Ernst & Young
8 Exh bition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
ey.com/au

Building a better
working world

Board of Taxation Secretariat
C/-The Treasury
Langton Crescent
Parkes ACT 2600
By email: CorporateResidency@taxboard.gov.au

9 October 2019

Australia's corporate tax residency rules – EY response

EY welcomes the opportunity to respond to the Board of Taxation *Corporate Tax Residency Consultation Guide*, September 2019 ("the Consultation Guide") to ensure that the corporate residency rules are operating appropriately in light of modern, international, and commercial corporate board practices and tax integrity rules.

We submit that the corporate tax residency rules, notably in relation to the central management and control ("CM&C") test of residency of a company that is not incorporated in Australia ("foreign company") do not operate appropriately in the current environment, especially since the expiry of transitional administrative approach provided by the Commissioner of Taxation ("the Commissioner"), set out below.

EY has been active throughout the ATO consultation process in relation to the broader impact of the changed ATO interpretation since the High Court decision in Bywater Investments Limited & Ors v Commissioner of Taxation; Hua Wang Bank Berhad v Commissioner of Taxation [2016] HCA 45; 2016 ATC 20-589 ("Bywater"), expressed by the ATO in the Taxation Ruling TR2018/5 Income tax: central management and control test of residency ("TR2018/5") and Practical Compliance Guide PCG2018/9, ("PCG2018/9")(together "the 2018 guidance").

When TR2018/5 was in development we identified it would create significant challenges as the interpretation changed from the preceding 15 years' interpretation expressed in TR2004/15. This concern led to the ATO introducing PCG2018/9 which included a useful transitional compliance approach. But that transitional compliance approach ended on 30 June 2019, which exposes the need for a change of legislation.

Our detailed submission contains our responses to the consultation questions. We have previously written to Mr Andrew Mills, Second Commissioner of Taxation regarding the administration of the law.

In summary, our submissions are as follows:

- The corporate residence law was identified in the Board's 2003 *Review of International Tax Arrangements* (RITA) as problematic, and the Board recommended replacement of the CM&C rules by a place of incorporation test. As outlined below, we think that was the right recommendation.

- The ATO 2004 Taxation Ruling *TR2004/15 Income tax: residence of companies not incorporated in Australia - carrying on business in Australia and central management and control* ("TR2004/15") was in our view a strategic instrument, announced by the Treasurer to respond to the Board's report, to resolve the issues about the application of the CM&C test for foreign companies which do not have business operations in Australia.

- TR2004/15 was replaced by the 2018 guidance. The ATO introduced a welcome transitional compliance approach in PCG2018/9: however that expired at 30 June 2019).

  So, all the issues emerge again, which are challenging for Australian significant global entities including public groups and private groups, particularly for Australian groups seeking to grow and expand internationally. This applies to companies across the spectrum such as emerging IT and fintech companies, medical technology and mining companies, services businesses in the engineering, design and professional services sector and internet marketing and platform activities. The withdrawal of TR2004/15 and its replacement by TR2018/5 ruling has re-exposed significant issues and uncertainties for corporate taxpayers identified in 2003 and in today’s commercial and tax environment this produces worse outcomes than arose in 2003. This requires legislative action.

- In the submission we add to the list of problems identified in the Consultation Guide.

- Stringent administration of the CM&C test in manner contemplated in TR2018/5 would be fundamentally inconsistent with various Australian tax rules which seek to encourage greater involvement of Australian companies and Australian individuals in the conduct of global businesses. It would also have the perverse effect of shutting Australians out of direct involvement in global business activities unless individuals consider whether to fly to overseas meetings and limit their involvement from Australia.

- We submit that the corporate residency test does not operate as a tax integrity rule. It is merely a scoping rule to differentiate between resident and non-resident taxpayers.

  We agree that the Australian tax system contains many very extensive tax integrity rules dealing with multinational business activities and foreign companies. As well the tax system is likely to be impacted as a result of the current OECD/G20 review of tax rules dealing with multinational businesses in the current globally digitalised environment, to propose changing taxing rights among countries – the reforms are targeted to be agreed globally within 18 months.

  In our view the corporate residency rules can be adjusted, to codify the position accepted by the ATO and government in the years from 2004 until 2018, without reducing the integrity of Australia’s corporate tax system.

- Because CM&C is a question of fact, income tax issues can arise merely because of a different application by the Commissioner of the law to the facts. The change of residency can have significant adverse income tax consequences. Changes of residency are further exacerbated if a company’s operations change over time. The adverse income tax implications are then magnified by the possibility that a foreign company might have multiple switches from non-resident to resident to non-resident.

- As corporate groups seek to operate with high levels of governance and justified trust in their tax management, and deal with requirements to disclose uncertain tax positions, the combination of tax scrutiny and broader corporate governance requirements magnifies the uncertainty and creates a significant problem in application and administration of the tax law.

- In some circumstances, corporate groups might be able to mitigate the adverse tax outcomes of some foreign 100% subsidiaries being residents of Australia by seeking to consolidate them into Australian tax consolidated groups. Even then, tax consolidation does not resolve all the resulting issues from Australian residence of a foreign company.

  But we are concerned that in the July 2019 Large Business Stewardship Group meeting, the Commissioner’s officers raised a concern that foreign companies becoming resident and entering tax consolidation might attract the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act* 1936. We submit that, in its report, the Board might note this uncertainty as a marker of the significance of these issues, recommend that the Commissioner should take taxpayer’s concerns into consideration, and recommend that the Commissioner make known and resolve the nature and extent of such concerns.

- The changed ATO interpretations, leading to increased likelihood of Australian resident status for foreign companies, may result in greater reliance being required on administration of residence tiebreaker rules under Double Tax Agreements (“DTA”), which are themselves changing as a result of Australian adoption of the new multilateral instrument (MLI) regime.

- We submit that changing the CM&C test to a place of effective management test will not alleviate the current uncertainty and should not be pursued.

- We submit that the actions providing the greatest certainty would be in summary that:

  - the sole test for corporate residency should be the place of incorporation. All the reasons that the Board of Taxation gave in 2003 during the RITA review for this recommendation still hold true today, all the more so given the many integrity measures introduced since then. We do not at this stage see any fundamental obstacles to its adoption. Moving to an incorporation only test is a clear option to reduce the uncertainties under the CM&C and POEM tests.

  - Alternatively, as a fall back but poorer option, if the CM&C-based tests were to be retained:

    - to provide that mere Australian CM&C will not automatically constitute trading or investment operations of the foreign business of the company taking place in Australia, thus preventing mere CM&C automatically causing the foreign company to be a resident of Australia

    - consideration could also be given, in summary, to preventing Australian residency where the foreign incorporated company is resident overseas, at minimum pursuant to double tax treaties (the UK, Canada and France take this approach, as detailed in the submission)

  - transitional mechanisms for any legislative changes would also need consideration.

- The voting power additional test of corporate residency, which as the Consultation Guide notes is seldom resorted to, should be removed from the definition.

- To provide certainty to the corporate sector, it would be desirable for the Commissioner to take administrative action pending a law change. That action might be developed using an approach somewhat like the "transitional compliance approach" at paragraphs 102 to 104 of PCG2018/9.

- We plan to consult with clients further in October and November to refine this suggested approach. The Board may wish to undertake further consultations to seek to develop effective rules, able to be administered by the corporate sector and by the Commissioner. It would be highly desirable for the reforms to be operative from 1 July 2020.

*   *   *   *   *

If you have any queries, please contact Alf Capito on 02 8295 6473 (alf.capito@au.ey.com) Mathew Chamberlain on 08 9429 2368 (mathew.chamberlain@au.ey.com) or Tony Stolarek on 03 8650 7654 (tony.stolarek@au.ey.com).

Yours sincerely

Alf Capito
Oceania Tax Policy Leader

Attachment: Submission

Building a better working world

Australia's corporate tax residency rules – EY response

Table of contents

We respond to the questions in the *Corporate Tax Residency Consultation Guide*, September 2019 (the Consultation Guide) discussion on various issues under different business scenarios and our views on the current corporate residency regime.

Our responses follow the order in the Consultation Guide, and for convenience we have reproduced the Consultation Question before our response. References to the ITAA 1936 and the ITAA 1997 are references to the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*, respectively, and together the Acts are referred to as the Tax Acts.

Tax policy context of our submission

Consultation Question 1 explores the current or anticipated practical problems that might arise from the application of the CM&C test in a manner consistent with TR2018/5, and the context has been discussed in the Consultation Guide. Consultation Question 2 explores the anticipated effect of a company becoming a resident because of the application of the CM&C test, and then explores whether the outcome would be problematic and contrary to Australia's general international tax policy.

Consultation Questions 3 to 6 are directed at alternatives to the CM&C test. We consider that these Consultative Questions all deal with the same general issue – that is, whether CM&C remains an appropriate test for residency and, if not, whether there is an appropriate alternative.

We submit that these Consultation Questions 3 to 6 and the answers must be informed by the policy behind Australia's international tax regime, the extent to which a test in addition to incorporation (including CM&C) will enhance or detract from that policy (including the perception of Australia's tax system amongst members of the OECD and countries with which Australia has a DTA), and the extent to which an alternative test would act as a remedial measure (given that the existing CM&C test had previously only been used in what the Commissioner appears to have considered extreme circumstances).

We have therefore prefaced Consultative Questions 3 to 6 with our consideration of Australia's international tax policy. Of course, there are considerations other than international tax policy. That said, as a general matter, under the domestic aspects of the tax legislation it is often preferable to be a resident of Australia (e.g. access of a shareholder to franking).

We have proceeded on the basis that the Board agrees that the CM&C test can be inherently uncertain. We agree further that, despite the uncertainty, the fact that a company not incorporated in Australia but with its CM&C in Australia is carrying on business in Australia might not alter all the Australian income tax outcomes for the company or for its shareholders. However this is not uniformly true.

We note that the Consultation Guide focuses on "subsequent changes" of law (we assume that these are changes since the mid '80s or since the 2003 RITA report). However, we submit that the issue is more fundamental than the changes to income tax law since 2014.

To place the issue in context, the policy of taxation of foreign source income has fluctuated over the existence of the Tax Acts. Prior to 1988 (subject to the application of a double tax agreement):

- ► the former section 23(q) of the ITAA 1936 had the effect that foreign source (non-dividend) income that was subject to tax in a foreign country was exempt income
- ► non-portfolio dividends paid by a foreign company to an Australian company, when they were not exempt from tax under s.23(q), were also free of Australian tax because of the rebate provided under the former section 46 of the ITAA 1936

- so (irrespective of how successive Governments explained underlying economic policies) in practice the Federal income tax law usually followed a policy of capital import neutrality
- the Commissioner had rarely litigated on the application of the CM&C under section 6(1) of the ITAA 1936 prior to 1988, and in each case the facts could be described as unusual
- nor in our experience has the Commissioner routinely paid close attention to the matter on review of a taxpayer’s affairs.

After the publication of Reform of the Australian Tax System: Draft White Paper in June 1985, the Australian income tax system was re-designed on a principle of capital export neutrality and national neutrality.

The policy of capital export neutrality was abandoned in 2004 through the expansion of the exemption of non-portfolio dividends paid by a non-resident company to a resident company, and the exemption of foreign income and gains derived by a resident company in carrying on business at or through a permanent establishment in a foreign country. The following statement was made at the time that capital export neutrality was abandoned:

> “… by boosting Australia's status as an attractive place from which to invest globally, this bill will make Australian companies internationally competitive, increasing employment both in Australia and overseas. The changes are not just relevant to big business with extensive offshore operations. They will also assist those emerging Australian businesses looking to expand offshore to take advantage of global opportunities.”[1]

These “subsequent additions” to the income tax legislation have largely had the practical effect that the Australian international tax policy for the taxation of the foreign source income of resident companies is now similar to the law prior 1988.

We submit that the Board’s considerations must be made in the light that Australia has for only a short time (16 years) preferred a policy of capital export neutrality over a policy of capital import neutrality, and the recent attention paid to CM&C as basis for residency is now being made in the context of an economic policy of capital import neutrality. Following the single High Court *Bywater* decision on an extreme set of facts, we submit the Commissioner need not have issued TR2018/5The Commissioner could have simply stated in a Tax Alert that in similar extreme facts the matter would be closely examined.

In terms of the design of the residency test, we submit that the issue can be stated quite simply. The sole question is whether the residency test conforms with the basic design features of Australia’s international tax policy. If the features of the test do conform, and in addition meet the other basic design principle for a tax system of efficiency, simplicity or sustainability, there is no reason to change the test. Conversely, if the features of the residency test are inconsistent with Australian international tax policy, we submit that serious consideration must be given to removing those features, in particular if those features offend basic design principles.

We submit that the CM&C test - as interpreted in TR2018/5 - is unnecessary to fully implement Australia’s international tax policy. Further, the CM&C test - as interpreted in TR2018/5 - offends basic design principles for a tax system of efficiency, simplicity or sustainability. The same can be said of the CM&C test more generally.

---

[1] Second Reading Speech accompanying the introduction of the *New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004* - https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r2017

1. Question 1 – CM&C difficulties

Consultation Question:
“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).”

EY response

EY concurs with the analysis of the limitations of the CM&C test in the Consultation Guide and the resulting difficulties identified, namely that the relevant foreign company:

- will no longer be a controlled foreign company for the purposes of Part X of the ITAA 1936
- will become a prescribed dual resident if its central management and control is present in Australia and the foreign jurisdiction and, if so, the company cannot be a member of a tax consolidated group and any dividends paid will be taxable in the hands of the Australian parent company (resulting in double taxation if the dividend is unfranked)
- will, if the Australian parent company is a member of a tax consolidated group and the company is not a prescribed dual resident, become a member of the tax consolidated group, which will trigger the asset cost resetting rules in Subdivision 705-A of the ITAA1997
- will not be eligible to provide its parent company the CGT participation exemption in section 768-505 (which applies to the sale of shares in foreign resident companies) in respect of capital gains arising from the disposal of shares in the company
- will require the cost base of the company's assets for CGT purposes to be recalculated in accordance with section 855-45 of the ITAA1997 – albeit with modifications including those arising from taxation of retained earnings.

We highlight some additional issues which the Board could note in its ongoing work on this issue.

1.1 CM&C administration is a barrier to Australia’s growth in international business

Fast-growing businesses seek to identify global opportunities, and Australia’s development involves creating opportunities for educated Australian individuals to play a role in global business operations - whether the relevant companies are Australian owned or foreign-owned. So Australia’s growth has included Australian companies’:

- IT skills seeing the development of foreign companies affiliated with the Australian parent or headquarters company
- design and engineering skills seeing the export of services and establishment of foreign companies
- professional skills seeing export of services and also establishment of foreign affiliated companies
- agricultural businesses establishing foreign marketing and other affiliated companies
- mining companies creating and identifying opportunities overseas and creating foreign companies.

However the ATO 2018 guidance and its revised interpretations of the CM&C rules create a significant risk that Australian involvement in foreign incorporated companies, unless this is very tightly managed, recorded in a timely manner and reviewed, will see foreign companies taxable as Australian residents.

As detailed below, the risks are even greater where Australian companies establish foreign companies which are in their early stage development (opening offices, hiring foreign staff, seeking foreign business opportunities, before the foreign company has commenced a large-scale operation with many foreign employees). The first stages of any international expansion create increased risk that the foreign company will be treated as an Australian resident. This means that the CM&C administration creates the greatest risk for:

- emerging Australian businesses whether small, medium or large
- high-growth Australian businesses looking for opportunities for global expansion.

Perversely, the CM&C policy has the effect of that Australian businesses are discouraged from taking an active role in their foreign affiliates and are indeed encouraged to transfer employees overseas rather than keeping them in Australia while involved in global expansion.

Further, the CM&C administration is counter to long-standing Australian incentives designed to encourage regional headquarters operations of foreign global groups in Australia. For example, the encouragement of rules for flow through of foreign source income through Australian companies to foreign shareholders (the conduit foreign income "CFI rules") are neutralised by the CM&C administration, to the extent to which a foreign group would in response prima facie bypass Australia as a regional headquarters location.

We expand on these issues in our response to question 2 but note that the CM&C interpretation is at odds with Australia's growth strategy.

1.2 Public and private groups establishing new foreign subsidiaries

Consider an Australian company which intends to establish a new foreign subsidiary to investigate future business operations, for example:

- a mining company wishes to explore doing business in a new country
- an Australian medical technology or IT group wishes to establish in US or Europe
- an Australian engineering firm wishes to develop European or Asian activities.

It might take time for the Australian company to:

- assemble a slate of foreign directors
- employ foreign individuals who can take on directorial and management roles and
- relocate experienced people from the group's other operations to the relevant foreign country to undertake senior management or directorial duties

In that interim period the "substantial majority" condition for the ongoing ATO compliance approach will not be satisfied unless the group undertakes significant effort to move a majority of decision-makers out of Australia at least for directors' meetings and key management meetings. The foreign company therefore has a significant risk of being an Australian resident, at least in the interim period until such a governance and business structure is developed.

For a non-public company the compliance concession will never be available.

In our view the CM&C interpretation represents a significant obstacle for Australian companies to grow and operate globally.

1.3 Foreign companies required for legal purposes

We highlight that high-growth Australian businesses expanding into foreign markets might be required to establish foreign local subsidiaries, for example:

- ► if a high-growth Australian IT or medical or pharmaceutical or fintech company is establishing in a foreign jurisdiction, the venture capital investor laws and practice in foreign jurisdictions may require that there be a subsidiary in the investors' location
- ► if an Australian business expands overseas and wishes to borrow funds from overseas banking sources, the lenders may require a subsidiary in the jurisdiction of the financiers for credit purposes.

Again, unless such companies navigate through the complexities of the current CM&C administration, they risk being taxed as Australian residents, with potentially adverse tax outcomes.

1.4 Groups cannot easily isolate foreign companies from Australian involvement

As highlighted in the Consultation Guide, current CM&C administration is inconsistent with modern corporate governance standards which require substantial shareholder/board involvement in a group's activities including foreign incorporated companies.

Where an Australian company wants to establish foreign subsidiaries to develop foreign markets, it might be difficult for the Australian group to find, in each foreign country of incorporation:

- ► individuals who have the necessary expertise,
- ► individuals who know and understand the Australian group's intellectual property, business plans, and commercial operations
- ► individuals who understand the Australian company's corporate culture
- ► individuals who understand the Australian company's accounting and other protocols.

The CM&C guidance has the effect that unless the Australian parent or oversight group limits their involvement or carefully minimises their involvement in the foreign company, then the foreign company stands a risk of being treated as a resident of Australia.

Further, for Australian companies with significant intellectual property or research located in Australia, there are significant commercial impediments in constraining the involvement of Australian IP leaders from interacting with their counterparts in foreign subsidiary or affiliate companies.

We suggest that there is a long commercial history of parent companies which have reduced their oversight of and involvement in foreign subsidiaries, and which have suffered significant commercial damage due to foreign individuals being unfamiliar with the parent company's practices, operations and plans.

It might be suggested that that the solution is to transfer Australian employees overseas, or to take the steps required in the PCG in relation to decision-making, in particular to document that

> "a substantial majority of the company's central management and is exercised in a foreign jurisdiction (that is not a tax haven) where it is treated as a resident for tax purposes under that jurisdiction's law through… Board meetings (including meetings undertaken by circular resolution or via the use of modern communication technologies including teleconferencing) where the majority of directors are not present in Australia when such meetings take place."

We say that this requirement is unacceptable in the modern world of international business, with Australia aspiring to be a growing economy with global ambitions and global involvement. The CM&C administration is inconsistent with Australia's economic and policy objectives.

1.5 Foreign companies can have multiple residency "flips"

The CM&C law & administration require analysis every year: they are not one-time "set and forget" rules.

Further, the prospect of changed residency status ("residency flip") under the current ATO analysis is not limited to merely one single change from non-resident status to resident status.

The uncertain application of the rules might see a company potentially having residency flips from non-resident to resident and back to non-resident in successive years or potentially even in a single year, with volatile tax outcomes. For example:

- a foreign incorporated company ForcoA, controlled by an Australian resident company, has conducted its activities in previous years with material Australian directorial oversight. Under the previous TR2004/15 it would not have been a resident of Australia as it was not carrying on business in Australia, under the ATO ruling TR2018/5 it would be treated as carrying on business in Australia as a result of the CM&C and thus be resident, however given the ATO transitional compliance approach in ATO PCG2018/9 the Commissioner would not have applied compliance resources in respect of that foreign company to deem it to be carrying on business in Australia.

  But, since the transitional compliance concession expired on 30 June 2019, the status of ForcoA since 30 June 2019 might be different and it might be a resident of Australia, causing a switch to Australian residency.

- assume that ForcoA is acquired by a different Australian holding company Acquireco, which goes to some effort to ensure that the CM&C of ForcoA is conducted overseas. ForcoA might have been treated as an Australian resident for a time, but after its CM&C is located overseas ForcoA might again be treated as a non-resident of Australia. So, on analysis the residency status of ForcoA might have a second switch back to non-resident.

Every such switch raises potential application of all the outcomes detailed in the Consultation Guide.

It might be thought that this issue would not arise in practice. But if ForcoA has significant assets or business activities or income then the financial effect of the uncertainty might be material.

1.6 Tax consolidation - ATO considering GAAR might apply

The Consultation Guide notes that a foreign company, which is owned by an Australian company which is a parent company of a tax consolidated group, and is not a prescribed dual resident, will automatically become a member of the tax consolidated group, with implications including that the cost base of the company's assets will be required to be recalculated.

The tax consolidation rules are important in integrating a foreign company which is an Australian resident into the Australian tax rules in a way which reduces the damaging tax outcomes which might otherwise apply. Tax consolidation does not resolve all of the issues, so tax consolidation is not a comprehensive remedy to the problems arising from the ATO interpretation of the CM&C rules.

We are therefore concerned about ATO comments presented to the July 2019 meeting of the Large Business Steering Group about potentially applying Part IVA to such consolidations, which has now raised a new front of tax uncertainty and which (having presumably circulated within the ATO) now needs to be resolved in public guidance.

We highlight that any actions that call into question the application of the tax consolidation rules, or which make the corporate residency status of a company uncertain, cause significant issues for corporate taxpayers.

We do not in this submission go into minute detail of the interface of the tax consolidation rules with each and every characteristic off a foreign incorporated company (100% owned) which is an operating company. The Consultation Guide has identified various factors, and we discuss below in more detail the implications for Australia's

- Thin capitalisation rules
- Controlled foreign company rules

There are further issues including the differential application for

- Tax administration including international dealing schedule and country by country reporting
- Tax consolidation cost setting rules for a foreign company e.g. the treatment of retained earnings for cost setting purposes

which we could outline if the Board desired.

1.7 Consequential issues for Australia's DTAs

The changes to Australia's CM&C administration create further issues arising from the impact of Australia's adoption of the MLI which makes changes impacting Australia's DTAs with countries which also adopt the MLI. In our earlier letter to the ATO we identified that this issue has already arisen in relation to the Australia: New Zealand DTA.

Broadly, under the previous formulation of the Australia: New Zealand DTA, a New Zealand incorporated company which might be resident in both Australia and New Zealand had the opportunity to self-assess its resident status. However, Australia's position in relation to adoption of the MLI removed the self-assessment capacity, requiring the company to approach the competent authority to resolve its residency status.

The ATO and the New Zealand Inland Revenue Department (IRD) have issued an administrative approach to allow certain companies the ability to continue to self-assess their residency position for purposes of the DTA – the MLI Article 4(1) administrative approach of May 2019.

We welcome that companies can self-determine their position in certain cases. But that administrative self-assessment approach applies only for groups with accounting income of less than A$250 million (NZ$260 million) and satisfying numerous other criteria - the group of which the taxpayer company is a member cannot have 20%+ passive income, 20%+ intangible assets not being goodwill or be engaged in tax disputes with either revenue agency.

The limited criteria make that administrative approach inapplicable for many Australian or New Zealand businesses with trans-Tasman business operations. It:

- does not address the concerns of larger Australian multinational companies (turnover >$250 million)
- for small to medium multinational companies, is overly restrictive, requiring the entire group in which the taxpayer company is a member not to have 20%+ passive income, 20%+ intangible assets not being goodwill or any current tax dispute of any kind with either revenue agency.

We note that the administrative approach is to be reviewed within two years of its issue or earlier as appropriate.

These issues are of concern currently in the Australia-NZ context but become relevant if such an approach were to be considered for other DTAs.

1.8 Acquisitions of foreign subsidiaries and prior year issues

The current ATO guidance requires Australian groups with foreign subsidiaries to engage in detailed analysis from a risk management and governance perspective to confirm that foreign companies’ tax residency is not Australian, to manage the risk of adverse tax outcomes from reviews in later years.

However, demonstrating non-resident status in prior years is a significant issue for companies which in the past operated in accordance with TR2004/15 principles, that is, that if the foreign company did not carry on business in Australia then the ATO would not consider or apply CM&C principles to treat the company as a resident, and as a result the company’s central management and control was conducted in Australia.

Assume that an Australian company acquires a foreign company from an Australian vendor or makes a takeover for an Australian group which has foreign subsidiaries. Assume that the target foreign company did not hitherto act diligently to locate the central management and control of its foreign subsidies into foreign countries because the foreign companies do not otherwise conduct business in Australia, ie due to the ATO previous approach in TR2004/15. Indeed, the foreign company board meetings might have been conducted in tax haven jurisdictions.

In this situation the foreign company might not have benefited from the ATO transitional compliance approach in PCG2018/9.

Further, the action by the acquiring Australian parent company, to normalise the position in relation to its foreign acquisition to ensure the foreign company is not resident in Australia, raises the issue of migration or change of residence in that year of normalisation of CM&C.

We observe that the PCG does not currently address normalisation of previous positions.

1.9 Joint-venture companies

A common ownership structure for foreign investment funds is a joint venture, under which two or more investors hold equal interests in a foreign investment fund and its underlying investee companies and assets. Although each joint venture party has ownership rights and decision-making powers proportionate to their economic contribution, in practice joint venture decision making is conducted by way of unanimous assent by all parties.

It would be useful to clarify arising from this review that an Australian resident investor with a minority ownership interest and minority decision making rights in a foreign company does not amount to “negative control” due to the in-practice requirement for unanimous decision making. The current ATO guidance does not clarify that this does not give rise to Australian CM&C and in fact leaves open the possibility of Australian CM&C contemporaneous with residence of foreign companies in foreign jurisdictions.

1.10 Strategic investor in foreign company undertakes urgent remedial action

A similar issue to the joint venture above arises where a major strategic investor, through an Australian company, has invested into an overseas investee company (Forco) with two or three other investors. Forco might have local directors and the companies might take care in operating their CM&C overseas, but commercial problems in Forco might require urgent action, and the Australian company or strategic investor might need to take a stronger role in the Forco activities to rectify the management or commercial problems. The ongoing compliance approach in PCG2018/9 does not fully address this scenario, and in any event is not available for non-public companies.

1.11 Carrying on business in Australia - distinguishable from CM&C – reform option

As identified in the Consultation Guide, the difficulties are magnified by the fact that (arguably) certain key court decisions and (certainly) the ATO interpretive approach have conflated two aspects of the corporate residence definition, that:

- the foreign company must carry on business in Australia and
- the central management and control must be in Australia.

As the Consultation Guide outlines, the early High Court decision of Malayan Shipping concerned a company in Malaysia which was unquestionably centrally managed and controlled by an Australian resident, in Australia. Further the Malayan company’s ship was chartered to the Australian controlling individual, who sub-chartered the ship to third parties. Thus, as a practical matter it could be said that the chartering business was essentially carried on in Australia, indeed by the same individual who undertook the central management and control of the Malayan company. Unfortunately, as the Consultation Guide outlines, the need for clear analysis of the two elements of the test did not arise in the Malayan Shipping case.

The previous landmark ATO Taxation Ruling TR2004/15 deconstructed these two legs of the residency definition, stating that:

> “If no business is carried on in Australia, the company cannot meet the requirements of the second statutory test and, in these circumstances, it is not a resident of Australia under the second statutory test. In these situations, **there is no need to determine the location of the company's CM&C, separate from its consideration of whether the company carries on business in Australia**. If the company carries on business in Australia it also has to have its CM&C in Australia to meet the second statutory test.” (emphasis added)

This interpretation separated the issues of the location of CM&C and consideration of whether the company carries on business in Australia into two independent tests.

The Consultation Guide notes this interpretation might be not without doubt. But the previous ATO interpretation:

- was a direct result of the 2003 Review of International Tax Arrangements by the Board of Taxation, consideration of the Board’s report by Treasurer Peter Costello and the government, and his public release that the ATO would provide public guidance on this very issue. So, this was a decision by the ATO at the highest levels, arising from a Board of Tax review and Treasurer and government oversight, as to the administrative approach to be adopted

- provided an effective platform for administration of Australia's tax law for 15 years.

TR2018/5 changed the ATO approach, causing ongoing challenges for Australian companies with foreign subsidiaries into the future, whether the Australian company is an Australian listed entity with substantial operations overseas, or a foreign-owned Australian company which has regional responsibility over foreign subsidiaries. TR2018/5 states:

> "It is not necessary for any part of the actual trading or investment operations of the business of the company to take place in Australia. This is because the central management and control of a business is factually part of carrying on that business"

We highlight that an effective mechanism to restore the procedural approach prior to the ATO 2018 guidance would be to separate, again, the issues of the location of CM&C and consideration of whether the company carries on business in Australia into two separate tests, without a finding of Australian CM&C automatically causing the foreign company to automatically be carrying on business in Australia.

We submit this requires a change in the legislation to separate out these two aspects of the test and make them two independent requirements.

For completeness we considered other mechanisms such as:

- An ATO tax ruling approach (we recognise, however, the ATO might find this difficult).
- An ATO practical compliance guide or administrative approach, for example by adopting an ongoing practice like the transitional compliance approach in PCG 2018/8. However, a PCG is no longer appropriate because it is not binding on the ATO. Courts have on several occasions noted that taxpayers can have no certainty in respect of the Commissioner's application of a PCG, given the Commissioner's duty to apply the law. Therefore, an ATO PCG approach, which is not binding on the ATO, would not achieve the requisite certainty for corporates.
- The exercise of the Commissioner's remedial power (but this is unlikely in the present circumstances of the perceived limits on the Commissioner's remedial power).

2. Question 2 – tax changes of recent years impacting on CM&C residency law

Consultation Question "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 Australia has strong tax laws covering non-residents and international business

We broadly support the Board's view that Australia's international tax laws (both domestic and DTA) largely replicate the practical impact of any classification of a foreign incorporated subsidiary as an Australian resident under the CM&C test.

These provisions include (but not limited to) those referenced at page 19 of the Consultation guide, the:

- controlled foreign company (**CFC**) rules
- transfer pricing rules, subject to questions about their different application in different countries
- capital gains tax rules applicable to non-residents as well as residents, subject to the comments in the Consultation Guide

We add to the Consultation Guide list of tax rules which operate to give Australia and enhanced fair share of the international income of foreign incorporated companies:

- Diverted Profits Tax, to prevent foreign incorporated companies selling, with the assistance of Australian associated companies, to unrelated Australian taxpayers
- Multinational Anti-Avoidance Law ("MAAL") which addresses transactions between Australian companies and related foreign entities which have the potential outcome of reducing the taxable income of Australian entities
- Expanded world-leading transfer pricing rules
- Revision of the Part IVA general anti-avoidance law (which even before revision has been applied successfully in relation to various cross-border tax strategies)
- Stapled trust-company tax rules
- Country by country reporting tax disclosure rules.

The Commissioner's December 2018 analysis of "Tax and Corporate Australia" notes that:

> "Australia has a strong domestic tax regime applying to large corporate groups, underpinned by a robust general anti-avoidance rule (known as the GAAR or Part IVA) and transfer pricing rules. Australia's tax regime has been significantly bolstered over the past few years across a range of areas. This includes through:
> - enhancements to the GAAR by introduction of the multinational anti-avoidance law (MAAL), the diverted profits tax and other amendments
> - enhancements to the transfer pricing provisions to align them to OECD best practice
> - adoption of a range of transparency measures, including Country-by-Country (CbC) reporting."[1]

A further key relevant change is the current international tax reform activity, being conducted by the OECD/G20/inclusive framework, under the "programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy" (digitalisation project). This is leading to the likely development of changed tax rules for multinational business activities and groups, including:

- a first pillar which might see changed rules for the allocation of profits within multinational business activities (including potentially changed nexus rules, and apportionment of profits)
- a second pillar which might give countries "tax back" powers to impose additional taxes in situations where multinational business activities conducted by a company operating in that country involve arrangements with the companies associates in a low tax jurisdiction whereby profits are extracted into a low tax jurisdiction.

[1] https://www.ato.gov.au/General/Tax-and-Corporate-Australia/A-strong-domestic-tax-regime/

The OECD project will, we understand, see a discussion paper issued in October, for urgent attention and development in coming months at meetings of the inclusive framework, G20 finance ministers and leaders, with a goal of a new system being developed by the end of 2020.

We submit that this environment allows the corporate residency rules to be adjusted, to codify the position accepted by the ATO and government in the years from 2004 until 2018, without creating integrity risks for the Australian corporate tax system, certainly so far as corporate groups are concerned.

2.2 TR2018/5 approach undermines other elements of law administration

We further submit that retaining and administering the CM&C test in the way contemplated in TR2018/5 without the transitional administrative concession in PCG2018/9 will

- undermine changes to the international tax regime since 2006
- undermine other areas of the income tax regime that are not usually thought of a part of the international tax regime (e.g. the tax consolidation regime).

As mentioned above, when the corporate residency rules were introduced, little attention was paid to the issue of residency under the CM&C test. While the policy of taxation of foreign source income has fluctuated over the existence of the *Income Tax Assessment Act 1936* subject to the application of a double tax agreement:

- the former section 23(q) of the ITAA 1936 had the effect that foreign source (non-dividend) income that was subject to tax in a foreign country was exempt income
- Non-portfolio dividends paid by a foreign company to an Australian company were, in effect, also free of Australian tax because of the rebate provided under the former section 46 of the ITAA 1936.

Further, recent changes to the international tax regime have had the practical effect that the Australian taxation of foreign source income is like the law prior 1987. Additionally, leaving aside *Bywater*, the Commissioner has rarely litigated on the application of the CM&C under section 6(1) of the ITAA 1936. Nor in our experience has the Commissioner paid close attention to the matter on review of a taxpayer's tax affairs.

We submit that the Board's considerations should be made in the light that Australia has for only a short time taxed foreign income, and only recently focused on CM&C.

Before *Bywater* and the 2018 guidance, companies sought to manage the impact of the CM&C residency test pursuant to TR2014/5: that is, unless a foreign company had an active business operation in Australia there would be no CM&C and no Australian residency outcome. We submit that, further, the ATO administered the law using the rules of TR2014/5, without any concern as to the integrity of the corporate tax system, because Australia's system contains extensive rules for taxation of Australian permanent establishments and other assets of non-residents.

Therefore, potential changes to the residency definition of the foreign incorporated companies arising from the interpretation and application of the CM&C test in a post *Bywater* environment could have an adverse impact on projected Government revenue only if both of the following conditions were to be satisfied:

- There were a significant number of foreign incorporated companies that are presently recognised and lodging returns on the basis that they are resident of Australia under the CM&C test. (However, in our experience, there are a limited under of foreign incorporated companies that are resident in Australia under the CM&C test).

- The changes to the international tax regime since 1990 would mean that the tax paid by these companies on foreign source income or taxable capital gains will change. (However, the effect of the income tax and capital gains tax rules applicable to foreign activities of companies is, as noted in the Consultation Guide, not to subject these to tax in most cases.

Conceptually, there is no apparent reason why changing the basis for residence would affect the projected Government revenue, although we recognise that it is theoretically possible.

Conversely, there is every chance that reforms to the international tax regime since 1990 will be undermined by an increased focus on residency under the CM&C test.

Therefore, unless the CM&C test can affect projected revenue and in the absence of integrity concerns, we submit that there is no tax policy reason for Australia to retain a law that imposes compliance and administrative costs for no apparent purpose.

2.3 Interaction with thin capitalisation

Put broadly, the thin capitalisation law will not be applicable to a resident company unless the company is controlled by a foreign company (an inbound investor) or controls a foreign company (an outbound investor). Thin capitalisation rules do not apply to debt used to fund the operations of a foreign branch of an Australian company. Instead, where the activities of an overseas permanent establishment give rise to income or gains that are not subject to tax because of section 23AH of the ITAA 1936, the debt is directly allocated to the permanent establishment and the deduction in respect of the debt is disallowed. Therefore, the restrictions on the deductions allowed for debt funding of operations is different where a foreign company is a resident of Australia.

We have set out below a possible outcome of treating a company that is not incorporated in Australia as a resident of Australia under the CM&C test.

Assume that an Australian company (“Headco”) is the head company of a tax consolidated group, and one of the subsidiary companies in the tax consolidated group is a finance company (“Finco”). The remaining subsidiary members of the tax consolidated group have operations in Australia or hold shares in foreign operating companies. Finco raises funds from various third party independent lenders in Australia and the funds are used in Australia operations of the tax consolidated group. As a matter of corporate governance and commercial reality, the directors or senior management of Headco are involved in overseeing the activities of the foreign subsidiaries. Headco considers that none of the foreign incorporated companies are residents of Australia.

The Commissioner later reviews the residency of the foreign companies in the Headco world-wide group and forms the view that the involvement of the management in the activities of one of the foreign companies (“Forco”) is in Australia. That involvement is substantial and the CM&C of Forco is in Australia because managing Forco is an integral part of the Forco operations and therefore Forco is carrying on business in Australia.

As explained in the Consultation Guide, the potential effect is that the Headco previously treated Forco as a CFC. As such, any dividend that it would receive from Forco would be NANE under s.768-5 of the ITAA 1997. If the Commissioner’s position is correct, under the single entity rule Headco is taken to have derived the underlying income and gains of Forco. Since none of the income or gains are passive income or tainted income, the income and gains are all exempt under s.23AH of the ITAA 1936.

However, that is not the end of the matter.

Headco had previously treated all the interest on the borrowings as deductible, since it was derived in carrying on business of the purpose of producing assessable income or dividends that were (or would be) NANE under s.768-5, and Headco did not breach the debt allowed under the safe harbour formula in the thin capitalisation rules.

However, if the analysis is that Section 23AH applies, under the thin capitalisation rules the interest is ignored in calculating the safe harbour formula. Instead the interest is directly allocated to the activities carried on at or through the permanent establishment. Because none of the foreign branch income is assessable income, interest might be disallowed.

2.4 Interaction with Conduit Foreign Income

Put broadly, amongst other things, the conduit foreign income rules ("CFI") were intended to further Australia's position as a regional holding company location. This is achieved by allowing foreign income (and in particular non-portfolio dividends, foreign branch income and capital gains to the extent that they were exempt under the participation exemption) to pass though Australia free of dividend withholding tax.

The basic scheme of the CFI rules is to allow companies that are resident in Australia to keep an account of their CFI income and use that account to record the profits of the company that are passed on to foreign shareholders, directly or through interposed resident companies, free of dividend withholding tax. Like the imputation system, shareholders need to be provided a distribution statement that declares an amount to be CFI income. An incorrect statement on a distribution statement could lead to administrative penalties of up to 15% of the dividend paid. Although imperfect, in practice the CFI accounting operated reasonably well. Further, in our experience, the CFI measures do have their intended policy effect.

We have set out below a possible outcome of treating a company that is not incorporated in Australia as a resident of Australia under the CM&C test.

Assume that a world-wide group decided, responding to Australia's laws to encourage Australian regional holding companies, to establish an Australian company ("Ausco") to own shares in its regional companies. Again, in accordance with Australian Government policy, Ausco located its regional management in Australia and was paid an arm's length return for the services it provided. Ausco received dividends from the foreign incorporated subsidiaries which it:

- Treated as NANE and
- on-paid to its foreign shareholder and declared these to be CFI income such that no dividend withholding tax was deducted.

Assume further that the Commissioner later reviewed Ausco and the regional companies and formed the view that the involvement of Senior Management in one of the foreign incorporated companies ("Forco") was substantial, the CM&C of Forco was in Australia, and because managing Forco was an integral part of Forco's operations Forco was carrying on business in Australia.

The effect might be that:

- the dividend previously paid by ForCo to Ausco, which previously was treated as NANE of Ausco under the dividend exemption, should instead have been treated as NANE of ForCo under the branch exemption.
- Because the dividend paid by ForCo was never declared to be CFI on or before it was paid to Ausco, the dividend that was paid by ForCo should have been included in the assessable income of Ausco. This would not have been the case had ForCo declared the dividend paid to Ausco to be CFI income, and had it known it was a resident of Australia it would have done so.

- Further, because Ausco had no CFI surplus, Ausco's declaration of the dividend it paid to its non-resident shareholder to be CFI was incorrect (and was also not franked). Ausco will be subject to an administrative penalty of up to 15% of the amount of the dividend.

ForCo now has a CFI balance (that it may never use), Ausco has a tax liability (which it could not have anticipated), and Ausco will have a franking balance (that it might never use). The effective rate of Australian tax in respect of the dividend paid by ForCo will be up to 45%, which arises only because of the uncertainty of the application of CM&C to the facts.

This outcome conflicts with Australian government policy at the time of the introduction of the CFI rules and Recommendation 3.11(1) of the Board of Taxation's report to the Treasurer on international taxation. The Government stated that:

> "what is done by these amendments will improve the attractiveness of Australia as a location for regional holding companies and particular businesses of foreign groups. The measure will also enhance the ability of Australian entities with foreign investments to compete for foreign capital and therefore encourage them to remain Australian residents if their foreign shareholding becomes significant."

We accept that some of this might have been alleviated had Ausco established a tax consolidated group before investing in ForCo. However, we consider it pointless for Australia to have a tax policy that imposes additional compliance costs on companies and encourages inefficiency. Arguably, to avoid this outcome, the foreign ultimate parent would preferably simply establish the regional holding company in another country.

Therefore, we submit that the administration approach to CM&C measures is directly in conflict with any measures to encourage Australian companies to be operated as regional holding companies for global groups.

2.5 Interaction with tax consolidation

As noted above, we submit that the uncertainty arising from the location of CM&C creates unacceptable difficulties in terms of the application of the tax consolidation rules. For this reason, it is imperative that if any change to the CM&C rules is contemplated it must not result in the uncertainty remaining.

3. Question 3 – Is place of effective management (POEM) useful?

Consultation Question: "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 EY response

We agree that as identified in the Consultation Guide there are varying countries' practices in relation to considering potential application of place of management (POM) or place of effective management (POEM) concepts for corporate residency.

Some countries use POM in their domestic tax rules while others use POEM – concepts which while similar are not identical.

The OECD Model Tax Convention (MTC) refers to POM of a person for purposes of the primary residence rule in Article 4, but then in the residence tiebreaker rule uses POEM:

> "the competent authorities of the Contracting States shall endeavour to determine by agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its **place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors**. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States" (emphasis added)

The 2017 MTC Commentary notes:

> "When paragraph 3 was first drafted ... preference was given to a rule based on the place of effective management ... [i]n 2017, however, the Committee on Fiscal Affairs recognised that ... there had been a number of tax-avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue ... was to deal with such situations on a case-by-case basis.[2]"

Our preliminary views are that there is no compelling reason for Australia to adopt a POM or POEM approach as the mechanism for replacement or adjustment of the CM&C rules because:

- While the POM and POEM have some attraction at first sight, focusing on the location of practical management and operational decision making on the tax residency of a foreign incorporated company, they do not add major certainty to the factual mix of issues in the CM&C analysis.
- The OECD and various jurisdictions have identified the uncertainty inherent in the rules and the difficulties arising from the increased electronic communications revolution which enables companies to be dynamically managed without the indicia of management which applied in previous years. Any finding as to POEM (like CM&C) still ultimately requires an analysis of specific facts and circumstances and the evidence which supports these matters. Many of the challenges identified by the Board in its discussion of modern corporate governance are still applicable to the POEM test. Primarily, the challenging issue is whether key management personnel must decide to meet remotely or using modern communications electronic techniques to make key decisions and the impact of such actions across different jurisdictions.
- We are very concerned that a new statutory construct of POM/POEM for Australia would involve a major legislative development lead time, and a period of uncertainty before the courts can consider the rules, during which period Australia would not have any greater certainty than arises under the CM&C approach.

Thus, our initial observation is that the investment of time and effort to convert the CM&C residence rules to POM/POEM would not be a good investment of Australia's intellectual and policy capacity.

3.2 A statutory override to align with particular bilateral tax treaty outcomes

We highlight in passing one very useful feature of the UK residency rules, designed to reduce the uncertainty between different outcomes under the domestic residency rules and those arising from application of DTAs. The UK has a rule that the outcome under a DTA determination is effective for UK

[2] Organisation for Economic Cooperation and Development, *Commentary to Article 4 of the Model Tax Convention on Income and Capital,* (2017), [22]-[23].

domestic purposes – to reduce different outcomes. In Australia's case this could see the amending law provide the re-incorporation of DTA residency status back into Australian domestic tax law. We discuss this below and refer to the Board's 2003 recommendation 3.13 which covered this issue also.

4. Question 4 – Other reform approaches

Consultation Question:
"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."

EY response

We submit that the key objectives are if possible for the domestic tax rules to (amongst other things):

- Increase certainty by reducing the risk of findings of residency in multiple jurisdictions at one time.
- Align with modern corporate communications practices and governance.
- The concept of carrying on a business needs further developed to ensure it properly encompasses:
  - Globally integrated businesses (e.g. an IT or medical technology or fintech company with Australian researchers).
  - Corporate residence should not operate if the foreign company is accepted as carrying on a business in a foreign jurisdiction. This would need to consider foreign companies in a preparatory or start-up phase, negotiating the establishment of businesses but not yet employing many employees.
  - Acceptance of the use of a holding company in a foreign location as a holding company, that is a company which does not have operational activities.

The suggestions below are only intended to assist the Board in developing solutions to the issue, and we have not yet decided on a preferred approach.

We intend to further consult with our clients in October and November to understand the potential implications of different approaches.

We would be pleased to participate in further discussions with the Board, to propose effective rules, able to be administered by the corporate sector and by the ATO, by year end, to assist in this urgent project.

4.1 The CM&C test is a scoping measure not an integrity rule

The Consultation Question refers any potential changes in CM&C should have regard to "maintaining integrity". The body of the Consultative Document also refers to the CM&C test as an integrity measure.

In our view the corporate residency rules can be adjusted, to codify the position accepted by the ATO and government in the years from 2004 until 2018, without reducing the integrity of Australia's corporate tax system.

In *Bywater*, the test for CM&C was applied as an integrity measure. However, we submit that the taxpayers in that case would have been subject to Australian taxation under one or more of the

Australian source rules, part four a general anti-avoidance rule, fraud or evasion or other rules. We are concerned that the purpose of the CM&C might have been overstated, and question whether it was ever necessary to rely on the CM&C test to maintain the integrity of the income tax system.

As far as we can determine the specific historical policy reason - the intended function – was not considered in *Bywater* or the Australian authorities, including *Malayan Shipping*, *North Australian Pastoral CompanyEsquire Nominees* etc. Nor was it explained in the Explanatory Memoranda to the ITAA 1936 or its predecessors.

The historical **function** of the test of CM&C was explained in *Bywater.* The majority in *Bywater* described the history of the test as follows:

> “The latter part of that definition, first legislated in 1930, **represents a statutory adoption of the test of residence**, formulated by Kelly CB and Huddleston B in *Cesena Sulphur Company v Nicholson* …” (footnote omitted, emphasis added)

We therefore have difficulty with the proposition that the test for CM&C was intended to be an “integrity measure”. Rather, it appears that the only intended function of the CM&C test was as a statutory recognition of what was understood to be the range of circumstances in which, under the common law, a company’s residency might be established, and regard might have been had to States’ income tax legislation. In our view the test operates as a scoping measure, to identify the taxpayer’s status for purposes of the Australian tax laws. There appears to be no further stated historical policy reason for the CM&C in s. 6(1).

As the Board, correctly, identified in its 2003 RITA report:

> “3.129 … residence tests for companies necessarily represent a departure from the policy ideal — an ideal which would be based on ultimate ownership of companies. As a result, countries generally adopt residence tests based on incorporation and/or management and then use various other measures to deal with problems to which these tests give rise. The main objective of the company residence test should be to produce certainty and ease of operation.”

Therefore, we submit any change to the CM&C test does not need to overly focus on the use of the CM&C test as an integrity measure. If an integrity measure is necessary, that integrity measure should be considered as a separate matter as touched on in the Board’s 2003 report.

We reiterate that Australia has adopted in recent years many integrity measures applicable to non-residents including:

- Multinational anti-avoidance law and diverted profits tax
- Expanded world-leading transfer pricing rules
- Updated controlled foreign companies rules
- Revision of the Part IVA general anti-avoidance law (which even before revision has been applied successfully in relation to various cross-border tax strategies)
- Non-resident CGT law in Division 855 of the ITAA1997
- Stapled trust-company tax rules
- Country by country reporting tax disclosure rules.

These provide Australia with significant integrity rules applicable to non-residents which have Australian business activities.

A further, current, international tax reform is being conducted by the OECD/G20/inclusive framework, under the "programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy" (digitalisation project). This is leading to the likely development of changed tax rules for multinational business activities and groups, including:

- ► a first pillar which might see changed rules for the allocation of profits within multinational business activities (including potentially changed nexus rules, and apportionment of profits)
- ► a second pillar which might give countries "tax back" powers to impose additional taxes in situations where multinational business activities conducted by a company operating in that country involve arrangements with the companies associates in a low tax jurisdiction whereby profits are extracted into a low tax jurisdiction.

The OECD project will, we understand, see a discussion paper issued in October, for urgent attention and development in coming months at meetings of the inclusive framework, G20 finance ministers and leaders, with a goal of a new system being developed by the end of 2020.

The outcome of this project should therefore also be recognised in considering the integrity of the Australian corporate tax system in the context of adjustment of the corporate residency law.

4.2 Reform: Australian CM&C not to result in business carried on in Australia

As outlined above, the CM&C test is unnecessary to fully implement Australia's international tax policy, and that it offends basic design principle for a tax system of efficiency, simplicity or sustainability.

We submit that some of the current concerns arising from the CM&C test (as interpreted in TR2018/5) could, with minimum disruption to the Australian tax system, be resolved by:

- ► Making it abundantly clear that residence of a foreign company under CM&C test requires two entirely separate considerations - the CM&C of the foreign company ("the first limb") and whether the foreign company carries on business in Australia ("the second limb").
- ► Addressing the meaning of the first limb or the second limb.

4.2.1 Focus on CM&C in Australia (the first limb of the CM&C test)

The statute might first make it abundantly clear that residence of a foreign company under CM&C test requires two entirely separate considerations. One way to then at least partially resolve the concerns raised by TR2018/5 would be for the statute to clarify and focus on the first limb, and to carve out certain matters from the list of factors to determine whether CM&C is in Australia. CM&C would then remain a question of fact based on the remaining factors.

For example, the statute could expressly provide that matters such as:

- ► administration,
- ► governance,
- ► oversight, and
- ► management

of the foreign company or the foreign company's activities that are conducted in Australia would **not** be relevant to a conclusion that CM&C is in Australia. CM&C would otherwise remain a question of fact without regard to those matters.

This might directly address resolve one of the concerns arising from TR2018/5 (i.e. the current and increasing responsibilities of the boards and executives of Australian parent companies of global groups).

There might still be the need to identify and reduce areas of concern, e.g. what activities should be considered or not considered, what amounts to "administration" "governance", "oversight", "management" etc. Further, this approach might not resolve issues for foreign holding companies that do not otherwise carry on business. Last, where a company does not need employees in a foreign country to conduct its business, there would be uncertainty surrounding when a company "carried on business in Australia".

Notwithstanding the difficulties and on-going uncertainties, as a potential solution to at least part of the issue this approach should at least be considered.

4.2.2 Focus on "carries on business in Australia" (second limb of the CM&C test)

A different approach to resolve the concerns raised by TR2018/5 might be to focus on and clarify the "carries on business in Australia" in order to make the second limb a true qualification of the circumstances in which a company carries on business in Australia for the purposes of the definition of "resident". This "carries on business" legislative reform would resolve the concerns raised by TR2018/5 and its focus on the first limb, and restrict the matters that could be taken would to determine whether the residency of the foreign company is in Australia

This approach would leave all the principles set out by the High Court in *Bywater* largely unaffected, which is consistent with making minimal changes to the declared law. It will also completely resolve the concern that the statements in TR2018/5 are an over-reach.

In considering whether a foreign company carries on business in Australia; any of the following approaches might be appropriate:

- Exclude the administration, governance, oversight, management etc. from matters that can give rise to carrying on business in Australia and this corporate residency. That is, the administration, governance, oversight, management etc. of the foreign company in Australia is not a factor to be considered in be considered to determine whether a company carries on its business in Australia. This is consistent with the exclusion of these matters from considerations of CM&C set out above but approaches the issue in a different way: to make it clear that the business is the whole of the company's business and not minor / peripheral matters.

- Focus in the activities of the company other than the administration, governance, oversight, management etc would require the focus to be on whether there is a "real business" that is carried on in Australia. For example, leaving aside the administration, governance, oversight, management etc, the foreign company must otherwise conduct a business that is substantially carried on in Australia at or through the foreign company's permanent establishment in Australia. This leaves the concept of "in Australia" and "substantially" for refinement.

- An additional approach which might merit consideration is to preventing Australian residency where the foreign incorporated company is resident overseas, at minimum pursuant to double tax treaties. This is outlined below.

The suggestions above are preliminary, intended to assist the Board in developing potential solutions to the issue. We have not formed a view on a preferred approach. Rather, we intend to further consult with our clients in October and November to understand the potential implications of different approaches. We would be pleased to consult further with the Board.

4.3 CM&C not to occur if an active business is carried on overseas

The concept of carrying on a business needs further development to ensure it properly encompasses:

- Globally integrated businesses (e.g. an IT company with Australian researchers)
- Corporate residence should not operate if the foreign company is accepted as carrying on a business in a foreign jurisdiction. This would need to consider foreign companies in a preparatory or start-up phase, negotiating the establishment of businesses but not yet employing many employees.
- Acceptance of the use of a holding company, that is a company which does not have operational activities.

If the CM&C test were to be maintained in some form, a more substantive change to the CM&C test might be achieved by replacing the "carries on business in Australia" requirement with a concept of "carrying on business in Australia and not carrying on business outside Australia". This would provide that only a company that has no substantial operations outside of Australia will be a resident of Australia, and only then if it carries on business in Australia. Again, administration, governance, oversight, and management of the foreign company or the foreign company's activities that are conducted in Australia would not amount to carrying on of business in Australia.

It might be suggested that we need an integrity rule to counter *Bywater* scenarios. But we submit that the combination of Part IVA, Diverted Profits Tax, Multinational Anti Avoidance Law, Hybrid Mismatch law, transfer pricing law and other measures makes it unnecessary to introduce yet another special anti-avoidance rule. These already operative integrity measures could be expressly referred to in the Second Reading Speech and Explanatory Memorandum.

4.4 Preventing Australian residency status where the foreign incorporated company is resident overseas, at minimum pursuant to double tax treaties

We note that the UK, Canada and France residency rules have anti-double-residence rules, designed to reduce the uncertainty between different outcomes under the domestic residency rules and those arising from application of DTAs. We are attracted to this concept, like others we have outlined, of identifying for a foreign company its primary place of business and primary country of residency and, for a company having primary residency in another jurisdiction, not making it also an Australian resident.

For example, the UK rule provides broadly that:

> **Companies treated as non-UK resident under double taxation arrangements**[3]
> (1) This section applies to a company which is treated as—
> (a) resident in a territory outside the United Kingdom, and
> (b) non-UK resident,
> for the purposes of any double taxation arrangements.

The Canadian rule provides that:

[3] UK Corporation Tax Act 2009 (s 18)

> **Deemed non-resident**[4]
> Notwithstanding any other provision of this Act (other than paragraph 126(1.1) (a)), a person is deemed not to be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada.

This approach aims to reduce the uncertainty of multiple corporate residency outcomes. The Board in its 2003 recommendation 3.13 was attracted to this approach.

We have not exhaustively considered this approach in this submission: for example, how might it operate if more than 2 DTAs could determine residence, and how would this procedurally sequence into the DTA residency tie-breaker rules (that is, it would not add to the certainty of our tax system if the foreign company needed to work through the DTA tiebreaker rules and procedures under the relevant DTA in order to resolve their Australian residency status).

We submit further that such a rule might apply more broadly than just under DTAs. It might for example apply to foreign companies incorporated in and resident in:

- Comparable tax countries, perhaps white list countries
- And possibly all DTA countries.

4.5 Implementing the reforms – law modifications are needed

We see that this issue will require legislative change, to amend the statutory definition of corporate residency.

For completeness we have considered that:

- The Commissioner might revise the Taxation Ruling (we recognise; however, the Commissioner might find this difficult).
- The Commissioner issuing a practical compliance guide or administrative approach, for example by adopting an ongoing practice like the transitional compliance approach in PCG 2018/8. However a problem with this approach is that Courts have on several occasions noted that taxpayers can have no certainty in respect of the Commissioner's application of a PCG, given the Commissioner's duty to apply the law. Therefore, practical compliance approach, which is not binding on the ATO, would not achieve the requisite certainty for corporates.
- The exercise of the Commissioner's remedial power (perhaps unlikely in the present circumstances).

5. Question 5 - incorporation as the only test of residency

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

[4] Income Tax Act (R.S.C., 1985, c. 1 (5th Supp.))

5.1 As in 2003, an incorporation rule is attractive to consider

We submit that the Board should consider place of incorporation or formation as the sole test for determining tax residency.

We submit that the Board made the correct recommendation in its 2003 RITA report that:

> **"Recommendation 3.12**
> The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia."

The short analysis in that report outlined that the other recommended changes to Australia's tax rules recommended in that report "make the test of corporate residence much less of a concern in ensuring the proper operation of the international tax system" and explained why concerns such as those which had arisen about the US their incorporation rule did not apply in Australia, given Australia's different tax rules and the powerful incentive of our imputation system in encouraging Australian companies to adopt Australian corporate residency status where possible.

We further submit that it is reasonable to expect that the taxation of Australian income tax policy and Government revenue will be unaffected, and that leaving aside extreme circumstances such as those in *Bywater*, there should be no integrity concerns. However, we submit that any change to incorporation should be the subject of detailed review and consultation.

We further submit that the transitional measures to ensure that foreign companies that now lodge their income tax returns on the basis that they are residents of Australia are not adversely affected by any change in the definition of residency (although this is matter that need to be considered for any change to the definition of residency).

Last, based on submission that any change to incorporation should be the subject of detailed consideration, changes to the existing operation and application of the CM&C test should be made as a matter of priority.

5.2 Further work to develop an incorporation test

We have provided our comments on replacing the current CM&C test with POEM, and some options that might be explored for replacing the existing CM&C test.

In contrast to all of these, a test of residency based on the place of incorporation or formation as the sole test for determining tax residency has numerous attractive aspects. It would provide certainty for companies, administrators, policy makers and the legislature, is consistent with corporate governance, recognises that companies carry on a wide range of business across different jurisdictions and are managed in different jurisdictions, that the place of CM&C is not simple and perhaps not relevant to anything but income tax, is consistent with the growth of digitalisation, is consistent with the reality of establishing holding companies in foreign jurisdictions, recognises that old expectations from the 1930s regarding how world-wide communication occurs are wholly inconsistent with technological changes, and is consistent with the practical reality that the other tests for residency are used infrequently.

We note the 2003 recommendation by the Board of Taxation of incorporation only as a basis for residence of an Australian company, and the Board's Recommendation 3.12 on the matter. We also note that those considerations were made in context of other Recommendations. We consider that it is worthwhile re-visiting the issue of incorporation as a sole source of residency, given that that the Board's 2003 previous recommendations on the taxation of non-portfolio dividends, foreign branch profits, foreign capital gains and conduit foreign income have largely been implemented.

We are aware that concern has been expressed regarding the interaction of amending s.6(1) to remove both the CM&C test and the control of voting power test and Australia's international tax agreements and international commitments, particularly to the OECD. We agree that a wholesale renegotiation of Australia's DTAs though not impossible would be undesirable, and that Australia should not be perceived as opening opportunities for tax international tax minimisation.

However, it is not apparent to us why Australia would need to renegotiate all of its international tax agreements if an incorporation only test for residency is introduced.

Further, unless real integrity concerns can be identified, nether the OECD nor any of Australia's DTA partners could reasonably suggest that Australia is not committed to minimising international tax avoidance. Since 1981 Australia has had a General Anti Avoidance Rule, and in response to BEPS has more recently introduced a Diverted Profits Tax, Multinational Anti Avoidance Law, Hybrid Mismatch rules, and had already implemented all of the OECD's recommendations on the application of transfer pricing. If real systemic integrity concerns were identified, further work would be needed to address these in considering adoption of this policy.

If the Board wished to further consider the issue of incorporation as the sole test for determining tax residency, the Board might wish to consider the following:

- While incorporation as sole test for determining tax residency would be inconsistent with Australia' major trading partners, it is adopted by some of Australia's DTA partners (in addition to the United States, the Philippines, Thailand and Chile use incorporation as the sole test of residency).

- As far as we can discern, it appears to us that the OECD does not suggest that a country should *never* use incorporation as sole test for determining tax residency under its domestic law. However, the *OECD Model Tax Convention on Income and on Capital* and the Commentary recommends against incorporation as a basis for resolution of cases where a company is a resident of both Contracting States.

- Under all of Australia's DTAs, a company cannot be a resident of Australia for the purposes of the DTA unless it is first a resident of Australia under s.6(1). Similarly, under all of Australia's DTAs, a company cannot be a resident of the other Contracting State unless the company is first a resident of that country for the purposes of the tax law of the other Contracting State. Because DTAs are always predicated on a company being a resident of Australia for domestic tax purposes, any change to the definition of resident under s.6(1) will automatically flow to the DTA. Changing Australia's test of residency (either by limiting or extending the tests in s.6(1)) will not necessitate Australia renegotiating its DTAs. Australia will be required to advise the other country party to the DTA (which it is in any event usual for any substantial changes to Australian law that affect a DTA).

- Although the precise terms of each of Australia's DTA would need to be reviewed, if Australia were to change its basis for residency of a company, then it appears to us that cases of dual residency will be resolved under a DTA on *the same basis* as set out in the existing DTA. For example, a DTA that resolves dual residency on the basis of place of effective management will still resolve cases of dual residency on that basis; a DTA that resolves dual residency on the basis of place of management and requires Competent Authority involvement (e.g. the DTA with New Zealand as modified by the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*) ("MLI") will still resolve cases of dual residency on that basis; etc.

- Most of Australia's DTAs provide for a process for Competent Authorities to discuss issues of dual residency, but no DTA requires the Competent Authorities to resolve the matter. Based on Australia's position under the MLI, it appears that Australia's preferred DTA negotiating position is that place of effective management is a factor in resolving cases of dual residence and requires the competent authorities to endeavour to resolve the matter. Australia's position does not need to change.

- We are not aware that any DTA was negotiated on the basis that Australia would never change its basis for residency, and we cannot see anything in the *OECD Model Tax Convention on Income and on Capital* or its Commentaries that suggests that countries cannot change their test for residency. As an example, the United Kingdom changed its test of residency in 2008 to include incorporation, but this did not necessitate a change to the DTA notwithstanding that it might have brought more companies within the scope of the DTA between Australia and the United Kingdom.

- In our experience, CM&C as a basis for residency of a foreign company has not been a focus of the Commissioner, and although we are aware of cases where foreign companies lodge income tax returns as residents of Australia in our experience this is infrequent. On this basis, we consider that it is reasonable to assume that issues of dual residence under Australia's DTAs would likely to have usually been an issue where the company was incorporated in Australia (the Commissioner could advise the Government on this matter). It is not readily apparent that a change to incorporation as a sole basis to determine residence would increase competent authority involvement.

We have not considered in detail Australia's general obligations under the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*), or the specific effect that the change of residency under s.6(1) would have on Australia's obligations. However, our initial review is that there would be no restriction under the MLI on Australia changing its test of residency under s.6(1).

Therefore, if the Government were to consider that a change to incorporation as the sole basis for residency is preferable to the existing definition in s.6(1) (bearing in mind that foreign incorporated subsidiaries are not only located in DTA countries), we suggest that a change should not be rejected on the basis that the OECD *might* not support the change, or that our DTA partners *might* not accept the change. Instead, they should be consulted before any change is made.

We agree with the Consultation Guide that past inappropriate use of incorporation rules was a factor in the OECD adoption of the BEPS agenda. However, even though Australia (in effect) previously based its test of residency solely on incorporation, we are not aware that this has given rise to any practical concerns with the OECD.

Finally, as a provision of last resort, we recognise that Part IVA should not be the basis for the design of the integrity of the tax system. But if integrity issues are not systemic, reliance on Part IVA is appropriate.

6. Question 6 - the "voting power" limb of residency

Consultation Question: "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."

Voting power limb should be repealed

We submit that there is no compelling basis for retaining the second limb of the test for corporate residence in any circumstances.

We further submit that the second limb be repealed irrespective of whether the central management and control test is retained or replaced with an alternative test.

We further submit that the repeal should be retrospective.

Reasons

The second limb of the test for corporate residence is generally inconsistent with international practices and with OECD standards. It is an anachronism, that does not conform with the basic design principles of efficiency, simplicity or sustainability of a tax system. It appears to be an historical relic of the corporate residency rules which applied in the context of state taxes at the time that ITAA 1936 was introduced. Its continued existence of the second limb cannot be justified.

Based on our experience, we agree with the statement in the Consultation Guide that the application of the second limb is "seldom resorted to" by the Commissioner, and we consider that this is an administratively reasonable and responsible approach.

Conversely, in a self-assessment environment, a taxpayer is legally required to apply the law to determine and cannot rely on its perception of the ATO's past or current practice as a basis for non-compliance and carries risk of administrative penalties if it does not lodge an income tax return or lodges an incorrect income tax return. For example, theoretically, an SGE would be open to automatic administrative penalties (subject to remission by the Commissioner) of up to $520,000 for **each form** that it did non-lodge.

Practically, we see no purpose for a provision of the income tax law (or any law) that is uniformly disregarded, not enforced and if enforced produces unnecessary punitive outcomes for taxpayers. We consider that, once brought to its attention, the legislature should be willing to repeal the law.

7. Transitional issues with a new tax residency rule

Transitional provisions will need to be considered in developing a legislative proposal.

For example, in order to ensure that the second limb had no effect on an on-going basis, consideration might be given to ensuring that the amendment applies for the issue of assessments for after a specified date (e.g. the date of introduction of the amending legislation). This would ensure that the existing definition could not have effect for previous years for any company that had not lodged its income tax return on the basis that it is a resident of Australia under the second limb. Where a company has lodged its income tax return on the basis that it is a resident of Australia under the second limb, consideration would need to be given to a suitable transitional rule to ensure that the company did not automatically change residence.