Law Council
OF AUSTRALIA

Business Law Section

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Review of Australia's corporate tax residency rules
Board of Taxation Secretariat
C/-The Treasury
Langton Crescent
Parkes ACT 2600

By email: CorporateResidency@taxboard.gov.au

Dear Ms Kelly,

Corporate Tax Residency Review

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity of commenting on the Consultation Guide released by the Board of Taxation in September 2019 entitled *Corporate tax residency - Consultation Guide* (**Consultation Guide**).

In light of the uncertainty highlighted by the High Court's decision in *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45 (***Bywater***) and the response to this decision by the Commissioner of Taxation (**Commissioner**) and the Australian Taxation Office (**ATO**), it is crucial to restore certainty regarding Australia's jurisdictional claim in respect of the taxation of corporations.

This uncertainty is currently creating unnecessary compliance costs for corporations seeking clarity on the residency status of their foreign subsidiaries and for foreign investment companies with Australian based, and/or influenced, management and decision making.

This submission addresses each of the six consultation questions posed in the Consultation Guide.

Summary

1. The Committee believes that the corporate tax residency rules are not operating appropriately in light of modern, international, and commercial board practices and international tax integrity rules. The commercial uncertainty and ambiguity has been recently highlighted. As a result, the rules are not consistent with, or aligned, with modern day corporate board practices. Furthermore, as the current rules do not clearly articulate Australia's jurisdictional claim it is not possible to conclude that they provide a strong base upon which rules developed to protect the tax system against multinational profit shifting, and other tax integrity rules, can operate consistently to achieve their policy aims.

2. The Committee suggests that a suitable approach to deal with the issue is to amend the existing rules, rather than introducing completely new rules or relying on an incorporation only test. The rules could be amended so that the second statutory test, namely the "central management and control" test in s 6(1)(b) of the *Income Tax*

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Assessment Act 1936 (Cth)[1] (**CMC test**) operates in a way that is similar to the position in the withdrawn Taxation Ruling TR 2004/15 *Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control* (**TR 2004/15**). Further amendments could be made to provide for a single location for central management and control (**CMC**) and for CMC to be determined by reference to "local" decision-making. In terms of further refinement of the CMC test, qualitative rather than quantitative criteria should be preferred, as should certainty and simplicity.

3. The Committee considers that replacing the existing test with the place of effective management (**POEM**) test may resolve some, but not all, the difficulties associated with the existing test. This may have some benefits and should be considered as an alternative, in more detail.

4. The Committee does not consider that there is any merit in retaining the third statutory test, namely the voting power test in s 6(1)(b) (**voting power test**). Based on the currently limited available information, the Committee does not consider that an incorporation only test is appropriate at this time.

Discussion

Consultation question 1

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).

5. As a general observation, the Committee agrees with the difficulties and limitations highlighted with the CMC test in the Consultation Guide. As follows, the Committee expands on and sets out some additional difficulties with the test.

General observation about the difficulties associated with the test

6. The difficulties in relation to the CMC test arise in part from its deep factual nature, which requires various matters to be considered and balanced, with limited guidance. For example, as noted in the Consultation Guide, in light of modern corporate practice there is uncertainty in relation to where CMC is exercised, who is exercising it and to what extent it needs to be exercised in Australia. There is also uncertainty as to when it is necessary to ascertain the exercise of that control.

7. The difficulties also arise from case law, and in particular the *Bywater* and *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156 (***Malayan Shipping***) decisions and the differing interpretations of those decisions which have been adopted. Both decisions reflected extreme factual circumstances, which are far removed from the reality of multinational businesses today – and yet these businesses are affected by these decisions, due to their impact on how the test is interpreted and applied.

8. The difficulties are compounded by the change in approach adopted by the Commissioner, in response to the decision in *Bywater*, as reflected in TR 2018/5 and PCG 2018/9. The consequences of this change are discussed in previous joint

[1] Unless stated otherwise, all legislative references are either to the *Income Tax Assessment Act 1936* (Cth) and/or the *Income Tax Assessment Act 1997* (Cth).

submissions by the Committee, in relation to Draft Taxation Ruling TR 2017/D2 *Foreign Incorporated Companies: Central Management and Control test of residency* (**Draft TR 2017/D2**)(Joint Submission, 26 May 2017) and Draft Practical Compliance Guideline PCG 2018/D3 *Income Tax: central management and control test of residency: identifying where a company's central management and control is located* (**Draft PCG 2018/D3**)(Joint Submission, 25 July 2018) which are attached to this submission.

9. That said, the difficulties in interpreting and applying the test are by no means a recent phenomenon. These were identified by the 1975 Commonwealth Taxation Review Committee (the **Asprey Committee**) at [17.15]:

> 17.15. The meaning of central management and control calls for clarification. It would bring some tax-haven companies within the jurisdiction of Australian tax if these words were held to be wide enough to include the exercise of control and direction of the company's affairs otherwise than in the formal proceedings of the board-room. It might be thought to be enough to give a residence in Australia that the board of directors habitually responds to instructions formulated in Australia, even though the board meets elsewhere. This wide meaning would, however, increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable: many wholly-owned subsidiaries of Australian resident companies, though incorporated in foreign countries and resident there, could become Australian resident companies. On the other hand, the objective of bringing tax-haven companies within the jurisdiction of Australian tax should not be lightly abandoned. Some compromise might be possible which would involve identifying tax-haven countries, either in the Act or, preferably, in regulations, and would provide that a company incorporated in such a country would be deemed to have an Australian residence if effective control and direction of the company's affairs are exercised in Australia, regardless of where the board of directors meets or other formal corporate proceedings take place.
>
> [emphasis added]

10. They were also noted in the 2002 Treasury Consultation Paper on the Review of International Taxation Arrangements at page 54 - 55:

> Largely, difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. However, the case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this.
>
> [emphasis added]

11. It goes without saying that this impacts on compliance costs, certainty and increases the risk of tax disputes (both domestic and international). For many taxpayers, this is not alleviated by guidance issued by the Commissioner, due to the limited and fact-specific examples provided in Taxation Ruling TR 2018/5 *Income tax: central management and control test of residency* (**TR 2018/5**) and Practical Compliance Guideline PCG 2018/9 *Central management and control test of residency: identifying*

where a company's central management and control is located (**PCG 2018/9**), as well as the broad statements about what matters may or may not be relevant.

12. Whilst much of the discussion has focussed on multinationals and large business, the impact of the ATO's change in view on the SME market has also been pronounced. Many Australian start-ups or small businesses simply do not have the resources to implement comprehensive decision-making structures and governance protocols offshore. Some do not have the capacity to pay a foreign director, and in many jurisdictions, one is not required. Many small business owners wish to retain very tight control over the operations and decisions of any overseas venture in Australia (generally with such oversight resting with the founders). Where such overseas subsidiaries carry on no practical business in Australia (putting aside the ATO's current view) the uncertainty and difficulty with the residence definition simply discourages expansion of young Australian businesses into new offshore markets. The highly restrictive nature of the ATO's "compliance approach", as articulated in PCG 2018/9, provides no comfort in this regard.

General observation - incongruency with modern corporate obligations and practice

13. Consistent with the discussion in the Consultation Guide, representatives of corporate taxpayers have expressed concerns that the CMC test, as it is currently understood, appears to counter their corporate governance obligations. Boards of Australian companies find it difficult to comprehend why they are now being required to abandon their corporate governance obligation imposed in respect of offshore subsidiaries.

14. This confusion is illustrated in the following informal observation in response to the Consultation Paper by an affected corporate taxpayer:

> At a high level, the concept of management and control needs to evolve to have regard to globally mobile workforces and management. In addition, there needs to be some distinction between management and control (management and control of local operations) vs. stewardship and governance (management and control of global strategic direction, capital allocations and risk). These concepts were developed when businesses relied on physical places to conduct meetings, execute resolutions, make agreements etc. Doing business and making decision in this manner seems quaint to me. Managing taxing risks on this basis seems impractical.
>
> Broadly, global companies will always have a capital prioritisation process for M&A, expansion, R&D, divestment, etc. that is centrally managed. They will also centrally manage a process for financing decisions. Some are more sophisticated than others.
>
> Often, each local region will put forward their case for capital prioritisation and funding, then the Investment Management Team (or person) and the Group Finance Team (or person) (could be the same team/person) will decide which projects and/or locations receive investment flows and on what terms. These are typically "high level decisions" with material and long-term consequences. As such, they require Senior Executive collaboration, input from experts and, sometimes, sign-off by the Board of the ultimate parent company.
>
> Once this process is complete, decisions are documented at group and local levels, then execution and operational control is managed locally. So, there are Stewardship, Governance and Strategic decision (high level, multi-disciplinary and collaborative) and local execution and operational decisions (local management decisions). Provided that the local management decisions are sufficiently substantive relative to the value adding activities that will take place

locally from the investment and funding decision, then that should be sufficient to establish local central management and control.

15. Although these comments are already captured to some extent in the Consultation Guide, discussion on the difficulties and limitations associated with the CMC test, they further reinforce the impact of these.

Additional difficulty – documenting evidence to support compliance with the test

16. From a practical perspective, the way in which the test currently operates and is administered places a significant burden on taxpayers to evidence and support their compliance. For example, in TR 2018/5, the Commissioner sets out the following guidance on where CMC may be exercised (at [35] to [38]):

> **Relevant considerations**
>
> 35. No single factor alone will necessarily determine where central management and control of a company is exercised. The relevance and weight to be given to each will depend on the facts and circumstances of the case and surrounding circumstances.
>
> 36. The matters most likely to influence a court's decision, as to where those who control and direct the operations of a company do so from, are:
>
> - where those who exercise central management control do so, rather than where they live;
> - where the governing body of the company meets;
> - where the company declares and pays dividends;
> - the nature of the business and whether it dictates where control and management decisions are made in practice; and
> - minutes or other documents recording where high-level decisions are made.
>
> 37. Other matters, of lesser weight, the courts have considered in analysing where a company's central management and control is exercised include:
>
> - where those who control and direct the company's operations live;
> - where the company's books are kept;
> - where its registered office is located;
> - where the company's register of shareholders is kept;
> - where the shareholder's meetings are held
> - where its shareholders reside.
>
> 38. These factors are used to help identify where a company's directors, or others, actually make its high-level decisions and in doing so where they actually manage and control the company.
>
> [citations omitted]

17. In a similar way, in PCG 2018/9 the Commissioner states at [77] to [78]:

> 77. Where decision makers are in multiple places, the Commissioner does not accept that a decision is necessarily made in the place it is formalised, or

where the last signature is placed on a resolution or vote on it is cast. For the purpose of determining the location of the central management and control of the company, the key question is where the decisions are being made as a matter of substance.

78. Where board meetings are conducted via electronic facilities (rather than physical attendance) the focus is on where the participants contributing to the high-level decisions are located rather than where the electronic facilities are based.

[citations omitted][emphasis added]

18. As evident from above, it is not merely a question of looking at the minutes of a board meeting, to determine the location of where CMC was exercised.

19. From a practical perspective, what this means for corporate taxpayers is that for the purposes of determining Australian tax residency, they need to consider numerous matters, form a view and then document the basis for the view adopted. Having regard to the matters set out above, depending on the circumstances, this may be a not insignificant task, requiring extensive fact-finding by a corporate tax manager, imposing compliance costs and internal obligations, to evidence compliance with the test.

Additional difficulty – limitations with amendment period

20. The Committee notes that one area in which uncertainty about a company's residency status can cause practical difficulties and differences in tax outcomes is the effectiveness of time limitations on the amendment of assessments.

21. Where a company is a resident of Australia, the standard amendment period in section 170 applies. However, where a company has been assumed to be a non-resident (on a genuine basis) and not otherwise earning income in Australia, it may not have lodged income tax returns in Australia. Consequently, the standard amendment period under section 170 never commenced. What this means is that if the Commissioner subsequently forms a different view about the tax residence status of the company in prior years, he may issue assessments which go beyond the standard amendment period – potentially many years.

22. Some companies may deal with this by pre-emptively lodging returns in Australia to start the clock running, out of an abundance of caution. However, it is questionable whether this should be required. It is also questionable whether such an unlimited amendment period otherwise remains appropriate. The Committee notes that this issue could be addressed by amending section 170, to provide for a limited amendment period arising solely from a finding in relation to corporate tax residency.

Consultation question 2

Comments 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.

23. The Committee recognises that since the introduction of the test for corporate residency in 1930, Australia's international income tax policy has significantly developed and evolved, which is reflected in the current income tax provisions, as well as Australia's comprehensive tax treaty network.

24. The Committee notes the importance of considering the operation of the CMC test, in the context of Australia's broader international tax policy and provisions. In this regard, to the extent that the objects of Australia's international tax policy can be achieved with a simpler residence test, which is less factually demanding, and allows for easier compliance, this approach should be preferred. To put it another way, it is important to consider what policy interest is being served by having a "difficult" residency test, in circumstances where it is possible that congruent outcomes can otherwise arise, under the broader income tax provisions.

25. That said, the Committee recognises that there are still numerous instances where the income tax legislation produces different income tax outcomes, depending on whether a company is, or is not, an Australian resident. In this regard, while the income tax legislation may have developed and evolved, this has not made the CMC test redundant. The CMC test serves a different purpose – it determines jurisdiction to tax, as well as which provisions apply and when.

26. For example, different outcomes may arise in relation to the application of the following provisions:

    (a) R&D concession (only available if a company is a resident);

    (b) withholding tax provisions (if payment is made by a resident / to a non-resident); and

    (c) as noted in the Consultation Guide, the consolidation provisions.

27. The Committee notes that the basis of determining residency will also impact on corporate trustees.

Consultation question 3

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.

POEM faces similar difficulties

28. Although POEM is consistent with the approach adopted in Australia's tax treaties and civil jurisdictions, the Committee considers that it may not increase commercial certainty as the test faces similar difficulties as the CMC test. This is due to its heavily fact dependant nature, and the lack of guidance on the scope and meaning of this test. In this regard, the Committee does not consider that it will add any additional certainty. Furthermore, the Committee notes that the inclusion of the POEM test in some of Australia's tax treaties, means that the test is already in a way, part of Australian domestic law.

POEM may be considered as an alternative

29. That said, the Committee appreciates that adopting a test featuring POEM may assist multinational enterprises, in that from an internal compliance perspective, in Australia they may be dealing with the same test as they apply in other jurisdictions which have also adopted this test, and which therefore makes compliance easier and more efficient.

30. Adopting POEM may also reduce some uncertainty because, in contrast to the CMC test, POEM can only be exercised in one location (as the test operates as a "tie-breaker"). Therefore, the uncertainty with determining to what extent CMC is exercised in Australia and whether CMC is exercised in more than one location should not arise.

31. Given its use in tax treaties as a tie-breaker, and by some jurisdictions, adopting POEM may also assist with achieving greater alignment of international tax rules, and reducing the scope for tax avoidance and disputes (noting the objectives of the BEPS project). It should also create an opportunity to potentially rely on international case law, commentary and guidance on the application of this test (noting that this guidance would be persuasive, rather than binding – but may assist taxpayers, the Commissioner and advisors).

32. Finally, adopting POEM, may also result in a helpful "reset" of Australia's case law in relation to determining corporate residence, including an opportunity to deal with the difficulties arising from *Bywater* and *Malayan Shipping*. This is because the courts would now be applying a different test, and therefore not bound by previous case law.

33. If POEM were incorporated into the residence test, then it should be clearly defined and sufficient guidance should be provided, including in the form of examples in the explanatory memorandum.

Consultation question 4

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.

Suggested approach – amended CMC test

34. The Committee considers that amendments could be made to the CMC test to increase commercial certainty and alignment with modern corporate practices.

35. While the Committee acknowledges that corporate residency has a role to play in maintaining the integrity of the tax system, the Committee considers that the function of the corporate residency test should be confined to determining Australia's jurisdiction to tax. Issues concerning the potential for abuse arising out of residence and dual residence should be addressed through other more targeted mechanisms, such as the specific provisions dealing with dual residence in the "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS".

36. Accordingly, amending the test, rather than introducing a completely new test, may be more appropriate and palatable from a policy and compliance perspective. This could address existing difficulties with the test, without creating additional complexity and uncertainty. Some potential amendments are considered as follows.

Amend the CMC test to codify the two-limb test, as set out in TR 2004/15

37. The Committee supports an alternative of amending the CMC test to codify the position adopted by the Commissioner in TR 2004/15, namely that CMC, in and of itself, does not amount to the carrying on of a business, as discussed in TR 2004/15 at [37]:

> 37. The reference to *Mitchell v Egyptian Hotels Ltd* (1915) AC 1022 indicates that mere trading is not sufficient and that there also has to be CM&C in order for a company to be resident in Australia under the second statutory test. However, it does not necessarily support the further proposition that if you have CM&C you are also invariably carrying on a business in that jurisdiction.

38. In broad terms, the effect of this amendment would be to provide for the test to operate as follows:

    (a) The second statutory test / CMC test would be a two-limb test, with “carrying on a business in Australia” and “CMC in Australia” as the two limbs. Each limb would be a question of fact.

    (b) There would be a separate definition for “carrying on a business in Australia” and for “CMC in Australia”.

    (c) The definition of “carrying on a business in Australia” would be drafted to specifically exclude the concept of CMC and supported by examples in the explanatory memorandum. The presence of examples is particularly important to give taxpayers certainty as to the scope of the concept of "carrying on a business", as this phrase can mean different things in different contexts.

    (d) The definition of “CMC in Australia” would be drafted to specifically exclude the concept of carrying on a business in Australia. Instead, it would focus on the

commonly understood meaning of CMC, arising from case law, focussing on high level decision making and good corporate governance. Again, the definition should be supported by examples in the explanatory memorandum.

(e) The definitions should allow for a foreign incorporated company, with Australian based directors, which does not carry on business in Australia, to be a foreign resident. To put it another way, it should allow Australian residents to set up a company in a foreign jurisdiction, and for Australian based directors to make CMC decisions in Australia, without giving rise to Australian tax residence for the company – provided that the foreign company does not actually carry on a business in Australia. This should address the current difficulties and compliance costs faced by taxpayers, discussed above.

39. This approach would be consistent with previous submissions on the Draft PCG 2018/D3 and Draft TR 2017/D2 (attached) and would address much of the uncertainty which has arisen following the decision in *Bywater* and the Commissioner's revised approach in TR 2018/5 and PCG 2018/9.

Single location for CMC

40. Although the courts have indicated that CMC can occur in two places (e.g. *Todd v Egyptian Delta Land Investment Co Ltd* [1929] AC 1), the Committee considers that the Commissioner has overstated the chance of this occurring in PCG 2018/9. In particular, despite recognising the possibility, the courts have only found a division of CMC in the unique fact pattern in *Swedish Central Railway Co v Thompson* [1925] AC 495.

41. That said, if the CMC test is retained, the Committee considers that the test should be amended so that it is not enough for the CMC test to be carried on to a substantial degree in Australia (e.g. as discussed in paragraph 90 of PCG 2018/9). Rather, the test should be amended so that there is a requirement to identify the single "central" location of CMC.

42. Given the possibility for CMC to be exercised in more than one country, a "tie-breaker" could be introduced into the definition of CMC in Australia. This could provide that where CMC is exercised in Australia and another country, it will only be considered to be exercised in Australia, where it is exercised in Australia to a degree that is equal to or more than any other place. For example, if a foreign incorporated company carries on a business in Australia through a branch and the branch hosts 1 out of 3 board meetings a year each year, CMC should not be considered to be exercised in Australia. Conversely, if 2 out of the 3 board meetings are held in Australia then CMC may be considered to be exercised in Australia.

"Local" CMC

43. The Committee suggests that evidence of "*local*" control and management of business operations could be sufficient to establish CMC in a location in which those same business activities are performed (whether that is managing a mine or maintaining a data centre/server or entering into financial arrangements and managing bank accounts). If those activities are supervised by a steering committee that is made up of shareholders, then the supervision should not of itself result in overturning the conclusion that there is local CMC, even if the supervision includes strategic direction, risk management, peer review, and governance protocols. This approach should ensure that sham arrangements are differentiated from genuine global businesses.

44. It is acknowledged that this process breaks down when the relevant asset or investment decision relates to something intangible and highly mobile that does not

require active management in the local jurisdiction (e.g. cash, crypto currencies, financial instruments, patents, brands etc.). However, managing these exceptions should not become the rule.

Qualitative criteria should be preferred

45. On page 17 of the Consultation Guide, there is a discussion about the use of qualitative criteria to determine where CMC is exercised to a substantial degree, and the problems associated with this. The Committee considers that reliance on qualitative, rather than quantitative criteria should be preferred. This is for several reasons.

46. Firstly, this should provide flexibility in terms of how the test may be satisfied. For example, companies should be able to appoint the most appropriate people to be directors, regardless of where they are located. It should not be the case that a company decides not to appoint a particular director, even if commercially desirable, solely on the basis that this would affect its tax residence. The test should be flexible enough to accommodate a range of considerations and factors.

47. Secondly, a qualitative approach should reduce the risk of an accidental change in residence. For example, if the test relied on the location of directors attending a board meeting, then an accidental change in residence could occur if a director had to attend from a different location (say Australia) due to unforeseen circumstances, such as an accident or personal needs.

48. Thirdly, a qualitative approach should allow the test to deal with future developments in corporate management and practice.

49. That said, the Committee recognises that there are difficulties with relying solely on qualitative factors. For example, again on page 17, the Consultation Guide notes:

> The use of qualitative criteria, such as identifying where central management and control has been exercised to a substantial degree, is problematic as it requires determinations to be made on a case by case basis as to whether an inexact threshold has been met. <u>This could, by way of example, require an assessment of the relative influence that is wielded by individual directors on a meeting by meeting basis, which is clearly an onerous requirement, difficult to substantiate and may be fluid.</u>
>
> [emphasis added]

50. In this regard, by way of example, the Committee considers that it would not be desirable for companies to have to consider the relative influence wielded by individual directors on a meeting by meeting basis, as this would be too onerous and uncertain.

51. Given the difficulties associated with relying solely on quantitative criteria, the Committee considers that it would be preferable if there were some quantitative criteria, which could be integrated into the CMC test. This could be in the form of criteria in the body of the test, the definition/s, the regulations and/or in the form of specific examples in the explanatory memorandum (which while not binding, could be persuasive).

Part-year residence

52. The Committee considers that one minor change which, if adopted, may improve simplicity without adversely impacting upon the other policy objectives. Currently, a lack of clarity arises where a corporate taxpayer is resident for only part of the year. This occurs where a non-resident company becomes a resident, or a foreign

incorporated company becomes a non-resident due to changes in its ownership or movements in its CMC.

53. There has been a view that once a company was a resident, it was assessable on all its income earned during the income year, including income earned prior to residency.[2] However, the Federal Court in *BHP-Utah Coal Limited v Federal Commissioner of Taxation* (1992) 23 ATR 258 (***BHP-Utah***) found that a company which "…comes to Australia during a part of a year of income is not subject to tax in Australia on the earnings derived from sources out of Australia whilst he was a non-resident."[3]

54. In July 2000, in the context of consultation with Treasury in respect of entity taxation, it was said that there was a need to ensure that the law was clear that entities can be resident for part only of an income year. This has occurred under the capital gains rules where there are rules that assign cost base to a company's assets where an entity becomes an Australian resident (Subdivision 855-B) and deem disposal of all CGT assets if a company ceases to be an Australian resident (CGT event I1 in s 104-160 happens[4]).

55. There is a need for clear start and end dates for companies which are resident for only part of an income year in respect of ordinary and some statutory income. Such a change would ensure that the law of company residency, within the jurisdictional framework, is simpler (more certain).

Consultation question 5

Whether an incorporation only test should be used as the sole basis for establishing corporate residency.

Modelling the cost of removing the other tests on existing taxpayers

56. A preliminary point is that as the current definition for corporate residency rules defines Australia's jurisdictional claim, the Committee is aware that any change could have an impact on either the Australian tax base or compliance costs. Therefore, in any policy discussion in a law reform context, such as raised with respect to this question, it is important to have access to revenue and other data to enable measurement of the impact of any reform proposals. Unfortunately, consistent with what occurred during the consultation process in 2003, that taxation data has not been made available. In its absence, any reform suggestions remain ill-informed and at best aspirational thinking.

57. If not available, a suggested solution is that the data could be sourced from tax return data and ASIC's corporate registration records. By matching incorporation data to tax return data of companies which lodge as residents, the percentage of corporates in the large, medium, small and micro business sectors that are Australian residents based upon incorporation could be determined. The balance of tax resident companies remaining, after discounting these companies, would be the companies who are resident due to the CMC test or the voting power control test. The taxable income of these companies would provide a revenue figure that would indicate the cost of removing these tests, assuming companies have been compliant.

[2] Davies J in *BHP-Utah Coal Limited v Federal Commissioner of Taxation* (1992) 23 ATR 258, 262; 92 ATC 4266, 4269 (***BHP-Utah***) referring to the theoretical basis for the view expressed in 11 CTBR[OS] Case 78.
[3] *BHP-Utah* at 262.
[4] s 104-160(1).

Implications of having only an incorporation test

58. As noted in the Consultation Guide, the 2002 Treasury consultative paper entitled *Review of International Taxation Arrangements* (the **RITA Consultation Paper**) explored options for reforming the company residency test, in particular the possibility of adopting an incorporation test as the sole test for residence of companies. The ease of avoiding the application of the test by not incorporating or incorporating companies offshore was recognised. They are not new with Lord Lorebum LC in *De Beers Consolidated Mines v Howe* (1906) 5 TC 198, 213, finding that incorporation was not an appropriate test for company residence, noting that if incorporation was used, a company: "... might have its chief seat of management and its centre of trading in England, under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad."

59. This concern was echoed in the debates in the House of Representatives when the Australian residency definitions were first introduced in 1930.[5] This vulnerability to manipulation flows from the test's reliance on form.

60. Leaving aside the issue of initial incorporation, it was recognised that the risk of Australian incorporated entities seeking to escape the jurisdiction through incorporation off-shore (corporate inversions) was low as a corporation cannot freely change its place of incorporation without triggering a tax on the accrued gains in respect of its property." The RITA Consultation Paper identified that some features of Australia's tax system would reduce the risk to Australia of relying on place of incorporation as the sole test of residency (the dividend imputation system, capital gains tax on any disposal, transfer pricing rules, Controlled Foreign Company (CFC) rules and the thin capitalisation laws). This view was accepted by the Board of Taxation, which recommended that the basis for residency of a company should be on whether it is incorporated in Australia.[6]

61. Although the Committee sees much to merit such a change, in a post-BEPS environment, we would expect that a recast second statutory test (i.e. the CMC test) would remain in some form.

Consultation question 6

Is there 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.

62. The Committee considers that there does not appear to be a compelling reason for retaining the voting power test, and that this should be repealed.

63. Despite the fact that it was based on the views expressed by the 1920 United Kingdom *Royal Commission on The Income Tax, Cmd 615,* adopted by the United Kingdom, *Report of the Income Tax Codification Committee* Cmd 5131 (1936), in s 7 of its draft Income Tax Bill and is reflected in judgements such as *British American Tobacco Co v Inland Revenue Commissioners* [1943] AC 335, 339, where Viscount Simon stated that owners of the majority of the voting power in the company are persons who were

[5] Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4859 (Sir John Greig Latham, Opposition Leader).
[6] Board of Taxation, *International Taxation: A Report to the Treasurer* (2003) 109 (Recommendation 3.12).

in effective control of its affairs and fortunes, it has not been adopted elsewhere in the world.

64. This test has not been effective in the Australian context due to the difficulty in satisfying key elements of the test. For example - although the operation of the test has not been considered by the courts, the operative words have been interpreted in other contexts. Thus, the courts have found that "control" means the "actual" control of the voting rights, not the mere holding of those rights: *Federal Commissioner of Taxation v Commonwealth Aluminium Corp Ltd* (1980) 143 CLR 646; 30 ALR 449; 11 ATR 42; 80 ATC 4371. Thus, the resident shareholders must have actual control over 50% of the voting power. Further, the test looks at the exercise of the "actual" control, not merely the "capacity" to control. In other words, in order to demonstrate control of voting power, that control must have been exercised in the general meeting. Thus, the test cannot be satisfied where the controlling resident owners abstain from voting at the general meeting.

65. Further, as the test is based upon actual control, it cannot be satisfied where controlling resident owners have beneficial control, as the actual control is vested in a non-resident trustee or nominee. Indirect forms of control, such as voting agreements with shareholders, may also not satisfy the actual control requirement. Thus, the test is easy to avoid, as shareholders who are residents of Australia might agree to transfer their shares to persons who are residents outside Australia, who would hold the shares as trustees.

66. Although the repeal of the voting control test would amount to, at best, a minor variation in the jurisdictional claim, its removal would ensure that the domestic law of company residency is simpler, be it within a slightly narrower jurisdictional framework.

Thank you again for the opportunity, and the additional time afforded to us, to prepare this submission. Should you wish to discuss further any aspects of the submission please do not hesitate to contact Clint Harding, Chair of the Committee (charding@abl.com.au or 02 9226 7236).

Yours sincerely

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