

**A Discussion of the Concept of ‘the Place of Effective Management’ in the Context of South African law, using Internationally Established Principles of Corporate Residency from the United Kingdom, Europe and Australia as Guidelines to Formulating this Concept in South African law.**

**Submitted as a dissertation component by**

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## **ABSTRACT**

The aim of this dissertation is to carry out the following:

- Discuss the concept of residency in South Africa and the evolution to the residence basis of taxation in South Africa.
- Examine the Organisation for Economic Co-operation and Development's (OECD) stance on the concept of 'effective management'.
- Examine the laws of the United Kingdom, certain European countries and Australia with regard to the concepts of 'management and control', 'management or control', 'place of effective management' and 'effective management'.
- Formulate a definition of the term 'place of effective management' in South Africa using these guidelines obtained from the various countries discussed.

## **DECLARATION**

I hereby declare that unless stated to the contrary, this dissertation is entirely my own work.

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Signature

## **ACKNOWLEDGEMENTS**

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## CHAPTER ONE

### SOURCE VERSUS RESIDENCY

#### Source to Residency Changeover in South African Fiscal Legislation

There are two main principles under which countries tax income – source and residency. South Africa's income tax system changed from a source-based system of taxation to a residence basis of taxation for its residents. The new 'residence minus' system was announced in the Budget Speech on 23 February 2000 and was adopted for years of assessment commencing on or after 1 January 2001.

Residents are now taxed on their world-wide receipts and accruals, with the exception of certain categories of income and activities undertaken outside South Africa being exempt from South African tax. This is, however, a hybrid system and taxes income on both a source and a residence basis.

South Africa's income tax system was previously based on what was commonly referred to as the 'source plus' basis of taxation. All income that was generated in the Republic and certain types of income that were deemed to be from a South African source, were taxable in terms of the Income Tax Act 58 of 1962 (the Act).<sup>1</sup>

#### Source versus Residence Basis of Taxation

Income derived by a person may be taxed by a country because of a connection between the country and the generation of the income (source based). Countries assert source jurisdiction to tax income on the basis that the income is generated from economic activity within the country.

Countries may also tax income (wherever it is derived) because the person earning the income is a resident of that country (residence jurisdiction).

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<sup>1</sup> 'Briefing Note Residence Basis of Taxation' – 15 September 2000 ([www.taxnet.co.za](http://www.taxnet.co.za)).

Most countries tax income on a basis that is both a source basis and a residence basis. What this means is that a person is usually taxed on income from both domestic and foreign sources, while non-residents are taxed only on domestic source-income.

South Africa changed to the residence basis of taxation for the following reasons:<sup>2</sup>

- The changeover would place the South African income tax system on a sounder footing thereby protecting the South African tax base from exploitation.
- The relaxation of exchange control brings with it the greater involvement of South African companies offshore – the changeover to the residence system, would ensure that these companies now fell within the South African tax net (assuming that they are South African residents as defined).
- To more effectively cater for e-commerce.
- One of the more important reasons for the changeover is that it brings South Africa in line with international tax principles. This indicates that South Africa is once again becoming involved in international business transactions and cognisance has been taken of the impact this will have on the South African tax base.<sup>3</sup>

The Margo Commission in its report commented upon the changeover as follows:<sup>4</sup>

‘The fiscal benefits resulting from the introduction of a worldwide basis of taxation would be reduced if there were a reduction in South Africa of the individual and/or company rates of tax, as has been recommended by the Commission.’

The Margo Commission concluded that from a revenue-collecting perspective, the adoption of a residence or source basis of taxation would hardly impact as regards direct investment (specific referral being made to active income), but that as regards passive investment, a residence or world-wide system would bring a definite revenue advantage.

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<sup>2</sup> ‘Briefing Note Residence Basis of Taxation’ – 15 September 2000 ([www.taxnet.co.za](http://www.taxnet.co.za)).

<sup>3</sup> Mosupa F: ‘The Implications of the Residence Basis of Taxation on Individuals’, 14 March 2002 ([www.etaxes.co.za](http://www.etaxes.co.za)).

<sup>4</sup> Paragraph 26.19.

The basic rationale of a residence basis of taxation has been contrasted to that of a source based system in the following terms by the Appellate Division of the Supreme Court (now the Supreme Court of Appeal):<sup>5</sup>

‘In some countries residence (or domicile) is made the test of liability for the reason presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is “source of income”; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy.’

### **Application of the Residence and Source Systems – International Trends**

Nowhere in the world are either the residence or source systems applied with a 100% degree of purity. In many instances, countries that apply the residence basis of taxation are generally required, in terms of double tax treaties

- to exempt income generated in another country, or
- to impose a credit for the tax imposed in the source state.

Accordingly, all residence-based systems still tax non-residents on income sourced within their jurisdictions.<sup>6</sup>

Countries with a source system have gradually extended the scope of their taxes by deeming certain types of income to be sourced within their jurisdictions (especially income of a passive nature) and therefore subject to tax there. Relief is granted to their taxpayers for taxes suffered in the source jurisdiction. There are various arguments advanced in favour of taxing passive income but these are not really convincing and are more pragmatic in nature. Essentially, it is argued that the state of residence of the taxpayer has enabled him to accumulate capital (to lend offshore), to develop intangible property (to license offshore) or to

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<sup>5</sup> *Kergeulen Sealing and Whaling Co Ltd v CIR*, 1939 AD at 487.

<sup>6</sup> Chapter One: ‘Introduction to the Taxation of International Income by Using the Source and Residence Principles of Taxation’ (*Katz Commission 5<sup>th</sup> Interim Report*) at 2 ([www.taxnet.co.za](http://www.taxnet.co.za)).

acquire a capital asset (to lease offshore) and that the taxpayer does not actively use the infrastructure of the other state where another taxpayer uses the capital or asset.<sup>7</sup>

Both these systems are strongly represented throughout the tax systems of the world, although it is in hybrid form. Brazil and Argentina have only recently changed over to a residence-based system. Latin America still, however, contains a strong sentiment towards the source basis. Malaysia experimented with both systems – initially having a source basis in force, then changing over to the residence basis in 1968. This lasted until 1973, when there was a changeover back to the previous system.

Many international bodies seem to utilise territoriality or source as a favoured system. In 1955 the International Chamber of Commerce changed their earlier support for a world-wide basis of international taxation to suggest that the source country should have the sole right to tax international income.<sup>8</sup> At its 1984 Buenos Aires conference, the International Fiscal Association pointed out the economic disadvantages of implementing the residence basis of taxation. The Association recommended ‘a system of territorial taxation or exemption’ and appealed to governments that had implemented the residence system to reconsider their decisions.

While academic debate still revolves around these two systems, the appropriate system depends ultimately on the specific country that is going to enforce the system and other factors, for example, economic strategies, net cross-border capital flows, the relative sizes of the national and domestic economies, relative tax rates, history and administrative capacity.<sup>9</sup>

#### **The Definition of a Resident within the Context of South African Law**

In implementing this change in South Africa, it was necessary to re-define one of the most important building blocks on which the income tax system is based, namely, what income is

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<sup>7</sup> Chapter One: ‘Introduction to the Taxation of International Income by Using the Source and Residence Principles of Taxation’ (*Katz Commission 5<sup>th</sup> Interim Report*) at 2 ([www.taxnet.co.za](http://www.taxnet.co.za)).

<sup>8</sup> Chapter One: ‘Introduction to the Taxation of International Income by Using the Source and Residence Principles of Taxation’ (*Katz Commission 5<sup>th</sup> Interim Report*) at 2 ([www.taxnet.co.za](http://www.taxnet.co.za)).

<sup>9</sup> Chapter One: ‘Introduction to the Taxation of International Income by Using the Source and Residence Principles of Taxation’ (*Katz Commission 5<sup>th</sup> Interim Report*) at 3 ([www.taxnet.co.za](http://www.taxnet.co.za)).

taxable. The definition of 'gross income' in s 1 of the Act was therefore amended to reflect the world-wide basis of taxation, whereby<sup>10</sup>

- residents are now taxed on their South African and foreign income, and
- non-residents are taxed on their South African-sourced income.

The concept of a 'resident' is fundamental to the world-wide or residence based system of taxation. A person who qualifies as a 'resident' as defined in s 1 is subject to tax in South Africa on receipts and accruals from anywhere in the world (para (i) of the definition of 'gross income').

The following persons are defined as being 'resident':

- Any natural person who is ordinarily resident in South Africa.
- Any natural person who is not at any time during the year of assessment ordinarily resident in South Africa but who is physically present in South Africa for certain periods.
- Any person other than a natural person that is incorporated, established or formed in South Africa.
- Any person other than a natural person that has its place of effective management in South Africa (definition of a 'resident' in s 1).

As this dissertation focuses on the term 'place of effective management' within the definition of the term 'resident', the focus is on the term of 'resident' as it applies to a person other than a natural person. In other words, the focus is on the term 'resident' as it applies to non-natural persons.

In terms of the Act's definition of a 'resident', a company is a 'resident' of South Africa if it

- is incorporated, established or formed in South Africa, or
- has its place of effective management in South Africa.

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<sup>10</sup> 'Briefing Note Residence Basis of Taxation' – 15 September 2000 ([www.taxnet.co.za](http://www.taxnet.co.za)).

*Persons other than Natural Persons Incorporated, Established or Formed in South Africa*

A person other than a natural person, for example, a company, a close corporation or a trust, incorporated, established or formed in South Africa will be a resident of South Africa and subject to tax in the country on its world-wide income.

*Persons other than Natural Persons Having their Place of Effective Management in South Africa*

A person other than a natural person, for example, a company, close corporation or a trust, that has its place of effective management in South Africa will be a resident of the country and subject to tax in it on world-wide income, even though it is not incorporated, established or formed in South Africa.

Any 'international headquarter company' as defined in s 1 is, however, excluded from being a resident even though it may be incorporated, established or formed, or may have its place of effective management in South Africa (para (b) of the definition of a 'resident' in s 1).

The Revenue Laws Amendment Act 59 of 2000 introduced the definition of a 'resident' in s 1 of the Act, which includes the term 'place of effective management' as one of the tests to determine the residence of a person other than a natural person.<sup>11</sup>

The previous inconsistent use in the Act of the concepts 'managed and controlled', 'managed or controlled' and 'effectively managed' was addressed simultaneously and a more uniform approach is now followed in the Act. The reference to 'managed or controlled' in Practice Note 7 dated August 1999, para 1.1.3, is therefore no longer applicable.

Although the Act refers to the place of effective management of a company, as opposed to its place of management or control, decisions in various cases, where the concept of management

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<sup>11</sup> Income Tax Interpretation Note 6 entitled 'Resident: Place of Effective Management (Persons other than Natural Persons)' issued on 26 March 2002 at 1, obtained from [www.sars.gov.za](http://www.sars.gov.za).

or control have been considered, can be helpful in determining the meaning of the term 'place of effective management'.

The Katz Commission,<sup>12</sup> recommended that the concept of 'effective management' as referred to in art 4(3) of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention be used consistently to designate the tax residence of persons other than natural persons. This it suggested would perhaps be best achieved through an appropriate definition in s 1 of the Act. The implementation of this concept it believed would have the benefit of employing terminology internationally commonly understood.

It is thus necessary for these terms, for example, 'management or control' and 'effectively managed' to be examined in the context of international precedent, in order for a more constructive guideline to be formulated in the context of South African law. Interpretation Note 6 renders a guideline as to the interpretation of the term 'place of effective management' but it is not legally binding, nor does it provide much clarity, in South African law. It is therefore the objective of this dissertation, to formulate a more accurate guideline to the term 'place of effective management', in conjunction with the guidelines as set out by the Commissioner. This it is proposed can be done by the formulation of a hierarchical test, which will assist in providing greater clarity to the determination of a non-resident's place of effective management.

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<sup>12</sup> Chapter Six: 'Introduction to the Taxation of International Income by Using the Source and Residence Principles of Taxation' (*Katz Commission 5<sup>th</sup> Interim Report*) at 1 ([www.taxnet.co.za](http://www.taxnet.co.za)).

## CHAPTER TWO

### OECD POSITION ON THE TERM 'PLACE OF EFFECTIVE MANAGEMENT'

#### Introduction

As a consequence of South Africa's change to the residence basis of taxation for its residents coupled with the fact that a large proportion of South Africa's trading partners also operate on the residence basis of taxation, the problem of international double tax needed to be addressed.<sup>1</sup>

Problems arise with regards to international double taxation because of the different ways in which countries levy their taxes. A consequence of this is that double tax could arise, which in effect would be the taxation of the same amount of income in two or more different countries.

How does this double tax arise?<sup>2</sup>

- Some countries tax on a source basis, while others may tax on the residence basis. Most instances of double taxation will arise as a result of the residence and source jurisdictional conflicts.
- Both countries may use the residence basis of taxation, but may not have the same definitions of 'residence'. In other words, double taxation can also arise from residence-residence conflicts where both contracting states treat a person as a 'resident' for tax purposes under their domestic law (with the result that the person is fully liable to tax in both states).
- Both countries tax on a source basis but have different definitions of 'source'.
- Both countries tax on a residence basis for residents, but on a source basis for non-residents.

To minimise this problem, countries enter into double tax agreements.

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<sup>1</sup> Huxham K and Haupt P, *Notes on South African Income Tax 2002*, 21<sup>st</sup> Edition, Hedron Tax Consulting and Publishing CC at 298.

<sup>2</sup> At 299.

## Double Tax Agreements and the OECD Model Tax Convention

The main focus of double tax agreements is to avoid double taxation, which, if not addressed may impede cross border flows of trade, investment and capital. Most countries have set about resolving these potential conflicts by drawing up and signing double tax agreements.

The OECD has attempted to standardise the tax position for member states by setting up a guideline in the form of a standard OECD model treaty.<sup>3</sup> This process began in 1956 and the treaty is continuously being upgraded to keep abreast of changes in international tax law and trade.

The OECD Model Tax Convention deals with residence-residence conflicts through tie-breaker rules in art 4 that allocates residence of the dual resident

‘...to one of those States, so that person is treated as a resident solely of that State for the purposes of the Convention.’<sup>4</sup>

‘In the case of an individual, the tie-breaker rules look at various indicia of personal attachment to a State with a view to determining to which State “it is felt to be natural that the right to tax devolves”.’<sup>5</sup>

For companies and other bodies of persons, a tie-breaker rule based on personal attachment is clearly not appropriate. The Convention also rejects a tie-breaker based on purely formal criteria, for example, registration. In giving preference to the state where the entity is ‘actually managed’,<sup>6</sup> it would seem that the intention is to select a criterion that reflects where the main management decisions are taken.

Article 4(3) of the OECD Model Tax Convention, states the following for a non-individual:

‘Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both

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<sup>3</sup> The OECD Model Tax Convention, as at 29 April 2000.

<sup>4</sup> ‘*The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule*’, OECD draft comment, February 2001 at 4 ([www.oecd.org.za](http://www.oecd.org.za)).

<sup>5</sup> Paragraph 10 of the *Commentary on Article 4* of the OECD Model Tax Convention.

<sup>6</sup> Paragraph 22 of the *Commentary on Article 4* of the OECD Model Tax Convention.

Contracting States, then it shall be deemed to be a resident only of the State in which its *place of effective management* is situated.’

(Emphasis added.)

Paragraph 1 as referred to in the above quotation reads as follows:<sup>7</sup>

‘For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.’

The meaning of the term ‘place of effective management’ is not defined in art 4 of the OECD Model Tax Convention. Paragraph 24 in the *Commentary on Article 4*, however, offers some guidance on the meaning of the term ‘place of effective management’.

Paragraph 24 reads as follows:

‘The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise’s business are in substance made. The place of effective management will ordinarily be where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An enterprise may have more than one place of management, but it can have only one place of effective management at any one time.’

This paragraph reinforces the point that the determination of a place of effective management is a question of fact. The factors to be examined include

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<sup>7</sup> Article 4(1) of the OECD Model Tax Convention.

- the place where directors meet to make decisions relating to the management of the company,
- where the centre of top level management is located,
- where the business operations are actually conducted,
- where controlling shareholders make key management and commercial decisions.

In addition, legal factors, for example,<sup>8</sup>

- the place of incorporation,
- the location of the registered office, and
- the place of residence of the directors

must be taken into account.

The term ‘place of effective management’ is also mentioned in art 8, art 13(3), art 15(3) and art 22(3) of the OECD Model Tax Convention. No definition of the term ‘place of effective management’ is given in any of these provisions, nor is there any further guidance given to determine the meaning of the term.

In the absence of any specific definition of the ‘place of effective management’, many commentators have been influenced by concepts used in domestic tax law residence rules, including ‘central management and control’<sup>9</sup> and ‘place of management’,<sup>10</sup> when considering the meaning of the term ‘place of effective management’.

The new paragraph 24 of the *OECD Commentary* makes it clear that an entity may have more than one place of management, but it can have only one place of effective management at any one time.

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<sup>8</sup> Paragraph 31 of the *OECD Discussion Paper*.

<sup>9</sup> See Hamilton R and Deutsch R, *Guidebook to Australian Taxation*, Legal Books Looseleaf Service, in paragraph [6.140].

<sup>10</sup> See Vogel K, *Double Taxation Conventions*, 3<sup>rd</sup> edition, Kluwer Law International, at 262.

### Guidance from the phrase ‘Central Management and Control’

The concept of ‘central management and control’ is dealt with in more detail under Chapter Three, Chapter Four and Chapter Five specifically. Central management and control is one of the residence tests adopted in a number of different countries for non-individuals.<sup>11</sup>

Determining a place of central management and control is a question of fact, as can be deduced from the numerous court cases dealing with this issue. It normally coincides with the place where the directors of the company exercise their power and authority (which will generally be where they meet).<sup>12</sup>

A leading case establishing the above principle was that of *De Beers Consolidated Gold Mines Ltd v Howe*.<sup>13</sup> In this case a company registered in South Africa worked diamond mines. It had its head office and general meetings of shareholders in South Africa. Its directors held meetings both in South Africa and in the United Kingdom, but the directors’ meetings held in the United Kingdom were found to be those where real control of the company was exercised. The company was accordingly found to be a United Kingdom resident.

In a number of Canadian cases,<sup>14</sup> the courts, relying on the statement of the Lord Chancellor in the *De Beers* case,<sup>15</sup> have found that the place of central management and control was where a company ‘really keeps house and does business’. Some of the factors taken into account in determining this place include the following:

- Place of incorporation.
- Place of residence of shareholders and directors.
- Where the business operations took place.

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<sup>11</sup> For example, the United Kingdom, Ireland and Australia.

<sup>12</sup> *Waterloo Pastoral Co Ltd v FCT* (1946) 72 CLR 262, *Capitol Life Insurance Co v R* (1984) CTC 141 and *Gurd’s Products Co v R* (1985) CTC 85.

<sup>13</sup> (1906) AC 455.

<sup>14</sup> *Birmount Holdings Ltd v R* (1978) CTC 358, *Tara Exploration & Development Co Ltd v MNR* (1970) CTC 557 and *Capitol Life Insurance Co v R* (1984) CTC 141.

<sup>15</sup> *De Beers Consolidated Gold Mines Ltd v Howe* (1906) AC 455.

- Where financial dealings of the company occurred.
- Where the seal and minute books of the company were kept.

#### **Residence in more than one State**

The variety of criteria for residence makes it perfectly possible for a company to appear to be resident in two or more states.

Article 4 of the OECD Model Tax Convention addresses this problem by providing tie-breaker criteria. These criteria can be applied where a taxpayer would be resident in both of the states that have entered into a tax treaty. They allocate the taxpayer to one state or the other.

The tie-breaker criterion for a company is that it is deemed to be a resident only of the state in which its place of effective management is situated.

#### **OECD Discussion Paper**

In February 2001 the OECD published a discussion paper titled ‘The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule’.<sup>16</sup> This discussion paper is discussed in more detail below.

This discussion paper starts by setting out the current rules on identifying the place of effective management. According to the existing commentary on the Model Tax Convention, the place of effective management is the place where key management and commercial decisions are made. It will normally be where the board of directors makes its decisions, but this is not a definitive rule and all the facts of individual situations must be considered. An enterprise can have only one place of effective management at a time.

The paper then reviews the use made of the concept of ‘place of central management and control’, that is used in the tax laws of several states and has been interpreted in court decisions. The paper also considers the use of the term ‘place of effective management’ in

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<sup>16</sup> February 2001, obtained from the website [www.oecd.org.za](http://www.oecd.org.za).

Swiss law, and of ‘place of management’ in German law. The discussion leads to a catalogue of factors that courts have taken into account in applying ‘place of effective management’ and closely related concepts.

They are as follows:<sup>17</sup>

- Where the directors meet to make decisions relating to the management of the company.
- Where the centre of top-level management is located.
- Legal factors including the place of incorporation, the location of the registered office and public office.
- Where controlling shareholders make key management and commercial decisions in relation to the company.
- Where the directors reside.

As the paper points out, in former times these factors would often all indicate the same state: a company would be incorporated and be run from one state. With the improvement of transport and communications, however, this need not be so. The directors of a company could live in several states and could use video-conferencing, so that there would be no need for them to meet physically at all. Alternatively, they could meet at several different locations in succession. This might result in no place of effective management being identified, or the identification of several states that could all be possible places of effective management. Only legal factors including the place of incorporation are immune from these developments.<sup>18</sup>

The following four approaches are considered as solutions to resolving the potential conflict that might arise if the above circumstances were found to exist:<sup>19</sup>

- Replacing the concept of place of effective management.

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<sup>17</sup> ‘The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule’, OECD draft comment, February 2001 at 7 ([www.oecd.org.za](http://www.oecd.org.za)).

<sup>18</sup> Baron R ‘*Breaking Residence Ties*’, published by BNA International Incorporated at 1 ([www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)).

<sup>19</sup> ‘The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule’, OECD draft comment, February 2001 at 10 to 15 ([www.oecd.org.za](http://www.oecd.org.za)).

- Refining the place of effective management test.
- Establishing a hierarchy of tests so that if one test did not decide residence, the next test would be tried and so on: but once a test gave a result, the process would stop and tests lower in the hierarchy would not be considered.
- A combination of refining the place of effective management test and establishing a hierarchy of tests.

The paper provides four proposed solutions, as stated above, and these are discussed in more detail below.

### **The Proposed Solutions**

#### *Replacing the Concept of Place of Effective Management*

In paras 50 to 61 of the discussion paper, the OECD suggests three possible replacements for the concept of place of effective management.<sup>20</sup>

- The first suggested replacement is to treat a company as resident in the state in which it is incorporated. As the OECD recognises, this would not be a good solution because a company can be incorporated in one state but do practically everything else in other states. Incorporation is a formal act of minimal economic significance. The OECD would be right not to pursue this option.
- The second suggested replacement is the place where the directors or the shareholders reside. This would certainly make more sense than using the place of incorporation. It would often correspond to the place where the business was carried on. Furthermore, if the residence of the directors were used, there would be a clear link with the test of where the directors meet, as they often meet in the state where they reside. Unfortunately, as the OECD recognises, a residence test will often fail to give a unique answer. Directors may well be distributed evenly over several states, and shareholders are even more likely to be geographically spread out. So this idea is hardly worth pursuing.

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<sup>20</sup> Baron R 'Breaking Residence Ties', published by BNA International Incorporated at 2 ([www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)).

- Thirdly, the OECD suggests that a company could be deemed to be resident in the state where it has the strongest economic nexus. This nexus would be indicated by the company's use of the factors of production (land, labour, capital and enterprise) to make profits. As the OECD acknowledges, this approach is close to that which is used to justify states taxing the profits of permanent establishments within their borders, and amounts to source taxation rather than residence taxation. The OECD says that even so, the idea of economic nexus could have links to the underlying rationale for residence taxation. Unfortunately, this point is not developed. A full argument for it could lead to an interesting re-formulation of the whole basis for allocating taxing rights.

The OECD does not discuss the rationale for residence taxation. Baron discusses the impact of the source and residence basis of taxation.<sup>21</sup> He says that even if residence taxation and source taxation had identical rationales, that would not make a conclusive argument for eliminating residence taxation. This is due to the fact that residence taxation reduced by the amount of source taxation tends to lead to different total tax burdens from source taxation alone. The elimination of residence taxation would therefore have real economic effects. The advantages and disadvantages would have to be considered.

The difference to total tax burdens made by adding residence taxation is greatest when the state imposing source taxation does so at a low rate. This means that many states would be reluctant to do away with the residence system of taxation. To do so would greatly increase the attraction of low-tax states as hosts of permanent establishments of companies owned and controlled in higher-tax states.

As the OECD paper points out in para 60, economic nexus might still be used as a tie-breaker without taking it to be the rationale for residence taxation. But it would then be at risk of being an arbitrary test, not linked closely enough to the real rationale for residence taxation (whatever that might be) and therefore at risk of producing illogical results. The rationale for a basis of taxation should be chosen first, and the practical tests used to apply the basis should follow the rationale.

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<sup>21</sup> Baron R 'Breaking Residence Ties', published by BNA International Incorporated at 2 ([www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)).

### *Refining the Place of Effective Management Test*

In paras 62 to 68 of the discussion paper, the OECD considers two ways to refine the ‘place of effective management’ test. Both are based on the factors listed above that may indicate the place of effective management (for example, where the directors meet, where the centre of top-level management is located).

- The first way is to decide residence on the basis of selected factors (the predominant factors), rather than to take all the factors into account.
- The second way, being an extension of the first, is to consider additional factors when consideration of the predominant factors is not enough to determine residence.

Paragraph 62 actually speaks of giving a weighting to various factors, but para 64 makes it clear that what is meant is considering additional factors when necessary. They are not so much given lower weights as called in when the predominant factors are inadequate. This makes the second way an example of the ‘hierarchy of tests’ approach. The additional factors, however, might well be weighted amongst themselves.

The predominant factors suggested are

- the place where the key management and commercial decisions are made in substance,
- where the most senior person or group of persons makes its decisions, and
- where the actions to be taken by the enterprise as a whole are determined.

These suggestions are entirely in line with the existing commentary in para 24. That is useful, because it implies reasonable continuity with the current rules. Put in terms of common law jurisdictions, the OECD suggestion on predominant factors amounts to codification of the current position on the lines of the existing commentary, and a decision to discard all the surrounding case law that would suggest taking other factors into account.

Certainly modification has a lot to be said for it. It makes the law more certain and more easily accessible.

On the other hand, one must be wary of the risk of losing flexibility. The OECD recognises that the predominant factors may not be enough to determine residence, being the very problem that the paper seeks to address. They therefore suggest other factors that need to be considered. These are as follows:

- The location of and functions performed at the headquarters.
- Information on where central management and control of a company is to be located contained within company formation documents.
- Place of incorporation or registration.
- Relative importance of the functions performed within the two states claiming residence.
- Where the majority of the directors reside.

The above listed factors should give some assistance in the determination of residence. But even a fully comprehensive list of this nature is still not enough to ensure that an answer is always found. The list is also a mixture of facts (for example, the functions performed at the headquarters) and evidence bearing on those facts (for example, information in company formation documents). And it is not clear that the list really takes the situation beyond the existing commentary in paragraph 24, in explicating the concept of the place of effective management. Making more progress probably requires re-thinking the rationale of residence taxation.<sup>22</sup>

#### *Establishing a Hierarchy of Tests*

Paragraphs 69 to 72 suggest a hierarchy of tests. It is first necessary to apply the ‘first’ test, then if it fails to give an answer, it is then necessary to apply the ‘second’ test, and so on. The OECD suggest the following possible hierarchy:

- Place of effective management.
- Place of incorporation.
- Economic nexus.

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<sup>22</sup> Baron R ‘*Breaking Residence Ties*’, published by BNA International Incorporated at 3 ([www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)).

- Agreement between the two states claiming residence.

This may be the most practical way forward so as to keep to something close to the existing rules, and avoid for the time being the question of whether those rules should be changed. It is odd, however, that the place of incorporation should appear anywhere other than last in the hierarchy. As already explained, the place of incorporation is arbitrary and may well have nothing to do with the location from which a business is directed. Considering the place of incorporation will also nearly always give a definite answer, so any tests below it in the hierarchy would hardly ever be reached.<sup>23</sup>

### *Combining Refinement and a Hierarchy*

Paragraph 73 suggests combining a refinement of the concept of place of effective management with a hierarchy. Given that the form of refinement outlined in para 64 already incorporates a hierarchical element, this approach is already being tried in the OECD's work.

The OECD emphasises the need to devise a tie-breaker test that always yields an answer. It points out that companies can have management structures introduced for legitimate commercial reasons, that then leave them exposed to the risk of dual residence, and therefore, to the risk of multiple taxation (particularly when, as sometimes happens, states deny the benefits of tax treaties to dual-resident companies).

In addition to the proposed solutions outlined above, the OECD suggests extending the approach used for ships. A shipborne place of effective management is treated as being in the ship's home harbour or in the state where the operator of the ship resides. But as the OECD recognises, this approach will not help when a place of effective management is spread among directors who live in many states and who use video-conferencing instead of physical meetings.

The OECD's discussion of place of effective management suggests that it, and perhaps residence taxation, are outmoded concepts. Tax concepts, including residence, are likely to be robust only when they are grounded in commercial reality. If a tax concept relies on where

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<sup>23</sup> Baron R 'Breaking Residence Ties', published by BNA International Incorporated at 3 ([www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)).

directors meet, and physical locations no longer matter for commercial purposes, then the tax concept may have had its day.

## CHAPTER THREE

### UNITED KINGDOM

#### An Examination of Case Law Surrounding the Term ‘Central Management and Control’.

##### Introduction

Unlike a trust or an English partnership, a corporation is a true legal entity. It is under English law, an artificial person, separate and distinct from its members and endowed with an existence independent of their existence.<sup>1</sup> More to the point, is that it may possess the status of residence and ordinary residence.

In looking at the definition of the word ‘residence’, the following was stated in *Calcutta Jute Mills Co Ltd v Nicholson*, by Huddleston B:<sup>2</sup>

‘Now the definition of the word “residence” is founded upon the habits and relations of the natural man, and is therefore inapplicable to the artificial and legal person whom we call a corporation. But for the purpose of giving effect to the words of the Legislature an artificial residence must be assigned to this artificial person, and one formed on the analogy of natural persons.’

A corporation may be a corporation sole or a corporation aggregate. Yet it is only with the second type, that the question of residence arises, more so with limited liability companies in particular.<sup>3</sup>

Why is this so? It is through the medium of the limited company (or a foreign equivalent) that by far the greater part of the world’s business and commerce is transacted<sup>4</sup>

‘a company not resident in the United Kingdom shall not be within the charge to corporation tax unless it carries on a trade in the United Kingdom through a branch or agency’

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<sup>1</sup> *Salomon v Salomon & Co* [1897] AC 22.

<sup>2</sup> (1876) ITC 83 at 103.

<sup>3</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 110.

<sup>4</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 110.

and even where it does so, it is chargeable to corporation tax only on<sup>5</sup>

‘trading income arising directly or indirectly through or from the branch or agency’

and on certain income and chargeable gains relating to assets used or held by or for the branch or agency.<sup>6</sup>

### **Residency of United Kingdom and Foreign Registered Companies**

Section 66 of the Finance Act 1988, provides that as from 18 March 1988 any company incorporated in the United Kingdom is conclusively presumed to be a resident of the United Kingdom.

Case law that formulated the test of residence on the basis of the location of a company’s central control and management is, therefore, of no relevance to any company that has been incorporated in the United Kingdom.

The test of central control and management is now applicable only to foreign registered companies. A foreign registered company will be deemed to be resident in the United Kingdom if the central management and control of the company is exercised in the United Kingdom.<sup>7</sup>

The term ‘central management and control’ was used by Lord Loreburn in one of the earliest of all cases concerning company residence.<sup>8</sup>

In *Bullock v Unit Construction Co Ltd*,<sup>9</sup> Lord Radcliffe summarised the position as it existed in 1959 and as it still exists today, as follows:<sup>10</sup>

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<sup>5</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 111.

<sup>6</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 111.

<sup>7</sup> *De Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198 at 213.

<sup>8</sup> *De Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198 at 213.

<sup>9</sup> (1959) 38 TC 712.

<sup>10</sup> At 738.

‘The necessity of establishing some common standard for the treatment of different taxpayers meant that the Courts of Law were bound in course of time to produce and apply some general principle of their own to form an acceptable test of residence. . . . [T]he principle was adopted that a company is resident where its central management and control abide: words which, according to the decision of the House of Lords that finally propounded the test, *De Beers Consolidated Mines Ltd v Howe*,<sup>11</sup> are equivalent to saying that a company’s residence is where its “real business” is carried on.’

The ultimate conclusion that corporate residence is a matter of fact came in *Bullock v Unit Construction Co Ltd*.<sup>12</sup> In this case, Unit Construction Company Ltd, a United Kingdom resident subsidiary of Alfred Booth & Co Ltd, a United Kingdom resident parent company, made subvention payments to three of its fellow subsidiary companies in Kenya. It claimed that those payments were, under s 20 of the Finance Act 1953, permissible deductions in arriving at its profits for tax purposes. This would have been so only if the three Kenyan subsidiaries were also residents of the United Kingdom. The Inland Revenue contended that they were not.

The three subsidiaries had been incorporated in Kenya and their articles of association expressly placed their management and control in the hands of their directors and required directors’ meetings to be held outside the United Kingdom. The three Kenyan subsidiaries must, argued Inland Revenue, be resident outside the United Kingdom, as a result of the subsidiaries’ incorporation in Kenya and the articles of association expressly placing the management and control outside the United Kingdom.

The court found as a fact, however, that, due to trading difficulties that the subsidiaries had encountered,<sup>13</sup>

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<sup>11</sup> (1906) 5 TC 198.

<sup>12</sup> (1959) 38 TC 712.

<sup>13</sup> At 735-736.

‘at the material times . . . the boards of directors of the African subsidiaries . . . were standing aside in all matters of real importance and in many matters of minor importance affecting the central management and control, and . . . the real control and management was being exercised by the board of directors of Alfred Booth and Co Ltd in London’.

The court, accordingly, found that each of the African subsidiaries was resident in the United Kingdom. Its finding was ultimately upheld in the House of Lords. Referring to the reversals the decision had suffered in the High Court and in the Court of Appeal, Viscount Simonds said the following:<sup>14</sup>

‘[T]he contention of learned Counsel for the Crown which has so far found favour with the courts is no less than this, that if by the constitution of the company, that is, by its memorandum and articles of association interpreted in the light of the relevant law, that is, in this case the law of Kenya, the management of the company’s business is contemplated as being exercised, and ought therefore to be exercised, in Kenya or at any rate outside the United Kingdom, then for the purpose of British Income Tax law the facts are to be disregarded and the control and management which as a fact are found to abide in the United Kingdom are to be regarded as abiding outside it. There is no doubt, I think, that the management of the African subsidiaries, which were incorporated in Kenya under the Kenya Companies Ordinance and registered in Nairobi, was placed in the hands of their directors and that their articles of association expressly provided that directors’ meetings might be held anywhere outside the United Kingdom. Nor can there be any doubt – for this is the unchallengeable finding of the Commissioners – that the management of the business of the companies was not exercised in the manner contemplated. Whence it follows that the business was conducted in a manner irregular, unauthorised and perhaps unlawful.

‘My Lords, I should certainly be prepared to admit that the many Judges who in the past have pronounced upon this question had not in mind such a case as this. But, with great respect to those who take a different view, the present case does not seem to lie outside the principle underlying their judgment. Nothing 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. It does not in any way alter their character that in greater or lesser degree they are irregular or unauthorized 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. If indeed I must disregard the facts as they are, because they are irregular, I find a company without any central management at all. For, though I may disregard existing facts, I cannot invent facts, which do not exist and say that the company’s business is managed in Kenya. Yet, it is the place of central management which, however much or little weight ought to be given to other factors, essentially determines its residence. I come, therefore, to the conclusion . . . that it

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<sup>14</sup> At 735-736.

is the actual place of management, not the place in which it ought to be managed, which fixes the residence of a company.’

Because the residence of a company is to be determined by the location of its central management and control, and because that location is a question of fact, a finding by the court that a company is resident in this place or that will always be indisputable provided the Court had before it evidence from which its findings can be made, and providing it does not misdirect itself in law.

It is for this reason that in no case brought before the courts of the United Kingdom, has a finding by such courts on a question of corporate residence ever been finally reversed. The court’s approach is well-illustrated by Lord Loreburn’s conclusion in the *De Beer’s* case:<sup>15</sup>

‘The Commissioners after sifting the evidence, arrived at the two following conclusions, . . . That the head and seat and directing power of the affairs of the Appellant Company were at the office in London, from whence the chief operations of the Company, both in the United Kingdom and elsewhere, were, in fact, controlled, managed and directed. That conclusion of fact cannot be impugned, and it follows that this Company was resident within the United Kingdom for the purposes of Income Tax.’

#### **Delegated Management and Control**

Delegated management and control and central management and control are mutually exclusive concepts.

In *Sao Paulo (Brazilian) Pty Co Ltd v Carter*,<sup>16</sup> an English company with an English board of directors had, through a supervisor in Brazil, and a workforce in his charge, built and was managing and working a railway in Brazil. Although, it was admitted that the London board purchased materials for use in Brazil, it was contended that they did not actually interfere in the carrying on of the business. The business was therefore carried on by the supervisor in Brazil. Lord Watson rejected that contention as follows:<sup>17</sup>

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<sup>15</sup> *De Beers Consolidated Mines v Howe* (1906) 5 TC 198 at 213-214.

<sup>16</sup> (1895) 3 TC 407.

<sup>17</sup> At 412.

‘Apart from authority, expressed or implied, which they have from the directors, neither the superintendent nor any other servant of the Company has any power to act in the carrying on of its trade. . . . The only person who can with propriety be described as carrying on the trade of the Company, are its directors.’

In *Calcutta Jute Mills v Nicholson*,<sup>18</sup> for instance, Huddleston B held that the central management and control of Calcutta Jute Mills, thought seemingly exercised by a director in India, was actually exercised from the company’s office in London where the board of directors met:<sup>19</sup>

‘From that office would issue all the orders to the managing director in Calcutta. No doubt, until he received orders to the contrary, he would have full power and discretion to do what he liked in Calcutta; but at any moment, from his head office, they might have revoked his authority, or altered any arrangement which he has made connected with the working of the company.’

The director in Calcutta was, for all his powers, a mere delegate and one had, therefore, to look beyond him to the delegators from whom his powers had been derived and by whom they were being sustained.

In *American Thread Company v Joyce*,<sup>20</sup> the delegation of powers was less obvious for American Thread Co Ltd. It was ostensibly managed and controlled by an executive committee of directors in New York. The Master of the Rolls, was, however quite clear that central management and control lay in Manchester, England. The following was stated in this regard:<sup>21</sup>

‘Now the current business, the daily purchasing and selling of raw materials and making them into thread is, no doubt, carried out by the executive committee in New York, the executive committee of the three. Who appoints them? The English board. It must be done by the English board where the majority of the directors, four out of seven, reside. They are appointed by them, their salary is fixed by them. In fact, the whole control of the machine, so to say, is kept and carefully kept at Manchester.’

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<sup>18</sup> (1976) 1 TC 83.

<sup>19</sup> At 107.

<sup>20</sup> (1913) 6 TC 1 and 163.

<sup>21</sup> At 229.

Personal qualities and excellence of a person exercising delegated powers are needless to say, quite irrelevant. The term 'head and brain' is often used as an alternative to 'central management and control'.<sup>22</sup> Rowlatt J has, however, stated the following in this regard:<sup>23</sup>

'I do not think when the head and brain are mentioned it is intended to allude to a clever manager. One might say in many businesses: "The whole head and brain of this business are in the General Manager, he knows all about it and far more than all the Directors put together." Therefore they leave it to him, and they are all well advised in doing so. It is not in that sense that the head and brain is meant. I do not think the cleverest servant in the world, although he possessed all the brains of the institution, could be said to be the head and the brain.'

These cases all illustrate that it is necessary to ask of those who appear to be exercising the control, in determining the location of a company's central management and control<sup>24</sup>

'To whom do you look over your shoulder? From whom do you derive your powers and who is able to modify or withdraw them?'

If the answer is<sup>25</sup>

'No-one. We derive our powers from the shareholders who appointed us and, short of the shareholders removing us from office, no-one can interfere with our powers',

identification of those who exercise central management and control will have been made. If the answer is otherwise it will provide a pointer either to those who truly exercise central management and control or to a person or persons who are one step nearer to the center than those to whom the question was addressed.

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<sup>22</sup> *Sao Paulo (Brazilian) Pty Co Ltd v Carter* (1895) 3 TC 407 at 410.

<sup>23</sup> At 411.

<sup>24</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 115.

<sup>25</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 115.

## The Real Business Test

It is one thing to state that a company resides where its central management and control actually abides and another thing to identify the factors that will attest to, and reveal the location of the management and control.

In the two cases in which the real business test was first established,<sup>26</sup> all business activities of the companies concerned were carried out, and largely controlled, outside the United Kingdom.

- Cesena Sulphur Co manufactured and sold sulphur in Italy.
- Calcutta Jute Mills Co manufactured and sold jute in India.

Cesena's main books, accounts and banking accounts were maintained in Italy and all Calcutta's property was situated in India. The directors of Calcutta did not have an office in the United Kingdom, but met in an office belonging to one of its members.

On the basis of the 'real business' test, the court held, however, that both companies were resident in the United Kingdom. Clearly, therefore, Kelly CB and Huddleston B could not have had the day-to-day management and control of the business activities of these companies in mind, when they concluded that the 'real business' was conducted in the United Kingdom, and not in India and Italy, respectively.

The clue as to what they had in mind is provided by Kelly CB who said the following:<sup>27</sup>

'[T]he answer to the question; Where does a joint stock company reside? is, . . . where its governing body is to be met with and found, and where its governing body exercises the powers conferred upon it by the Act of Parliament, and by the Articles of Association, where it meets and is in bodily and personal presence for the purposes of the concern.'

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<sup>26</sup> *Calcutta Jute Mills Co Ltd v Nicholson* (1876) 1 TC 83 and *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88.

<sup>27</sup> At 95.

The ‘real business’ of Calcutta Jute Mills Ltd and of Cesena Sulphur Co Ltd was, in other words, carried on, not in India or Italy, but in the place from which the decision to carry out operations in India or Italy had emanated. Huddleston B said the following of the Cesena Sulphur Co Ltd’s business:<sup>28</sup>

‘No doubt the manufacturing part may be done and was done in Italy; so supposing that in another part of the world they found sulphur and carried on their business there, the manufacturing part of the business would be carried on there, no doubt; but the administrative part of the business would be carried on at the place from which all the orders came, from which all the directions flowed, and where the appointments were made, where the appointments of the officers were revoked, where the agents were nominated, where their powers were recalled, where the money was received (whatever may have been sent), where the dividends were payable, and where the dividends were declared. We find that all these Acts are performed in London. I cannot help thinking that the main place of business of the Company is in England.’

The place of central management and control is, then, not necessarily the place where the company’s manufacturing or trading activities take place, but<sup>29</sup>

- the place where the parameters governing those activities are set, and
- the place where the fundamental policies to be implemented in the United Kingdom or elsewhere are conceived and adopted.

### Shareholder Control

The test of corporate residence involves the identification of the place of central management and control (not *or* control). In other words, the control in question is that which relates to the highest level of management of a company’s business and must not, therefore, be confused with the control that vests in a company’s shareholders.<sup>30</sup>

The distinction was stressed by Moulton LJ in *Stanley v Gramophone and Typewriter Ltd* when he said the following:<sup>31</sup>

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<sup>28</sup> At 107.

<sup>29</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 118.

<sup>30</sup> Davies D Booth: *Residence, Domicile and UK Taxation*, 6<sup>th</sup> edition (2001), London at 115.

<sup>31</sup> (1908) 5 TC 358 at 376.

‘[T]he individual corporator does not carry on the business of the corporation: he is only entitled to the profits of that business to a certain extent, fixed and ascertained in a certain way, depending upon the constitution of the corporation and his holding in it. This legal proposition . . . is not weakened by the fact that the extent of his interest in it entitles him to exercise a greater or lesser amount of control over the manner in which the business is carried on. Such control is inseparable from his position as a corporator, and is a wholly different thing both in fact and in law from carrying on the business himself. The Directors and employees of the corporation are not his agents, and he has no power of giving directions to them which they must obey. It has been decided by this court in the *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunningham*<sup>32</sup> that in an English Company by whose Articles of Association certain powers were placed in the hands of the Directors, the shareholders could not interfere with the exercise of those powers by the Directors even by a majority in General Meeting. Their course is to obtain the requisite majority to remove the Directors and put persons in their place who agree to their policy. This shows that the control of the individual corporators is something wholly different from the management of the business itself. Nor is this principle less true than when the holding of the individual corporator is so large that he is able to override the wishes of the other corporators in matters relating to the control of the business of the Company. The extent but not the nature of his power is changed by the magnitude of his holding.’

The conclusion to be drawn from this is that a company whose business is, in fact, managed and controlled by a board of directors in, say, London, will none-the-less be resident in England even if, say, 90% of its shares are owned by an individual resident in South Africa. This proposition was specifically approved by the Court of Appeal in *Bullock v Unit Construction Co Ltd*<sup>33</sup> and still stands. The Court of Appeal also assented to the proposition, however, that<sup>34</sup>

‘a shareholder who holds sufficient shares in a company can *de facto* control its affairs by his ability to remove directors who disagree with his policy and to vote others into their places’.

It should be noted that the word here is ‘can’ not ‘will’. To continue with the example given above, if the South Africa resident shareholder, contrary to his rights, actually interferes with the board’s exercise of its powers and, by the threat of removal which his 90% shareholding tacitly poses, persuades or pressures the board into implementing his policies and carrying out his wishes, he will *de facto* control the company’s affairs and as a result thereof, the company’s residency will be located in South Africa and not in London, England.<sup>35</sup>

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<sup>32</sup> [1906] 2 Ch 34.

<sup>33</sup> (1959) 38 TC 712 at 729-730, per Romer LJ.

<sup>34</sup> At 730.

<sup>35</sup> Davies *D Booth: Residence, Domicile and UK Taxation*, 6<sup>th</sup> ed (2001), London at 116.

*American Thread Co v Joyce*<sup>36</sup> dealt with a shareholder's consideration in detail. There, the Crown contended that the operations of the American company were controlled from Manchester for the following two reasons:

- A majority of its directors met there.
- The English parent company owned the entire share capital of the American company.

In the Court of Appeal, Buckley LJ went to some lengths to emphasize that it was not shareholder control on which the finding that the American company was resident in the United Kingdom rested. In this regard he stated the following:<sup>37</sup>

'The shareholders can, no doubt, by virtue of their votes control the corporation; they can compel directors . . . to do their will, but it does not follow that the corporators are managing the corporation. The contrary is the truth; they are not. It is the directors who are managing the affairs of the corporation. . . . [T]he executive committee in New York were in fact controlled . . . on this side in extraordinary sessions of the Board which were held once a fortnight, and the real control, the head and seat and directing power of the affairs of the Company were here. It was in that sense that the control was here.'

Kelly CB's choice of the term 'governing body'<sup>38</sup> in preference to the term 'board of directors' emphasizes the fact that in some instances, it might be found that the central control and management of a company is being exercised unconstitutionally by a single shareholder or by a group of shareholders rather than by those who have the constitutional right to exercise management and control.

The central management and control of a company will usually, *de facto* and *de jure*, be in the hands of its board of directors but, as the Inland Revenue states in a statement of practice, it will not always be the situation:<sup>39</sup>

'In some cases . . . central management and control is exercised by a single individual. This may happen

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<sup>36</sup> (1913) 6 TC 1 and 163.

<sup>37</sup> At 32-33.

<sup>38</sup> *Calcutta Jute Mills Co Ltd v Nicholson* (1876) 1 TC 83 at 95.

<sup>39</sup> United Kingdom Statement of Practice Note 1190, in para 13.

when a chairman or managing director exercises powers formally conferred by the company's Articles and the other board members are little more than ciphers, or by reason of a dominant shareholding or for some other reason. In those cases the residence of the company is where the controlling individual exercises his powers.'

The case of *Apthorpe v Peter Schoenhoffen Brewing Co Ltd*<sup>40</sup> concerned the wholly-owned American brewing subsidiary of an English company. The directors of the English company had full power of management and control of the affairs of the American company but they delegated these powers to a committee of management in Chicago. The court found that<sup>41</sup>

'the head and seat and directing power of the [English] Company were at the [English] Company's registered office in the City of London, and that if the business at Chicago and the profits made thereby were technically the business and profits of the American company, the American company was for such purpose the agent of the [English] Company'.

In its statement of practice, the Inland Revenue declares its position on wholly-owned subsidiaries to be as follows:<sup>42</sup>

'It is particularly difficult to apply the 'central management and control' test in the situation where a subsidiary company and its parent operate in different territories. In this situation, the parent will normally influence, to a greater or lesser extent, the actions of the subsidiary. Where that influence is exerted by the parent exercising the powers which a sole or majority shareholder has in general meetings of the subsidiary, for example to appoint or dismiss members of the board of the subsidiary and to initiate or approve alterations to its financial structure, the Revenue would not seek to argue that central control and management of the subsidiary is located where the parent company is resident. However, in cases where the parent usurps the functions of the board of the subsidiary (such as *Unit Construction* itself) or where that board merely rubber stamps the parent company's decisions without giving them any independent consideration of its own, then Revenue draw the conclusion that the subsidiary has the same residence for tax purposes as its parent.'

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<sup>40</sup> (1899) 4 TC 41.

<sup>41</sup> At 46.

<sup>42</sup> United Kingdom Statement of Practice Note 1190, in para 16.

The statement then goes on to say the following:<sup>43</sup>

‘The Revenue recognise that there may be many cases where a company is a member of a group having its ultimate holding company in another country which will not fall readily into either of the categories referred to above. In considering whether the board of such a subsidiary company exercises central management and control of the subsidiary’s business, they have regard to the degree of autonomy which those directors have in conducting the company’s business. Matters (among others) that may be taken into account are the extent to which the directors of the subsidiary take decisions on their own authority as to investment, production, marketing and procurement without reference to the parent.’

A critic of Inland Revenue’s statement said the following:<sup>44</sup>

‘There will be relatively few boards of directors of subsidiary companies who make important decisions without any reference to the parent company. Very often a representative of the parent company will be a member of the board, and the parent company will frequently make its wishes very plain. But provided the subsidiaries company’s minutes show that the directors did not consider themselves to be relieved of their duties as directors, and provided they have come to a decision that the parent company’s suggestions are indeed in the best interest of the company, there should not be any doubt that the subsidiary company directors have continued to exercise central management and control. The real test is surely whether the subsidiary directors review the company’s affairs and consider recommendations by the parent company rather than simply implement them without question.’

## Finance

As discussed, policy-making (the real business test) is the primary expression of control and management. The raising and allocation of the funds must also be an almost equally important manifestation of the management and control, as without this function a company’s policies could not be implemented.

In *American Thread Co v Joyce*,<sup>45</sup> the Master of Rolls noted that the business of the New York company was one where seasonable purchases of cotton had to be made, and commented as follows:<sup>46</sup>

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<sup>43</sup> Paragraph 17.

<sup>44</sup> Sandy C ‘Company Residence: A Critical Look at the Recent Statement of Practice’ January 1984 *Taxation Practitioner* 12.

<sup>45</sup> (1913) 6 TC 1 at 163.

<sup>46</sup> At 229.

‘Those purchases of cotton necessarily involve considerable financing. The whole policy depends really upon aye or no, shall we finance to the extent of, I think in one case it appears £300 000. The New York people cannot do all that. The whole purse-strings in the sense of money coming in by borrowing are kept most zealously at Manchester, and by means of those purse-strings they are able to control and do control the policy of the Company and the mode in which they carry on their business of buying and selling.’

A similar issue was found to exist in *New Zealand Shipping Co Ltd v Thew*,<sup>47</sup> a case concerning the company’s place of residence. Lord Sterndale noted the following:<sup>48</sup>

‘The London Board have the control of borrowing.’

The court then referred to the company’s articles of association, and noted the existence of<sup>49</sup>

‘a number of clauses . . . showing the entire financial control of the London Board over the business’.

Taking those factors into account with the other factors, he had no hesitation in concluding that the central management and control of the company was located in London.

Similarly in *De Beers Consolidated Mines Ltd v Howe*,<sup>50</sup> the Lord Chancellor took as evidence that the company was resident in the United Kingdom the fact that<sup>51</sup>

‘London has . . . always controlled . . . all questions of expenditure except wages, materials, and such like at the mines, and a limited sum which may be spent by the Directors at Kimberley’.

One important pointer as to who controls the finances of a company will lie in the authorization of major capital expenditure. In the *New Zealand Shipping Co* case,<sup>52</sup> the court

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<sup>47</sup> (1922) 8 TC 208.

<sup>48</sup> At 223.

<sup>49</sup> At 224.

<sup>50</sup> (1906) 5 TC 198.

<sup>51</sup> At 213.

<sup>52</sup> (1922) 8 TC 208.

had found as a fact that the New Zealand Board had consulted the London Board in regard to transactions that involved the expenditure of large sums of money.<sup>53</sup>

Lord Buckmaster then noted the following:<sup>54</sup>

‘The London Board has . . . the sole duty of constructing and acquiring ships.’

A further factor to be considered, though this factor alone is not a determinative factor of central management and control, is the declaration of dividends. In the *American Thread Company* case,<sup>55</sup> one of the factors that led Hamilton J to uphold the finding of the lower court that the central management and control of the American company rested with the English directors was the following:<sup>56</sup>

‘In each year the directors, sitting in extraordinary session in England, recommend what the dividend on the common stock should be . . . But in the year 1904, when the dividend was 16%, though the Board by resolution recommended that rate, the gentleman who sent the cablegram to the American directors said that the Board had decided that the dividend should be 16%, and went on to say: “Arrange for usual formal resolutions as regards dividends on preferred shares and common stock without delay.” Accordingly, the 16 % was announced.’

These words of Hamilton J make it clear that, so far as dividends are concerned, what it is necessary to look for when attempting to locate the place of central management and control is the person, or group of persons, who actually decide upon the quantum of the dividend – not the persons who formally resolve to pay it, or give their formal approval to its declaration.

In *Calcutta Jute Mills Co Ltd v Nicholson*,<sup>57</sup> it was asserted in support of the proposition that the company was resident in India, that the activities of the company in England were minimal, consisting of little more than the dividing between the English shareholders of the amount, less expenses, remitted to that country from India. Huddleston B refused this contention by pointing out the following:<sup>58</sup>

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<sup>53</sup> At 216.

<sup>54</sup> At 229.

<sup>55</sup> (1913) 6 TC 1 and 163.

<sup>56</sup> At 25.

<sup>57</sup> (1876) 1 TC 83.

<sup>58</sup> At 107.

‘The operation of the Company in London was, not to divide the amount sent among the shareholders, but it was to ‘declare’ the amount; and I apprehend that, within the meaning of that clause, the directors in London, who have full power, might say, “Well, we do not approve of this system upon which the division has been made, and we shall require a different dividend for the future”, or something of that kind, – showing plainly that they exercise the authority, and that they are the persons who are the principal body.’

## Conclusion

United Kingdom cases have clearly established the meaning of the phrase ‘central management and control’ and thus in the process resolved the issue of company residence in the country.

As a synopsis, central management and control is located where the controllers of the company meet and exercise their control. This is usually in the country where meetings of the board of directors meet. They are usually the ‘controllers’ of the companies. Multiple residency will thus result where ‘central management and control’ is exercised in more than one country, for example, some part of the superior and directing authority of the company is located in more than one country.<sup>59</sup>

The residence of a company is thus not necessarily the country where it carries on trading operations, nor where the majority of its shareholders reside. The place where its shareholders reside is entirely irrelevant in determining where the company resides.<sup>60</sup>

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<sup>59</sup> *Union Corp Ltd v CIR* [1953] AC 482.

<sup>60</sup> Williams R C *Capital Gains Tax – A Practitioner’s Manual* (2001).

## CHAPTER FOUR

### EUROPEAN POSITION

#### FRANCE

#### THE CONCEPT OF RESIDENCY AND AN EXAMINATION OF THE TERM 'PLACE OF EFFECTIVE MANGEMENT'

##### Residence of Corporations: The French Territorial Approach

French corporate income tax is based on a strict principle of territoriality, embodied in art 209 I of the French Tax Code (FTC), whereby profits realised in France, whether by French or foreign companies, are taxable in France and profits realised from operations outside France escape French corporate income tax.

Although this principle is subject to provisions in tax treaties concluded by France, the territorial scope of French corporate income tax is recognised by all treaties entered into by France.<sup>1</sup>

##### Domestic Principles

Article 209 I FTC provides, amongst other things, that<sup>2</sup>

'profits subject to corporate income tax are determined . . . taking into account only the profits realised by *enterprises operating in France* and those for which the right to tax is granted to France by a tax treaty relating to double taxation'.

(Emphasis added.)

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<sup>1</sup> Douvier P 'Permanent Establishment: the Next Topic for Litigation?' BNA International Inc at 2, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

<sup>2</sup> Douvier P 'Permanent Establishment: the Next Topic for Litigation?' BNA International Inc at 2, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com)

There is no definition for the term ‘enterprises operating in France’. It has developed a meaning through the various French Supreme Court cases, as the ‘habitual exercise of a commercial activity’.

Three situations characterise this<sup>3</sup>

- either a French business conducting industrial or commercial activity, or
- the existence in France of a complete commercial cycle of operations, or
- the presence in France of a permanent representative of the foreign entity which carries out activities in France.

Under this principle French companies are subject to corporate income tax only on profits realised from French operations. Profits realised from operations outside France are not subject to French corporate income tax. As a corollary, foreign companies are subject to corporate income tax only if they operate an enterprise in France.

In the absence of any commercial operations in France, carried out either directly or through a representative, the existence of a French business taxable in France cannot be established. A company with its main operations abroad and a head office in France, that carries out no commercial activity but performs only an administrative function is not taxable in France.<sup>4</sup>

There is no legal provision stating that companies with either their registered or effective seat of management in France are subject to French corporate income tax. Therefore, a company organised under the laws of a foreign jurisdiction is subject to corporation tax in France on income attributable to only commercial or industrial exploitation situated in France, that is, taxed according to France’s territoriality principle. In this respect, the fact that a company incorporated abroad is regarded as having its actual head office in France does not in most instances (industrial or commercial business) trigger adverse tax consequences as long as its activities continue to be carried out by (one or more) ‘enterprise(s) exploited outside France’.<sup>5</sup>

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<sup>3</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 2, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

<sup>4</sup> Ministerial Answer ARTAUD, JO 22 July 1922, n° 13791.

<sup>5</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 2, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

In these situations, the income taxable in France would consist of the part attributable to the French head office, provided it constitutes an ‘enterprise exploited in France’ or a permanent establishment, and of other elements of income, for example, financial proceeds that may not be attributed to foreign establishments of the company.

For a company with a true head office in France, the implications of the position taken by the French tax administration on the above grounds may prove detrimental. In the absence of any activities actually carried out by an enterprise outside France to which the proceeds may be associated, such proceeds are taxable in France. This may be inferred from a situation involving a company whose registered seat was in a foreign jurisdiction, but that ran establishments situated only in France; the proceeds of its portfolio were regarded as taxable in France because they were linked to the activities carried out and taxable in France.<sup>6</sup> This case law is cited by the French tax administration, and commented on as follows:<sup>7</sup>

‘Foreign enterprises which exploit exclusively establishments situated in France and which registered head office is their sole foreign settlement are subject to tax in France on their total operations.’

#### **Treaty principles: the Concept of Permanent Establishment**

Tax treaties including the concept of a permanent establishment supercede domestic territorial principles. Treaty principles are in substance, however, similar to domestic principles. A permanent establishment is characterised by a ‘place of management’ while the residence of a company is distinguished by the ‘place of effective management’, in this regard.

#### **Income Tax Treaty Rules**

##### *OECD Definition*

Under para 1 of art 4 of the OECD Model Tax Convention, the term ‘resident of a Contracting State’ means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.

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<sup>6</sup> CE 1 February 1937, n° 46710, CE 9 March 1934, n°13022.

<sup>7</sup> D. Adm. 4H 1413 n°41.

Article 3(3) of the Convention provides as follows:

‘[W]here by reason of the provision of paragraph (1) a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the Contracting State in which its “place of effective management” is situated.’

Under French law, the residence of companies is determined in the following hierarchy:<sup>8</sup>

- Cognisance is taken of the domestic laws of each of the contracting states.
- The treaty test of the ‘place of effective management’ is to be applied only in residence conflicts, as a tie-breaker rule.

#### *Residence under French law*

The FTC does not provide for any comprehensive definition of ‘residence’ for companies, as it does for individuals in art 4B.

The definitions available are only those of the seat, head office and effective place of management, which may be found in the companies law, certain statements of practice from the French tax authorities and certain particular provisions of the FTC. Case law in this respect is scarce and results from civil courts rather than administrative courts, that are competent on direct tax issues.<sup>9</sup>

#### **Company law**

Article 3 of the law of 29 July 1966, on commercial companies reads as follows:

‘Companies whose head office is located within the French territory are governed by French Law. Third parties may avail themselves of the registered seat, but such registered seat is not binding upon them if the actual seat of the company is situated elsewhere.’

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<sup>8</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 3, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

<sup>9</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 3, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

## Statements of practice and French legislation

The tax concept of seat as specified by the tax administration follows the civil definition. The seat<sup>10</sup>

is, in principle, the registered head office as mentioned in the articles of incorporation. However, if the registered head office appears to be fictitious, one should refer to and take into account the actual head office at which the managing, directing and controlling bodies of the company are mainly situated. The actual head office corresponds to the effective place of management concept used in most tax treaties concluded by France.’

As regards tax assessment procedure, notably the place where a company must be taxed, the French tax administration gives the following definition of a ‘head office’:<sup>11</sup>

“‘Head office’ means the place where the company has the centre of its legal activity, i.e., the place where its directing bodies and administrative services are located. The true head office is mentioned in the articles of incorporation.

‘Where the head office so mentioned is fictitious, a head office may be regarded as being located at

- the place where the main contracts are concluded,
- the place where bank accounts are opened,
- the place where shareholders’ meetings are held,
- the place where the books are kept, in full.’

The true head office is the effective place of management, in other words, ‘the place where management decisions are taken’. In most instances it is also the registered head office.

French legislation that refers to the residence of companies is specific and concerns only the residence of foreign companies. Article 105 of the Finance Act 1990 established that

‘foreign entities whose head office is located outside of France are those which have their effective place of management outside of France, irrespective of their French or foreign nationality’.

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<sup>10</sup> D. Adm 4H – 1413 n°1, 1 September 1985.

<sup>11</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 3, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

In the context of dividends paid by French subsidiaries to European Union parent companies art 119 of the Finance Act 1990 provides that the beneficiary must have its effective place of management in a European Union state. These French tax code provisions refer to the concept of effective place of management to determine the residency of companies but technically apply only within the scope of these provisions.

#### Case law

Case law on this matter is rather limited, as most decisions are rendered by civil courts and direct tax issues are judged by administrative courts. This limited case law is also attributable to the French having the territoriality principle in place.

A decision of the Paris court ruled that<sup>12</sup>

‘where the registered office and the administrative, accounting and commercial departments are located in different places, the head office is situated where the direction function is fulfilled and where the main decisions are taken’.

In practice, under French law, the tax authorities may not accept that a foreign company is a resident of France because of its actual seat for the reasons described above. The only way would be to demonstrate that, from the treaty, the foreign company is a resident in France, because of an effective seat in France or because it has no substance in the foreign country and, correlatively, the only operations it has are in France.

Although the principle of territoriality and the place of effective seat are not the same kind of criterion, the OECD commentaries on the model convention provide that the limitation<sup>13</sup>

‘has to be interpreted restrictively because it might otherwise exclude from the scope of the convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended’.

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<sup>12</sup> CA Paris, 28 October, 1992, RJDA 2193, number 113.

<sup>13</sup> Douvier P ‘Permanent Establishment: the Next Topic for Litigation?’ BNA International Inc at 4, obtained from website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com).

In practice, French entities are ‘tax resident’ in the meaning of art 4(1) of the OECD Model of Convention where they have their ‘head office’ in France, in other words, they are incorporated in France and they have their seat in France. A company is deemed to be French resident for convention purposes if it has its ‘head office’ in France, since the existence of this seat implies that the company is operated in France and therefore fulfils the conditions of the territoriality principle.

French companies are resident in the meaning of art 4(1) on the ground that since they are incorporated in France or have their seat in France, they are deemed to fulfil the requirements of the territoriality principle.

### Conclusion

Resident companies are companies that have their legal seat or that have their effective seat in France. The French tax administration considers that the ‘effective seat’ is the place where the management and the administrative and controlling organs of the company are mainly located. In addition, it mentions that<sup>14</sup>

‘the effective seat corresponds to the place of effective management as provided by most tax treaties concluded by France’.

This is reasserted in D. Adm. 4 H-1422 No. 6 of 1 March 1995, that provides that the

‘place of effective management (*siège de direction effective*) means the place where the effective management as well as the effective administrative and controlling organs of the company are located’.

The French Supreme Administrative Court has indirectly confirmed this point of view of the French tax administration. In particular, the Supreme Administrative Court held<sup>15</sup> that the place of effective management of a company is the place where the tasks of managing and conducting the business were actually performed.

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<sup>14</sup> D. Adm. 4 H-1413 No. 1 of 1 March 1995.

<sup>15</sup> Conseil d’Etat 5 July 1999, No 171211.

## GERMANY

### 'PLACE OF MANAGEMENT'

Germany, together with various other countries, for example the Netherlands, uses the 'place of management' as the residence test to determine residence of non-individuals.

As far as German domestic law goes, Professor Vogel states the following:<sup>16</sup>

'The German domestic term "place of management" is very similar to the treaty term "place of effective management", and even more so because the former term is interpreted by the courts to refer to the factual conditions.'

According to German case law, a place of management is regarded as the place where management's important policies are actually made. Professor Vogel states that<sup>17</sup>

'what is decisive is not the place where the management directives take effect, but rather the place where they are given'.

In a decision published in February 1998,<sup>18</sup> the Federal Tax Court ruled on the meaning of the 'place of effective management' of a partnership for domestic law purposes. According to this decision, there can be only one place of effective management.

- For companies, that place is where the decisions on the handling of business affairs are taken.
- For partnerships, the decisive place is the place where the partners who represent the partnership in its daily business perform their business activities.

It is the center of top-level management or the place that the person authorised to represent the company carries on his business managing activities. If a controlling shareholder does manage the conduct of the company's business, then that shareholder may be regarded as

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<sup>16</sup> Vogel K, *Double Taxation Conventions*, 3<sup>rd</sup> Edition, Kluwer Law International at 262.

<sup>17</sup> At 262.

<sup>18</sup> Docket No. IV R 58 / 95; 3 July 1997.

being in charge of the top-level management, and the place where those decisions are made would appear to be the center of management. Vogel, however, indicates that a place from which a business is merely supervised would not qualify. He also states that under German law, if the place of management cannot be determined by the application of these criteria, the top manager's place of residence may determine the residence of the company.<sup>19</sup>

## SWITZERLAND

### 'PLACE OF MANAGEMENT'

#### Residence of Corporations

Corporations are considered as residents and are thus subject to full taxation if<sup>20</sup>

- they are incorporated in Switzerland, or
- if their place of effective management is located in Switzerland.

Under the place-of-incorporation test, a company's residence is determined by its formal place of incorporation. Therefore when a company is incorporated in Switzerland, it will be treated as a Swiss resident corporation. In Switzerland, the place of incorporation is determined by the place that the head office of a company is registered in the Commercial Register.<sup>21</sup>

The position as regards companies incorporated outside Switzerland remains the same for Swiss resident corporation purposes, if it is effectively managed from within Switzerland.

Switzerland uses the concept of 'place of effective management' in its domestic law.

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<sup>19</sup> 'The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule', OECD draft comment, February 2001 at 7 ([www.oecd.org.za](http://www.oecd.org.za)).

<sup>20</sup> Article 50 DTL and Article 20, para 1 THL.

<sup>21</sup> X Oberson and H R Hull 'Switzerland in International Tax Law' (2001) IBDF Publications, Amsterdam at 38.

Switzerland distinguishes between the ‘place of effective management’ and where mere administrative management or decision-making is done by executive bodies, for example, where the decisions of a board of directors are limited to control of the company and to basic decisions.

Due to there being no case law assigning meaning to the term ‘place of effective management’, it would be expected that the same interpretation would apply to the term as used in Swiss treaties and its domestic law.<sup>22</sup>

Any decision to subject a company to income taxes on the basis of effective management in Switzerland is therefore made by means of circumstantial evidence and at the discretion of the competent authorities, who seek to determine the domicile of the individuals who run the company, where the company’s bank accounts are held, where it has its mailing address and where accounts and other mail is sent to.<sup>23</sup>

In summary, the ‘place of effective management’ in Swiss law is where the important decisions are taken – this is the determinant factor.

## **BELGIUM**

### **‘PLACE OF MANAGEMENT’**

#### **Corporate Taxation**

Belgium imposes two types of taxes on the profits of companies:

- Corporate income tax that is levied on the world-wide income of resident companies, in other words, companies established in Belgium and

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<sup>22</sup> ‘The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule’, OECD draft comment, February 2001 at 7 ([www.oecd.org.za](http://www.oecd.org.za)).

<sup>23</sup> Oberson (2001) at 35; Athanas / Widruer in *KommentarDBG*, Article 50 N 61T; Reymond J.A. (1992 – 93) at 348.

- tax on non-resident companies that is levied on Belgian-source income of companies that are established abroad and on their foreign-source income to the extent that this income is connected with a Belgian establishment of the non-resident company.

All companies and associations, organizations or establishments that have legal personality, that have their registered office, main establishment or place of management in Belgium and that are engaged in profit-making activities or in the operation of a business, are subject to corporate income tax. Fulfillment of these criteria is necessary to qualify as a resident taxpayer.<sup>24</sup>

The taxable income of a non-resident taxpayer includes all profits made through a Belgian establishment or a permanent establishment located in Belgium.<sup>25</sup> An associate of an entity that has no legal personality is deemed to have a permanent establishment if it has its registered office, its main office or its place of management in Belgium or if the entity earns certain Belgium-source income listed in art 229(2) ITC'92.

No definition or case law surrounds the term 'place of management' and this seems to indicate, as in the Swiss position that it is left to the discretion of the taxing authorities in Belgium, if and when the situation arises, to determine the residence of corporate taxpayers.

## DENMARK

### 'PLACE OF MANAGEMENT'

Companies are liable to tax as residents only if they are 'hjemmehørende' (translated as 'belonging to') in Denmark. Public and private companies established under Danish law, that require registration with the Commerce and Companies Agency, are always considered as Danish residents. This also applies if a company's entire business is carried on abroad or its place of management is located abroad.<sup>26</sup>

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<sup>24</sup> Article 2, § 2, 1° and 2° ITC'92.

<sup>25</sup> Article 228 ITC'92.

<sup>26</sup> Anderson P S *GET – II*, International Bureau of Fiscal Documentation, Supplementary No 142, February 2000 at 117.

From 1995, foreign-incorporated companies and other entities not registered in Denmark, are considered resident in Denmark if their place of management is located in Denmark.<sup>27</sup> To determine the location of the place of management, the place of day-to-day management is normally decisive. The residence of the shareholders or the place where the shareholders' meetings take place are normally of no importance. Thus, if the board of executive directors or the head office is located in Denmark, the entity is resident in Denmark.

On 8 August 1995, the Danish Western High Court decided a case that involved the interpretation of the phrase 'the place of effective management' in art 15(3) of the Denmark-United Kingdom treaty.<sup>28</sup>

The case involved a Danish national who was resident in the United Kingdom but was also resident in Denmark for tax purposes. The Danish national was employed by a Danish ship-owner. In 1983, he was offered employment with the ship-owner's wholly-owned subsidiary registered in the Bahamas and operating a number of vessels in the Caribbean. The wholly-owned subsidiary paid salaries out of its administration office in Miami. The ship-owner had, however, to approve the subsidiary's strategy and top-management decisions. The ship-owner continued to make contributions to the pension scheme of the Danish national scheme while he was employed by the subsidiary, and guaranteed that, upon the termination of his employment with the subsidiary, he would be offered a new position with the ship-owner in Denmark. From 1 July 1985, the activities and employees of the subsidiary were transferred to another company where the Danish ship-owner had only a 28% ownership. The new company's head office was located in Miami.

Under the treaty the Danish employee was deemed resident in the United Kingdom. In determining whether Denmark had a right to tax his employment income, it was necessary to apply art 15(3) of the treaty. Under art 15(3) the state where an enterprise operating ships in international traffic has its place of effective management may tax income derived from employment exercised aboard these ships.

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<sup>27</sup> Section 1(6) SEL.

<sup>28</sup> VLD of 8 / 8-95, 7., 1.B-2498-92.

The High Court found that the Danish national's employment constituted 'employment exercised aboard a ship . . . operated in international traffic' under art 15(3) and that, until 1 July 1985, the place of effective management was located in Denmark. The court's conclusion was based on the fact that the Bahamian company was a wholly-owned subsidiary of the Danish ship-owner who made the top-management decisions. Consequently, until this date, Denmark had a right to tax the income. After 1 July 1985, however, the place of effective management was no longer in Denmark since the Danish ship-owner held only 28% of the shares of the new company, and the latter's head office was located in Miami. Denmark, therefore, lost its right to tax the income after 1 July 1985.

As far as holding companies and other companies that carry on business of a nature that does not require day-to-day management are concerned, the place where other decisions are made is, instead, decisive. For holding companies, this means that the place where negotiations on how to finance the company take place, or the place where decisions on how to make use of shareholder's rights are made, are taken into account.<sup>29</sup>

If an entity is resident in another state and a tax treaty between Denmark and that state would require Denmark to reduce Danish tax on foreign income from a permanent establishment in that state by an amount that is higher than the tax paid in that state by the entity, that entity is not considered a resident of Denmark according to the place of management test. This can also apply if treaty relief is granted through an exemption or matching credit. If the income of the permanent establishment is derived from a third state, this exception is not applicable.<sup>30</sup>

Under Danish law (the Commercial Foundation Law or the Foundation Law), a foundation is found to be resident, if it is established under this law. Foundations and similar institutions are also resident if their place of management is located in Denmark.<sup>31</sup>

For the place of management test, the location of the daily management is normally decisive. Thus, a foundation established under foreign law is normally resident if its administrator is resident in Denmark. If the board of the foundation carries out the daily management or if there is no daily management, the place where the board makes its decisions can be decisive.

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<sup>29</sup> CIR 82, 29 May 1997, 2.1.1.

<sup>30</sup> Section 1(6) SEL; CIR 82, 29 May 1997, 2.1.2.

<sup>31</sup> Section 1(4) FBL.

Once again, residence of board members is not relevant in determining the place of management.<sup>32</sup>

## NETHERLANDS

### RESIDENCY AND EFFECTIVE MANAGEMENT

Companies are deemed to be residents, for the purposes of corporate income tax and dividend withholding purposes, if incorporated in the Netherlands.<sup>33</sup> Companies may also be treated as residents of the Netherlands for tax purposes, if they are deemed to be ‘actually situated’ there on the basis of ‘facts and circumstances’, whether they are incorporated in the Netherlands or not.<sup>34</sup>

As these terms are not defined in tax legislation, there is extensive case law that has provided some guidance, in the form of factors that are important for the determination of residency status of the companies. In general, a key factor is the place where the effective management is located. Other relevant factors include<sup>35</sup>

- the place of residence of the directors and members of the supervisory board,
- the place of residence of an individual (majority) shareholder,
- the place where general meetings of shareholders occur,
- the location of the company’s assets,
- the location of the bookkeeping, and
- the nature and location of the business activities.

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<sup>32</sup> CIR 82, 29 May 1997.

<sup>33</sup> Article 2(4) Vpb; Article 1(3) DB.

<sup>34</sup> Article 4(1) AWR.

<sup>35</sup> van Haaren J S A and van Haaren-Nieboer I J *GET – II*, International Bureau of Fiscal Documentation, Supplementary No 159, October 2001 at 107.

## NORWAY

### RESIDENCY AND 'CENTRAL MANAGEMENT AND CONTROL'

Norway's tax jurisdiction, according to domestic legislation, includes the Kingdom of Norway, the continental shelf, Svalbard, Jan Mayen and the Norwegian dependencies outside Europe (Bover Island, Peter I's Island and Queen Maud's Land). Under international law, it may be debatable whether these dependencies are covered by Norwegian tax jurisdiction. In double treaties signed by Norway and other countries, Norway specifies that Svalbard, Jan Mayen and the dependencies are not covered.

#### Residency

Under s 2-2 of the Norwegian Tax Law, resident companies are subject to tax on their worldwide profits and gains. The term 'resident' is not defined in the legislation and neither is there case law that offers any help in this respect. Case law seems to suggest that the 'central management and control' is decisive, both for companies formed in Norway and those formed abroad.

The Norwegian Ministry of Finance takes the view that companies incorporated in Norway are resident in Norway and that the 'management and control test' applies to foreign companies only.<sup>36</sup>

In this statement, the Ministry of Finance considered the situation where a Norwegian incorporated company moves its management and administration abroad. According to s 15(1)(b) of the Norwegian Tax Act, a company is resident for tax purposes if it is 'hjemmehørende' in Norway. This term can be translated as 'having one's home [in]' or 'being a native [of]'. The term is not defined in Norwegian legislation. In principle, incorporation is not in itself sufficient to constitute residence, although, as a practical matter, it often is.

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<sup>36</sup> Ministry of Finance Statement, 7 May 1998, Sk.n. 98-220.

It is generally agreed that s 15(1)(b) means that the residence in Norway of a foreign-incorporated company must be determined by examining the factors that connect the company to Norway. In borderline situations, the place of residence depends on the location of the effective management, which in Norway means the non-executive board.<sup>37</sup>

The Ministry stated that, if a company is incorporated in Norway and transfers its management and operations abroad to a large extent, the residency in Norway for tax purposes must also be determined by examining factors that connect the company to Norway. As stated above, incorporation in Norway is itself not sufficient to constitute residence. On the other hand, the fact that the non-executive board meets outside Norway does not automatically make the company non-resident. Other factors of importance are<sup>38</sup>

- the location of the company's main administration,
- the application of Norwegian company law,
- the location of the day-to-day management,
- the allocation of functions between the company's activities in Norway and abroad, and
- the place of the shareholders' general meetings.

It is important, however, to determine if the company is still subject to Norwegian company law. The Ministry stated that, in practice, a company is either

- subject to Norwegian company law and resident for tax purposes, or
- not subject to Norwegian company law and a non-resident for tax purposes.

It was further stated that, if a company is no longer considered Norwegian for the purposes of Norwegian company law, the owners must dissolve the company through liquidation.<sup>39</sup>

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<sup>37</sup> 'Tax Consequences of Moving Management of Norwegian-Incorporated Company Abroad', *Tax News Service*, 5 October 1998, Volume 32, Issue 40 at 346.

<sup>38</sup> Gjems-Onstad O and Eriksen N *GET – II*, International Bureau of Fiscal Documentation, Supplementary No 160, December 2001 at 85.

<sup>39</sup> 'Tax Consequences of Moving Management of Norwegian-Incorporated Company Abroad', *Tax News Service*, 5 October 1998, Volume 32, Issue 40 at 347.

## ITALY

### RESIDENCY AND THE ‘PLACE OF EFFECTIVE MANAGEMENT’

#### Domestic Rules Governing the Residence of Companies in Italy

For the issue of the fairness of referring to personal criteria in identifying the place of effective management, Italy issued the following observation on the Commentary:<sup>40</sup>

‘Italy does not adhere to the interpretation given in paragraph 24 above concerning “the most senior person or group of persons (for example, a board of directors)” as the sole criterion to identify the place of effective management of an entity. In its opinion the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management.’

This observation was made in response to the reference made in the OECD commentary to that of using personal criteria, for example, the residence of the directors or shareholders in determining the place of effective management.

In order to understand the reasons behind Italy’s observation, a brief overview of the domestic rules governing the residence of companies in Italy is needed. These provisions will also be discussed in light of the opinions found in the OECD discussion paper. Indeed, although the term ‘place of effective management’ used in art 4(3) of the OECD Model Tax Convention must be interpreted independently, unlike the term ‘place of management’ used in art 4(1), that refers to

the definition in domestic law, it may nevertheless be useful to examine the interpretation given by scholars and courts on the corporate residence criteria under Italian law.

In Italy, companies are subject to corporate income tax and a regional tax on productive activities. Corporate income tax is levied on the following:

- Joint-stock companies, limited liability companies, partnerships limited by shares and co-operative and mutual insurance companies, and

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<sup>40</sup> Romano C ‘The Evolving Concept of “Place of Effective Management” as a Tie-Breaker Rule under the OECD Model Convention and Italian Law’, September 2001 *European Taxation* at 340.

- public and private entities other than companies, with or without legal personality, whether or not their sole or main business purpose is to conduct business activities.
- Non-resident companies and entities of every kind are subject to corporate income tax on income derived in Italy. Partnerships (commercial and non-commercial) are treated as transparent entities and are not subject to corporate income tax, other than partnerships limited by shares.

#### **Residence of Persons other than Individuals**

For income tax purposes, persons other than individuals are considered to be resident if, for the greater part of the taxable period, their legal seat, place of management or main business purpose is in Italy. The place where the company was incorporated is relevant only for international private law purposes, not directly for tax law purposes.

The legal seat is the place indicated in the company's articles of incorporation. The Italian Civil Code, that regulates the establishment of the seat of a legal person, states, however, that third parties may consider the place of effective management to be the seat of a legal person.<sup>41</sup>

The legal seat certainly has the advantage of being easily ascertainable. It has been rejected, however, for treaty law purposes as a means of identifying where the place of effective management is.

Paragraph 22 of the OECD Commentary on art 4 denies the relevance of purely formal criteria. The OECD discussion paper points out that a purely formal criterion (place of incorporation) as a tie-breaker rule would not offer a solution in the bilateral relations between two contracting states when a company is incorporated (registered or having its legal seat) in a third state.<sup>42</sup> Paragraph 56 of the OECD discussion paper also emphasized that in some jurisdictions, a company may be incorporated in more than one country, that would render the place of incorporation ineffective as a tie-breaker rule.

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<sup>41</sup> Article 46(2) Italian Civil Code.

<sup>42</sup> Paragraph 53 of the OECD discussion paper.

## Place of management

The place of management is often identified with the place of effective management in Italian case law and tax literature.<sup>43</sup> This is considered to be the place from where the company's directors manage the company, in other words, the place where the main decisions are made.<sup>44</sup>

The 'place of effective management' must not be identified with the place where the assets and properties are located or where the business activities are actually conducted.<sup>45</sup> Significance is attached to the place where the management directives are given, and not to the place where they take effect.

Earlier case law seems to identify the 'place of effective management' with the place where the directors reside or meet, and where the general meeting is called and held.<sup>46</sup> It is also interesting that the 'place of effective management' has been identified with, amongst other things, the location that third parties refer to in order to contact the company.<sup>47</sup>

References have also been made by the Supreme Court to the place where the corporate bodies necessary to carry on the business are situated, where the general meetings are held, or where the accounting books (including bank account statements, receipts or other commercial mail) are maintained.<sup>48</sup>

Italian scholars and case law point out the necessity of looking at the actual administrative activity carried on and not at the formal title of a person as a director of a company.<sup>49</sup>

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<sup>43</sup> Italian Supreme Court decision of 30 January 1998, No 959.

<sup>44</sup> Italian Supreme Court decision of 10 December 1974, No 4172; Italian Supreme Court decision of 16 June 1984, No 3604; Italian Supreme Court decision of 9 June 1988, No 3910.

<sup>45</sup> Italian Supreme Court decision of 13 October 1972, No 3028.

<sup>46</sup> Italian Supreme Court decision of 13 October 1972, No 3028.

<sup>47</sup> Italian Supreme Court decision of 16 June 1984, No 3604.

<sup>48</sup> Italian Supreme Court decision of 10 December 1974, No. 4172, in *Diritto e Pratica Tributaria*, 1975. II. 948.

<sup>49</sup> Italian Supreme Court decision of 10 December 1974, No. 4172, in *Diritto e Pratica Tributaria*, 1975. II. 948.

Moreover, contrary to what has developed in German case law and tax literature, they do not agree that the place of residence of the directors should be looked at to identify the place of effective management, but rather the place of the ‘formation of the concrete will’.<sup>50</sup>

The residence of the directors can be used only as a supplementary factor to establish the place of management of a company. More precisely, the residence of the directors is considered a significant factor in identifying the place where the managing activities are carried on.<sup>51</sup>

With respect to day-to-day management, there is no clear and straightforward answer in Italian case law and tax literature. Although the management activities conducted daily in carrying on the business may be broader in scope and more numerous than the activities of the board, the decisive criterion should be the nature of the decisions taken and their impact on the business of the company. Thus an analysis on a case-by-case basis is unavoidable. In other words, an examination on a factual basis of each scenario, must be concluded so as to determine the day-to-day management.

Finally, recent Italian case law has opened the possibility of holding board of directors meetings by way of video or teleconferencing. In particular Italian courts have approved the registration of company statutes containing special provisions allowing board meetings to be held by way of video or teleconferencing if all the participants are identifiable and may intervene.<sup>52</sup> In this situation the board meeting is considered to be held wherever the president of the board is. Previously, this was not possible due to a provision in the Italian Civil Code requiring the presence of the directors, and that they be given the opportunity to intervene in order for the board’s decisions to be valid.

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<sup>50</sup> Romano C ‘The Evolving Concept of “Place of Effective Management” as a Tie-Breaker Rule under the OECD Model Convention and Italian Law’, September 2001 *European Taxation* at 341.

<sup>51</sup> Romano C ‘The Evolving Concept of “Place of Effective Management” as a Tie-Breaker Rule under the OECD Model Convention and Italian Law’, September 2001 *European Taxation* at 341.

<sup>52</sup> Romano C ‘The Evolving Concept of “Place of Effective Management” as a Tie-Breaker Rule under the OECD Model Convention and Italian Law’, September 2001 *European Taxation* at 341.

### Main or Exclusive Business Purpose

The main or exclusive business purpose is the purpose determined by law or indicated in the articles of incorporation if they are in the form of a public deed or private authenticated (or registered) deed. The main business purpose is deemed to be the essential activity conducted so as to pursue directly the basic goals indicated by the law or articles of incorporation.<sup>53</sup>

In the absence of a public deed or private authenticated deed, the main business purpose is determined according to the activity effectively performed by the company within the Italian territory. For non-resident entities, regardless of the articles of incorporation, the decisive criterion is the activity effectively performed within the Italian territory. The main business purpose should not be identified with the assets owned by the company unless these assets represent the means to carry on the corporate business.<sup>54</sup>

The main or exclusive business purpose test does not appear to conflict with the list of examples of criteria used for domestic law purposes referred to in art 4(1).

The test under discussion is certainly the closest one to the economic nexus concept considered by the OECD,<sup>55</sup> under the three factors of production (land, capital and labour) that may be used as tie-breaker rules. The reference to the place where the main and substantial activities are carried on could also solve the problem raised by the OECD of a company treated as a resident for tax purposes under the domestic law of both contracting states with a place of effective management in a third state.<sup>56</sup>

There are significant objections, however, to the adoption of this test as a tie-breaker rule.

- First, the enormous difficulties in ascertaining what characterises the strongest economic connection to a state. So as to ascertain whether a company has its main business purpose in a state, an analysis of the overall activities, including the foreign activities, would be

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<sup>53</sup> There is no consolidated case law on the main or exclusive business purpose test.

<sup>54</sup> Romano C 'The Evolving Concept of "Place of Effective Management" as a Tie-Breaker Rule under the OECD Model Convention and Italian Law', September 2001 *European Taxation* at 342.

<sup>55</sup> Paragraphs 59 to 61 of the OECD discussion paper.

<sup>56</sup> Paragraph 45 of the OECD discussion paper.

needed to evaluate the prevalence of the activities performed within the territory of that state.

- Finally, the adoption of such a tie-breaker rule could lead to a potential discriminatory effect against multinationals resident in small countries.<sup>57</sup>

The legal seat, place of management or main (or exclusive) business purpose must be present, in the Italian territory for the greater part of the taxable year (at least 183 days). This requirement prevents a foreign company or entity from being subject to tax in Italy on its world-wide income if it has had, only for a short time, its legal seat, place of management or main business purpose within the Italian territory.

### **Conclusion**

It is sufficient to satisfy one of the criteria mentioned above, to be considered a resident in Italy. There is no hierarchy among these factors; nor should one factor prevail over another.

Consistent with the recommendations in the OECD discussion paper, several criteria are considered cumulatively in determining the residence of a company from an Italian perspective. Each situation is assessed on a factual basis taking all these criteria into account.

Italian law's formulation of the corporate residence criteria adopted, as interpreted by their courts and scholars, appear, however, to be strongly linked to formal aspects, for example,

- where the legal seat is, or
- what the articles of incorporation indicate.

Considering the observation made by Italy in the 'new' para 24 of the OECD Commentary with respect to the place where the most senior person or group of persons makes its decisions, more weight will probably be given to other criteria, for example, the place where the main and substantial activities are carried on, as opposed to the residency of the directors or shareholders of the corporate entity.

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<sup>57</sup> Paragraph 61 of the OECD discussion paper.

## CHAPTER FIVE

### AUSTRALIA

#### Corporate Residency in Australia

Under s 6(1) of Australia's Income Tax Assessment Act 1936, a company is a resident of Australia if it meets one of the following three alternate tests:<sup>1</sup>

- It is incorporated in Australia.
- It carries on business in Australia and is centrally managed and controlled in Australia.
- It carries on business in Australia and its voting power is controlled by shareholders resident in Australia.

In Australia, the term 'centrally managed and controlled' is not defined in the domestic tax legislation. There are a number of court cases, however, that provide some guidance on how the place of the central management and control is to be determined. Understanding the factors which determine a place of central management and control may provide assistance in determining a 'place of effective management'.

The courts have also taken certain other factors into account when determining the place of central management and control. In *North Australian Pastoral Co Ltd v FC of T*,<sup>2</sup> the taxpayer company was regarded as a resident of the Northern Territory where its actual business operations were located, notwithstanding that its directors' meetings were held in another state.

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<sup>1</sup> Income Tax Assessment Act 1936 (Cth), s 6(1).

<sup>2</sup> (1946) 71 CLR 623.

This conclusion was reached based on the following facts:

- The company's whole undertakings, being, incorporation, registered office, public office and full books of account were located in the Northern Territory.
- The directors met in Brisbane, Queensland, as a matter of convenience.
- The manager of the property in the Territory took the responsibility for the success or failure of the venture.
- Visits to the property by the directors and consultation with the manager were acknowledged to be of importance in reaching policy decisions.

In *Malayan Shipping Co Ltd v FC of T*,<sup>3</sup> however, the court held that the company was a resident of Australia because the managing director exercised from Australia complete management and control over the business operations of the company, notwithstanding that the trading operations were conducted abroad.

#### **Subsidiary Companies and Determination of Residency in Australia**

It will be necessary to consider the possible application of the second and third tests under residency to determine if a subsidiary is a fiscal resident of Australia. The 'central management and control' test has its origins in the United Kingdom judicial concept of corporate residence.

Based on judicial authorities, the 'central management and control' of a company is located at the place where the directors exercise their powers of management.<sup>4</sup> Generally, this is where the directors' meetings occur.

This is the position even if the directors act on instructions from some other person, as was the situation in *Esquire Nominees Ltd (Trustee of Manolas Trust) v Federal*

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<sup>3</sup> (1946) 71 CLR 156.

<sup>4</sup> *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455; *Koitaki Para Rubber Estates Ltd v FC of T* (1940) 64 CLR 15.

*Commissioner of Taxation*.<sup>5</sup> This case concerned a company (the taxpayer) incorporated in Norfolk Island, in accordance with the Companies Ordinance of that Territory of the Commonwealth of Australia. It has its registered office and its central management and control there.

The sole question before the court concerned whether or not the proceeds of the dividend paid to the taxpayer by Mitchell Investments Ltd was income derived by the taxpayer from sources within Norfolk Island.

The court looked at various factors to determine the 'central management and control'. The following was stated by Barwick CJ:<sup>6</sup>

'Further, in my opinion, the place where the company makes its investment income will be the place where it has its central management and control. It will, of course, be different in the case of a company conducting manufacturing and trading activities. In the case of such companies the place where these activities are carried on can be seen in fact to be the geographical source of the profits these activities yield.

'To apply these propositions to the present circumstances, Mitchell Investments Ltd has only one shareholding and that shareholding produced its income. Nothing in the company's manner of conducting its affairs requires consideration. The amount received from Pharmaceutical Investments Ltd represented both its gross and its net profit. As already indicated, its central control and management was in Norfolk Island. Its profits were not made in more than one place, so the complications which can arise in the case of a trading company, do not arise here. The geographical source of its profit, being its net income from investment, was Norfolk Island, for there, in my opinion, that profit was made.'

Provided the directors of the subsidiary are not Australian residents and that directors meetings occur outside Australia, then the central management and control of the subsidiary is likely to be outside Australia.

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<sup>5</sup> *Esquire Nominees Ltd v FC of T* 72 ATC 4076; 73 ATC 4114.

<sup>6</sup> At 4120.

This is the position even if an Australian resident company gives the subsidiary's directors voting instructions on motions to be put to directors' meetings of the subsidiary.

The subsidiary will not be a resident under the third test if either it does not carry on business in Australia or if it does carry on such business in Australia and its voting power is not controlled by Australian residents. There is no authority as to the meaning of 'carry on business' in Australia in the context of the residence test. It is likely that it is a reference to source concepts, particularly the United Kingdom distinction between trading 'in' and trading 'with'.

### **Dual Residence**

There are several possible bases for dual residence. The easiest dual residence situation to construct relates to the incorporation and management and control tests. A company may be a dual resident because it is incorporated in Australia, and managed and controlled in a country that uses that as the test, for example, the United Kingdom.

Alternatively, a company may be incorporated in a country that uses that as the test, for example, the United States, and is managed and controlled in Australia.

While dual residence may expose a taxpayer to taxation of world-wide income in more than one jurisdiction, it may also provide advantages to taxpayers.

- For example, a dual-resident company may be able to group the same loss against two separate sources of income.
- Another example is that a dual-resident company may qualify for certain tax benefits under Australian domestic law, but avoid full Australian taxation because of the tie-breaker rules in the residence article of a Double Taxation Agreement.
- Similarly, a company may qualify as a dual resident to avoid the operation of anti-avoidance rules under Australian domestic law targeted at non-residents.

Further measures to limit the tax advantages of dual-resident companies were introduced in 1997. These measures are aimed at dual-resident companies that are essentially foreign companies. In other words, Australian residence is artificially constructed for tax purposes.<sup>7</sup>

The tax advantages referred to above are excluded by effectively treating a 'prescribed dual resident' as a non-resident for the purposes of the relevant provisions. A company is a 'prescribed dual resident' if one of the following tests is satisfied:<sup>8</sup>

*The first test*

The first test is satisfied if all the following conditions are met:<sup>9</sup>

- The company is a resident of Australia for the purposes of the income tax law (see above).
- There is a double tax agreement between Australia and a foreign country.
- The double tax agreement contains a provision that is expressed to apply where, apart from the provision, the company would, for the purposes of the agreement, be both a resident of Australia and a resident of the foreign country. In other words, there is a dual-resident tie-breaker rule for companies in the double tax agreement. This condition seems to assume that the residence article in the relevant double tax agreement follows the structure of the residence article in the OECD Model Tax Convention. This is the situation in Australia's double tax agreements with the United Kingdom and Singapore where there is a complete allocation of corporate residence for the purposes of the double tax agreements without the situation arising of the company being both a resident of Australia and

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<sup>7</sup> Burns L 'Host Country: Australia' obtained from the website [www.worldtaxandlaw.com](http://www.worldtaxandlaw.com), published by BNA International Incorporated at 3.

<sup>8</sup> Income Tax Assessment Act 1936 (Cth), s 6(1).

<sup>9</sup> Australia-United Kingdom Double Tax Agreement, art 3(1); Australia-Singapore Double Tax Agreement, art 3(1).

a resident of the United Kingdom or Singapore for the purposes of the double tax agreement.

- The double tax agreement provision has the effect that the company is, for the purposes of the agreement, a resident solely of the foreign country.

#### *The second test*

The second test is satisfied if both the following conditions are met:

- The company is a resident of Australia solely under the ‘central management and control’ test (see above).
- The company is a resident of another country under the ‘central management and control’ test. In other words, if the company is a dual resident as a result of divided ‘central management and control’.

#### **Hybrid Entities**

There are no specific rules in the Australian income tax law dealing with hybrid entities. A limited partnership formed in Australia is treated as a resident company for the purposes of Australian income tax.<sup>10</sup>

Section 94T deals with the residence of corporate limited partnerships, and reads as follows:

‘For the purposes of the income tax law, the partnership is:

- (a) a resident; and
- (b) a resident within the meaning of section 6; and
- (c) a resident of Australia; and
- (d) a resident of Australia within the meaning of section 6;  
if and only if:
- (e) the partnership was formed in Australia; or

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<sup>10</sup> Income Tax Assessment Act 1936 (Cth), s 94J, s 94K and s 94T.

- (f) either;
  - (i) the partnership carries on business in Australia; or
  - (ii) the partnership's central management and control is in Australia.'

A private company incorporated in Australia and owned by foreign residents will be a resident company for Australian income tax purposes.

## CHAPTER SIX

### CONCLUSION

#### DEFINITION OF THE TERM 'PLACE OF EFFECTIVE MANAGEMENT'

This dissertation focuses on the concept of the 'place of effective management' as it is not defined in the South African Income Tax Act.

It is the aim of this dissertation to examine the ordinary meaning of this term, taking international precedent into account. A possible hierarchy of tests is proposed in order to assist in prescribing a meaning to this term.

As can be seen from the contents of this dissertation, the terms 'effective management' or 'effectively managed' are used by various countries throughout the world, together with the OECD in various documentation and writings.<sup>1</sup>

What can be gleaned from international precedent, is that this term does not have a universal meaning. Various countries and members of the OECD have attached different meanings to it.

It is important to bear in mind that this concept of effective management is not about determining shareholder control or control by a board of directors.<sup>2</sup>

Management as mentioned in the term 'place of effective management' is concerned with the company's purpose and business and not in the shareholder's function.

To determine the meaning of the term 'place of effective management', it should be borne in mind that distinctions can be drawn between the following:<sup>3</sup>

- The place where central management and control is carried out by a board of directors.

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<sup>1</sup> 'Resident: Place of Effective Management' (2002) 51 *The Taxpayer* at 67.

<sup>2</sup> (2002) 41 *Income Tax Reporter* at 211.

<sup>3</sup> (2002) 41 *Income Tax Reporter* at 211.

- The place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day regular and operational management and business activities.
- The place where the day-to-day business activities are carried out.

As stated in *Silke*,<sup>4</sup> although the Act refers to the ‘place of effective management’ of a company, rather than to its management or control, case law examining the concept of management and control, assists in formulating a definition for the determination of the ‘place of effective management’.

#### **Management or Control Principles**

As part of this conclusion, it is necessary to briefly outline some of the principles that have emerged relating to the principle of management or control:

- The question whether a company may be regarded as being managed or controlled in a place is one of fact.<sup>5</sup>
- The place of registration or incorporation of a company does not necessarily determine the place of management or control. In other words, in determining residency, regard should be had to where a company really does ‘keep house and do business’, not where a company eats or sleeps.<sup>6</sup>
- Management or control of a company may occur in a country where a company is not registered or incorporated. The South African legislature caters for this situation as a company is a resident of South Africa if it is incorporated, established or formed or has its ‘place of effective management’ in the Republic. This shows that the legislature has recognised and accepted the principle mentioned above.

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<sup>4</sup> *Silke on South African Income Tax*, Butterworths electronic version 2002, in para 14.45.

<sup>5</sup> ITC 1054 (1964) 26 SATC 260.

<sup>6</sup> *Calcutta Jute Mills v Nicholson* (1876) ITC 83.

- Management or control of a company has been found to be the place where directors meet and exercise their control over the business of the company or the place where the superior and directing authority of the company is to be found.<sup>7</sup>

From this, it is confirmed that the place of management or control of a company is not necessarily the place where the company carries on its trading or manufacturing operations or where the majority of the shareholders reside.

It is clear from the case law that the residence of shareholders or directors is of no importance in determining where the central management and control of a company is. The OECD, however, refers to this criteria as a determinant factor in establishing corporate residency.

- Management or control of a company may be divided between more than one country. In *Union Corporation Ltd and others v CIR*,<sup>8</sup> it was suggested that management or control of a company may be found in any country where there is present some part of the superior and directing authority of the company.

*Silke* submits that it is:<sup>9</sup>

‘doubtful whether there is any significant distinction between the terms “managed” and “controlled” as they were used in the Income Tax Act. In practise, SARS was reluctant to draw any distinction between the two terms, and looked for the place where the dominant control on questions of policy was exercised by the directors as distinct from the shareholders, unless the directing power of the company was to be found in more than one country, with the result that it was managed and controlled in different countries. For example, it acknowledged that when a company carried on separate businesses in different countries and the businesses were independently managed and controlled in each country the company must be regarded as managed and controlled in each country.’

#### **Guidance from the Concept of ‘Place of Management’**

Germany and the Netherlands use the ‘place of management’ as a residency test to determine the residency status of non-individuals. Switzerland uses the concept of ‘place of effective

<sup>7</sup> *Union Corporation Ltd & others v CIR* (1953) AC 482, 34 TC 207, per Sir Raymond Evershed MR at 271.

<sup>8</sup> *Union Corporation Ltd & others v CIR* (1953) AC 482, 34 TC 207, per Sir Raymond Evershed MR at 271.

<sup>9</sup> *Silke on South African Income Tax*, Butterworths electronic version 2002, in para 14.45.

management' in its domestic law. German case law seems to indicate that the place of management is regarded as the place where important policy decisions are made. Professor Vogel states that<sup>10</sup>

'what is decisive is not the place where management directives take effect but rather the place where they are given'.

He further states that the place of management is the centre of the top level management or the place at which the person authorised to represent the company carries on his business management activities.

If these criteria do not help in ascertaining the place of management, under German law, Vogel suggests that a further criterion be used in determining residency of a company. This criterion is the top manager's place of residence.<sup>11</sup> It is submitted that this cannot be used as one of the determining factors to establish corporate residency, due to the various impracticalities associated with determining the residence of one or more shareholders or directors. These high-powered individuals may be frequent travelers due to the nature of their work, having more than one abode in various countries. How would one establish their residency if they lived in country A for six months a year, and country B for the rest of the year? What is the situation where a major international company, has more than twenty top managers residing in various parts of the world?

It is submitted that the residency of directors or senior managers should not be a factor that is considered in determining the 'place of effective management', together with the actual activities and physical location of senior employees. With the use of technology today, companies can be controlled at the touch of a button from across continents (for example, via e-mail or by teleconferencing). Travel is also becoming more and more common and for the reasons mentioned above, the residency of directors or senior managers, would not be a viable factor to be considered in determining the 'place of effective management'.

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<sup>10</sup> Vogel K, *Double Taxation Convention*, 3<sup>rd</sup> edition, Kluwer Law International at 262.

<sup>11</sup> 'The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule', OECD draft comment, February 2001 at 6 ([www.oecd.org.za](http://www.oecd.org.za)).

To use this criterion as one of the determining factors would render this test of corporate residency utterly useless and inconclusive.

#### **The Commissioner's View**

The Commissioner for the South African Revenue Services has expressed the view<sup>12</sup> that the 'place of effective management' is the place where the policy and strategic decisions made by the board of directors are executed and implemented on a regular day-to-day basis. This is determined irrespective of where the overriding control is exercised or where the board of directors meets and this may also be a different place to where the day-to-day business activities are carried out.

If these management functions are executed at more than one location, then the place of effective management will be the place where the day-to-day business activities are carried out and should the activities be carried out from various locations, it is necessary to determine the place with the strongest economic nexus.

When determining the 'place of effective management', all the relevant facts and circumstances need to be taken into consideration and the following list, which is not exhaustive, has been provided in Interpretation Note 6:<sup>13</sup>

- Where the center of top-level management is located.
- Location of and functions performed at the headquarters.
- Where the business operations are actually conducted.
- Where controlling shareholders make key management and commercial decisions for the company.
- Legal factors, for example, the place of incorporation, formation or establishment, the location of the registered office and public officer.
- Where the directors or senior managers or the designated manager, who are responsible for the day-to-day management reside.
- The frequency of the meetings of the entity's directors or senior managers and where they take place.

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<sup>12</sup> Income Tax Interpretation Note 6 issued on 26 March 2002.

<sup>13</sup> Income Tax Interpretation Note 6 issued on 26 March 2002.

- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity.
- The actual activities and physical location of senior employees.
- The scale of onshore as opposed to offshore operations.
- The nature of powers conferred upon representatives of the entity, the manner in which those powers are exercised by the representatives and the purpose of conferring powers to the representatives.

The South Africa position focuses on where the day-to-day management occurs in determining the place of effective management while much of the foreign case law seems to indicate that the controlling factor is where key management and commercial decisions are taken. Taking key management and commercial decisions into account, for the same reasons mentioned above (in the paragraph relating to the residency of directors), could pose a problem as a company could have, for example, five top managers that live in five different countries, each handling different portfolios and making decisions concerning different aspects of the company's commercial and key management policies. How does one ascertain the place of key management and commercial decision making in this instance?

As the place where key management and commercial decisions are taken, is the main criterion that has emerged through an examination of the case law, however, it is still the most predominant factor and should be prioritised in this manner.

Establishing a hierarchy of these factors as a guideline, as opposed to the list detailed in Interpretation Note 6, that is not exhaustive in itself, would contribute greatly to making the determination of a company's 'place of effective management' more efficient.

It must be remembered that Interpretation Note 6 is merely a guideline used to interpret the legislation when attempting to establish the corporate residency of a non-individual that is not incorporated or formed in South Africa. This Interpretation Note is by no means definitive nor does it form part of the legislation, hence the need for considering other sources of guidance.

### **Proposed Hierarchy of Tests in Order to Determine the Place of Effective Management**

A hierarchy of tests is proposed in order to streamline the process of determining the residency of a non-natural person. As proposed by the OECD, the 'first' test should be applied and if it fails to give an answer, the 'second' test should be applied and so on. The following possible hierarchy is suggested:

- Place of effective management (where the day-to-day management occurs as well as strategic management).
- Place of incorporation.
- Economic nexus.
- Agreement between the two states claiming residence.

This may be the most practical way forward so as to keep to something close to the existing rules, and avoid for the time being the question of whether those rules should be changed. The place of incorporation is arbitrary and may well have nothing to do with the location from which a business is directed. Considering the place of incorporation, however, will also nearly always give a definite answer, so any tests below it in the hierarchy would hardly ever be reached.

It is submitted that this form of approach will add more 'definition' to the term the 'place of effective management' and not leave it as open to interpretation as it currently stands. The current interpretation could result in numerous places being allocated as the 'place of effective management' of a non-natural person.

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