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Review of Australia's corporate tax residency rules

Board of Tax Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

By Email: *CorporateResidency@taxboard.gov.au*

Dear Sir/Madam

CORPORATE TAX RESIDENCY REVIEW

1. Thank you for the opportunity to provide comments on the Board of Taxation's ("**the Board**") Corporate Tax Residency Consultation Guide ("**Consultation Guide**") which deals with the current operation of Australia's residency rules for companies ("**Residency Rules**") and to the extent they can be reformed in light of modern practices.

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many taxpayers that are impacted by the Residency Rules.

3. Our submission contains high-level comments and responses to the specific questions contained in the Consultation Guide.

POLICY OF THE RESIDENCY RULES

4. The definition of "resident" or "resident of Australia" was added into the income tax legislation in 1930 by the amendments contained in the *Income Tax Assessment Bill 1930* (the "**1930 Amending Act**"). It has not changed in 89 years.

5. However, the world of business has changed significantly, in particular:

    5.1. Globalisation, digitisation and lowering trade barriers have made international business operations available to a much larger cohort of taxpayers who range significantly in size from micro businesses to large listed groups;

5.2. The global tax landscape has changed enormously in the past few years as a result of the Base Erosion and Profit Shifting ("**BEPS**") measures; and

5.3. Australia's taxation rules have become much more sophisticated with a large number of regimes introduced to ensure that Australia obtains an appropriate share of the global revenues of cross-border businesses.

6. When the Residency Rules were introduced they had a lot of ground to cover as they were trying to correctly identify which companies should be taxable in Australia on income derived from sources outside Australia (i.e. from foreign sources). This was without the benefit of other profit attribution rules such as transfer pricing or controlled foreign company ("**CFC**") rules.

7. Australia's tax landscape is very different today. Since 1930, we have seen the introduction of a series of measures which seek to ensure that Australia taxes income and gains with an appropriate connection to Australia, for example:

7.1. Transfer pricing rules to ensure income and gains derived from assets, functions and risks emanating from Australia are able to be brought to tax in Australia;

7.2. CFC rules to ensure that the derivation of highly mobile income and gains can be taxed in the hands of Australian controllers of CFCs even though profits are not repatriated to Australia;

7.3. Thin capitalisation rules to ensure that the costs of finance do not burden Australian operations disproportionately;

7.4. A myriad of withholding taxes to ensure that Australia can tax income and capital flows with the requisite connection to Australia;

7.5. Hybrid mismatch rules to deal with double deduction or deduction/no or low inclusion outcomes;

7.6. A general anti-avoidance rule ("**Part IVA**") to cancel tax benefits from tax avoidance schemes;

7.7. Targeted anti-avoidance rules for significant global entities, specifically the Multinational Anti-Avoidance Law and the Diverted Profits Tax;

7.8. The adoption by Australia of the Multilateral Instrument ("**MLI**") – and new double tax treaties adopting MLI features – containing a Principal Purpose Test to deny taxpayers access to treaty benefits in certain circumstances to prevent treaty abuse; and

7.9. Increasing levels of transparency in relation to the international dealings of corporate groups with some level of activity in Australia.

8. The result of all of these developments is that the Residency Rules are no longer the only mechanism for ensuring that Australia collects its "fair share" of tax from foreign incorporated companies. The tax residency of the ultimate individual owners of the company and the place of value creation are far more significant factors in this regard.

CORPORATE RESIDENCY RULES TODAY

9. In the period between the issue of Taxation Ruling TR 2004/15 and the High Court decision in Bywater in 2016 ("**Bywater**") there was a sense by taxpayers and advisors that the Commissioner of Taxation ("**the Commissioner**") would only seek to use corporate residency as a primary tool in policing taxpayer behaviour in egregious cases. In TR 2004/15 the Commissioner had provided a ruling on the operation of the management and control limb of the corporate residency definition that seemed to be well understood and accepted and it did not appear that he was seeking to apply a broad interpretation to the concept of 'carrying on business in Australia' in the context of the voting control limb.

10. However, following the Bywater decision the Commissioner released Taxation Ruling TR 2018/5 and Practical Compliance Guideline PCG 2018/9. The interpretation of the residency test by the Commissioner in these interpretive documents significantly broadens the circumstances in which companies may be treated by the Commissioner as being Australian tax resident, with the consequence that:

    10.1. Corporates are significantly changing their governance practices at some cost to ensure that they fall within the heightened requirements set down by the Commissioner; or

    10.2. They must suffer the consequences of being Australian tax resident companies.

11. This raises an interesting policy quandary in the context of a business which is to a large extent the same, but one group spends funds on sophisticated tax advice and governance practices to ensure its overseas subsidiary is non-resident, and the other group does not. In this scenario the taxpayers would get different outcomes – both at a significant cost. Intuitively these sorts of outcomes seem wrong from a policy perspective.

CONSEQUENCES OF MORE AUSTRALIAN TAX RESIDENT COMPANIES

Initial Consequences

12. At first instance, a broadened scope of Australian corporate residency is unlikely to have material revenue effects for Australia. This is because:

    12.1. The largest group of companies that are likely to be caught are those that may have management and control in Australia, but have all their active business activities outside Australia - the profits of such companies are likely to be non-assessable non-exempt income pursuant to section 23AH of the *Income Tax Assessment Act 1936*; and

    12.2. Companies without active business operations will typically have income which would be non-taxable if derived by an Australian resident (i.e. non-assessable non-exempt dividends) or will have income which is attributed to Australian residents under the CFC rules.

13. It may however expose these entities to higher foreign taxes, particularly in the context of dual resident entities in a tax consolidated group that acquire goods or services from consolidated group members which are Australian resident only. Such dual resident companies may be denied tax deductions in overseas jurisdictions with hybrid mismatch provisions on the basis that such payments are ignored in the hands of the Australia recipients under the single entity rule. If the relevant company was a non-resident, the overseas jurisdiction would ordinarily allow the deduction and Australia would tax the receipt, which is a better outcome for Australia's tax revenue as well as the right policy outcome.

14. Notwithstanding that Australia would gain little revenue and may in fact be giving up tax revenue to foreign jurisdictions, the compliance costs borne by taxpayers will be significant, in particular:

    14.1. Tax compliance costs:

        14.1.1. Even where the tax payable is negligible, the cost of undertaking the necessary tax analysis across multiple areas of tax and completion of voluminous disclosure items (particularly transfer pricing related) will be a material expense for businesses; and

        14.1.2. The types of tax issues that may need to be considered in relation to dual resident entities will often be more complex than those to be dealt with by entities which are resident in just one jurisdiction – i.e. the scope for being a 'deducting hybrid' pursuant to the Hybrid Mismatch rules is much higher for dual resident entities;

    14.2. Administrative penalties - exposure to administrative penalties can be particularly significant in the context of significant global entities; and

    14.3. ASIC compliance costs – obtaining an ARBN (for foreign incorporated companies) together with annual compliance and filing requirements.

Flow on Consequences

15. While the Australian tax consequences of a company being resident versus non-resident may not have material tax consequences for the company itself in the ordinary course of operations, it will have a number of negative flow-on consequences which seem contrary to policy, for example:

    15.1. Distributions from such companies to Australian shareholders may not be eligible for relief pursuant to Subdivision 768-A of the *Income Tax Assessment Act 1997* ("**ITAA97**") (we note that changes are proposed to extend the relief to entities which are not Part X residents but dual resident entities will only be able to achieve this outcome where they can apply a treaty residency tie breaker which is of very limited utility in a post MLI world[1]).

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[1] Item 111 of Treasury Laws Amendment (Measures for a later sitting) Bill 2019: miscellaneous amendments (exposure draft).

15.2. The sale of shares in such companies will not be eligible for relief pursuant to Subdivision 768-G ITAA97.

15.3. Entities owning interests in such entities will not be able to avail themselves of flow-through treatment pursuant to Division 830 ITAA97 – this is of particular concern for funds management structures because it is common practice to hold investments in transparent entities (i.e. US LLCs or LLPs which are pass-through for US purposes).

15.4. Entities in which governance practices may evolve thus raising the prospect of 'flip flopping' in and out of Australian residency will also have the additional challenges of:

15.4.1. CGT Event I1 where they will be deemed to have disposed of all non-taxable Australian property assets upon cessation of Australian tax residency; or

15.4.2. Joining and exiting a tax consolidated group, which will also trigger CGT consequences.

16. Given the host of integrity and transparency measures which protect Australia's tax base as outlined earlier in our submission, the Residency Rules should aim to provide the right policy outcome for the vast majority of taxpayers who seek to do the right thing and to eliminate unintended adverse outcomes that arise when foreign incorporated companies are treated as residents. The current residency rules, as interpreted by the Commissioner, do not give rise to such an outcome.

PROPOSED POLICY GUIDING PRINCIPLES

17. The formulation of new residency rules should have the following guiding principles:

17.1. They should promote certainty – this is essential given the significant compliance and flow-on costs that can result from getting this wrong;

17.2. They should not seek to cover the broadest range of companies – as discussed above there are ample integrity rules to ensure that Australia collects its fair share of global tax revenues;

17.3. They should be developed with ALL taxpayers in mind, from micro businesses with limited resources to large multinationals with sophisticated governance structures; and

17.4. They should seek to support Australian businesses seeking to grow their business internationally by reducing the cost of complying with the rules – whether in governance costs or compliance costs.

18. One of our suggested guiding principles relates to ensuring that all taxpayers are represented. In our experience, the focus of guidance in relation to residency rules has traditionally been drafted on the assumption that businesses have a need for relatively sophisticated board practices. In the context of privately held groups, this

level of governance is not needed as there is no separation between owners and executives. Any updated residency rules need to be cognisant of this fact.

19. In addition, our experience is that closely-held companies, for whom generally, less tax is at stake, will find it difficult to obtain the residency determination from a competent authority. Our impression is that the authorities do not think it is worth their time and effort. Following implementation of the MLI, this makes it extremely difficult for such companies undertaking ordinary transactions to obtain treaty benefits and significantly undermines one of the main purposes of such tax treaties (i.e. to facilitate cross-border trade and investment). Therefore, assuming that treaty tie breakers will resolve dual residency issues will have the effect of discriminating against smaller taxpayers.

SUGGESTED SOLUTIONS

Preferred approach – Incorporation-only test

20. Our view is that the existing suite of integrity measures protecting Australia's tax base and the decreasing importance of corporate residency should allow for an incorporation-only test. This will provide a number of benefits, in particular:

    20.1. It will provide taxpayers with absolute certainty.

    20.2. It will reduce compliance costs – i.e. tax returns will only be required in one jurisdiction rather than multiple jurisdictions.

21. An incorporation test will also recognise the fact that in the current business environment it is very hard to do business in overseas jurisdictions without a local company. For example, this may be needed to open and operate a foreign bank account, comply with anti-money laundering laws, employ local residents or obtain visas to employ Australian individuals to supervise the start up of the local operation, operate within certain regulated industries and may also be a commercial necessity where customers and suppliers are generally more accustomed to dealing with companies established in their jurisdiction.

22. We acknowledge that if an incorporation only test was adopted that there are some circumstances in which entities may have limited local substance, however:

    22.1. In the context of active trading entities - so long as taxpayers properly apply transfer pricing rules such that the profit of the overseas entity reflects its functions, assets and risks, there is no risk to the Australian revenue. Indeed, for most outbound groups, they will have a preference for paying tax in Australia rather than overseas to ensure that they obtain a franking credit; and

    22.2. In the context of passive investment entities – we would anticipate that the CFC rules would operate to attribute passive investment income to Australian attributable taxpayers.

23. We note that there may be concerns that adopting an incorporation only test could result in companies which are resident of nowhere. However, for the reasons noted above, Australia's current rules allow little if any scope for taxpayers to use such an

approach to 'game' the tax system. If we use the taxpayers in the Bywater case as an example, a combination of Australia's CFC, sourcing and transfer pricing rules should have allowed the Commissioner to collect appropriate Australian tax on the profits of those taxpayers.

24. In addition, the economic substance rules that have been recently introduced as part of the BEPS project, significantly reduce the scope for taxpayers to utilise traditional tax haven jurisdictions.

Alternate approach – Statutory central management and control

25. If the Board does not think that an incorporation only test is feasible, a possible alternative would be a two limbed test where a company will be Australian resident where:

    25.1. It is incorporated in Australia; or

    25.2. Both of the following criteria are met:

        25.2.1. Its central management and control is in Australia (but with objective criteria being codified to test the place of central management and control); and

        25.2.2. It carries on business in Australia (where central management and control is not considered to be part of carrying on a business).

26. In our view the voting control test should not be included. This is on the basis that:

    26.1. There is considerable uncertainty associated with the concept of what constitutes 'carrying on a business', particularly given the view of the Commissioner that almost all companies carry on a business[2]; and

    26.2. The myriad of integrity rules introduced since 1930 make this test redundant.

27. As noted above, if 'management and control' was to be retained as part of an alternative residency criterion, it is important that objective criteria are codified to ensure that taxpayers can apply the test with certainty.

28. For example, the rule might be that central management and control is deemed to be located outside Australia for a year of income if more than 50% of all director decisions were made (dates being based on executed resolutions or minutes of board meetings) while the relevant director(s) were physically outside Australia when those decisions were made. In this regard we note that the rules would need to cater for sole director companies where 'board meetings' are not held.

29. We acknowledge that having a codified management and control test of this nature may allow taxpayers to ensure that a company is a non-resident company in a manner that may be perceived as artificial. However, as noted above, there are ample

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[2] Taxation Ruling TR 2019/1.

integrity rules to ensure that Australia's share of global tax revenue is collected in the context of activities undertaken by non-resident companies.

30. We note for completeness that if central management and control were to be tested on an income year basis, consideration should be given to situations in which it might be appropriate to allow for part-year residency (perhaps significant changes in directors).

31. We do not support adopting a "place of effective management test" given the lack of judicial authority on this concept and lack of clarity on its meaning from the OECD. Further, such an approach would not provide the necessary certainty for taxpayers given that it is an OECD concept that may adapt as it develops in other parts of the world rather than in Australia.

OTHER CONSIDERATIONS

Transitional rules

32. The main adverse tax consequences for a company changing residency (or a trust as a result of changes to the tax residency of its corporate trustee) are the impact of CGT and tax consolidation. The crystallisation of unrealised gains on ceasing to become a resident as well as the joining or leaving of a tax consolidated group as a result of changes to residency is a material risk for corporate groups containing foreign incorporated companies.

33. It is clear that these regimes are based on continuously testing the residence of a company rather than on a 'once-and-forever' or annual basis. The tax residence for companies should be "sticky" and not something that can easily change (e.g. with every board meeting or director decision).

34. We note that the Consultation Guide does not mention transitional measures. We suggest that as part of its review, the Board consider appropriate transitional or grandparenting rules should it recommend a residency test different to the current Residency Rules. This could include for example:

    34.1. Ability for affected companies to choose grandparenting of the previous residency rules indefinitely or for a specified time;

    34.2. A specific carve-out from CGT Event I1 for affected companies; and/or

    34.3. Targeted relief from adverse outcomes arising from entities ceasing to be part of a tax consolidated group.

Consistency in Residency Concepts for different entities

35. While we understand that the review of residency rules for limited partnerships and trusts is not specifically part of this review, we believe that it is important that there be consistency in residency rules between different types of entities commonly used for business and investment purposes. Therefore, we would strongly recommend that consideration be given to the following points:

35.1. Harmonising the residency definition as between companies and limited partnerships which are deemed to be companies; and

35.2. Updating the definition of residency for trusts and ensuring that such updates are consistent with the policy approach used for updates to any corporate residency definition (whether or not one of the trustees is a company).

CONSULTATION QUESTIONS

Consultation question 1

The Board seeks stakeholder comment on the difficulties associated with the central management and control test that have been discussed in this chapter 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).

36. As noted above the central management and control test, as interpreted by the Commissioner, seems to largely assume relatively sophisticated board practices in companies with multiple directors. However, this tends not to be the case with closely held groups who have less of a need for board governance practices and are far more likely to have sole director companies.

37. In addition, the current interpretation of the central management and control test leaves significant scope for foreign incorporated companies to be Australian tax resident, thus making them dual resident. Given the relatively small dollars involved in the context of closely-held companies many competent authorities may not be willing to devote resources to making residency determinations pursuant to requirements in the MLI. This means that closely-held companies will be less likely than large taxpayers to resolve dual resident company situations in the way intended by the MLI.

38. The Board should consider these additional difficulties for closely-held companies.

Consultation question 2

The Board seeks stakeholder comment on the primary theme that has informed the preceding discussion under Part 4 of this chapter, 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.

39. We agree that additions to income tax legislation have made the central management and control test largely redundant in an integrity sense. Key provisions that give this result include but are not limited to transfer pricing rules (now on a self-assessment basis) and CFC rules.

40. We highlight our comments in respect of Division 830 ITAA97 as an additional instance where a part of the income tax legislation depends on whether a foreign incorporated subsidiary is a resident under the central management and control test.

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.

41. Refer to our comments above where we do not endorse an alternative test that features place of effective management as we do not think this will increase commercial certainty for taxpayers.

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.

42. See our comments above where we suggest incorporation only as the preferred test, with an incorporation and/or statutory central management and control test as an alternative test.

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.

43. We endorse this approach. Refer to our comments above.

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.

44. See our comments above where we support the removal of the “voting power test”.

If you would like to discuss any aspect of this submission, please contact either Theo Sakell on (03) 8610 5503 or Denise Honey on (03) 8610 5401.

Yours sincerely

T T SAKELL
Executive Director

Yours sincerely

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