Business Council of Australia

cta Corporate Tax Association

4 February 2020

Review of Australia's Corporate Tax Residency Rules
Board of Taxation Secretariat
C/-The Treasury
Langton Crescent
Parkes ACT 2600

Dear Secretariat

Corporate Tax Residency - Reform Options

The Corporate Tax Association (CTA) and Business Council of Australia (BCA) welcome the opportunity to provide comments on the Board of Taxation's Corporate Tax Residency Reform Options paper (the options paper).

As the Board is aware, the ATO released a slightly revised version of Practical Compliance Guideline PCG 2018/9 late last year, which clarified certain matters associated with the ATO's compliance approach to the question of corporate central management and control (CMAC) and extended transitional periods. While these clarifications and the extension are welcome, the practical issues with trying to manage CMAC under the current common law test remain. This is because the current residency test is fundamentally a fact and circumstances threshold assessment rather than a bright line test – which an incorporation only test would provide.

As the majority in the *Bywater* case at paragraph 77 said:

> "As a matter of long-established principle, the residence of a company is first and last a question of fact and degree to be answered according to where the central management and control of the company *actually* abides. As a matter of long established authority, that is to be determined, not by reference to the constituent documents of the company, but upon a scrutiny of the course of business and trading. Accordingly, to conceive of the task in terms of identifying established exceptions .....is both antithetical to the factual nature of the test and unhelpful."

Any modern business that looks to expand offshore and/or uses modern corporate governance practices is likely to have some hallmarks of CMAC and carrying on of business in Australia. Examples include a small business or start-up looking to grow and expand offshore, newer digitalised business models or any business that makes use of modern communication technologies to manage business activity from more than one location. The facts and circumstances in some cases can make the activities of a board or its directors both acts of CMAC and also the carrying on of a business.

The old ruling TR 2004/15 recognised this, and as a practical matter, attempted to bifurcate the carrying on of a business and CMAC limbs of the test as two separate and distinct activities. This test worked well in the context of an active offshore business with "hard assets" or a permanent establishment in an offshore jurisdiction (such as a mine or factory) at one end of the spectrum (especially given the CFC rules were in operation). However, the test possibly did not work well for a digitalised business model where there may be no "hard assets" or permanent establishment offshore, the board activity was more operational than "directorial" and income was passive in nature.

Upon consideration of the Board's options paper, the CTA and BCA believe the Board should consider an incorporation only test possibly supplemented with an integrity rule to stop manipulation of residency status. It is clear an incorporation only test would minimise compliance costs for all businesses – small, large and emerging. Integrity rule changes (if they are required at all) may not be needed given the suite of integrity measures outlined in the options paper. The current residency rules as applied in cases such as *Bywater* operate as an historic artificial integrity measure but apply as a threshold question, rather than after the relevant substantive rules have operated – which is how integrity rules should and do operate. An incorporation only test resolves most of the practical problems with the current rules which require CMAC to be tested as a threshold question in every circumstance and would allow other integrity rules to operate as intended. If the Board considered it necessary to introduce a supplementary integrity rule to support an incorporation only test, a thorough analysis of the operation of Australia's existing suite of anti-avoidance rules should first be undertaken to ensure any new integrity rule was, in fact, required.

If the Board has concerns with an incorporation only test, the CTA and BCA believe a codification of the intent of the withdrawn ruling TR 2004/15 would be of some practical assistance and would reduce uncertainty – but it is a second-best option. Our suggestion is if the Board does not consider an incorporation only test is possible and a modified CMAC test is preferred, it may be easier to design any modified test by reference to the tax outcomes if a taxpayer is deemed a non-resident and the participation exemption/CFC rules were to apply rather than trying to develop criteria (or checklists) for what is "carrying on a business" and separate criteria for what is "CMAC" in Australia. Either way, the feedback reflected in the options paper demonstrates that the status quo is not an option.

We have attached our observations on the Board's consultation questions as an Appendix to this letter.

Please feel free to contact us directly should you wish to discuss any aspect of this submission.

Yours sincerely,

Michelle de Niese
Executive Director
Corporate Tax Association

Jennifer Westacott
Chief Executive
Business Council of Australia

Appendix

Board of Tax Consultation Questions

Reform Option 1 - legislative modification of the CMAC and carrying on of business test

Question 1

The Board seeks stakeholder feedback on how the CMAC test may best be modified in order to ensure that having central management and control in Australia cannot, by itself, be taken to also constitute the carrying on of a business in Australia for tax residency purposes.

In our view, if an incorporation only test is not adopted, modifying the CMAC test to exclude certain board or director activity undertaken in Australia as not meeting the CMAC limb of the residency test is a possibility.

The practical problem is that in applying specific facts to the CMAC test, taxpayers may also be required to apply the same facts to the "carrying on of a business" limb of the current test (as in the *Malayan Shipping* case). Providing a "checklist" approach of criteria to CMAC, and the same checklist approach to "carrying on of a business" may be problematic to define and potentially arbitrary in outcome. It could be argued that the issue in *Bywater* was in fact a "checklist approach" to residency adopted by the taxpayer in attempting to create the mirage of being a non-resident.

An alternative solution therefore could be to retain the current test of carrying on of a business and CMAC in Australia, but in certain circumstances, deem certain tax outcomes (rather than board or director activity or a "checklist" of factors) as not being CMAC or the carrying on business in Australia where there is no loss to revenue.

To illustrate, a company could be deemed to not have its CMAC in Australia, or be carrying on business in Australia if, assuming it was a non-resident of Australia:

a) it passed the active income test under the CFC rules; or
b) its income would be attributed under the CFC rules.

For example, assume a foreign incorporated subsidiary had an active manufacturing business in New Zealand but all its directors and board only met in Australia where all key decisions were made for ease of operation, efficiency and governance reasons. On applying the current CMAC and carrying on of a business test it would be treated as an Australian resident. However, on the assumption it was a non-resident, it would have to test if it passed the active income test in the CFC rules. Assume it undertakes that analysis and has no eligible designated concession income. It would thus be deemed not to be a resident of Australia under (a).

Assuming the same facts, but on the assumption the company failed the active income test and its income was attributed, it would similarly be deemed to be a non-resident under (b).

In such cases, it presumably would not matter where the directors undertook their fiduciary responsibilities or whether they used modern communication technology etc. The ultimate flexibility for CMAC and carrying on of business is maintained. There is no loss to revenue in the sense that the CFC rules or the exemption in sec 23AH would otherwise apply as intended by our participation exemption regime. Part IVA could also apply as intended to deal with cases of manipulation where the CFC rules were not enlivened as intended.

Question 2

If the CMAC test is modified to be a two-step test then the Board seeks stakeholder comment on whether it is necessary to define (by legislative amendment) either the first limb or the second limb of the test.

In thinking about your response to this question consider the following:

- *What requirements/factors do you consider to be important for inclusion in the test in order to clarify what is meant by "carrying on business in Australia" and "central management and control"?*

- *Should the "carrying on business in Australia" aspect of the CMAC test also include a de minimis mechanism under which a company will be deemed not to satisfy the requirements of the first limb in the event that a certain threshold level (such as, for example, Australian turnover of the company as a percentage of global turnover) is not exceeded?*

- *Should the "carrying on business in Australia" test only have effect for the company residence rules?*

- *If central management and control is being exercised in both Australia and a foreign jurisdiction what requirements/factors should be incorporated into a legislative tie-breaker test?*

As outlined in our response to Question 1 there would be no need for any codification of what amounts to the "carries on business in Australia" and "CMAC" for the purpose of the definition of corporate residence in sub-section 6(1) if there was a deeming rule in circumstances where the tax outcomes would result in the same policy outcome as under the CFC rules.

A focus on the tax outcomes of non-resident status would not require a separate test to expressly provide an attribution of CMAC to a single location, nor require *de minimis* tests. The analysis currently undertaken under the CFC rules would operate in practice and not add additional layers of complexity or potentially arbitrary outcomes based on whether a company meets a threshold or otherwise.

Reform Option 2 - an incorporation only test

Questions 4 - 7

In assessing the merit of a potential move to an incorporation only test, it is important to outline some history with the CMAC ("actually abides") test. The HRMC International Tax Handbook provides some detail behind the common law development of the CMAC test. It notes at paragraph ITH 309:

> "In the early days [common law] regarded a company as resident in this country if it was incorporated here. Viscount Sumner refers to the matter in the Egyptian Delta Land case (ITH311). He mentions Dowell who was the Board's Solicitor and whose `Income Tax' was a standard work. The 1874 edition of Dowell, the first edition, said nothing at all on the subject of company residence. The second edition in 1885 merely said that a company incorporated here was resident here. We clearly started with the idea that residence was determined by incorporation and in the middle of the nineteenth century

there was no problem. But as foreign trading became more complex this simple view was questioned."[1]

The complexities arose with the 1876 case of *Cesena Sulphur* which was, in essence, an anti-avoidance case. As Lord Loreburn later said in the 1906 case of *De Beers* when dealing with the argument of Mr. Cohen (counsel for De Beers) that an incorporation only test was the test of UK corporate residency:

> "I cannot adopt Mr. Cohen's contention. In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it 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 and distributing its dividends abroad. The decision of Kelly C.B. and Huddleston B. in the Calcutta Jute Mills v. Nicholson and the Cesena Sulphur Co. v. Nicholson, now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides." (emphasis added)[2]

The CMAC test in the Australian Act introduced in 1930 was the codification of the *Cesena Sulphur* principles affirmed in the Privy Council in *De Beers* in 1906.[3] Thus the history of the "actually abides" test is that it was a common law ersatz tax integrity rule introduced by the courts because the incorporation only test was ripe for abuse as at that time UK tax laws did not have integrity rules such as CFC rules or Part IVA that could have applied to deal with the tax benefit.[4]

The practical problem is Australian tax law has matured since 1930 however the CMAC test remains as a historic anomaly where non Australian incorporated companies must, as a matter of law, first apply the CMAC test as a threshold question. That being the case, it is arguable the subsequently enacted integrity rules that could apply (such as the CFC rules and Part IVA) are somewhat ineffective when dealing with CMAC.

Australian cases such as *Koitaki, Northern Australian Pastoral, Waterloo Pastoral, Malayan Shipping, Esquire Nominees* and *Bywater* all involve the application of the "actually abides" test in the context of income being otherwise exempt. It is submitted that the full facts and circumstance analysis required in such cases is similar to what would be required in applying Part IVA, if it could be applied. As was noted in *Bywater*; "[a]s has been explained, none of those decisions supports the idea that a company is taken to be resident in where its board meetings are held.....and held in that place in the hope of avoiding tax liability in the place where the decisions are actually made."[5] (emphasis added).

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[1] See https://www.gov.uk/hmrc-internal-manuals/international-manual/intm120210#IDAPP1SG

[2] See https://groups.google.com/forum/#!topic/alt.lawyers/mrlg8O3Egbg

[3] See Bywater Investments and Commissioner of Taxation [2016] HCA 45 (Bywater) at paragraph 45

[4] Ironically, the UK introduced an incorporation test in 1988, when there was abuse of the CMAC only test. See https://www.gov.uk/hmrc-internal-manuals/international-manual/intm120210#IDAPP1SG at ITH446.

[5] At paragraph 66 of the High Court judgment in Bywater

This history and context is important in assessing the need for a retention of a CMAC test, which is now redundant given developments with other integrity rules and the policy decision made to adopt a participation exemption regime.

The "redundancy" problem with the CMAC test comes vividly to light with the *Bywater* case - the Commissioner could not seek to apply Part IVA in *Bywater* as the Commissioner had to first determine the threshold question of whether Bywater (and the other entities) were residents under the primary CMAC test. If Bywater was a non-resident under the primary test, then arguably Part IVA cannot apply, as the taxpayer has effectively already passed a quasi-integrity rule. An incorporation only test (supplemented with the CFC rules) would not suffer from this shortcoming, as Part IVA would apply after the substantive rules have operated, allowing a full assessment of the facts, including the quantum of the tax benefit.

CMAC as a threshold question is the practical problem

The practical result of having to apply the CMAC test as a threshold matter is unfortunate. It requires all non Australian incorporated companies in all cases (even when there is no loss to the revenue or no anti-avoidance motive) to go through the CMAC facts and circumstances test and put in place CMAC processes that in many cases purely add compliance costs. Ironically, in some cases, the operation of the CMAC test results in taxpayers engaging in contrived tax motivated behaviour to prove it is a non-resident, the sole motivation being to avoid the risk of being considered a resident, as there is no direct loss to revenue.[6]

A move to support an incorporation only test would resolve this. This would then allow the CFC and other tax integrity rules to operate as intended after the substantive rules apply.

Policy reasons to reduce the cost of unnecessary compliance

The result of a move to an incorporation only test would be that it would not matter where or how a company is managed in cases where the CFC rules operate. The CMAC of a company would then only be relevant in cases where there is a tax benefit and Part IVA, MAAL or DPT rules could possibly operate. The other significant outcome of not applying the CMAC "actually abides" test as a threshold test is that it would remove the perverse need for contrived proof of honest behaviour, such as sending directors offshore to meet.

Moreover, a one director start-up company expanding offshore would not have to travel offshore for board meetings to maintain non-resident status, directors can be located wherever makes commercial sense and any communication technology or means (such as circular resolutions) or combination thereof could be used. It is only where the board of such companies abrogates their fiduciary duty for the dominant purpose of creating a tax benefit (as was in effect the outcome of cases such as *De Beers, Bullock, Bywater* and *Malayan Shipping* to name a few) would a foreign incorporated subsidiary ever be effectively treated as an Australian resident.[7] It is submitted that if there was an incorporation only test in place at the time of the Bywater transactions, Part IVA would have applied to cancel the tax benefit if the CFC rules had not operated. The issues with paying dividends, de-consolidation and requirement to file returns noted in the options paper would disappear. The CFC rules could operate as intended, and any residual tax benefit not caught by the CFC rules or other integrity rules could be swept up by the operation of Part IVA, the MAAL or DPT rules.

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[6] This includes for example the holding of board meetings offshore because of the risks of getting CMAC wrong as outlined in the options paper.

[7] In Malayan Shipping profits from income derived in Singapore was exempt from Australian tax. De Beers exempt from UK tax, and in Bywater arguably relieved from Australian tax under the UK or Swiss treaties, but for the operation of Part IVA, if it could apply.

Risks with an incorporation only test

The options paper does highlight a potential risk with an incorporation only test where a Singaporean incorporated entity is managed from Australia and generates a passive capital gain in New Zealand.

While such a company would not be an Australian resident under an incorporation only test, it is not clear from a policy perspective if this is necessarily the "wrong" answer given our participation exemption rules as buttressed by the CFC rules and the BEPS agenda more broadly.

Any revenue exposure would appear to be outbound Australian companies to countries without an incorporation test (only Singapore and the Philippines) with no PE in that country. It is unlikely that foreign companies would incorporate in Australia and manage abroad to take advantage of an incorporation only test given Australia's high corporate tax rate. In this context it is worth noting the impact of the MLI and the principal purpose test and that that Australia reserves its right under treaties to apply Part IVA.

We also note the CFC rules would most likely apply to attribute the gain, and if not, Part IVA would apply if the dominant purpose of such an arrangement was to create a "tax free" gain. The MAAL and DPT would potentially also apply to SGEs.

The "stateless income" issue that has been raised as a potential risk in the context of changes to our corporate residency rules is the very issue Pillars One and Two of the OECD/Inclusive Framework is focussing upon and will undoubtedly address.[8]

US style "inversion" risk also seems remote. Unlike the US, Australia has general anti-avoidance rules and an imputation system. Incorporating a new holding company in a foreign jurisdiction to hold Australian operations would mean dividends flowing back to Australian shareholders would be unfranked. While dividends flowing to non-resident shareholders would not be taxable or subject to withholding tax in Australia, dividends from Australian companies to the parent would remain in the Australia tax net. Any leakage would be profits derived by the new "parent" potentially from the Australian group making deductible payments to the parent for services provided, which would be subject to transfer pricing rules, and potentially the DPT or Part IVA.

The need for transitional rules

We note that it is only in the case of a foreign incorporated entity that is an Australian resident due to CMAC in Australia that any transitional rule may be required. It is not known how common this set of circumstances is (and therefore may be a question for the ATO to provide information on). As such a transitional rule may not be necessary.

We note that when the UK introduced an incorporation test to supplement its CMAC only test in 15 March 1988, a three stage rule was adopted:

- subject to the incorporation rule from 15 March 1988
- qualifying for an indefinite exception from the incorporation rule

[8] See https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf, and http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

- qualifying for a five year exception from the incorporation rule, becoming UK resident on 15 March 1993.[9]

Consideration could be given to similar sorts of transitional rules, if the need for transitional rules was considered practically necessary.

[9] See https://www.gov.uk/hmrc-internal-manuals/international-manual/intm120050