a company's 'real business is carried on where the central management and control actually abides.'²⁰ He also said that this was a question of fact to be determined on the evidence before the court.²¹ In ascertaining where the central management and control abides, Lord Loreburn focused on where the high-level decisions and functions were made such as the negotiation of contracts, the application of profits and the appointment of directors. Based on the facts before him, he concluded that this took place in London where the majority of directors and life governors lived and where the directors meetings were held.

III. THE CENTRAL MANAGEMENT AND CONTROL TEST: ONE OR TWO ELEMENTS?

The leading authority in Australia on the second statutory test in sub-section 6(1) of ITAA36 is the High Court case of *Malayan Shipping Company v Federal Commissioner of Taxation*.²² *Malayan Shipping* centred on the charter of a Norwegian tanker in London by the taxpayer

¹⁶ [1906] AC 455.

¹⁷ *Ibid*, 458.

¹⁸ [1929] AC 1.

¹⁹ *Ibid*, 12.

²⁰ Above n 16, 458. The formulation of central management and control was adopted with approval from the decisions in *Calcutta Jute Mills v Nicholson* (1876) 1 Ex. D.428 and *Cesena Sulphur Co. v Nicholson* (1876) 1 Ex. D.428.

²¹ *Ibid*.

²² Above n 6. Recent English cases on central management and control do not challenge the judicial dominance of *Malayan Shipping* in Australia. In addition there have been no recent decisions in Australia on the central management and control concept or testing the limits of TR2004/15.

company which was incorporated in Singapore. Instructions were issued on behalf of the company by a Melbourne businessman, Mr Sleigh. He was the managing director and held the majority of shares in the company. It was apparent that Sleigh had all the say in the company's operations. He organised the contracts and charted the course of the business. The evidence showed that he had the power to appoint and remove the other directors. The only business of the taxpayer company in the relevant years was the sub-charter to Mr. Sleigh of the tanker on ten voyage charters with the necessary documents being prepared and executed by him in Melbourne, Australia.

The issue before the High Court was whether the taxpayer company was a resident of Australia within the meaning of the second test of residence contained in sub-section 6(1) of ITAA 36 during the relevant years of income. His Honour, Justice Williams found that the company was a resident of Australia and was therefore assessable on the income derived by it from the sub-charter operations. This decision and the reasoning behind the decision has been the subject of much conjecture and is addressed by the Commissioner of Taxation in taxation ruling TR2004/15.

Williams J addressed the submission made by the appellant which:

... contended that since the definition [within the second statutory test] required that the company should be carrying on business in Australia and also that the central management and control should be in Australia...the carrying on of business could not refer to the control of the operations of business from which the profits arose but only to the actual operations themselves.²³

Williams J also made reference to the appellant's contention that as the contracts were made by the taxpayer in Singapore it was not carrying on business in Australia within the meaning of the Act. In his deliberations, Williams J referred to *Mitchell v Egyptian Hotels Ltd* where Lord Parker of Waddington said: '[w]here the brain which controls the operations from which the profits and gain arise is in this country the trade or business is, at any rate partly, carried on in this country.'²⁴ His Honour went on to state:

*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 situated 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.*²⁵

This opinion goes some way to deciphering the purpose of the second statutory test. A company not incorporated in Australia may be carrying on business in Australia but without its central management and control being in the same country. In this situation the company

²³ Ibid, 159.

²⁴ [1915] A.C. 1022, 1037.

²⁵ Above n 6, 159.

will not be a resident of Australia in accordance with sub-section 6(1). Satisfaction of both elements is required in this context in order to deem a corporate entity as a resident. But is the converse true? If central management and control is found to exist in Australia, does the company, not being incorporated in Australia, have to be carrying on business in Australia to satisfy the test of residency? In this respect, Williams J said:

*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.*²⁶

This statement is suggestive of a general principle that if a company's central management and control is in Australia, then that function forms part of its business and hence the company is carrying on business in Australia. It is this general principle that may lead to a view that the first element of the test is essentially superfluous thus leading to an essentially one-element requirement. However, based on the remarks of Williams J, the first element is there as a reminder that mere trading or the conduct of the lower level management functions will not of themselves give rise to a company being a resident. Something additional is needed. Central management and control refers to the functions at the pinnacle of power. It refers to the high-level decision making such as the appointment of directors, the formulation of the company's strategic direction, the activities which are at the heart of the profit-generating capability, namely the brain.²⁷ Williams J refers to the business of the company being the central management and control. So there appears to be a divergence of activity: some activity is mere trading and on the other hand, some activity constitutes central management and control.

The notion of a one-element approach appears to be similarly expressed in *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation*²⁸ where Dixon J said:

In the first place, it is well to remember that the basal principle is that a company resides where its real business is carried on and that it is for the purposes of ascertaining where that is that the subsidiary principle is invoked that the place where the superior direction and control is exercised determines where the real business is carried on.

However, it is important to note that this case was not about the application of the definition of resident in sub-section 6(1) but rather related to the former paragraph 23(m) of ITAA36 which provided an exemption from income tax to Northern Territory residents for income they derived in the Territory. Dixon J was applying the common law to the particular fact situation to ascertain whether or not the taxpayer was resident of the Territory. However, the remarks of Dixon J do emphasise the hierarchy of business activities with a differentiation between 'real' business and the mere operational aspects.

²⁶ Ibid.

²⁷ Lord Parker, *Mitchell v. Egyptian Hotels Ltd*, above n 24, 1037.

²⁸ (1946) 71 CLR 623, 629.

It is useful to note the comments of the Taxation Review Committee Full Report²⁹ on the central management and control issue. The report says:

A resident of Australia in relation to a company is defined by exclusively statutory tests, though one of these—central management and control—uses the language of judicial decisions that adopts the notion of residence of a company under United Kingdom law.³⁰

The report goes on to say:

As the test has been interpreted, the reference to carrying on business in Australia is unnecessary: central management and control, it is said, involves the carrying on of business. In any event, in the Committee's view it should be enough to give a company a residence in Australia that its central management and control is here.³¹

It is also interesting to note the concern of the Committee that the meaning of central management and control needed clarification. It said that the phrase might be interpreted widely enough in some circumstances so as to '... increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable.'³²

As a final note, Professor Dirkis refers to the Explanatory Notes in relation to the second statutory test. As he says, the Note on Clause 2 in the Explanatory Notes of the Bill to Amend the Income Tax Assessment Act 1922–1929 (Cth), 11 provides that:

The definition was intended to apply '...to companies...whose central management and control is in Australia' thereby ensuring that a '...number of companies incorporated outside Australia whose sole or principal business is located in Australia' were taxable as residents.³³

This Explanatory Note provides further support for the view that central management and control, alone, would be sufficient to deem a company to be a resident of Australia under the statute.

IV. THE COMMISSIONER'S VIEW IN TR2004/15

Prior to the release of TR2004/15, the difficulties with the decision of the High Court in *Malayan Shipping* had been raised in the Federal Treasury's consultation paper called the Review of International Taxation Arrangements.³⁴ That paper detailed particular problems

²⁹ Taxation Review Committee, Commonwealth, *Full Report* (Canberra, AGPS, 1975).

³⁰ *Ibid*, paragraph 17.13.

³¹ *Ibid*, paragraph 17.14.

³² *Ibid*, paragraph 17.15.

³³ Above n 8, 36.

³⁴ The Federal Treasury, above n 10.

with the current tests of resident for companies including confusion over the application of the second statutory test. The consultation paper says:

*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...*³⁵

In the following year, the Board of Taxation recommended a simple and certain test for the residence of companies. A company would only be resident of Australia if it was incorporated in Australia.³⁶ Much of the argument from business for a simple test of incorporation hinged on the perceived difficulties with central management and control, both whether that was enough in fact for the carrying on of a business and its practical application. Concerned that the Government may adopt an 'incorporation in Australia' test which the ATO regarded as open to abuse and not reflecting the economic reality, and hence giving rise to residency by choice for tax purposes. The ATO convinced the Government not to accept the recommendation but instead await a review and possible ruling on the issues of central management and control and whether that made life less difficult in practice for companies who were not incorporated in Australia concerned about their residency. One year later, the Australian Taxation Office produced TR2005/14 on 'the residence of companies not incorporated in Australia – carrying on business in Australia and central management and control.'³⁷The ruling was the ATO's attempt to clarify the operation of the second statutory test of company residence and avoid the worst possible outcome from its point of view – an 'incorporation in Australia' test as the sole determinant of residence here.

The ruling makes a number of points in support of a strict two-element construction of the second statutory test. For a company to be resident under the second statutory test, two conditions must be satisfied. First, the company must be carrying on business in Australia and second, it must have its central management and control in Australia.³⁸ The ruling goes on to say:

*If no business is carried on in Australia, the company cannot meet the requirements of the second statutory test. In these situations there is no need to determine the location of the company's central management and control, separate from its consideration of whether the company carries on business in Australia.*³⁹

To further clarify its position, the ruling says that '...if the company carries on business in Australia it also has to have its central management and control in Australia to meet the

³⁵ Ibid, 54.

³⁶ The Board of Taxation, International Taxation: A Report to the Treasurer, (Canberra, 2003), 109 <http://www.taxboard.gov.au/content/reviews_and_consultations/international_taxation_arrangements/report/downloads/international_taxation_arrangements_report_volume_1.pdf>.

³⁷ ATO, above n 1.

³⁸ Ibid, paragraph 5.

³⁹ Ibid, paragraph 6.

second statutory test.⁴⁰ The general thrust of the ruling is that the central management and control function does not constitute part of the business operations being carried on.

Part of the reasoning employed by the Taxation Office in supporting its general interpretation of the test is based on its views about various principles of statutory construction. Citing *Broken Hill*⁴¹ and *Jackson*,⁴² the ruling argues that a basic rule of statutory determination requires that 'the plain words of an Act must be given full meaning and effect.'⁴³ The ruling goes on to say that 'it is arguable that an interpretation giving effect to all the words of the second statutory test is preferable to one making the words 'carries on business in Australia' superfluous and unnecessary.'⁴⁴

The second line of reasoning employed in the ruling refers to the decision in *Malayan Shipping*.⁴⁵ The Commissioner argues that because the two separate requirements of the test were satisfied by the same set of facts so *Malayan Shipping* should be limited to its facts.⁴⁶ The Commissioner then says that '[o]n the question of whether the company was carrying on business in Australia, Williams J acknowledges that the question of where business is carried on is in every case one of fact.'⁴⁷

In response to this view, it could be argued that the Commissioner is taking Williams J's comments out of context. The tenor of Williams J's findings would appear to be unequivocal. He says that '...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.'⁴⁸ What is open to question is whether the central management and control is in Australia. This is the 'question of fact' to which Williams J referred.

The ruling provides a number of examples to illustrate the Commissioner's interpretation of the second statutory test. At paragraph 71, Example 2 refers to a company incorporated in Papua New Guinea but in which the board meetings of its directors are mainly held in Australia.⁴⁹ At those meetings all the major policies and strategic decisions are made. All of the trading activities are conducted in Papua New Guinea. The Commissioner's view in respect of this fact situation is that the company is not a resident of Australia for income tax

⁴⁰ Ibid.

⁴¹ *Broken Hill South Ltd (Public Officer) v Commr of Taxation (NSW)* (1937) 56 CLR 337 at 371 per Dixon J.

⁴² *Jackson v Secretary, Department of Health* (1987) 75 ALR 561, 571.

⁴³ ATO, above n 1, paragraph 28.

⁴⁴ Ibid, paragraph 29.

⁴⁵ Above n 6.

⁴⁶ ATO, above n 1, paragraph 33 and 34.

⁴⁷ Ibid, paragraph 35.

⁴⁸ Above n 6, 159.

⁴⁹ ATO, above n 1, paragraph 71.

purposes. This is because the company is not carrying on business in Australia even though its central management and control is in Australia. However, as Shaflender et al say, '[o]ne may query whether applying the principle outlined in *Malayan Shipping* to the [ruling's] example would produce a different result.'⁵⁰ It is contended in this article that it would.

V. RISK MANAGEMENT AND RELIANCE ON TR2004/15

Can taxpayers take comfort from the general thrust of TR2004/15? It is strongly argued in this article that there is a clear risk where the affairs of companies are structured in reliance on TR2004/15. In accordance with the law, a company may be deemed a resident under the test whereas the Commissioner's view as expressed in TR2004/15 might suggest that the company is not a resident. As Shaflender et al say, 'if *Malayan Shipping* is judicial authority for the proposition that if a taxpayer's central management and control is in Australia then the taxpayer necessarily carries on business in Australia'⁵¹ then the Commissioner's view cannot displace the law. Clearly there is a conflict but from a practical perspective the legal issues raised by the difference between the ATO' ruling and the *Malayan Shipping's* interpretation might be found in the fact that the Commissioner has the responsibility to administer the income tax laws and his officers are bound to apply the Tax Ruling in appropriate circumstances until a Court or the Parliament of Australia clarifies the law.⁵²

It is interesting to note the almost non-binding nature of the language the ruling uses. For example in the preamble to the ruling, the Commissioner says that '...[t]his ruling provides *guidelines* [emphasis added] for determining whether a company, not incorporated in Australia, is a resident of Australia under the second statutory test...'⁵³ It goes on to say that '... while every case turns on its facts, this ruling gives guidance to companies determining their residence under the second statutory test.'⁵⁴ On reflection this is not surprising since taxation rulings are not binding on taxpayers, although taxpayers may open themselves up to increased penalties if they do not follow the ruling and the Commissioner's view is ultimately upheld by the court.⁵⁵

It is not too hard to imagine scenarios in which taxpayers might want to adopt the view of the High Court in *Malayan Shipping* that central management and control is carrying on a business and challenge the Commissioner's approach in the ruling. For example, some companies incorporated overseas may or may not want to be residents of Australia.

⁵⁰ Shaflender L, et al, 'Residence of companies not incorporated in Australia', *Taxation in Australia*, (2004) 39(4), 187.

⁵¹ Ibid.

⁵² Division 358, *Taxation Administration Act 1953* and PS LA 2008/3.

⁵³ ATO, above n 1, paragraph 1.

⁵⁴ Ibid, paragraph 2.

⁵⁵ *Division 358, Taxation Administration Act 1953*.

Depending on their circumstances and leaving aside tax treaty implications, they may want to argue that they have their central management and control in Australia and are residents of Australia even though they may not otherwise be carrying on business in Australia, at least as understood through the prism of the Taxation Ruling. Applying *Malayan Shipping* could produce a different residency result than relying on the ruling. The ruling may give little solace to taxpayers in those circumstances to confidently arrange their affairs in the knowledge that their Australian residency status for tax purposes will be clear.

Other concerns arise in relation to some of the terminology employed in the ruling. For example, at paragraph 9, the Commissioner addresses the ‘carries on business in Australia’ element within the test. The ruling says that the Commissioner ‘... draw[s] a distinction between a company with operational activities... and a company which is *more passive* [emphasis added] in its dealings. It will be appreciated that there will be some overlap in any particular situation.’ This raises concerns because it effectively admits that the particular circumstances and business activities of the taxpayer will be of the essence in determining whether business is carried on in Australia. Where there is overlap there is potential doubt.

Another point is that taxpayers relying on binding public rulings must have their circumstances on all fours with the arrangements which are the subject of a public ruling. In *Bellinz and Others v Commissioner of Taxation*⁵⁶, the taxpayer arranged its affairs in reliance on various rulings, not all of which were binding, so that it could claim substantial depreciation deductions under a ‘lessor partnership’. One of the issues addressed by the Court was whether the lessor partnership was entitled to rely on public rulings under Part IVAAA of the *Taxation Administration Act 1953*.

In response, the Court held that ‘while underlying the ruling a philosophy to permit depreciation in respect of hire purchase arrangements may be gleaned, none of the rulings relates to an arrangement or class or arrangement precisely similar to the present arrangement.’⁵⁷ This result further highlights the fact that TR2004/15 may not be the ‘Holy Grail’ that some tax planners may think it is and that reliance on it may be problematic if the central management and control test comes before the Australian courts in the future.

Even if risk management reasonably leads a company to rely on TR2004/14, or more interestingly, to not rely on it, there are still major practical problems associated with applying the statutory definition.

⁵⁶ 84 FCR 154.

⁵⁷ Ibid 169.

VI. WHERE IS CENTRAL MANAGEMENT AND CONTROL LOCATED?

Irrespective of the interpretation given to the second statutory test, there still remains the sometimes perplexing issue of where the central management and control actually is on a given sets of facts. This invariably becomes a question of who exercises central management and control and where they exercise it.

As Gillies says:

*The logical place to commence the search for central management and control is in the provisions of the company's constituent documents. Typically they will provide that the power to control the company's destiny is vested in the board of directors.*⁵⁸

As a starting point one could therefore look to where the board meets to transact the company's business as being the place where the central management and control is exercised. But as one commentator notes, this does not necessarily go to the root of the answer because an agreement may have been entered into where the directors will vote in accordance with the instructions of another or because independent judgment is not exercised there.⁵⁹

In the *De Beers* case the question arose as to whether a company should pay income tax on the basis that it was a resident of the United Kingdom. The company was incorporated in South Africa and had its head office situated there. The profits of the company were generated solely from the extraction and sale of diamonds in that country. Although general meetings of its directors were held in both Africa and London, the fact that the majority of the directors lived in London and the latter place was where the chief control of the company's affairs took place, was influential in the House of Lords concluding that the company was resident in the United Kingdom. Lord Loreburn, in addressing the issue of where the company's real business is carried on and hence its central management and control, stated that '[t]his is a question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading.'⁶⁰

The determination of where central management and control is exercised as a question of fact was enunciated in *Unit Constructions Co Ltd v Bullock*⁶¹ where Viscount Simonds held that '[n]othing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another.'⁶²

⁵⁸ Gillies P., 'Understanding Company Residence: Central Management and Control', (1989) August/September, *The CCH Journal of Australian Taxation* 54.

⁵⁹ Hamilton et al; *Guidebook to Australian International Taxation*, (Prospect Publishers 2001), 2.

⁶⁰ Above n 16, 458.

⁶¹ [1959] 3 All ER 831.

⁶² *Ibid*, 834–835.

In *Unit Constructions*, the taxpayer, an English company, sought a tax deduction in respect of certain outgoings to African subsidiaries of its English parent. Although the subsidiaries were registered in Africa, the taxpayer argued that they had become resident of the United Kingdom by reason that the directors of the subsidiaries had stood aside and de facto control had been assumed by the directors of the United Kingdom parent. This assumed control in the United Kingdom ran contrary to the subsidiaries' articles of association which stated that directors' meetings could be held anywhere outside the United Kingdom.

Viscount Simmonds held:

*It does not in any way alter ... [the fact that the acts of management] in greater or less degree ... are irregular or unauthorised or unlawful. The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative.*⁶³

Lord Radcliffe in *De Beers* set out the de facto principle when he said that '[t]he articles prescribe what ought to be done; but they cannot create an actual state of control and management in Africa which does not exist in fact.'⁶⁴

The decision in the Australian case *Esquire Nominees Ltd v Federal Commissioner of Taxation*⁶⁵ stands in contrast to the findings of the court in *Unit Constructions*. In *Esquire Nominees* the taxpayer was incorporated in Norfolk Island and acted as trustee of a Norfolk Island trust. The taxpayer's directors were all residents of Norfolk Island and all the meetings of the directors were held there. However, the facts showed that the agendas for the Norfolk Island meetings were arranged by a group of Australian accountants who acted on behalf of the taxpayer's beneficial owners. One of the issues before the High Court was whether the taxpayer was a resident of Australia on the basis that its central management and control was located there and accordingly that the income of the trust would be assessable under Australia's jurisdiction to tax.

The Commissioner, relying particularly on the 'de facto' principle expounded in *Unit Constructions* argued that because the real control and influence was exercised in Australia then the taxpayer was resident there. However, the High Court was not persuaded by this contention.

In finding that the taxpayer was not a resident of Australia, Gibbs J said that '[i]t is well settled that, for income tax, a company is resident where its real business is carried on, and its real business is carried on where the central management and control actually abides.'⁶⁶ He then went on to point out a number of indicia in support of the taxpayer not being a resident. They included the fact that all the directors resided in Norfolk Island, all the A class

⁶³ Ibid.

⁶⁴ Above n 16, 458.

⁶⁵ (1973) 129 CLR 177.

⁶⁶ Ibid, 190.

shareholders who were natural persons were resident of Norfolk Island, all the meetings of the company and its directors were held there and the business of the company was to act as trustee on Norfolk Island.

In the final analysis Gibbs J was swayed by the fact that although the firm of accountants had the power to influence, indeed strongly influence, the trustees, central management and control was located in Norfolk Island because the trustees would be sufficiently independent to always act in the best interests of the beneficiaries. Where the directors did comply with the directions of the accountants this was done because taking the directions was considered to be in the best interests of the beneficiaries. However, '[i]f, on the other hand, [the firm of accountants] had instructed the directors to do something which they [the taxpayer] considered improper or inadvisable, I do not believe that they would have acted on the instruction.'⁶⁷

In conclusion, Gibbs J said:

*[The taxpayer] was in my opinion managed and controlled there [Norfolk Island], none the less because the control was exercised in a manner which accorded with the wishes of the interests in Australia. The appellant was, in my opinion, a resident of Norfolk Island.*⁶⁸

Although this case went on appeal to the Full High Court, the issue of whether the taxpayer was resident was not in contention.

The main difference between *Esquire Nominees* and *Unit Constructions* appears to hinge on the fact that in *Unit Constructions* the directors in Africa stood aside from the control emanating from the United Kingdom, whereas this did not occur in respect of the Norfolk Island directors who performed their duties despite the strong influence coming from Australia. This would appear to be a moot point. As Hamilton and others say:

*A more cynical observer might say that the distinction rests on the mere technicality of transmitting 'suggestions' to be formally adopted by the directors' meetings [and] [p]rovided that the communications are simply 'suggestions', management and control seem to be difficult to prove.*⁶⁹

Irrespective of the Court's reasoning, the factual situation surrounding *Esquire Nominees* indicates how easily a company's circumstances could be arranged to achieve a desired taxation outcome under the central management and control test.

A case with similar lineage to *Esquire Nominees* is *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd.*⁷⁰ This case concerned the control of businesses carried on in Australia principally by non-residents under the former s136, ITAA36. Through a chain of shareholdings, predominant ownership of the shareholder could be traced to non-

⁶⁷ Ibid, 191.

⁶⁸ Ibid.

⁶⁹ Hamilton et al, above n 59, 2-17.

⁷⁰ (1980) 143 CLR 646.

resident interests. During one of the income years in question, the majority of the directors were non-residents.

The majority of the High Court held that for s136 to apply, the control exercised must be de facto control as opposed to capacity to control.⁷¹ As the non-residents had not, in actuality, exercised control over the business during the relevant years, the section had no application. The high-level decision making was exercised, in the main, by directors resident in Australia. The findings of the majority were based essentially on a form over substance approach which was specifically rejected by Murphy J in his dissenting judgment. In that judgment, Murphy J expressed his concern about arrangements which were engineered to gain favourable taxation outcomes. He said:

[s]ection 136 was intended to be an effective instrument for the Commissioner to deal with non-residents controlling businesses in Australia in such a way that they were able to reduce taxable income by shifting available profits elsewhere or by other devices.⁷²

Murphy J did not accept the contention that the company's business activities in Australia were not controlled by non-residents. He based his view on the principle that it is inappropriate to think of transnational business conglomerates in terms of particular business components and subsidiaries. Viewing the business operations in Australia as part of a transnational corporation the taxpayer was controlled by non-residents.

The decisions in cases such as *Esquire Nominees* and *Commonwealth Aluminium Corporation* reveal the potential uncertainty that may exist as to where central management and control is located in given fact situations. This, coupled with the uncertainty about the interpretation of the second statutory test, is a very real source of concern and confusion for foreign entities planning their corporate structures in connection with Australia.

VII. IS IT TIME FOR A CHANGE?

This article has referred to major problems with the application of the second statutory test for company residence and central management and control. These problems include the issues of lack of predictability and the potential for tax planning and avoidance.

By most standards, the test lacks predictability in its application because of its form over substance approach. First, it is not clear whether it has an essentially one-element or two-element formulation. The Commissioner, through TR2004/15, appears to have manufactured an outcome which holds that the test consists of two components both of which must be satisfied if a company is deemed to be a resident of Australia. But given that the courts see the place where central management and control as being a place where the business is carried out, there must be doubts about the efficacy of TR2004/15. In addition,

⁷¹ Ibid, Stephen, Mason and Wilson JJ 656.

⁷² Above n 70, 655.

where central management and control can turn on precise fact situations, so again there must be doubts about the residency of some foreign companies in Australia under the ruling and the existing case law. On the other hand, it could be argued that the case law is responsible for the confusion and not the ruling.

There is also an additional burden the test places on companies in the light of the self-assessment code operating in Australia. Consistent with the self-assessment framework is the obligation of the Commissioner to assist taxpayers to satisfy their statutory requirements by providing them with appropriate information and guidance. Tax rulings are a product of that obligation where the provision of clear pronouncements on how the law operates should be provided. Whether TR2004/15 meets this requirement with any degree of satisfaction is debatable given the length of the document and the difficult areas of the law it traverses and, as contended in this article, the ATO's incorrect application of the settled law on central management and control.

Professor Dirkis supports the view that the central management and control test also fails on anti-avoidance grounds. He explains how this concern goes deep into taxation history when in 1930 '[t]he leader of the Opposition...in the House of Representatives noted that the central management and control test would be avoided by '...encouraging companies to remove their central management and control from Australia and arrange to be controlled by persons abroad.'"⁷³

What also makes the application of such a test more difficult is the move by multinational conglomerates to less hierarchical structures and global decentralisation of their business operations. Collett provides, by way of example, Rio Tinto's claim that it 'has largely autonomous business centres scattered around the world'.⁷⁴ Finding where central management and control exists in such circumstances may be very difficult if not impossible to determine. Another possibility cited by Collett is where firms reorganise themselves into self-standing units which are brought together to achieve particular outcomes but which are adaptable to changing environmental circumstances confronting the corporation.⁷⁵

These evolutions in corporate structures and operations would not have been envisaged at the time the resident rules were first enacted. In those earlier days business operations were more centrally operated and the physical connection with a particular jurisdiction was generally obvious.⁷⁶ Running in tandem with these changes is the impact of electronic commerce. As this mode of commerce builds momentum, fewer transactions will conform to conventional ways of undertaking business. The tendency of electronic commerce to distort

⁷³ Above n 8, 49.

⁷⁴ Collett M., 'Developing a New Test of Fiscal Residence for Companies', (2003) 26(3) *UNSW Law Journal* 629.

⁷⁵ *Ibid*, 630.

⁷⁶ Graetz M.J., 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies', (2000–2001) 26 *Brooklyn Journal of International Law* 1357.

and override geographic and political boundaries will tend to place further pressure on concepts such as residence and permanent establishment of a company.⁷⁷

What is urgently needed is a major change to the existing rules in which corporations are taxed in Australia. Some go further. Graetz says that for corporations in the context of foreign direct investment 'the idea of residence – an idea central to any discussions of principles and policies relating to international taxation...seems both outdated and unstable.'⁷⁸ Alluding to a move away from traditional tests of residence, Graetz argues that '...in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties.'⁷⁹ This means alternative tests, taking into account the complexities of the modern cross-border world and the drive by big business to reduce tax 'costs' must be mentioned, if only briefly. It is not within the purview of this paper to examine in any detail alternatives.

VIII. ALTERNATIVES TO THE SECOND STATUTORY TEST

This paper has been about highlighting problems with the central management and control test for company residency. It would be remiss however, not to mention various proposed alternatives to the test. All of them have conceptual and practical problems.

One of the popular recommendations for corporate residency is a stand-alone incorporation test. This is the test that is used in the US and allows 'Apple' to avoid paying income tax in their country of residence. Apple is incorporated in the US, a single test of residence but has its central management and control in Ireland, again a single test country. As Antony Ting states, a company incorporated in Ireland with its central management and control in the US is therefore not a resident of either countries.⁸⁰ Prior to 2013, Ireland had a single, central management and control test whereby any company that did not have its central management and control in Ireland was not regarded as a resident for taxation purposes. However, in 2013 the Irish government amended the definition of corporate residency in order to catch companies that were 'stateless'. For companies incorporated in Ireland prior to 24 October 2013 they had until 1 January 2015 to comply with the new test.⁸¹ According

⁷⁷ McLaren, J (ed) *Advanced Taxation Law* (Thomson Reuters, 2015) 1162. The concept of Permanent Establishment is defined in all Australian Double Taxation Agreements as the place through which a business enterprise is wholly or partly conducted. It could be a branch, an office, a factory, a workshop, a mine site or agricultural operation. The internet and E-commerce is challenging this concept of a permanent establishment. For more details see page 1163.

⁷⁸ Graetz, MJ above n 76,1422.

⁷⁹ Ibid.

⁸⁰ Antony Ting, above n 2, 46.

⁸¹ Antony Ting, above n 3, 238.

to Antony Ting, the place of central management and control can be easily manipulated in practice.⁸²

Another option would be to re-engineer the central management and control test so that both a 'carry on business' and a 'central management and control' test would be needed to be satisfied for a foreign company to be deemed to be a resident. This would remove some of the doubt that presently exists in regard to the test as it currently stands. Professor Dirkis says such an option would assist in minimising compliance costs for companies by 'narrowing the range of non-resident companies caught under the current judicial interpretation of the ...test.'⁸³

Yet another option would be a variation on the central management and control test in which the central management and control element is removed thus requiring a carrying on business element alone. This approach may be seen to reflect more fundamentally the economic connection that a company has with a geographic location and with less emphasis on control. This approach has some similarities with the permanent establishment principle: an essentially source-based notion. However if the *Malayan Shipping* analysis is correct, a company having its central management and control in Australia would be carrying on a business in Australia and so would be a resident. Any provision along the lines suggested would have to fully exclude central management and control from the scope of carrying on a business in Australia.

The internet and other modes of electronic technology challenge the determination of where wealth is generated. For a 'carries on business' test, it may be difficult, if not impossible, to determine where servers and other telecommunications devices are located. As Thorpe notes:

*The problem centres around the issue of whether, due to the decentralised and mobile nature of the Internet, the commercial activity taking place in Cyberspace fits within conventional international tax system definitions and rules followed by most countries and taxing jurisdictions.*⁸⁴

Hence, under this model, it would be necessary to show that an enterprise conducting business over the internet has an economic connection with Australia. Clearly the rise of digital communications threatens tax bases and undermines sovereignty. For example the OECD has said:

⁸² Ibid.

⁸³ Dirkis, above n 8, 65.

⁸⁴ Thorpe K.E., 'International Taxation of Electronic Commerce: Is the Internet Age Rendering the concept of Permanent Establishment Obsolete?', (1997) 11 *Emory International Law Review*, 634.

[T]he challenges brought about by the digital economy raise systemic challenges regarding the ability of the current international tax framework to ensure that profits are taxed where economic activities occur and where value is created.’⁸⁵

Fiddling with the central management and control test will not address these wider BEPS issues.

In this article, the primacy of the resident concept for corporations has remained unchallenged. However, given the fundamental difficulties in framing robust corporate tests, is there an alternative proposal that relies less on the resident shibboleth? If the rules of corporate integration currently employed, in one form or another, by most developed countries could be adapted and extended into a fully integrated global system then the current emphasis on the residency approach for corporations could potentially take on less importance. A logical, but radical, extension to global corporate integration would be to remove the impost of taxation entirely at the company level and tax only individual shareholders. This approach would therefore remove the need to establish the associated sets of corporate resident rules. Various vested interests, including national capital in Australia, implementation difficulties and the need for a unified global approach make this an unlikely option in the short term.

Some have suggested that a view founded on more conventional economic thinking would be to tax companies purely on a source basis. The reliance on a source-based jurisdiction to tax wealth creation was endorsed by a group of economists appointed by the League of Nations to investigate the question of double taxation. The Centre for Tax Policy and Administration for the OECD says that although there are strong theoretical arguments for income being taxed exclusively in the state of residence, the League of Nations economists reported that ‘...taxation should be based on a doctrine of *economic allegiance*: ‘whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income.’⁸⁶ They concluded that wealth creation should be taxed at its origin (source) and where the wealth is spent (residence). This approach may challenge capital exporting countries and their tax bases.

Graetz, for example, although referring to international tax in the context of permanent establishments, poses the question:

[W]ould it be worth exploring whether a threshold amount of sales, assets, labor, or research and development within a nation could better serve to establish both the source of business income and as a threshold for the imposition of income taxation?⁸⁷

⁸⁵ OECD, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, Paris, 2014) 4 <<http://dx.doi.org/10.1787/9789264218789-en>>.

⁸⁶ Ibid 11.

⁸⁷ Graetz, above n 76, 1421.

Other approaches argue for variations on what is known as the formulary apportionment model.⁸⁸ Essentially this uses various formulae based on the factors of production such as labour, capital and land (e.g. payroll, sales and property) to apportion income to different jurisdictions. Difficulties in determining an appropriate formula that reflects the real economic activity in a particular jurisdiction and in implementing the approach, especially without some sort of international consensus, make this another cure which may be worse than the disease.

None of the alternatives on offer provide an easy solution.

IX. CONCLUSION

This article has analysed the second statutory company residence test and the difficulties and uncertainties it generates particularly for foreign-based companies having a connection with Australia. The concern is that the uncertainty about how the test applies may act as a deterrent to companies wishing to establish a presence in Australia.

Although the Commissioner, through the publication of TR2004/15, has expressed a general view that the test constitutes two requirements, there is a potential conflict between that view and the law as determined by the High Court in *Malayan Shipping*. Another difficulty is ascertaining where the central management and control is located as a matter of fact, especially in the digital age with instant communications through the ether and with links such as videoconferencing.

If a residency-based company test is to remain in Australia, which is likely, then new thinking is required to address the changing nature of commerce across the globe and to enable Australia to protect in part its company tax base. The ATO's current views on the central management and control test, incorrect in law as it has been interpreted by the courts, does neither.

⁸⁸ For an interesting discussion of this approach, see Kerrie Sadiq, 'Taxation of multinational banks: using formulary apportionment to reflect economic reality (Part 1)' (2011) 22(5) *Journal of International Taxation* 46.