KPMG submission

Board of Taxation Consultation Paper

Review of company tax residency rules

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Executive Summary

KPMG welcomes Board of Taxation's review and the opportunity to comment on the Consultation Paper ("CP") *Review of Company Tax Residency Rules*.

The current tests for determination of company tax residency are the source of considerable administrative difficulty for taxpayers, in particular those Australian-headquartered groups who are looking to grow their business by selling into new overseas markets. The review represents an opportunity to recommend simplification of the test, at minimal risk to the Australian revenue.

Our key recommendations are as follows:

1. **Australia should adopt the place of incorporation as the sole test of company residence.**

   This approach would provide significant practical and administrative benefits for outward- and inward-investing groups, without presenting a material risk to government revenue. The risks identified in previous reviews have significantly reduced due to Australia's unilateral action such as the Multinational Anti-Avoidance Law and the Diverted Profits Tax, and due to multilateral action, in which Australia is participating, such as the Multilateral Instrument and anti-hybrid mismatch rules. The opportunity for 'stateless' income is now insignificant.

   Transitional rules would be required in order to avoid adverse consequences for foreign-incorporated companies that might cease Australian residence if CMC were removed.

2. **In the alternative, if a central management and control, or place of effective management test is retained, the legislation should be modified to the effect that such activities on their own cannot constitute the carrying on of a business in Australia.**

   The government could eliminate much of the practical difficulty the test is otherwise likely to cause by applying the test only where the company undertakes business operations in Australia that are additional to effective or central management and control. The existing voting power test should also be repealed.

3. **A company which is solely resident of an overseas jurisdiction under one of Australia's bilateral tax agreements should be treated as non-resident for all purposes of Australian tax.**

   This would significantly reduce complexity and uncertainty regarding a foreign-incorporated company's Australian tax position.

Detailed comments

Consultation question 1

The Board seeks stakeholder comment on the difficulties associated with the central management and control test that have been discussed in Chapter 5 so far, and whether there are additional difficulties with the test that the Board's attention should be drawn to (particularly if such difficulties are attributable to matters other than board practices and if they arise in the context of an inward investing corporate structure).

1.1 The Board has accurately summarised in Chapter 5 the difficulties with the application of the central management and control ("CMC") test faced by Australian multinational groups and by non-residents investors that are seeking to use Australia as a regional holding company.

1.2 The Board has identified in Chapter 5 that the evolution of corporate governance practices and the use of modern communication tools have changed the way in which board decision are made. Both of these factors have been significant to the way Australian multinational groups governed their foreign subsidiaries, and their adoption was enhanced by the certainty given to taxpayers in Taxation Ruling TR 2004/15.

1.3 It is also our experience that the speed at which critical commercial decisions need to be made has also increased since the introduction of TR 2004/15. Particularly in relation to the making of foreign investments through foreign controlled subsidiaries, it is not practical and in many cases not physically possible within the time constraints of a transaction for Australian resident board members of foreign subsidiaries to meet outside of Australia to make critical investment decisions. Yet, under the guidance provided by the Commissioner, a failure to do so could affect the residency of the foreign company. Even more troubling is that a reversion to critical decisions being made offshore could result in a foreign subsidiary ceasing to be an Australian resident, with the attendant tax costs that would follow such an outcome.

1.4 The costs to businesses of satisfying the CMC test, both financially for the business and personally for individuals, should not be underestimated. These are costs that are for the large part being incurred solely to meet the CMC test without there being any productivity benefit for Australia and without certainty that the CMC test will be satisfied.

1.5 Modern business practices and communication equipment mean that it is very often unnecessary for Australian resident directors to travel to make key business decisions and participate in board meetings for foreign resident subsidiaries, and they only do so to enable the CMC test to be satisfied. This in itself poses a concern for business.

1.6 In PCG 2018/9, the Commissioner advises that he will not apply his resources to assessing the residency of a foreign incorporated company in circumstances that include where the foreign incorporated company has not entered into or carried out "*any artificial or contrived arrangements that affected the location of its central management and control*." It is reasonable for taxpayers to expect that the Commissioner would take the same approach to the assessment of CMC on an on-going basis.

1.7 It is common for key decisions about the operations or investments of foreign companies within Australian multinational groups to be made by the Board or management of the Australian controlling company within Australia. Holding a board meeting in a foreign jurisdictions to consider and approve those decisions could itself be seen as a contrived arrangement, where a majority of the directors are Australian residents that could attend the meeting from Australia using modern communication technology. The uncertainty is even greater when the board members of the foreign company are also directors or senior management of the Australian controlling company that made the operational or investment decision that the foreign company is to implement.

1.8 A practical way of dealing with the CMC test is for foreign-incorporated subsidiary to appoint foreign-resident directors. Unfortunately, it is often the case that they will be less-suited to the role than an Australian resident peer, and the appointment of external directors can come at a significant additional cost to the Australian multinational group.

1.9 Further, as the *Bywater Investments* case illustrates, the external directors need to be actively involved in the decision making of the company to be relevant to the CMC test. As a result, Australian multinationals will encourage non-resident directors to take an active role in their directorship duties. However, it is also the case that if the independent director did not agree with group policy then it remains that they would be quickly removed from their role. As such, the efficacy of entering into such an arrangement is uncertain.

1.10 The ATO discusses in its guidance that CMC generally rests with the board of a company. Common foreign business entities such as a US limited liability corporation ("LLC") may not be legally required to have a constituted board, and therefore if the principal decision-makers reside in Australia it may be very difficult to evidence that management and control actually takes place overseas. Consequently the LLC is at risk of being considered Australian resident, even though it may have no operations, assets or customers in Australia.

1.11 As the Board discussion in Chapter 6, the concept of place of CMC differs from the concept of place of effective management ("POEM"). The difference in the meaning of these terms creates additional complications for taxpayers. First, a company can still be a resident of Australia due to it having its CMC here, even if its POEM is overseas for tax treaty purposes, with adverse tax consequences flowing from that mismatch. Further, Australia's double taxation agreements, as modified by the OECD Multilateral Instrument ("MLI"), confirm that a dual resident entity may be denied treaty benefits until the tax authorities of the two countries have determined its sole residence jurisdiction for the purpose of the agreement. At this early stage following implementation of the MLI, taxpayers will have varying levels of confidence in the speed and reasonableness of these determinations. This is because:

- there is a lack of transparency as to how the tax authorities will reach a conclusion, including whether the decision will be influenced by the taxation revenue outcomes that will arise from a particular conclusion; and
- it is not possible to know how minor changes in facts and circumstances may impact the decision, and whether a further determination may be required at a later time.

1.12 For an inward investing corporate group, the CMC test inhibits the group from sending directors or senior executives to Australia to build and optimise the business in Australia, where those individuals would need to retain a board or management role at the foreign parent company. This would particularly be the case for an entrepreneurial company with a small board and management team.

1.13 Australia has implemented over many years provisions which encourage non-residents to invest in Australia and use Australia as a holding jurisdiction. These measures include the conduit foreign income rules, the participation exemption for capital gains and the simplification of the rules relating to the treatment of foreign dividends as non-assessable non-exempt income. The application of the CMC test post the release of TR 2018/5 will, in our view, create so much uncertainty that the use of Australia as a regional holding jurisdiction may become untenable.

Consultation question 2

The Board seeks stakeholder comment on the primary theme that has informed the discussion under Part 4 of Chapter 5, being whether certain subsequent additions to the income tax legislation have imported at least some degree of redundancy into the central management and control test. The Board also seeks stakeholder assistance in identifying instances in which any other part of the income tax legislation produces different tax outcomes that are dependent on whether a foreign incorporated subsidiary company is, or is not, an Australian resident under the central management and control test.

2.1 In 2019 the risk of a company artificially achieving favourable tax outcomes in the absence of a multilateral web of CMC or similar tests is minimal. A combination of enhanced CFC rules, plus unilateral and multilateral action on addressing hybrid mismatch arrangements have significantly restricted the legitimate opportunities for exploiting mismatches in tax rules between jurisdictions. We have described some of the Australian measures that have reduced this risk in the following paragraphs.

2.2 The hybrid mismatch rules implement into Australian income tax law the recommendations of the OECD. The rules are intended to deter the use of certain hybrid arrangements that exploit differences in the tax treatment of an entity or financial instrument under the income tax laws of two or more countries. If a payment was made creating a deduction and non-inclusion amount and the receiving entity was considered "stateless" due to mismatches in residency rules between two countries, the Australian hybrid rules would apply to neutralise the deduction for the Australian taxpayer entity.

2.3 The Multinational Anti-Avoidance Law ("MAAL") targets multinational entities that avoid a taxable presence by booking their revenue offshore despite undertaking significant work in Australian with direct connection to Australian sales. Penalties associated with tax avoidance schemes were also increased as part of the MAAL. The MAAL is intended to encourage multinationals to restructure their operations by creating a taxable permanent establishment in Australia.

2.4 The Diverted Profits Tax ("DPT") is aimed at taxpayers' arrangements with offshore related parties that lack economic substance, and which divert Australian profits to lower tax countries. Under the DPT assessment, tax would be payable on the amount of diverted profits at a penalty rate of 40 percent.

2.5 In addition, Australia also has a comprehensive CFC rules to limit artificial deferral of tax by using offshore low taxed entities. Under Australia's CFC rules, domestic companies that have a controlling interest in a foreign company are liable to pay the Australian corporate tax rate for certain passive and tainted income derived by the foreign subsidiary in overseas jurisdictions.

Consultation question 3

The Board seeks stakeholder comment on whether the central management and control test should be replaced with an alternative test that features place of effective management. The Board is particularly interested in how place of effective management would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

3.1 A POEM test would align the domestic law with the wording in the majority of Australia's bilateral tax agreements, and therefore significantly reduce the risk that Australia could treat a company differently for domestic law purposes from the way it applied the treaty provisions.

3.2 However a better approach would be to eliminate the CMC test altogether and to simply rely on the place of incorporation as the test for corporate residency. Please refer to our comments in response to Consultation Question 5.

Consultation question 4

The Board seeks stakeholder comment on whether there are criteria other than central management and control or place of effective management that could be used to establish corporate residency. The Board is particularly interested in how alternatives would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

4.1 If either of the CMC or POEM tests are used in future, the government should modify the legislation such that where a company has its CMC or POEM in Australia, but does not otherwise carry on business here, it should not be considered a resident of Australia.

4.2 This would greatly simplify the position for foreign-incorporated subsidiaries which were incorporated specifically for the purpose of doing business in an overseas jurisdiction, but whose directors are Australian resident and hold their meetings in Australia.

4.3 It is important for the health of Australia’s economy that unnecessary impediments to selling into new overseas markets do not arise. The current structure of the corporate tax residency test imposes just such an impediment, as the administrative complexity that arises from dual tax residence is considerable.

4.4 The government should additionally modify the domestic legislation to ensure that where a company is treated solely as a resident of the foreign jurisdiction for the purposes of a bilateral tax agreement, it should consequently be treated as a non-resident for all Australian tax purposes.

Consultation question 5

The Board seeks stakeholder comment on whether an incorporation only test should be used as the sole basis for establishing corporate residency.

5.1 KPMG supports this option. Fundamentally, disregarding the CMC test, current Australian tax rules are sufficient that if a foreign-incorporated company carries out business operations in Australia, it will still be taxable in Australia on the profits as a non-resident. Similarly, if an Australian group incorporates foreign subsidiaries, then the foreign-sourced profits of the subsidiaries are attributed to the Australian parent for tax purposes, where Australian tax would otherwise be avoided through the subsidiary’s non-resident status.

5.2 Based on current Australian and international tax rules and matters under consideration at OECD level, we see minimal risk to the revenue in adopting the place of incorporation test as the sole test for company tax residence. This possibility was canvassed as part of the Board of Taxation’s Review of International Tax Arrangements (“RITA”) in 2003, and since then the key perceived risks in adopting this approach have been removed. A source of perceived risk in relation to place of incorporation as a sole test has been the potential for abuse where the country of incorporation has a CMC-only test. As far as we are aware, the countries that currently apply a CMC-only (or similar) test in determining company tax residence, also have a complementary anti-avoidance rule. Ireland applies CMC as its primary test of company residence, but since 2014-15 has implemented anti-avoidance rules which ensure that a company incorporated in Ireland but with its CMC in another jurisdiction cannot be “stateless” in terms of tax residence. This situation might otherwise arise if the jurisdiction in which CMC was located applied an incorporation-only test of residence.

5.3 The US, as the CP points out, is unique among developed countries in having place of incorporation as its sole test. However since 2017 the US has undertaken significantly reformed its international tax rules, and has significantly reduced the advantages that US-headquartered groups could obtain from setting up subsidiaries and retaining profits in low-tax jurisdictions. These measures include an expanded scope of CFC-style income attribution, and a participation exemption in respect of foreign dividends.

5.4 The OECD report, *Addressing Base Erosion and Profit Shifting ("BEPS")* was the trigger for the 2013 launch of the OECD BEPS project, aimed at reforming international tax rules to realign taxation of profits with the underlying economic activities and value creation.

5.5 BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation, or partial non-taxation and in some instance notes the concepts of 'residence; and 'source' are the root for these problems. Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be rendered ineffective due to the ongoing work in the context of the BEPS Project. The work on BEPS will also increase transparency between taxpayers and tax administrations and among tax administrations themselves.

5.6 Risk assessment processes at the level of the competent tax administration will be enhanced by measures such as uniform transfer pricing documentation requirements, coupled with global country-by-country ("CbC") reporting. CbC reporting is aimed at combating tax avoidance through requiring multinationals to provide more comprehensive information to the tax authority in their headquarters jurisdiction and in each jurisdiction in which they operate.

5.7 The MLI, is a multilateral treaty that enables jurisdictions to swiftly modify the operation of their tax treaties to implement measures designed to better address multinational tax avoidance and more effectively resolve tax disputes. A feature of the MLI articles that Australia has so far adopted is an expanded definition of a taxable permanent establishment and a strengthened rule for how the status of dual-resident companies can be resolved.

5.8 The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures are implemented in a coordinated manner, taxation is more aligned with where economic activities takes place. This will restore taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim to put an end to the phenomenon of so-called stateless income. Australia has fully cooperated with the OECD's initiatives.

5.9 If our proposal was adopted such that the test for Australian corporate residency moves to a sole incorporation test, there would need to be transitional rules. For example, for an existing foreign incorporated company that has its CMC in Australia, the transitional rules would need to address whether the foreign-incorporated company continued to be an Australian resident, or would revert to being non-resident (and if so, with what consequences).

5.10 With reference to the facts of *Hua Wang Bank Berhad v Commissioner of Taxation*, if a sole incorporation test was adopted to determine corporate residency, a question arises as to what will prevent an Australian resident taxpayer from incorporating a company in a low-tax jurisdiction and avoiding tax.

5.11 Australia's CFC regime operates to protect the Australian tax system from this type of arrangement by taxing certain passive income of foreign subsidiaries controlled by Australian residents. The primary decision of *Hua Wang* briefly mentioned Australia's CFC rules and the use of registered debentures to circumvent them. The facts in *Hua Wang* highlight gaps in the CFC rules (which were also highlighted in the Board of Taxation's review of the Anti-Tax Deferral Regime in 2007), rather than problems associated with adopting a sole incorporation test.

5.12 As part of its Tax Avoidance Taskforce, the ATO has a Top 320 Private Groups tax performance program program, which seeks to address community perceptions that some of Australia's high wealth individuals and their associated entities do not pay the right amount of tax. The ATO's administrative programs should also counter concerns of Hua Wang Bank-type structures from recurring.

Consultation question 6

The Board also seeks stakeholder comment on whether there is a compelling basis for retaining the second limb of the test for corporate residence (under which a company is a resident if it carries on business in Australia and has its voting power controlled by shareholders who are residents of Australia) in the event that the central management and control test is replaced with an alternative test.

6.1 We see no advantage in retaining this test, where the government eliminates the CMC / POEM test and relies solely on the place of incorporation test.