[¶859] “It’s the vibe of the thing”: Esquire Nominees (re)considered by the High Court, 25 November 2016

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Contributed by Associate Professor Justin Dabner, Law School, James Cook University, Cairns, Australia; Adjunct research fellow in Business Law and Taxation, Faculty of Business and Economics, Monash University, Australia

Introduction

The High Court in *Bywater Investments Limited* v *Commissioner of Taxation*; *Hua Wang Bank Berhad* v *Commissioner of Taxation* 2016 ATC ¶20-589 has affirmed the decision of the Full Federal Court (2015 ATC ¶20-549) in holding that the taxpayers could not rely on *Esquire Nominees Limited as Trustee of Manolas Trust* v *FCT* 73 ATC 4114 to assert that they were non-residents where the boards of the taxpayers were acting in accordance with the wishes of an Australian resident. In “Is Esquire Nominees under assault?” *Australian Tax Week* (24 March 2016), the author suggested that the Full Federal Court, by distinguishing *Esquire Nominees*, had cast doubt on the ability to rely on *Esquire Nominees* in denying that a company was an Australian resident. The High Court decision, while not going so far as rejecting the decision in *Esquire Nominees*, has interpreted the case in such a way as to provide little opportunity to structure “tax haven companies” to avoid the Australian residency rules.

Corporate residency and Esquire Nominees

The test for corporate residency contained in s 6(1) of ITAA 1936 provides for three alternative scenarios. Incorporation in Australia is the first test. A company that is not incorporated in Australia may, nevertheless, be an Australian resident if it carries on business in Australia and has its central management and control here. Should a foreign incorporated company (such as one incorporated in a tax haven) have its board meet outside Australia then it might avoid being treated as an Australian resident under this second test. The third test focuses on whether the majority of the shareholders are Australian residents. The decision in *Patcorp Investments Limited (formerly Patrick Corporation Limited) & Ors* v *FCT* 76 ATC 4225 means that in the application of this test reference is made solely to a company’s register and the ultimate beneficial ownership (where the shares are held in trust) is irrelevant.

For companies seeking to avoid the second test it is common to appoint foreign directors who meet overseas. Of course, the ultimate (Australian resident) owners of the company will want these directors to act according to their wishes. However, to avoid central management and control being sheeted back to Australia the directors must be seen to be independently minded, although focused on the Australian interests. This creates a tension traditionally resolved by ensuring that there is no legal control over the board of directors vested in the domestic interests and couching any communications between the two in terms consistent with this state of affairs.

Esquire Nominees is viewed as the authority underpinning this approach. In a much quoted paragraph in the judgment of Gibbs J at first instance (72 ATC 4076, at 4085; and endorsed by the Full Court) his Honour opined that although an Australian accounting firm sent “instructions” to the overseas directors the firm “had no power to control the directors.” Although the firm may have had power to exert strong influence the directors simply complied because they accepted that it was in the interest of the beneficiaries and had the accountants instructed the directors to do something which they considered improper or inadvisable they would not have acted on the instruction.

Viewed as a victory of form over substance many have been heralding that, given the chance, the High Court would revisit this decision (for example see Cindy Chan, “Corporate Residence: has Esquire Nominees stood the test of time?” 49(5) *Taxation in Australia* 253) if not to reverse it, at least to ensure that the precedent was restricted to circumstances where directors really do exercise independent judgment in contrast to the mere “rubber stamping” of instructions from Australia. *Bywater Investments* is exactly that case.

Bywater Investments

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The taxpayers in *Bywater Investments* had structured their offshore corporations to have local directors and meetings. “Instructions” came from Australia from a Sydney based accountant, a Mr Gould. Squarely at issue was as to whether the taxpayers could rely on the authority of *Esquire Nominees* to avoid Australian residency.

At first instance it was held that notwithstanding the overseas location of the directors the real business of the entities was conducted by Gould from Sydney without the involvement of the directors. Thus the “central management and control” was situated in Australia. On appeal, the Full Court of the Federal Court endorsed this conclusion. Critical to the outcome in *Esquire Nominees* had been that the compliance of the directors with the wishes of others was only because the directors accepted those wishes to be in the interests of the beneficiaries. This situation was to be contrasted with the facts of the instant case. The taxpayers’ urging to give weight to factors such as the place of incorporation, the shareholding of each company and the place of incorporation of corporate shareholders, the location of the directors, the minutes of meetings of the boards of directors, the place at which the meetings were held, and the place at which the transactions were entered into as constituting the businesses of each of the taxpayers did not alter the conclusion. The taxpayers’ case was compounded by the lack of probity in the evidence given by their chief witness nor did the nature of communications between Gould and the directors assist.

The taxpayers’ subsequent appeal to the High Court was dismissed by unanimous decision (Gordon J issuing a separate judgment differing from the rest of the Court in her Honour’s focus on the relevant double tax treaties). The Court emphasized that, as a matter of long-established principle, the residence of a company is a question of fact and degree to be determined according to where the central management and control of the company actually abides, and that is to be determined by reference to the course of the company’s business and trading, rather than by reference to the documents establishing its formal structure. The Court held that the fact that the directors were located abroad was insufficient to locate the residence of the companies’ abroad in circumstances where the directors had abrogated their decision-making in favour of Gould and only met to rubber-stamp decisions made by him in Australia.

The Policy Arguments

It is easy to characterize the decision as one that simply distinguished *Esquire Nominees* on the facts and did not vacate any of the reasoning in that case. However that would lead to an understatement of the significance of the decision. After all the High Court rarely grants special leave to hear tax matters. Although not rejecting *Esquire Nominees*, borrowing from Dennis Denuto, Darryl Kerrigan’s frazzled lawyer in *The Castle*, the High Court has established a new “vibe”.

The author’s earlier consideration of the Full Federal Court decision concluded with the observation that the decision was a warning that blind faith reliance on the authority of *Esquire Nominees* was now a risky proposition. Certainly the wording of communications from Australia to foreign directors needed to be reviewed but also Australian corporate groups with overseas subsidiaries urgently needed to undertake a risk analysis. The uncertainty in departing from the entrenched view that the assertion of some authority over an overseas subsidiary’s board by its holding company does not, on its own, render the subsidiary an Australian resident is point that was, in fact, expressly alluded to by counsel for the taxpayers (see para 34). The Court rejected this argument as exaggerated (at para 80).

Taxpayers’ counsel had also sought to support a “form over substance” approach to ascertaining central management and control by reference to where the board meets by citing the approach adopted in *Patcorp* to the third residency test. This argument was given swift treatment (at para 79). Similarly a suggestion that the enactment of the controlled foreign company rules in lieu of a change to the control test to a “habitually responds to instructions formulated in Australia” test, as support for a general understanding of *Esquire Nominees*, was also rejected. The Court stated that nothing in *Esquire Nominees*, in the recommendations of the Asprey Committee or the subsequent enactment of the CFC rules implied that a company should be regarded as a non-resident where its board acted upon the dictates of an Australian resident (at para 82 and 83).

Conclusion

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The proposition that central management and control is where the board meets in the absence of a *legal power* over the board residing in someone else has now been comprehensively rejected (see for example para 68). Apparently this never was the law; the enquiry has always been where control exists as a matter *of fact*. Many advisers might be forgiven for viewing the High Court decision in *Bywater Investments* as a revision of history. Regardless, the (new) vibe is clear — and maybe as it should have always been — and Australian taxpayers with "connections" to foreign companies would do well to review the residency status of these entities. Mere reliance on the location of the formal constituents of a company to satisfy a factual enquiry as to the location of the central management and control will not be decisive.

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