2016 . Vol 3 No 10

Contents

Information contained in this newsletter is current as at December 2016

LexisNexis Butterworths

Bywater Investments Ltd v Commissioner of Taxation [2016] HCA 45: Be alert, not alarmed

John W Fickling *WESTERN AUSTRALIAN BAR*

Introduction

Many years ago, during 4 formative years of my career in London, I routinely advised cross-border entities and funds as to the tax issues involved in establishing holding companies in different jurisdictions to facilitate the making of investments in various jurisdictions. This involved, back then, establishing local holding companies in particular countries and it was critical that those holding companies would be tax resident in their country of incorporation, and only tax resident in that country of incorporation. For years if not decades, different countries have had differing thresholds to satisfy in order to ensure that a local holding company is tax resident in that local country and no other country.

The general guidance for local holding companies to be resident in the intended country (and not resident in any unintended country), whether that country be Malta, Germany, Hungary, Singapore, Luxembourg or some other country, would need to have substance which generally centred around four key tenets, with some variation depending on the particular country:

- first, holding board meetings for that local holding company, properly constituted in the local holding company's country;
- second, appointment of sufficiently capable local directors to the local holding company who would not be seen as mere puppets vis-á-vis any non-local directors who will actively consider instructions of the company's parents;
- third, the maintenance of proper board minutes and board papers documenting the robust consideration of matters at local board meetings; and
- fourth, the presence of all necessary local office presence for the local holding company jurisdiction as is customary.

Issues of substance for local holding companies do not just go to tax residence, but also go to issues around whether such local holding companies have permanent establishments in unintended countries, meet the necessary substance for transfer pricing purposes and meet the necessary substance for access to Double Tax Agreements.

In essence, the recent High Court case of *Bywater Investments Ltd v Commissioner of Taxation; Hua Wang Bank Berhad v Commissioner of Taxation*[1] (*Bywater*) stands for the proposition that from an Australian tax law perspective, establishing non-residency of offshore incorporated companies means as a matter of "fact and degree" ensuring robust procedures are in place so that non-residency of the offshore company holds water.

It is generally the case where inadequate operational procedures are put in place or not followed, either due to sheer laziness or due to *bush lawyers* with an over-simplistic understanding of tax residency law that the Commissioner of Taxation (the Commissioner) will be able to attack the tax residence of offshore companies. In London among international tax professionals there is, often spoken about but the source of which is never known, an *urban legend* about directors conducting a board meeting for their "offshore" Maltese company in a meeting room in London, while *HM Revenue & Customers* were in the adjacent meeting room conducting an audit on a related company. If such *laziness* occurs in practice, despite the best advice and operational procedures in place, the intended tax residency of an entity is at risk of being thwarted.

In *Bywater*, the plurality of the High Court dismissed an appeal from the Full Court of the Federal Court, ultimately, an appeal from the first instance of Perram J, where Perram J had held that certain companies incorporated outside Australia, broadly stated and wholly controlled by one Mr Vanda Gould, were tax resident in Australia.

As an overall remark, and consistent with the title to this article "Be alert, not alarmed", a fair reading of the High Court decision indicates that Australian companies and organisations which maintain offshore subsidiaries which broadly stated, comply with the above four tenets will in all likelihood continue to be considered non-resident for the purposes of Australian tax law.

Of course, companies which maintain such offshore subsidiaries should be reviewing the practices of the local directors and the written operational procedures of such companies to ensure their operational processes are

compliant with the above four tenets, and where appropriate seeking the expert advice of tax barristers who can render opinions as to the suitability of those operational processes.

As a further overall remark, it may be said that the plurality of French CJ, Kiefel J, Bell J and Nettle J (the plurality) seem to have been very careful to state in their judgment that where Australian offshore subsidiaries have the appropriate board structures and operational procedures in place, that those companies can continue to be non-resident for Australian tax purposes.

If there is any headline take away points from the plurality's decision, it is that the test of corporate non-residency for companies which are subsidiaries of Australian companies is one of "fact and degree". The plurality clearly rejected the proposition that the mere existence of a foreign board would be enough, rather when considered as a question of fact and degree, the local board must do its statutory duty, even if it ultimately tends to act at the direction of the offshore company's Australian controllers. Subject to this proviso, the plurality's decision is arguably a strong following of *Esquire Nominees Ltd v Federal Commissioner of Taxation*[2] (*Esquire Nominees*), discussed below, which has long considered to be one of the seminal cases on corporate tax residency in Australian tax law.

It is this point to which affected taxpayers should be attuned: this is now unquestionably an area which requires advice from tax advisors who have a demonstrated track record in establishing facts to the satisfaction of a court's rather than providing advice on a set of "assumptions". Post *Bywater,* taxpayers will want to know that if the Commissioner ever questions the tax residence of their offshore subsidiary, their advisor will know how to present these facts so that the advice that they have previously given holds true. Recent cases relating to individual tax residency show[3] there is often a large disconnect between the theory of where individuals are tax resident and what can actually be successfully proven in a court. As these cases demonstrate, where facts are successfully marshalled in support of the taxpayer's case. the same may ultimately hold true. I can't stress this enough: advice as to tax residency of an offshore entity based on the "facts and assumptions as we understand them" is unlikely to hold water if and when the Commissioner conducts a review. When the *rubber meets the road*, as will be happening in the aftermath of *Bywater* for many Australian businesses with offshore corporate subsidiaries, actual real-world courtroom experience of tax counsel in adducing and proving facts is going to prove invaluable.

I note that what is said in this article is necessary preliminary: this article is being written a short time after the publication of *Bywater* on 16 November 2016. As time passes, the understanding of the full depth of the High Court's 186 paragraphs in *Bywater* and the ramifications thereof will be better understood.

Residency of companies in Australia

Where a company, not incorporated in Australia, is not tax resident in Australia, it will only be taxed in Australia for income tax purposes, broadly stated on its Australian source income. However, if that same company is tax resident in Australia it will be taxed on its worldwide income.

Further, and relevantly, there are specific rules for specific areas of tax law — one being capital gains tax, where tax residents are taxed on their worldwide capital gains, whereas non-residents are only taxed on, broadly stated, dispositions of taxable Australian property. In the case of Australian Stock Exchange (ASX) shares, a non-resident company can, broadly stated, if it holds less than 10% of the ASX company hold and derive capital gains on Australian shares without triggering an Australian capital gain for itself. It was this aspect that many of the companies in *Bywater* were seeking to exploit.

There are additional complexities, particularly when Double Tax Agreements are involved, which are beyond the scope of this article.

Section 6(1) of the Income Tax Assessment Act 1936 (the 1936 Act) relevantly provides that a company is tax resident in Australia if:

- the company is incorporated in Australia; or
- the company:

> … 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.

As the plurality said by the plurality in [40] in *Bywater,* following *Esquire Nominees*:

> The latter part of that definition, first legislated in 1930, represents a statutory adoption of the test of residence … that a company's central management and control is located at the place where the company's operations are controlled and directed and the question of where a company's operations are controlled and directed is invariably a question of fact to be determined, not according to the construction of the company's constitution, but upon a scrutiny of the course of business and trading. [Footnotes omitted.]

Bywater key propositions

In *Bywater*, the High Court delivered two judgments, both dismissing the appeals: one of the plurality of four justices, as referred to above and a further judgment of Gordon J. Naturally, this article focuses on the plurality's reasons. In essence, the four key points made by the plurality are as follows:

- First, the mere existence of a local board of the offshore company is not enough to establish for the purposes of s 6(1) that the company is not tax resident in Australia. As the plurality at [41] noted:

> Accordingly, the question in this case is **whether**, in view of Perram J's findings concerning the role which Gould played and the absence of substantive decision-making by the boards of the appellants, **the fact that the boards of the appellants were located abroad was sufficient to locate the residence of the appellants abroad**. As will be seen, the course of authority comprised of the cases leading up to Esquire Nominees and the cases in point that have since been decided is largely, if not wholly, opposed to that conclusion. Hence, as will be explained, **the appellants' submissions** as to the effect of those authorities **should be rejected**.[Emphasis added.]

- Second, if the board of an offshore company is accustomed to act at the behest of its Australian controllers, so long as the local company's board of directors are doing their statutory duty as directors and properly reviewing directions received to ensure that directions received are in the interests of the company and consistent with the law, then that will not in and of itself result in the local company being tax resident in Australia. As was noted first by the plurality at [66]:

> … it is clear that Gibbs J found as a fact that the board meetings were held on Norfolk Island and that substantive decisions were made by the board.
> Admittedly, the directors complied with the advice of Australian accountants. But, as Gibbs J found, they did so "because they accepted that it was in the interest of the beneficiaries [of the trust], having regard to the tax position, that they should give effect to the scheme" and, if they had been advised to do something "which they considered improper or inadvisable", "they would [not] have acted on the instruction". In contrast to the facts of the present appeals, *Esquire Nominees* was not a case of a board rubber-stamping decisions made by others. [Footnotes omitted.]

  What the plurality said at [66] was then confirmed at [71] where the plurality noted:

> And in contradistinction to ***Esquire Nominees,*** **where the Norfolk Island board was found actively to have considered and approved the advice of the Australian accountants**, [in the present case] it was not established that there were any meetings of the appellants' boards at which any part of the business of share trading or money lending was considered or approved, or at which any other of Gould's directions was considered or approved.

- Third, in guiding what is essentially a question of fact and degree (refer to the fourth point below), the English case of *Wood v Holden (Inspector of Taxes)*[4] (which applied *Esquire Nominees*) has some credence in distinguishing proper and improper control exercised through a company's "constitutional organs":

> More recently, in the United Kingdom, in Wood v Holden, the Court of Appeal drew a distinction between cases where central management and control is exercised through a company's constitutional organs on the basis of external advice or influence, but in fulfilment of the constitutional organ's functions, and cases where the functions of the company's constitutional organs are usurped by an outsider who dictates the decisions to be implemented, independently of or without regard to those constitutional organs. [Footnotes omitted].

- Fourth, the question of central management and control, and tax residence will turn on the facts and degree as to *where the central management and control of the company actually abides* and that there is no rule that a company will be determined *merely* because its board does not meet in Australia. As the plurality further stated at [83]:

> *"As a matter of long-established principle, the residence of a company iis first and last a question of fact and degree to be answered according to where the central management and control of the company actually abides. As a matter of long-established authority, that is to be determined, not by reference to the constituent documents of the company, but upon a scrutiny of the course of business and trading. …* ***Each case depends on its own facts and circumstances, albeit that those cases that have been decided may provide a degree of guidance in relation to those still to come****."* [Emphasis added.]

The overt factual failings to establish corporate non-residency in Bywater

The above remarks can be compared to the factual observations of the plurality in *Bywater* where it was noted that Perram J had found that as a matter of fact, the local boards of directors were not fulfilling their functions. It is the author's contention that, the High Court rightly held, where the taxpayers in *Bywater* failed in their task to establish the non-residency of the various entities was the subject of the appeal. Most pertinent were the plurality's remarks as to the failures of operational processes at [61]–[63]:

> First, as was earlier noticed, in the case of Bywater, **there were no minutes and the only evidence of any meetings of directors was evidence given by Borgas, which Perram J rejected as untruthful**. In the case of Chemical Trustee and Derrin, there were minutes recording meetings of the boards **but those minutes reveal that there was seldom more than one meeting of directors per year in addition to annual general meetings. The minutes refer only to formal business, such as the adoption of the annual accounts, the absence of a declaration of any**

> **dividend, directors' remuneration and auditors' remuneration. There is no written record of the boards of Chemical Trustee or Derrin ever considering any item of substantive business or corporate policy**. For all that appears, such, if any, business as was implemented from Neuchâtel was implemented by Borgas, acting on the direct instructions of Gould, without consultation with the boards of directors …
>
> Secondly, as was earlier recorded, Perram J found as a fact that Borgas was simply Gould's puppet or cypher; the meetings of directors in Neuchâtel were mere window dressing that consisted of rubber-stamping decisions actually made by Gould in Sydney and implemented by Borgas as Gould's factotum; Borgas' role as a director was fake; and the minutes of Chemical Trustee and Derrin were contrived to make it appear otherwise. **That leaves no reason to suppose that Gould and Borgas paid punctilious attention to the formal governance structure of the companies or to anything else**, apart from that which was considered necessary to conceal Gould's involvement in the management and control of Bywater, Chemical Trustee and Derrin.
>
> Thirdly, even if all of the formalities had been scrupulously observed, in the sense that all decisions made by Gould in Sydney were communicated to Borgas for formal adoption at a board meeting and were in fact formally adopted at such a meeting before being implemented, there would remain **Perram J's undisputed findings of fact that the directors acted "without thought" at those meetings because they "took no part to any extent in [the] decision-making processes"**. Given the "well settled" line of authority that the question of where the central management and control of a company actually abides is to be determined by the solid facts and not by the terms of the company's constitution, why should meetings of directors which are no more than mere window dressing, serving only to rubber-stamp decisions actually made by others in another place, be regarded as the actual exercise of central management and control? [Emphasis added.]

It is to be noted that Perram J, at first instance, was wholly unrestrained, from a judicial perspective, in his use of language, where he described at [398] in *Hua Wang Bank Berhad v Commissioner of Taxation* (*Hua Wang FCA 1392*)[5] *(*includes Corrigendum dated 10 March 2015*)* the situation as such:

> [T]he crooked pantomime being conducted on Mr Gould's behalf in London (by Lubbock Fine), in Switzerland (by Mr Borgas) and in Samoa by the far-flung employees of Asiaciti.

Because the factual failings in *Bywater* were so overt, there is little to be gained from further analysis of the facts in *Bywater*. As was said in the introduction to this article, tax advisors rendering advice on facts and assumptions as we understand them is simply not going to be what taxpayers need if and when the Commissioner conducts a review as to the tax residence of offshore entities, but rather taxpayers should be ready with hard, documented evidence which can be adduced in a court.

Perram J's remarks as to distinguishing Esquire Nominees not maintained by the High Court

It is worth mentioning in passing that Perram J's remarks in the case below, in *Hua Wang FCA 1392*, published on 19 December 2014, caused some significant consternation for those taxpayers with offshore companies, particularly where Perram J appeared at distinguishing *Esquire Nominees* as being limited in its relevance to trust companies. It is stated at the outset, that what has been said in this article, that Perram J's apparent distinguishing of *Esquire Nominees* was not followed by the High Court.

In *Hua Wang FCA 1392,* Perram J said at paras [398]–[400]:

> The **particular** passage [in Esquire Nominees] upon which reliance was placed was at 190:
>
> > 'In the present case the appellant was incorporated in Norfolk Island and had its office there. All the directors resided in Norfolk Island. All the A class shareholders who were natural persons were residents of Norfolk Island and it seems proper to conclude that the other A class shareholder, Myee Ltd, was also a resident. All meetings of the company and of the directors were held in Norfolk Island. The business of the company was to act as trustee on Norfolk Island. These facts strongly support the conclusion that the appellant was a resident of Norfolk Island.'
>
> **In Esquire Nominees the taxpayer was a trustee company**. As it happens, it was the trustee of some 12 trusts in favour of the Manolas family. They, it need hardly be said, were not resident in Norfolk Island. The evidence showed that the trustee company, as trustee, gave effect to the views of a firm of accountants in Adelaide in making decisions about what the trust should do. This did not deter Gibbs J from concluding that Esquire Nominees was resident in Norfolk Island.
>
> But the reasons for this are obvious. The business decisions made by Esquire Nominees were decisions relating to its business as a trustee, not the trusts themselves. **Whilst the accountants could tell the trustee what to do qua trustee they could not tell the directors of the trustee company what to do qua company**. Insofar as the trustee's own business was concerned it made good sense for it to give effect to the wishes of those behind the Manolas trusts speaking through the vector of the accountants. But in doing so they were giving effect to their own view that it was in the trustee's best interests as a trustee company to do as it was told. [Emphasis added.]

One commentator, Mr Robert Gordon, previously experienced tax counsel at the Victorian Bar, noted in one article soon after the judgment in *Hua Wang FCA 1392*:[6]

> On the facts as found by Perram J, that Mr Vanda Gould (an Australian tax resident) was the beneficial owner of the companies, and had "usurped" the boards of the companies, there was no need to distinguish Esquire Nominees. His doing so potentially risks the status quo …

> Whilst on the facts, Perram J's understanding of the ratio of Esquire Nominees would not have affected the outcome in Hua Wang Bank, in one instance because the company held no directors meetings (e.g. Bywater Investments), and in others, as the directors did not know enough of the company's business to make any informed decision (e.g. Hua Wang Bank), **the analysis of the ratio of Esquire Nominees in the Hua Wang Bank decision is at odds with TR 2004/15 and inconsistent with Wood v Holden**. [Emphasis added.]

It suffices to say, that Mr Gordon's criticism of Perram J's decision in *Hua Wang FCA 1392* appears to have had credence, because, as the above analysis shows, the High Court plurality's decision in *Bywater* does not actually or appear to distinguish *Esquire Nominees.* The same can be said of the Full Court's decision in *Bywater Investments Ltd v Commissioner of Taxation* which similarly, also did not actually or appear to distinguish *Esquire Nominees*.

As is apparent, the decision from below in *Hua Wang FCA 1392* should be seen as a case which "turns on its own facts" and following the High Court's decision in *Bywater*, should not be seen as causing alarm for well-managed offshore subsidiaries.

Conclusion

As was said at the outset in this article, following *Bywater,* taxpayers in Australia with offshore subsidiaries should be alert, not alarmed.

The Commissioner is in all likelihood likely to use the decision in *Bywater* to conduct reviews on taxpayers with offshore subsidiaries to determine if those offshore subsidiaries are truly, as a matter of fact and degree, non-resident. It remains to be seen whether the Commissioner will be referring to the High Court's plurality's concluding remarks, that:

> As a matter of long-established principle, the residence of a company is first and last a question of fact and degree to be answered according to where the central management and control of the company actually abides …

in constructing new arguments so as to run arguments of Australian residency of offshore entities where the facts are less stark and less extreme than they were in *Bywater*.

As was said in the introduction to this article, taxpayers should be prepared by ensuring that they have optimal operational processes in place and that those operational processes are followed.

John W Fickling
Barrister
Western Australian Bar
jwfickling@taxbar.com.au
www.wabar.asn.au

Footnotes

1. *Bywater Investments Ltd v Commissioner of Taxation; Hua Wang Bank Berhad v Commissioner of Taxation* [2016] HCA 45; BC201609799.
2. *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; (1973) 1 ALR 145.
3. *Re Dempsey and Commissioner of Taxation* (2014) 98 ATR 698; [2014] AATA 335; BC201481302; *Re Dempsey and Commissioner of Taxation* (2014) 98 ATR 698; [2014] AATA 335; BC201481302.
4. *Wood v Holden (Inspector of Taxes)* [2006] 1 WLR 1393; [2006] EWCA Civ 26.
5. *Hua Wang Bank Berhad v Commissioner of Taxation* (2014) 100 ATR 244; [2014] FCA 1392; BC201411365.
6. R Gordon "Residence of companies: Esquire Nominees unnecessarily distinguished" (4 February 2015), http://pointonpartners.com.au/residence-of-companies-esquire-nominees-unnecessarily-distinguished/.