



WEEKLY COMMENT: FRIDAY 18 JANUARY 2013

1. Last week I looked at the implications for natural persons of the currently available draft interpretation statement *INS0117: Income tax-residence* ("the draft IS") released on 7 December 2012. Submissions close on 31 January 2013.
2. This week I consider the implications for companies and trusts.

Residence of companies

3. The discussion in the draft IS starts by noting that the definition of "company" in s. YA 1 includes a wide range of entities established under the laws of other countries that, although not companies in the strict sense, are treated as companies for tax purposes in New Zealand. If any such entity satisfied any of the company tests of residence, it would be a New Zealand resident company and be liable for tax here on its worldwide income.
4. A company incorporated under the *Companies Act 1993* is resident in New Zealand. The other tests for a company's tax residence are considered below.

Head office test

5. The head office test requires there to be an office that is above all others: the place of administration and management that is superior to all others; the office from which the business of the company is direct it and carried on. The *focus is on a physical place*, in the sense of a building, from which the overall operations of the company are directed and carried on.
6. Relevant factors may be:
 - (a) The location of senior management staff;
 - (b) Where the major strategic and policy decisions are made;
 - (c) Whether specialised functions, for example of an advisory nature, are carried out in a particular office;
 - (d) Whether the staff of the company consider that an office is the head office.

Centre of management test

7. The centre of management test focuses on the highest level of management – i.e. the place where *the company as a whole is managed from on a day-to-day or regular basis* (*Koitaki Para Rubber Estates Ltd v FC of T* (1941) 64 CLR 241). The focus is on the management of the entire company, not just the New Zealand operations.

8. The test is a de facto test: the focus is on the company's actual centre of management – following *NZ Forest Products Finance NV v CIR* (1995) 17 NZTC 12.073 and *Egyptian Delta Land & Investment Co Ltd v Todd* (1929) 14 TC 119 – i.e. where the persons giving the instructions are located – whether or not they are officers of the company.
9. A company does not need to have an office in New Zealand to satisfy the centre of management test and if it does have an office here it does not need to be the head office – the focus is on the broader question of whether the management of a company is centred in New Zealand or because the day-to-day decision-making is effectively undertaken from New Zealand.

Director control test

10. This test focuses on the *superior management* of the company. But the test requires directors to act in their capacity as directors when they exercise control. That focuses on management of the company rather than on ownership.
11. The director control test can be satisfied if *de facto control* is exercised from New Zealand. If the nominated directors do not exercise control of the company but de facto directors exercise control from New Zealand, the company will be resident in New Zealand even though the de facto directors are not directors under the Constitution of the company. This is the meaning given in the draft IS to the concept of “whether or not decision-making by directors is confined to New Zealand”.
12. The test focuses on persons carrying out the duties of a director and the place from which those duties are exercised. They need not necessarily be directors. For example, if the directors of a company incorporated in Hong Kong acted under instructions from a New Zealand individual, that individual would be a director of the company.
13. In deciding whether directors are acting under instructions from someone else, the remuneration provided should be considered to see if it reflects their apparent duties and responsibilities. Nominated directors who merely “rubber stamp” decisions already made by others will be acting under instructions from person regarded as a director.
14. However, New Zealand directors must exercise *control over the entire company*, not just over the New Zealand operations.
15. Other factors that may be relevant include: whether directors exercise control on a *continuing basis*, and whether they exercise power equally. For example, a *simple majority approach* may not be appropriate if power is not exercised equally.
16. There is a discussion about *companies without conventional directors* such as unit trusts. The manager of a unit trust would be a director because they're involved in making the major decisions in relation to the unit trust. If the manager exercises control of the unit trust from New Zealand, the unit trust will be a New Zealand resident.
17. The definition of director is broad enough to encompass *both natural persons and companies* that are appointed or that act as directors. This could result in a New Zealand resident company being treated as a director of a company established in another jurisdiction.

Comparison between the centre of management test and the head office and directors tests

18. In the director control test the emphasis is on superior management, and the place where the central and directing mind of the company resides.
19. The head office test focuses on a physical place – i.e. on the office from which the business of the company is directed and carried on.
20. The centre of management test focuses on the place from which the company as a whole is managed on a day-to-day basis.

Examples of company residence

21. There are a number of examples illustrating the company residence tests. The conclusions have not changed from those expressed in the corresponding examples in *PIB No 180*. A couple of the more interesting examples are:
 - *Example 19:* Company A is incorporated in Hong Kong, it carries on business manufacturing clothes there, and all its operations are managed from Hong Kong. There is no office in New Zealand. Meetings of the Board of Directors are held in Hong Kong, but the directors act on the instructions of the New Zealand parent company. The Hong Kong company is resident in New Zealand under the director control test.
 - *Example 22:* A unit trust that invests primarily in shares issued by public listed companies is managed by a New Zealand incorporated company. The manager makes all the major decisions related to marketing etc. The unit trust is a company and is resident in New Zealand under the director control test.
 - *Example 23:* An Australian incorporated subsidiary of an Australian company which involves marketing products in New Zealand has its day-to-day management taking place in its Auckland office. The Australian subsidiary is resident in New Zealand under the head office and centre management tests.

Implications of changing company residence

22. There's some discussion about the implications of changing company residence in terms of:
 - (a) Taxation of foreign source income;
 - (b) Company imputation;
 - (c) The CFC regime;
 - (d) The financial arrangements rules;
 - (e) Grouping of losses; and
 - (f) Provisional tax.

The tie-breaker test in double tax agreements

23. There is a discussion about the tie-breaker test in double tax agreements in relation to dual resident companies, but there are no examples given. The only examples relate to the grouping of losses of dual resident companies.

24. It is noted that paragraph 259 that where New Zealand adopts the test in Article 4 paragraph 3 of the OECD *Model Convention*, and the residence of a dual resident company is allocated to the State in which a company has its “place of effective management”, reference should be made to the OECD *Commentary* on the meaning of this term, as it reflects the meaning the parties intended it to be given.
25. Until 2000, New Zealand gave the term “place of effective management” a special meaning under paragraph 25 of the *Commentary* on Article 4, paragraph 3: For New Zealand, “place of effective management” meant the place where the day-to-day management of the company is carried on. This rider was removed in 2000, and New Zealand became subject to the general meaning under the OECD *Commentary*.
26. In the July 2008 update to the *Commentary* on Article 4, paragraph 3, the sentence “The place of effective management will ordinarily be the place 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 entity as a whole are determined; however, no definitive rule can be given” was removed.
27. Hence, the place of effective management no longer means simply the place where the most senior persons make the decisions. Paragraph 24 of the *Commentary* now reads:
- “24. As a result of these (earlier) considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business *as a whole* are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”

Residence of trusts

28. There is a brief discussion about the residence of settlors and trustees. The focus is on a settlor becoming a resident and becoming liable as agent of the trustee for income tax payable by the trustee on trustee income.
29. It is noted that the residence of the trustee is generally not relevant in determining the treatment of trustee income: New Zealand sourced trustee income is always subject to tax, and foreign sourced trustee income is subject to tax on the basis of the residence of the settlor.
30. There is a more detailed discussion regarding the election that a settlor who becomes tax resident in New Zealand can make under sections HC 30 and HC 33 in the section on the implications of the change in the tax residence of an individual, in paragraphs 118 to 124 of the draft IS.
31. There is no discussion in the draft IS about the implications of a New Zealand resident settlor becoming a non-resident. In particular, there is no discussion regarding the ability of departing settlors to make an election under s. HC 33 so that a trust retains complying trust status. However, paragraph 10.88 on page 91 of *Appendix to Tax Information Bulletin* Vol 1 No. 5, November 1989 “Explanation of Taxation of Trusts” states that:
- “... s. 228(7) (of the Income Tax Act 1976, which is now s. HC 33) permits any trustee, settlor or beneficiary of a trust to elect to pay tax on trustee income in any other situation where the trustee, settlor or beneficiary considers it appropriate to make an election. For example, if a

person who settled a trust while resident in New Zealand ceases to be resident trustee income derived from outside New Zealand ceases to be liable to income tax from the income year in which the settlor is not at any time resident in New Zealand. The trust will therefore cease to be a qualifying trust from that income year because a portion of the trustee income ceases to be liable to income tax. To avoid that consequence, the trustee, settlor or beneficiary may consider it appropriate to elect to pay tax on trustee income from the income year in which the settlor is first not resident in New Zealand at any time.”

32. In a brief discussion about the residence of trust beneficiaries there is a mention of the special rule regarding beneficiaries who cease to be resident and become resident again within 5 years. Such beneficiaries are treated as deriving income under s. CV 15 and s. HC 23 to the extent to which they would have been treated as deriving beneficiary income or taxable distributions from a foreign trust or a non-compliant trust had they remained in New Zealand during their period of absence. The income is treated as being derived on the day on which the beneficiary becomes resident again.
33. The residence rules for natural persons apply to natural person beneficiaries and the residence rules for companies apply to company beneficiaries.



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