Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

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

31 January 2020

Reform of Australia's residency rules
Reform option 2 - Adoption of an incorporation-only test

Dear all

EY is submitting two separate standalone submissions to this inquiry – one dealing with adopting an incorporation only test of residency (our strongly preferred approach) and a second involving amending the existing central management and control test of residency.

EY welcomes the opportunity to respond to the questions raised by the Board in *Corporate Tax Residency Reform Options* December 2019 (Options Paper) options for setting the corporate residency of a foreign company. "These are:

1) retention of the existing 'carrying on business and central management and control' test (collectively referred to as the **CMAC test**) but with some form of legislative modification; and

2) adoption of an incorporation-only test.

This Submission addresses our preferred adoption of an incorporation-only test, which responds to questions 5 to 7 in the Options Paper. However, even if an incorporation-only test is introduced, we maintain our submission that, in the interim, some short-term and immediate modifications to the CMAC test are necessary.

We discuss reform option 1, amending the CMAC test, in our separate submission.

We note that this the residency rules applicable to foreign companies were examined by the Board of Taxation in 2002 in its Review of Australia's International Tax Arrangements (**RITA**). The Board was not attracted to amending the CMAC rules and recommended in February 2003 that Australia should adopt an incorporation-only rule for determining corporate residency.

Executive summary

This Submission contains our general observations on Australian income tax policy, the design of the Australian corporate income tax system and effect of changing to an incorporation-only test (Section 2.2 below). Taking into account these matters, we submit:

- The underlying policy basis for Australia's corporate income tax system is now firmly based on capital import neutrality (**CIN**).[1]

[1] While a hybrid of national neutrality and capital export neutrality remains for non-corporate resident taxpayers, what is relevant is that CIN is not extended to non-corporate resident taxpayers.

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- As far as is possible, any test for the residency of company should be consistent with the policy basis underlying the Australian corporate tax law. An incorporation-only test is consistent with policy and is practical but not pragmatic.

- As far as possible, the test of the residency for a company should also be consistent with the basic requirement for certainty and should not result in arbitrary outcomes.[2] An incorporation-only test meets these basic requirements.

- The CMAC test (either as it stands or in a modified form) is inconsistent with policy. For example, it militates against developing Australia as a location for reginal headquarter or regional holding companies. Further, it creates a disincentive for Australia multinational groups from governing their foreign subsidiaries from Australia and locating their senior executives in Australia.

- As discussed in our separate submission and our previous submission, the CMAC test as it currently appears to operate is inherently flawed. While the legal principles underlying the CMAC test are settled, the application of those principles to the facts must be considered annually and can be uncertain. The CMAC test can result in arbitrary tax outcomes, which might favour the taxpayer or the revenue. The possible changes raised in reform option 1 of the Options Paper (including any bright line test), and other changes we have considered, will introduce new and different uncertainties.

- We do not anticipate that the change to an incorporation-only test will produce on-going "technical" issues. However, the incorporation-only test would be consistent with a self-assessment system whilst the CMAC test (in its current or modified form) is not, especially once impacted by Australia's Double Tax Agreement (**DTA**) network. Under an incorporation only test there will be increased certainty, and compliance and administrative costs will decrease (Section 3.1 below).

- An incorporation-only test does not give rise to any systemic integrity issues (Section 2 below). In particular, the current design of the corporate international tax system, and in particular the branch exemption, the controlled foreign company (CFC) measures, the dividend exemption, transfer pricing measures and the imputation system have the effect that the Australian taxation of a foreign incorporated company with its CMAC in Australia (which would be classed as a non-resident under the incorporation-only test) and a foreign incorporated company without its CMAC in Australia (presently a non-resident) are reasonably analogous. That is, retaining CMAC as a residence test serves no purpose.

- An incorporation-only test does not of itself raise any significant new specific integrity issues and reduces existing specific integrity issues (Section 3.2 below). For example, the CMAC test might be manipulated from year to year and create integrity concerns, whereas the incorporation-only test cannot. On balance, any specific identifiable integrity risks will be decreased under an incorporation-only test.

- If the Board decides that specific integrity concerns arise, these concerns can be addressed by specific integrity measures (Section 3.2 below). Restructure possibilities are unlikely to give rise to integrity issues (Section 6 below).

- A change to incorporation-only test is not inconsistent with Australia's DTAs or the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*

[2] The fundamental principles for taxation are set out in *Asprey Committee Report* 31 January 1975

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(**MLI**), and should not necessarily require renegotiation of Australia DTAs or a change in Australia's position under MLI (Section 10 below).

- Transitional measures will be necessary if there is a change to an incorporation-only test, but these transitional would not be complex and are unlikely to have widespread application (Section 11 below). In any event, we anticipate that transitional measures will also be necessary if there is a modification to the CMAC test.

We have also included our observations on the potential application of the CFC measures under an incorporation-only test (Attachment B).

For clarity, where matters were raised in our 9 October 2019 submission (**first submission**) after the Board of Taxation consultation guide (**Consultation Guide**) we have repeated our considerations in this Submission.

We have not considered the question of residency of a trust, which might have different tax policy considerations.

* * * * *

If you would like us to expand on anything raised in this Submission, please do not hesitate to contact me on (02) 8295 8888 or at alf.capito@au.ey.com.

In the alternative, please contact Tony Stolarek on (03) 8650 7654 or tony.stolarek@au.ey.com, or Mathew Chamberlain on (08) 9429 2368 or at mathew.chamberlain@au.ey.com.

Yours sincerely

Alf Capito
Head of Tax Policy, Australia

Attachments:

- EY submission
- Attachment A - Reviewing the design features of Australia's international tax rules
- Attachment B - CFC measures and integrity concerns

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EY submission

1. General observations on the issues raised by the Board

As indicated in the Options Paper, we agree that abandoning CMAC as a residency test will be a significant change that will require detailed consideration of the operation of the existing law (if the change was not significant it might not be worth doing), but if difficulty was a reason for retaining the existing fundamental aspects of the Australian income tax system then it would never change.

However, an on-going basis, the incorporation-only test is simpler and does not of itself raise any significant new *specific* integrity concerns and reduces existing integrity concerns (Section 3.2 below). For example, the CMAC test might be manipulated from year to year and create integrity concerns, whereas the incorporation-only test cannot. On balance, the identifiable integrity risks are decreased under an incorporation-only test.

We are aware of arguments that CMAC is appropriate as an on-going test (other than as an integrity measure). The arguments appear to rely on an unstated underlying policy of capital export neutrality and the necessity to attach residency of a company by reference to a domicile based on the governing mind of the company. We submit that an argument that CMAC (or an equivalent) is a valid basis for residency because it has historically been a basis for implementing capital export neutrality should be rejected.

We wish to emphasise that EY is not submitting that Australia should adopt a pure territorial basis for taxation under which residence is immaterial. A pure territorial basis for taxation is inconsistent with current Australian tax policy. For example, Australia's imputation system extends to shareholders of companies that are residents of Australia. The recent ATO administrative change to the residency test that has *increased* the possibility that a foreign incorporated company could be a resident of Australia might be inconsistent with the imputation system, whereas a change to the residency test that *decreased* the possibility that a foreign incorporated company would be a resident of Australia would be wholly consistent with Australian tax policy.

The Board appears to be concerned that a change to an incorporation-only test might have integrity concerns. We agree that a change to an incorporation-only test can only be made if it does not give rise to insurmountable new integrity issues. However, we find that reference to "integrity" is imprecise without identifying the nature of the integrity concerns. We have considered the nature of the potential integrity matters (Section 2.2 below). Put simply, to determine whether there is an integrity concern it is first necessary to consider the issue in the context of the policy and design of the Australian income tax system (Section 2.2 below).

We submit that the change to an incorporation-only test can be made if it does not undermine, nor is it contrary to, the underlying policy and fundamental design of Australia's corporate income tax system (for convenience we have referred to this as a "systemic" integrity issue). Whether a systemic issue arises must be determined by first recognising and accepting that the Australian corporate income tax system is now based on a policy of CIN. CIN, broadly stated, requires that all investments in Australia pay the same marginal rate of tax regardless of the residence of the investor.

We have referred to other integrity issues as "specific" integrity issues and discuss potential specific integrity measures that might be considered by the Board (Section 3.2 and Attachment B). On balance, we submit that any specific integrity issues that might arise can be dealt with by limited specific integrity measures or, if appropriate, by Part IVA.

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It has been suggested that a change to incorporation-only test might lead to a protracted DTA renegotiations. EY would be hesitant to support a change to an incorporation-only test if that change would lead to protracted DTA re-negotiations or would create a perception that Australia does not adhere to its commitments to the OECD. However, we submit that there is no apparent basis for this concern (Section 10 below).

We have also considered the nature of any necessary transitional measures (Section 11 below).

2. Integrity of Australia's tax system (Consultation question 6)

We reiterate that EY would not support an incorporation-only test if that test would give rise to systemic avoidance of Australian tax.

In our experience, there are relatively few foreign companies that lodge income tax returns as residents of Australia based on CMAC. We expect that the ATO could confirm this.

Therefore, the revenue issue is largely confined to the risk of *behavioural* changes. We submit that in some areas the change to an incorporation-only test of residency might act as an integrity measure which will protect the Australian revenue, and we suggest that the ATO could confirm this.

We are aware that some submissions, whilst agreeing that the CMAC test is its current form is undesirable, might prefer that a CMAC test (either in its current or in a modified form) should be retained as an integrity measure that will prevent any significant behavioural change, or that an incorporation-only test must be supplemented with new integrity measures. We are not aware of the details of any proposed alternative integrity measure. However, we are concerned that proposals for integrity issues might not pay due regard to the policy and fundamental design of the international corporate income tax system.

2.1 Nature of "integrity" in the tax system

Integrity concerns might arise from arrangements that are blatant, artificial, and contrived.[3] This includes Bywater type arrangements (discussed at Section 9 below).[4] We submit that these arrangements are already adequately dealt with the revised general provisions of Part IVA and the Diverted Profits Tax (subject to our comments regarding minor changes to the Diverted Profits Tax discussed Section 9.2 below). We further submit that (extreme) *Bywater* type arrangements should not influence policy or fundamental design of the tax system, nor should they otherwise be dealt with as integrity measures.

The remaining integrity concerns can be either systemic or arise from specific circumstances.

Systemic integrity concerns would arise only if the change to an incorporation-only test is *contrary to or undermines* the basic policy and basic design features of Australia's corporate income tax system.

We submit that an incorporation-only test is not contrary to Australia's corporate tax policy. We further submit that the fundamental design features of the tax legislation, *viewed together*, would not be undermined by removing CMAC as a test of residency. We have discussed these design features in greater detail at Section 2.2 below and in Attachment A.

[3] This expression it is often used to describe schemes to which Part IVA might apply.

[4] Refer to *Hua Wang Bank Berhad v Commissioner of Taxation, Bywater Investments Limited v Commissioner of Taxation, Chemical Trustee Limited v Commissioner of Taxation , Southgate Investment Funds Limited v Commissioner of Taxation, Derrin Brothers Properties Limited v Commissioner of Taxation*, together referred to here as the Bywater related cases (citations omitted).

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Specific integrity concerns would only arise if the change to an incorporation-only test *creates* a specific integrity concern. If such specific integrity concerns arise, we submit that they can be addressed if they are reasonably anticipated or as they arise. A mere perception that there might be a potential specific integrity concern should not be the starting point for policy consideration. If a perceived specific integrity concern exists under the existing law (i.e. if it exists independently of the CMAC test) we submit that such a perceived concern is not relevant to consideration of the adoption of an incorporation-only test. Whether or not the Government chooses to address any such perceived integrity concern is a separate matter.

2.2 The design of Australia's corporate income tax system

In 1988 the then-taxation of foreign income and the general foreign tax credit system (for underlying foreign taxes) implemented the policy of capital export neutrality (broadly, residence-based taxation).[5] [6] When Australian tax policy changed to the change to the policy of CIN (more focused on source-based taxation), the design of the corporate tax system evolved.[7] Provisions of the Tax Acts that were originally introduced as anti-avoidance designed to "protect the revenue" now, *viewed together with the basic provisions of the corporate tax system*, implement the policy for the taxation of companies (i.e. CIN and, generally, national neutrality for the resident shareholder).

These measures include the:

- foreign branch exemption and the foreign non-portfolio dividend exemption
- transfer pricing provisions
- thin capitalisation measures
- CFC measures, which largely replicate the branch exemption
- Conduit Foreign Income measures
- the taxation of the dividends paid by a resident company (coupled with the imputation system and CFI measures)

We submit that removing corporate residence based on the corporate mind of a company does not adversely affect a source-based system like Australia's.

Because the interaction of these provisions is fundamental to consideration of whether an incorporation-only test creates systemic integrity issues, we have discussed these design features in greater detail at Attachment A.

2.3 Stateless income

At paragraph 4.2.2 (Residency manipulation and revenue cost) the Options Paper mentions a concern with "stateless income". As outlined below, this is an issue under any corporate residency test including

[5] Under capital export neutrality, broadly a resident of Australia would face the same tax burden wherever they chose to invest. CEN is thought to support residence-based systems or worldwide source-based taxation. CIN instead means that all investments in a country attract the same marginal tax rate regardless of the investor's residence, and involves taxation by a source country with exemption in the residence country. Although later described as a form of CIN, when Australia introduced the exemption for non-portfolio dividends and branch income these were merely pragmatic compliance measures (page 12 of the Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Bill 1990*.

[6] The bases for adopting CIN were explored in and in *Review of Business Taxation* chaired by John Ralph *Review of International Taxation Arrangements System A consultation paper prepared by the Commonwealth Department of Treasury*, August 2002 and *International Taxation A Report to the Treasurer* the Board of Taxation 28 February 2003. We have not considered the merits of CIN as a tax policy.

[7] CIN largely persists for foreign shareholders in an Australian company through the interaction of dividend withholding tax, the imputation system, conduit foreign income and Australia's DTAs.

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those of other countries, and we outline how Australia's CFC rules apply as well as other integrity rules both current and potential.

The concept of "stateless income" has not been described in detail. We submit that care needs to be taken when using the term in the discussion of integrity issues.

As far as we can discern, the term "stateless income" was first described as:

> "… income derived by a multinational group from business activities in a country other than the domicile [however defined] of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the firm's customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company … without shifting the location of externally supplied capital or activities involving third parties." [8]

This concept was developed, in part, to examine whether capital export neutrality or CIN was an appropriate policy for the taxation of income of a US company, and focussed on the factors of production and source of capital. However, Australia has adopted a system of CIN, and Australia's tax system already takes into account the movement of income within a multinational group without shifting the location activities involving third parties (e.g. transfer pricing and the Diverted Profits Tax) and the location of capital (e.g. conduit foreign income rules and imputation).

The term has been widely used in the BEPS discussions where the OECD explained:

> "Corporate tax is levied at the domestic level. When business activities cross borders, the interaction of domestic tax systems can mean that income is taxed by more than one jurisdiction, resulting in double taxation. That is what the current international tax rules were designed to prevent. However, the same rules have in some instances facilitated the opposite, i.e. double non-taxation. Further, the interaction between domestic tax systems can also leave gaps which result in income not being taxed anywhere (stateless income)."[9]

Where an Australian resident company directly derives foreign source income, the possibility for stateless income is reduced by Australia limiting the branch exemption to foreign income derived in carrying on business at or through a permanent establishment in a foreign country. This is consistent with the OECD position (adopted in all of Australia's DTAs) that the temporal and geographical nexus of activities establishes a connection between the company's customers or the factors of production. The amount of the income that can be allocated to the foreign branch is governed by transfer pricing. In the context of Australia's policy of CIN, once the income is allocated to the factors of production the income is not stateless unless the assets generating the income are inherently mobile.

In part, Australia's CFC measures target some, but not all, forms of stateless income albeit that they were not phrased this way.[10] For a non-resident subsidiary of an Australian company (i.e. a CFC), under the existing law it is theoretically possible for stateless income to arise from mobile assets. Further, we submit that, practically, there are few identifiable circumstances where the income will not attach to the permanent establishment. As far as passive income is concerned, any potential for an increase in stateless income is solely a function of the slight difference between the operation of the branch

[8] Edward D Kleinbard, *Stateless Income* 11 Fla. Tax Rev. 699 (2011).
[9] *Top 10 FAQs about BEPS* OECD. This reappears in relation to the digital economy, see Chapter 11 of *Tackling BEPS in the Digital economy*
[10] We have disregarded tainted services income which it appears did not follow the same policy as passive income and tainted sales income.

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exemption and the CFC measures. However, if this is the integrity concern it can be dealt with by a minor amendment to the CFC measures, and we submit that this difference is an insufficient reason to abandon an incorporation-only basis for residence.

Where a foreign company is a resident of Australia solely because of the CMAC test and would not have been a CFC if the CMAC was not in Australia, we submit that the taxation of the foreign source income of the foreign company is not an issue that concerns Australia - the foreign company's factors of production are not in Australia and the capital of the company did not come from Australia. The location of the governing mind should be irrelevant. For example, the Options Paper includes an example which was put to the Board:

> "A company incorporated in Singapore but controlled and managed in Australia would hence not be a resident in either jurisdiction. If the company then, for example, derives a capital gain from the disposal of property located in New Zealand it will, *prima facie*, not be subject to tax anywhere."

We assume that the example contemplates that the shareholders of the Singapore incorporated company are resident of Australia.

If the Singapore incorporated company is a CFC, whether or not the capital gain is taxable will need to be considered under the CFC rules, and the outcome will depend in on the nature of the property. Once the CFC measures are taken into account it is unclear why, from an Australian perspective, this can be described as stateless income.[11]

If the Singapore incorporated company is not a CFC, it is unclear why Australia should be concerned. The property located in New Zealand would have no economic connection with Australia and the majority of the capital of the Singapore company would not have been provided by Australian investors.

It is therefore unclear to us whether the example is intended to identify an integrity concern where the Singapore incorporated company is not a CFC; or where the Singapore incorporated company is CFC with no attributable taxpayer; or where the Singapore incorporated company is a CFC with an attributable taxpayer but has no attributable income. We suggest that the example might be further developed to examine the integrity concern. We make this comment because it is extremely important for detailed policy analysis to be undertaken in relation to any perceived integrity issues in order to identify precisely if and what policy action may be required.

3. Specific integrity measures

3.1 The difficulty of using CMAC as specific integrity measure

The reasons why the CMAC test is no longer a practical test have been set out in our previous submission. Put briefly, the corporate environment (now and into future) makes the declared law unmanageable for taxpayers. Notwithstanding that we consider that a CMAC test cannot applied and administered to give a reasonable outcome for all taxpayers we submit that a specific integrity measure should go no further than taxing the diversion of income and gains accruing to the benefit of residents of Australia.

[11] We note that if the CM&C of the company is in Australia, the company might still be a CFC under the control rule section 340(c) of the ITAA 1936.

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We submit that in considering CMAC (in its current form or in a modified form) as a specific integrity measure is appropriate only after taking into account the following:

- it can be applied efficiently and can be administered in a reasonable way for all taxpayers
- it will not be arbitrary
- the test is appropriately targeted, and the outcome is not punitive (i.e. the test would have the effect of taxing the income and gains that are the subject of the integrity risk)
- there is no better integrity measure that is more likely address the integrity concerns

As currently formulated, the CMAC test involves applying a test that is a difficult question of fact, relies on detailed factual enquiries from year to year, is uncertain, and is susceptible to disputes on the application of the law to those facts. Further, a CMAC test cannot be applied efficiently and cannot be administered in a reasonable way for all taxpayers. The test also diverts a company's senior management from productive activity. Further, Australian corporate taxpayers now operate in a self-assessment environment. This militates against efficiency, certainty and administrability.

In addition, based solely on changes in corporate governance, the CMAC test might have the effect that a foreign incorporated company is a resident Australia in one year, becomes a non-resident in another year, and then again becomes a resident subsequently (**residence flips**). Depending on the circumstances, the outcome might sometimes disadvantage a taxpayer and sometimes disadvantage the Revenue. Such arbitrary outcomes are undesirable.

A CMAC test can also have the effect of taxing income and gains that are not the subject of the integrity risk. It can apply to cases where there was no diversion of income and gains to a foreign company (i.e. it would apply to non-abusive cases) and taxes the *entirety* of the income and gains if not otherwise exempt.

Last, we consider that the existing anti-avoidance measures, appropriately modified, will adequately deal with any integrity risk (refer Section 9 below).

3.2 Specific integrity concerns under the CFC measures

It appears that the only *specific* integrity concern that might exist is the treatment of the income and gains of a foreign company resident in a "listed country", particularly where the income is derived from a source outside the listed country and is not taxed in the listed country. In this case, there is a non-neutrality between the treatment of a branch of a resident company and the treatment of a CFC. We do not consider this issue to be one that is a function of a change to an incorporation-only test. However, we have raised the issue in anticipation of an argument that the CFC measures cannot be relied upon to give a neutral outcome as between the treatment of a branch and the treatment of a CFC.

Put broadly, it is theoretically possible for a CFC that is a resident of a listed country to derive passive income from sources outside any listed country. In this case, the income might not be subject to the CFC measures. In the case of income derived directly by an Australian resident company, the exemption for foreign income derived at or through a permanent establishment might not apply. This situation is already dealt with under the CFC measures, which provide the Regulations might be made specifically to deal with this issue, or Regulations might be made to treat the amount as "eligible designated concession income". We have discussed the operation of the CFC measures in the context of a listed country in Attachment B.

We are aware that concerns have been expressed that the CFC measures can be avoided by ensuring that the economic ownership of the foreign company can be "disguised" and this may have occurred in

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the Bywater cases. We reiterate that these issues arise under the current provisions that identify the taxpayers with an interest in a CFC (i.e. the attributable taxpayers) and the extent of the economic interest (i.e. the attribution percentage). We highlight that these issues arise under the current CMAC as well as any other corporate residency formulation. We have discussed the operation of the CFC measures in Attachment B.

In considering any policy response, it is important to identify if this integrity concern might arise from arrangements that are

- "blatant, artificial and contrived" and thus subject to anti-avoidance rules
- arise from egregious behaviour including disguising the substance of an arrangement (that is, tax evasion behaviour)

as distinct from any issue in the legislation. To the extent that these arrangements currently exist they are an issue with the existing CFC measures and should already have been dealt with. We also expect that a taxpayer that engages in activities or arrangements that are intended to "disguise" the substance of an arrangement is as likely to be involved in artificial disguising CMAC, and in fact a major international trend of tax authorities including the ATO has been to work collaboratively to access information to counter such attempts. The Commissioner's current (and expanding) ability to access in information will over time reduce these possibilities (refer to our comments at Section 5 below).

4. Transferor trust type measures

We are concerned with the suggestion in question 6 that the transferor trust measures might be a basis for sound policy where a transferor who has transferred property or services to a non-resident company.

We submit that any consideration of whether the transferor trust measures should be used as a template for an integrity measure should take into account their original policy, the intended scope, the actual scope, and the practical application. We can only conclude that transferor trust measures are in practice punitive and were designed to have this effect.[12]

The transferor trust measures currently contain two aspects:

- current taxation of the transferor under income attribution rules
- taxation including an interest charge on distributions from a non-resident trust not previously attributed[13]

It is unclear from the Options Paper which aspect of the transferor trust measures would act as a basis for an integrity measure.

Very broadly, the transferor trust measures apply to a transferor of property as defined.[14] A transferor is obliged to include in its taxable income the attributable income in respect of the trust. While the attributable income is reduced to take into account amounts that are already subject to Australian tax (amounts which are taxed to a beneficiary, franked dividends, etc), the entire net income of the trust is

[12] We note that the transferor trust measures were reviewed by the Review of Business Taxation, and in the Board of Taxation RITA review.
[13] Refer ATO outline of transferor trusts at https://www.ato.gov.au/Forms/Foreign-income-return-form-guide-2019/?page=6
[14] See ATO discussion of who is subject to the measures at https://www.ato.gov.au/Forms/Foreign-income-return-form-guide-2019/?page=7

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attributable with little regard to the amount transferred to the foreign trust. Further, the current transferor trust rules also have significant unresolved issues which make them difficult to apply.

The measures were designed to be punitive. It is possible that a minor transfer of property to a foreign trust can result is significant taxation without regard to the purpose for the transfer, the commercial basis for the transfer and the economic effect of the transfer. We submit the measures do not provide a sound basis for any integrity rule.

In context, the transferor trust measures were designed in the 1980s, when it was considered that there was seldom a commercial or personal reason to transfer money to a foreign trust, except as means to shelter income and gains from Australian tax. Whatever the merits of the assumption, the transferor trust measures were designed as a deterrent: the legislature was largely unconcerned with taxation far in excess of the benefit that might arise to the transferor. Further, the transferor trust measures were developed in 1988 where ATO access to information was difficult, which is no longer the case.

The second element of the transferor trust measures was to impose an "interest charge" on any distribution from a foreign trust which had not been attributed in an earlier year under the attribution rules. Like GIC, the interest charge was penal in nature and is adjusted on a quarterly basis, currently approximately 8.54%.[15] We are unsure whether the Options Paper was referring to this aspect of the transferor trust measures, however, the concept behind the interest charge was also punitive taxation. Before considering this as an integrity measure, we submit that it needs to be fully developed, including the taxpayers that it would apply to, the circumstances in which it would apply, the type of income to which it would apply, etc., but most important why it is necessary at all.

5. Difficulties in access to information

To place matters in perspective, when the reform of the corporate international tax system in the 1980s commenced the environment for international investment was different since:

- cross border money flows were relatively small
- the ATO had little experience with monitoring cross border money flows
- there were comparatively few DTAs, none of which provided for automatic exchange of information
- the ATO was not equipped to devote resources to information gathering
- collecting, collating and manipulation of information was not automated
- there may have been difficulties in identifying beneficial ownership of foreign companies

None of this represents the current commercial and regulatory environment.

Following the opening of the Australian financial system, to facilitate the changed policy for Australia's monetary system AUSTRAC was established under the *Financial Transaction Reports Act 1988* as the primary reporting agency governing cross border money flows. Since that time, under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, comprehensive data is collected, and the cross-border cash flows are strictly monitored. AUSTRAC makes information available to the ATO.

Now:

- most of Australia's comprehensive DTAs have provision for automatic exchange of information

[15] See ATO discussion of application of transferor trust rules at https://www.ato.gov.au/Forms/Foreign-income-return-form-guide-2019/?anchor=Part_2_Application_of_section_99B#Part_2_Application_of_section_99B

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- the OECD (and other international bodies such as the European Union) insist that countries enter exchange of information agreements
- Australia now has an extensive network of tax agreements directed solely at the exchange of information
- the ATO has the computer resources to manipulate the data it collects

Like the environment that existed when CMAC was introduced, the landscape for the cross-border information gathering has fundamentally changed. The information sources available to the ATO are significant and are ever expanding. Additionally, the ATO, using the major government funding for the Tax Avoidance Task Force, can apply advanced analytical tools to assist in its analysis of foreign entities.

ATO foreign information sources include the following global initiatives (in addition to occasional disclosures such as those which arise under the Panama Papers or Lux Leaks disclosures):

- enhanced information exchange and mutual assistance provisions under DTAs
- tax Information Exchange Agreements for countries which do not have DTAs
- pressures on tax havens arising from the EU grey list of non-cooperative tax jurisdictions for jurisdictions not compliant with good governance tax standards
- the "Common Reporting Standard" (CRS) for the reporting and exchange of financial account information on foreign tax residents (Australia has adopted the CRS and received the first exchange of information in 2018[16]
- the ATO is an active participant through the Global Forum on Transparency and Exchange of Information pursuant to which countries exchange information including relating to beneficial ownership, engage in peer reviews and improve their national systems
- country adoption of disclosures of beneficial ownership arising from the Financial Action Task Force (FATF) to combat money laundering and terrorist financing, and the G20 High-Level Principles on Beneficial Ownership Transparency to improve the transparency of beneficial ownership information.
- the UK is already providing beneficial ownership data[17] which we expect is available to the ATO. EU countries are obliged to do so in 2020
- Australia has commenced policy development in relation to a Beneficial Ownership Register (BOR) as summarised at section 1.2 of the Open Government Partnership Australia,[18] a Freedom of Information Treasury response identifies the next step required by the government[19]
- Australia is a key participant in the Joint Chiefs of Global Tax Enforcement, known as the J5, formed in mid-2018 to lead the fight against international tax crime and money laundering.

The above processes are operational and developing.

We note that the J5 brings together leaders of tax enforcement authorities from Australia, Canada, the UK, US and the Netherlands as outlined on the ATO website[20]. These initiatives enable ownership data

[16] https://www.ato.gov.au/General/International-tax-agreements/In-detail/Common-Reporting-Standard/?=redirected
[17] https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8259
[18] https://ogpau.pmc.gov.au/commitment/12-beneficial-ownership-transparency
[19] https://treasury.gov.au/foi/2528
[20] https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Joint-Chiefs-of-Global-Tax-Enforcement/

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in relation to company beneficial ownership to counter tax evasion. This included, as per the ATO[21], a 23 January 2020:

> "Global tax chiefs … unprecedented multi-country day of action to tackle international tax evasion. A globally coordinated day of action to put a stop to the suspected facilitation of offshore tax evasion has been undertaken this week across the United Kingdom (UK), United States (US), Canada, Australia and the Netherlands"

The ATO's Deputy Commissioner and Australia's J5 Chief, Will Day, said that this operation shows that the collaboration between the J5 countries is working:

> "Today's action shows the power of our combined efforts in tackling global tax crime, fraud and evasion. This multi-agency, multi-country activity should degrade the confidence of anyone who was considering an offshore location as a way to evade tax or launder the proceeds of crime."

The above processes are operational and developing.

As well, Australia is participating in the international G20/OECD/Inclusive Framework initiatives addressing digitalisation of the international business environment. This is likely to see multilateral agreement developed in 2020, potentially involving the concepts currently referred to as Pillar 1 and Pillar 2. These will also lead to enhanced system integrity and information available to the ATO associated with foreign companies.

6. Corporate restructuring and inversions (consultation question 5)

The Board asks whether some form of corporate restructuring will take place if an incorporation-only test is introduced and has specifically referred to "inversions".

In brief, the imputation system militates against an inversion by a resident publicly listed or widely held company. Generally, the capital of Australian based multinationals is predominantly owned by Australian based shareholders, and a significant share of the total capital of those companies - 35% to 40% - is owned by Australian superannuation funds.[22] This makes imputation fundamental to the capital management of an Australian based multinational and militates against inversions.

Further, we note that there would generally be no incentive for an inversion since:

- Australia's general exemption of foreign companies or branches of an Australian company eliminates that as a perceived tax benefit of an inversion
- the general taxation of the foreign source income of a non-resident company eliminates that as a perceived tax benefit of an inversion
- the Australian base for a foreign incorporated company would be taxable in Australia as a permanent establishment or branch
- services provided by the Australian base/management centre to a foreign incorporated company would be required to be commercial under our Australian transfer pricing laws

[21] https://www.ato.gov.au/Media-centre/Media-releases/Global-tax-chiefs-undertake-unprecedented-multi-country-day-of-action-to-tackle-international-tax-evasion/

[22] These are general statements and estimates and are not based on EY's own research. We expect that, if relevant to the Board's considerations, Treasury is better placed to provide the Board with detailed and accurate statistics.

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A further disincentive would be that Part IVA would make inversions of Australian companies with no commercial basis difficult.

Although no one can make definitive statement on this matter, it is unlikely that inversions motivated by Australian income tax considerations will result from the change to an incorporation-only basis for residency.

6.1 The concept of an inversion and the underlying policy considerations

One concern may be that a change to an incorporation-only basis will result in Australian resident groups being “inverted” for tax purposes, based on the experience in the US.

The US experience involved situations where a US incorporated corporate group, widely held and listed on the stock exchanges, was restructured such that the parent company located in the US became a subsidiary of a foreign company and the ultimate shareholders were substantially the same, while at the same time the management of the group did not change (i.e. the higher-level management of the new parent company remained with its subsidiary). This was the original concept called in the US a “naked inversion”. Because it is assumed that such inversions were motivated purely by tax considerations the term has gained a pejorative connotation.

Under the current law, if an Australian company was acquired by a foreign incorporated company and the CMAC of the new parent company would be in Australia, the new parent would be a resident of Australia. Under an incorporation-only test the new parent company would be a non-resident.

We submit below that US-style inversions would be most unlikely to occur in relation to Australian listed companies or any company seeking to benefit from the imputation system.

6.2 The US environment

The US income tax rules caused inversions to be of interest for a number of reasons:

- the US CFC rules allowed low-taxed foreign income to be generated in foreign subsidiaries of US groups
- the US did not have a general exemption from taxation of a foreign dividends, so dividends from foreign subsidiaries would be taxable to the US parent company with broadly tax credits for underlying foreign taxes. However, if the foreign subsidiary had suffered only minimal or no income tax, the US parent company of a multinational group was disinclined to receive dividends from its foreign incorporated subsidiaries.
- the US had a high nominal corporate tax rate. While there were various benefits for onshore US businesses, the high corporate tax rate would apply in relation to dividends received from foreign subsidiaries in many cases
- the US does not have an imputation system, and as a result there could be a further detriment to the shareholders of the US parent to receive dividends paid out of the foreign profits of a US company (i.e. the taxation of companies and their shareholder can result in classical double taxation).
- the US does not have a general anti-avoidance rule like Australia’s Part IVA, and, broadly, a transaction which was commercially explicable and beneficial might not attract the operation of any general anti-avoidance rule. Nor did the US have a Diverted Profits Tax like Australia’s, or a Multinational Anti-Avoidance Law like Australia’s.

The US saw multiple successive tax policy actions against inversions, including, very broadly:

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- preventing “naked inversions” whereby a mere foreign holding company without any real business activity acquired a US company, by requiring a foreign acquirer to have a specified percentage of the overall business of the merged foreign and US group
- increasing the foreign acquirer’s minimum business percentage of the merged foreign and US group to 25%
- targeting transactions where US shareholders handled more than 80%, then later more than 60% of the stock in the merged foreign and US group
- treating various transactions of inverted companies as taxable in the US
- action to strengthen the US thin capitalisation laws

As well the US introduced the 2017 tax reform contained in the *Tax Cuts and Jobs Act* (**TCJA**) which included a range of substantial measures, notably:

- lower corporate taxes on onshore US corporate income
- stronger rules to counter the use of deductible payments to controlled foreign companies in low tax jurisdictions (under the broad acronym of base erosion anti-abuse taxation (**BEAT**)
- restricting the ability of inverted companies to bring back profits into the US

6.3 The UK environment

We understand that in the UK inversions did occur prior to the reform of the UK’s tax system to reduce the rate of corporate tax, introduce limits to the taxation of the foreign income of UK companies, and the introduction of tax relief for shareholder designed to reduce double taxation (which in some respects can be more generous that Australia’s imputation system). Further, we understand that consideration of inversions occurred more recently for UK multinationals because of the possibility of the United Kingdom ceasing to be a member of the EU under BREXIT.

However, once the UK reduced its rate of corporate tax and reduced the taxation of foreign income it appears that inversion activity ceased.

6.4 The Australian environment

In contrast to the US, the underlying policy for Australian corporate tax is CIN. We submit that it is inappropriate to compare the possibility of the inversion of an Australian company (where the policy is CIN with an imputation system) with the possibility of the inversion of a US company (where the policy is capital export neutrality with little relief at the shareholder level).

In addition, the imputation system makes it desirable for a company with an Australian shareholder base to be incorporated in Australia. As noted, generally, the capital of Australian based multinationals is predominantly owned by Australian based shareholders, and a significant share of the total capital of those companies - 35% to 40% - is owned by Australian superannuation funds.[23] This makes imputation fundamental to the capital management of an Australian based multinational and militates against inversions.

We note also that Australia has a wide range of laws which would apply if a foreign incorporated company had its central management and all located in Australia. These would include:

- the Australian base for the foreign incorporated company would be taxable in Australia as a permanent establishment or branch

[23] These are general statements and estimates and are not based on EY’s own research. We expect that, if relevant to the Board’s considerations, Treasury is better placed to provide the Board with detailed and accurate statistics.

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- services provided by the Australian base/management centre to the foreign incorporated company would be required to be commercial under our Australian transfer pricing laws
- Part IVA would make inversions of Australian companies with no commercial basis difficult.
- Australia's general exemption of foreign companies or branches of an Australian company eliminates the perceived tax benefit of an inversion and the general taxation of the foreign source income of a non-resident company eliminates the perceived tax benefit of an inversion,
- Australia's imputation system does not allow a non-resident company to pay franked dividends to Australian shareholders

Although no one can make definitive statement on this matter, it is unlikely that inversions motivated by Australian income tax considerations will result from the change to an incorporation-only basis for residency.

6.5 Potential responses to inversions

While specific anti-inversion measures could be implemented in response to any perceived specific integrity risk, based on the US experience it is reasonable to expect that the specific integrity measures would be complex. However, other responses might be considered.

Any significant inversion would be subject to Australia's Foreign Takeovers Act would need to be reviewed and approved by the Foreign Investment Review Board (**FIRB**). If there is a residual concern that inversions might affect the Australian revenue, approval by FIRB would be dependent on FIRB being satisfied that the proposed transaction did not adversely affect the Australian income tax base.

Part of FIRB's role is to consider whether an acquisition of an Australian company by a foreign company would not give rise to adverse income tax outcomes. For example, prior to the introduction of the original thin capitalisation measures, part of the FIRB process was to review the level of related party debt funding of the acquisition, and as part of the process the matter was routinely referred to the Commissioner. Currently, every significant foreign investment including in Australian infrastructure projects and restructures of existing foreign-owned Australian businesses is subject to FIRB review processes, which involve ATO scrutiny. This scrutiny gives the FIRB, ATO and government a high degree of information about foreign takeovers and transactions.

We submit that any adoption of an incorporation-only test could be accompanied by a government announcement highlighting the role of the FIRB in monitoring behavioural responses, and noting the readiness of government to take further action if inappropriate behaviour occurred.

Given that it is unlikely that there will be significant inversions of Australian multinationals, the impact on the revenue would be minimal.

7. Evaluation of effects

We are unable to assist the Board with the evaluation of the effect of restructuring on Australia's corporate tax base. The behavioural changes can only be costed by the Treasury and the ATO.

However, we expect that the following matters will need to be taken into account:

- the number of foreign-incorporated companies that lodge their income tax income tax returns on the basis that the company is a resident of Australia is, we expect, not significant. The tax imposed on these companies would accrue also under Australia's source based system for taxing foreign residents. However, there might be revenue involved if these companies derived "passive" foreign

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source income directly or through a non-resident CFC. Transitional provisions can be implemented to ensure that these companies remain residents while their CMAC is in Australia, which would ensure that there is no adverse revenue effect. We have discussed the possible transitional measures at Section 11 below

- to the best of our knowledge, tax revenue forecasting does not take into account estimate of revenue that might have arisen under the current laws if the Commissioner had been aware of tax avoidance arrangements (e.g. Bywater arrangements). On this basis, such arrangements cannot have a revenue effect for corporate tax collections in previous years or projections for future years (i.e. these are "windfall gains" to the revenue)
- fixing the company residence laws so that CMAC could not be a mechanism for obtaining a different tax outcome (e.g. by importing foreign tax losses) might protect the corporate income tax base

While these areas might need to be explored the incorporation-only test should not be rejected on the basis that there *might* be unspecified adverse revenue effect, without considering identifiable positive revenue effects.

8. The Bywater related cases

We are concerned that there is a perception that these types of arrangements require major initiatives at policy or design level (or otherwise dealt with as integrity measures), and that this might stand in the way of consideration of the residence issue.

In the Bywater related cases there was little apparent commercial or economic basis for the companies to be incorporated outside Australia and the putative ownership of the companies was an attempt to obscure reality. In some cases, there was no basis for the company's existence at all. The arrangements in the Bywater related cases were "blatant, artificial and contrived" and some aspects can be described as a sham.[24] Put simply, the arrangements were egregious, offensive and the full operation of the law was disregarded.

The arrangements in the Bywater related cases might have been adequately dealt with by applying the:

- existing source principles
- existing CFC measures (the application of the CFC measures to the Australian apparent controller Mr Gould was mentioned in the litigation, but not explained)
- general anti-avoidance measures in Part IVA (refer to Section 9 below).

On a go-forward basis the principal purpose test in the DTAs might also apply. As reported in the media, it appears that at least some of the parties committee criminal offences in the process.

All these arrangements occurred under the current law. Therefore, these arrangements are **not** an example of an integrity issue that is relevant to whether an incorporation-only test should be adopted.

9. The role of Part IVA and the DTA "principal purpose" tests

Part IVA or the principal purpose tests in the DTAs should (and do) deal with extreme circumstances.[25] They should not be the relied on to ensure that the law operates according to the policy intent. Systemic

[24] We have used the expression "blatant, artificial and contrived" because it has often been used as a convenient way to describe the arrangements to which Part IVA was intended to apply.
[25] Our reference to Part IVA includes the Multinational Anti-Avoidance Law and the Diverted Profits Tax

integrity concerns can only be dealt with at the level of the development of the policy itself, and specific integrity concerns should be dealt with when the law is designed.

But the benefit of Part IVA (and now the principal purpose tests in the DTAs) is that they allow the policy and the design features of the law to be developed free of concern about extreme circumstances.

In our previous submission we noted that the blatant avoidance of the incorporation-only test could be dealt with under the general provisions of Part IVA Diverted Profits Tax and the Multinational Anti-Avoidance Law. We now consider the potential application of Part IVA in more detail.

9.1 Part IVA generally

The general provisions of Part IVA are suited to mitigating the more abusive misuse of an incorporation-only test.

The application of Part IVA is fact specific. In practice, the complexities of medium to large businesses makes the fact-finding process difficult and can impose a compliance burden for taxpayers and consume ATO resources. There is further difficultly in the judgements that needs to be made when weighing the eight factors set out in the legislation.

Even so, the Commissioner has invariably been successful when applying Part IVA to "marketed schemes"[26], in which the facts a reasonable straightforward, and in circumstances that had little or no commercial basis for the narrow arrangement. The Commissioner's significant losses were in cases where there was a clear commercial basis for the arrangement, but the conclusion based on the weighing of factors was difficult[27] or where on the facts the Court concluded that Part IVA was quite clearly not an issue.[28] Other decisions on Part IVA can best be described as decisions on the development of the principles of Part IVA.[29]

9.2 Diverted Profits Tax

The underlying principles of the Diverted Profits Tax are suited to the application to arrangements that seek to misuse an incorporation-only test, specifically the "principal purpose" test (in contra-distinction to a "sole or dominant purpose" test) and the exemption where arrangements have economic substance.

The Diverted Profits Tax regime came into effect on 11 December 2015, and we doubt that the Commissioner has had the opportunity to fully explore its practical application.

We expect that the Commissioner's concern might be with persons are not part of the same corporate group. Further, one issue with using the DPT is that it is limited to significant global entries (**SGEs**). Consequently, if the Diverted Profits Tax regime was to be an effective counter to misuse of the incorporation-only test, the thresholds for its application could be reduced but strictly confined to misuse of the incorporation-only test.

There might be administrative issues in applying to the Diverted Profits Tax regime to smaller taxpayers, and with smaller taxpayers themselves ensuring that their activities were not subject to it. Unless the Commissioner released a detailed compliance guide for the benefit of taxpayers and ATO officers,

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[26] Examples include *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 and *Hart v Commissioner of Taxation, Puzey v Commissioner of Taxation* [2002] FCA 1171

[27] Compare *Metal Manufactures Ltd v Commissioner of Taxation* (1999) FCA 1712 and *Eastern Nitrogen Ltd v Federal Commissioner of Taxation* (2001) 108 FCR 27

[28] For example, *Noza Holdings Pty Ltd v Commissioner of Taxation* [2011] FCA 46

[29] For example *Commissioner of Taxation of the Commonwealth v Peabody* (1994) 181 CLR 359

Building a better working world

taxpayers would face increased compliance costs and ATO auditors would face misallocation of resources. Development and a compliance guide specifically for small taxpayers might be time consuming, but there will benefits to the ATO and the Revenue in applying resources to those arrangements that have little or no substance (being the primary target of the regime).

9.3 The principal purpose test in the DTA

There appears to be a concern that a company could be incorporated in a foreign country with which Australia has a DTA, and derive what, absent the DTA, would be Australian source income or gains. Provided that the gains are not derived in carrying on business at or through a permanent establishment in Australia, the DTA would have the effect that the income or gains were not taxable in Australia.

A similar argument arose in the Bywater related cases, although in the Bywater related cases the Court decided that based on the facts the relevant companies were not resident of a DTA country (Switzerland or the UK).

If a company could successfully argue that it was a resident of the foreign country, the principal purpose test in the DTA would need to be considered. Although the Court has not yet considered the meaning of "principal purpose", it is possible that this will be a lower threshold than a sole or dominant purpose test. It is our understanding the Australia's DTA negotiating position is that DTAs must contain a principal purpose test, which is consistent with the MLI.[30] [31]

From an administrative standpoint the principal purpose test is "self-executing". Unlike Part IVA, the Commissioner's resources will be devoted to reviewing whether the taxpayer has correctly applied the law, and then apply a discretion to deny the tax benefit. The Commissioner's resources will simply be devoted to ensuring the taxpayer has correctly applied the law.

9.4 Multinational Anti-Avoidance Law

The Multinational Anti-Avoidance Law is a part of the suite of measures aimed at avoidance of Australian tax.

Put broadly, the law might apply where a foreign company supplies goods or services to an Australian (non-associate) and an associated resident that is commercially dependent on the foreign company undertakes activities directly in connection with the supply of those goods or services. If the income is not already connected with a permanent establishment in Australia, the law might apply if the principal purpose, or one of the principal purposes of the scheme, was to obtain an Australian tax benefit or to obtain an Australian and foreign tax benefit.

Although the law only came into effect for income years commencing on or after 1 January 2016, the Commissioner now has experience with applying it. Subject to our comments below regarding the threshold for the law, it might have some relevance to preventing avoidance related to an incorporation-only test. However, the principle of the law is that there are dealings with third parties and a resident is commercially or economically dependent on the foreign company, which covers many but not all of the potential issues.

[30] Most DTAs contain a principle purpose test (either because it is contained in the DTA or because they are covered tax agreements under the MLI). The US DTA has a limitation of benefits test.
[31] From an administrative standpoint the principal purpose test is "self-executing". Unlike Part IVA, the Commissioner's resources will be devoted to reviewing whether the taxpayer has correctly applied the law.

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Consistent with the Diverted Profits Tax regime, if the law was to be used as an anti-avoidance measure to avoid misuse of the incorporation-only test, the threshold for its application might need to be reduced, again confined to the misuse of the incorporation-only test.

Nevertheless, the law has its role in the suite of anti-avoidance measures available to the Commissioner.

10. Australia's international tax commitments

10.1 Renegotiation of DTAs

It has been suggested that a change to incorporation as a sole test of residency might lead to protracted negotiation processes with other countries. We do not understand the basis for the statement.

Since our earlier submission, we have further examined Australia's international tax commitments. Put broadly, all of Australia's DTAs define a company as a resident of Australia solely by reference to whether that company is a resident of Australia for the purposes of Australian tax. The DTA residence references do not require the Australian residence to be by incorporation or otherwise. Further, the change to an incorporation-only test would not change the basis on which the tie breaker provisions of Australia's DTAs operate.

Our research suggests that incorporation as a sole test of residency is not contrary to any of Australia's DTAs, and none of Australia's DTAs would need to be amended or renegotiated (including the DTAs that are Covered Tax Agreements under the MLI). Further, the *International Tax Agreements Act 1953* would not need to be amended in our view.

It is not our place to speculate on the possible reaction of Australia's DTA partners. All that we can say is that, based on international practices and policy statements, there is no apparent basis to expect that our major trading partners would have any concern. Provided that a DTA does not *necessarily* need to be amended, and in the absence of any evidence or reasoned argument, it is counter-intuitive to expect that the mere notification of a change in Australia's residency test with no effective change to the tie breaker would lead to any objections by any DTA partner.

In any event, there is no need to speculate since the matter can be easily explored with each DTA partner by the Competent Authorities.

10.2 OECD limitations on an incorporation-only test

Since our earlier submission, we have further examined OECD limitations on incorporation as a sole test of residency.

The *OECD Model Tax Convention on Income and on Capital* and its Commentaries, the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and its Explanation do not clearly support any conclusion that the OECD considers that incorporation as a test of residency is unacceptable.

The tie breaker is different. The OECD was concerned about incorporation as a sole test for purposes of the tie breaker under DTAs. Australia's DTAs almost exclusively base the tie breaker on criteria other than incorporation. Further, Australia has notified the OECD depository that its position is a tie breaker based on place of management and agreement by the Competent Authority. Changing to an incorporation-only test will not necessitate changing the definitive list lodged with the OECD depository. Further, based on the definitive lists and provisional lists of other countries which Australia has a DTA (as per the OECD database as at 31 October 2019) no other DTA could be affected.

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We acknowledge that Article 4 of the OECD Model Tax Agreement refers to a liability to worldwide taxation based on domicile, residence, place of management or any criterion of a similar nature (arguably, incorporation is not "of a similar nature"). The Commentary to the OECD Model Tax Agreement then expands on this concept. However, notwithstanding that Australia generally follows the OECD Model Tax Agreement, it has been a longstanding practice for Australia's DTAs to initially define a resident of Australia *solely* by reference to whether a company is a resident of Australia for the purposes of Australian tax. Incorporation is, *per se*, irrelevant. Of course, consistent with the requirement in Article 4, DTA benefits might be denied where a company is not subject to tax on its world-wide income, but in Australia's DTAs this has nothing to do with the domicile, place of management etc of the Australian resident company.

Regarding the BEPS process, the Options Paper noted:

> "… a prevalence of organisations **exploiting differences between countries** with incorporation-only tests and countries utilising a version of the real seat rule was one impetus behind the OECD's BEPS agenda". (emphasis added)

We consider that the substantive issue that concerned the OECD was not incorporation as a test of residency, *per se*, but with organisations exploiting differences between countries with different tests of residency, and incorporation as a sole test of residency being an obvious example.

Notwithstanding, the outcome of the BEPS agenda did not mandate that countries depart from incorporation as a sole test of residency. Instead, the OECD included recommendations that were intended to overcome the issue, which led to the MLI proposal for companies intending to use DTA tiebreaker rules to approach the competent authorities of both jurisdictions for resolution of the issue.

Although in a slightly different context, we note that the General Secretariat of the Council of the European Union, in its memo on the issue of non-cooperative jurisdictions released on 4 October 2019, specifically stated that there was no issue with companies basing their tax system on source, if this was supplemented by robust CFC measures.[32]

In any event, whether the OECD has concerns, and the nature and extent of any concerns, can be tested directly with the OECD by the Australian Government.

11. Transitional provisions (Consultation question 7)

A transitional rule would be required if there is a change to an incorporation-only test (in the same way as a change in the CMAC test would require consideration of a transitional rule). Because the scope of this submission has been confined to the incorporation-only test, the discussion of transitional rules here is similarly restricted to a change to an incorporation-only test.

As noted in the Options Paper:

[32] https://www.consilium.europa.eu/en/press/press-releases/2017/12/05/taxation-council-publishes-an-eu-list-of-non-cooperative-jurisdictions/pdf

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> "… the adoption of an incorporation-only test will necessitate the implementation of transitional arrangements to deal with existing companies incorporated outside Australia that treat themselves as Australian residents, and file tax returns accordingly".

However, we do not accept that a potential adverse effect should govern the design of the Australian income tax system.

We assume that few foreign companies currently lodge Australian income tax returns on the basis that they are residents of Australia. On that basis, the impact of a change to an incorporation-only test is likely to affect few companies.

The simple resolution is for a foreign-incorporated company to remain a resident of Australia if it is currently lodging income tax returns on the basis that it is a resident of Australia, provided that the company maintains its CMAC in Australia. If so, the change to an incorporation-only test would have no effect on the company (e.g. the CGT and consolidations issues mentioned would not arise). Once a foreign-incorporated company ceases to maintain its CMAC in Australia all the income tax impacts of a change in residency would arise (e.g. the CGT and consolidations issues mentioned above) in precisely the same way as under the currently law.

Thus the CMAC test would have a residual operation and would remain an ongoing issue but based on an assumption that few companies currently lodge income tax returns based on CMAC (which would need to be tested) the issue will be confined and of diminishing relevance over time.

Whether the timing for the transitional is based on the lodgement of returns for the year ended before the commencement date or the year after the commencement date, or another date, is a minor policy issue.

The Commissioner might be concerned that this transitional rule might constrain the ability to deal with existing *Bywater* type situations. We remain sceptical that CMAC was necessary to deal with this type of egregious behaviour. However, if the Commissioner has fundamental concern, consideration could be given to a transitional rule that treated a foreign company as a resident of Australia on an ongoing basis if it had its CMAC in Australia, even though it had not lodged a return. However, in doing so, the Commissioner would be required to rely on the statements in the original taxation ruling on CMAC.

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Attachment A

Reviewing the design features of Australia's international tax rules

We have briefly set out below our views on the design feature of Australian corporate international tax system, taking into account that the development of the Australian corporate international tax system has the effect that provisions of the Tax Acts that were originally introduced to "protect the revenue" now, *viewed together with the basic provisions of the corporate tax system*, implement the policy for the taxation of companies (i.e. CIN and, generally, national neutrality for the resident shareholder).

1. The exemption of foreign branch income

Put broadly, at a high-level, the taxation of foreign source income and the exemption of foreign income in the corporate international tax system can be summarised as follows:

- where income is derived by a resident or non-resident company from a **source in Australia**, Australia may (and does) exert its right to tax the amount. The source of the income is generally determined according to "ordinary concepts"[33]. The withholding tax system is slightly different and can be described as a "quasi source" rule (e.g. interest paid by a resident company to a non-resident company is a taxed notwithstanding that it might not be sourced in Australia under ordinary concepts)
- where the **active income** derived by a resident company is derived in carrying on business at or through a **permanent establishment in a foreign country**, Australia may (but generally does not) exert its right to tax the amount
- where the **passive income** derived by a resident company is derived in carrying on business at or through a permanent establishment in a foreign country, Australia may (and generally does) exert its right to tax the amount
- where income derived by a non-resident company **does not have a source in Australia**, Australia may (but does not) exert its right to tax the amount
- Australia does not tax foreign branch income of an Australian resident when it is remitted to Australia and, similarly, Australia does not tax Australian branch income of a non-resident on a remittance basis

We submit that this is the basic scheme for the taxation of companies, and all other features of the Australian corporate income tax system including the dividend exemption and the CFC measures, must be viewed taking into account this paradigm.

2. The role of the CFC measures

The CFC measures were introduced in 1990 as an anti-avoidance measure. Even then, the original proposal was that the CFC measures would implement capital export neutrality.[34]

The CFC measures are no longer merely anti-avoidance measures. Put broadly, the role of the CFC measures as an anti-avoidance measure changed in 2004 when the non-portfolio dividend and the foreign branch exemptions (originally included as compliance measures) were extended to apply to all "active" income as already defined in the CFC measures. While legislatively the income derived at or

[33] Australia's DTA include deeming provisions that might affect the source of the income.
[34] Draft White Paper , *Taxation of Foreign Source Income: A Consultative Document* (1985), *Taxation of Foreign Source Income: An Information Paper* (1989)

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through a branch become consistent with the CFC measures, in policy terms the CFC measures became consistent with the paradigm set out in Section 1 above:

- leaving aside income taxed under the withholding tax provisions, where income derived by a CFC is already taxed in Australia (other than under the withholding tax provisions) the amount is disregarded under the CFC measures. This is analogous to the taxation of a non-resident foreign company
- where the income derived by a CFC is active income the income is generally not subject to tax under the CFC measures. This is analogous to Australia's treatment of any resident with a branch in a foreign country
- where the income derived by a CFC is passive income, the income is generally subject to tax under the CFC measures according to the resident owner's interest in the CFC. This is analogous to the taxation of any resident having a branch in a foreign country
- where the income of a CFC accrues for the benefit of a non-resident with an interest in the CFC, the income is not taxed under the CFC measures. This is analogous to the treatment of a non-resident that derives income from a source outside Australia

Therefore, removing the CMAC rule makes no difference to the amount taxed in Australia.

However, the CFC measures do not precisely replicate the branch exemption, and to this extent integrity issues might arise. We have discussed the integrity issues in Attachment B.

3. The taxation of dividends

The taxation of non-portfolio dividends derived by a resident company generally follows the paradigm set out in Section 1 above. Like foreign branch income remitted to a resident company, Australia does not tax foreign profits remitted to Australia by a foreign company in the form of a dividend provided that the Australian shareholder has the requisite interest in the foreign company. Consistent with the CFC measures, as a pragmatic matter, the requisite interest was set at 10%.

As part of the Conduit Foreign Income (**CFI**) measures, a dividend paid by a resident to a non-resident from non-portfolio dividends is not taxed, which is consistent with dividends paid by a resident to a non-resident from foreign branch income.

Therefore, removing the CMAC test generally makes little difference to the amount taxed in Australia.

We note that in some cases removing the CMAC test can potentially increase taxation, since the dividends paid by the non-resident (under an incorporation only rule) from sources in Australia might be included in the assessable income of the shareholder. For example, a dividend paid by a foreign incorporated company that has its CMAC in Australia would not be subject to tax if they were franked or declared to be CFI. The on-payment of dividend would be unlikely to be subject to Australian tax. However, under a sole-incorporation test the dividends paid by that company might be subject to tax with no benefit of the imputation system.

4. The role of transfer pricing

The principles for the taxation of a company's income (as discussed at Section 1 below govern *whether* the income of a company is taxed. However, the *amount* that might be taxed is then governed by the transfer pricing provisions.

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Originally, the transfer pricing provisions were best described as an anti-avoidance measure but that is no longer the case. Now, the transfer pricing measures are predicated on the underlying concept that the return to the company is allocated to jurisdictions based on economic substance (functions, assets, risks etc). To the extent that the foreign company has at least some substance from activities in a particular country, the return to the company for that economic activity will be allocated to the company, but the return for Australian economic substance of the company will still be allocated to, and taxed in, Australia irrespective of whether the company is a resident of Australia or not. Based on the trend since 1990, considering the modifications to the transfer pricing provisions in 2015, and the unavoidable world-wide trend the impact of transfer pricing provisions is only likely to increase. It is sufficient to note that the current transfer pricing provisions are adequate to deal with the allocation of an appropriate return to the economic activities conducted in Australia, and unlike the former transfer pricing provisions there is now no presumption that that there is a purpose of avoiding tax.

An Australian company, a foreign company and a CFC are all subject to the transfer pricing rules.

Therefore, the same rules apply irrespective of whether the income is derived by a resident of Australia in respect of activities in Australia, the income non-resident deriving income with an Australian source, or the passive income of a CFC. Changing to a sole-incorporation basis will have no significant effect.

5. The role of thin capitalisation

Thin capitalisation was originally a legislative mechanism that replaced the requirement for the FIRB to review foreign investments.[35] Since FIRB's considerations previously took into account the effect of an investment on the Australian revenue and FIRB of foreign investments were routinely referred to the ATO (i.e. the FIRB tax considerations were themselves anti-avoidance in nature), the original thin capitalisation measures could be considered a specific "anti-avoidance" measure as they were restricted to related party borrowings.

However, the existing thin capitalisation measures apply whether or not the lender is related to the borrower.

6. Imputation, Conduit Foreign Income and withholding taxes

The interaction of the CFI measures and the withholding taxes measures ensures that the remittance of profits by a resident company to a non-resident shareholder out of exempt foreign branch income or exempt foreign dividends is not taxed. The principle is that Australia should not tax Australian resident companies raising capital from offshore for foreign investment. However, only an Australian resident company can provide franked dividends.[36]

The imputation system is a means of preventing classical double taxation of dividends, irrespective of whether the shareholder is a resident of Australia or not. The result is that profits (wherever derived) remitted to resident of Australia will be taxed with a credit for the Australian tax paid by the company (and national neutrality will apply), and profits derived in Australia after remittance to non-resident will (after withholding tax) have been taxed at the full corporate tax (subject to a DTA).

[35] Page 16 of the Explanatory Memorandum to the *Taxation Laws Amendment Bill (No.4) 1987*
[36] This ignores the application of the imputation to trans-Tasman arrangements, which is a minor aspect of the imputation system.

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Attachment B

CFC measures and integrity concerns

The CFC measures were based on a policy that there were usually valid reasons for an Australian company or group to incorporate a foreign company to conduct business, irrespective of the type of income and gains, and deferral of Australian tax until the profits were remitted to Australia was acceptable. However, in some circumstances Australian taxpayers were not entitled to defer tax on some types of income, because there was a risk that these types of income might have been diverted to the foreign company to minimise Australian tax.

The CFC measures could have been based on a purpose or motive test. However, the Government rightly decided that a purpose or motive test would be complex, overly fact dependent, difficult to comply with, and difficult to administer. The Government decided that the policy would:

- apply to foreign companies that were "likely" to be influenced by resident taxpayers (i.e. CFCs)
- apply to taxpayers that were likely to influence that behaviour (i.e. attributable taxpayers)
- identify the types of income and gains that were "prone" to diversion (i.e. tainted income)
- tax the attributable taxpayer on its economic interest in the income (i.e. its attribution interest)
- calculate the diverted income based on Australian tax principles

There are four specific integrity rules within the CFC measures, being:

- the entitled to acquire rule and tracing through trusts
- the "control rule"
- the eligible designated concession income rules
- the 2004 Regulations

We have a fundamental concern that consideration of the need for an integrity measure to supplement an incorporation-only test will not pay regard to the breadth of the definition of a CFC.

If there is an integrity measure to supplement to an incorporation-only test, that integrity measure should not merely mimic the CMAC test, should only apply in abusive circumstances (or where it is reasonable to assume that there might be abuse), should not have a purpose or motive test, and should not have the effect that the economic owners of the foreign company are taxed on more than their economic share of the income or gain that is not otherwise subject to tax.

In the end, it appears that the only specific integrity concern that might exist is the treatment of foreign company resident in a listed country and, even then, we do not consider the issue to be one that is a function of a change to an incorporation-only test.

1. The CFC control test

The control rule in the CFC measures was defined widely as an integrity measure and it is possible that the full extent of the control rule in the CFC measures might not have been fully presented to the Board. For this reason we have briefly discussed the control rule below.

There seems to be some concern that there might be some difficulty in applying the CFC control tracing rule by disguised ownership. However, similarly artificial arrangements can be used to disguise CMAC so such artificial arrangements should not be conflated with the incorporation-only test. To the extent that the Commissioner's enquiries can identify CMAC of a foreign company, the Commissioner's enquiries can equally disclose "control" for the purposes of the CFC measures. In the end, it is always possible to legislate to include integrity measures, but in contrast evasion can only be punished.

1.1 The *mechanical* control rule in the CFC measures

The CFC measures contain three alternative tests for control. Two of these are largely mechanical: a foreign company will be a CFC if it one of these tests are satisfied:

- five or fewer Australian residents (each having at least 1% interest) have, or are entitled to acquire (directly or indirectly) at least a 50% of the interests in the foreign company
- an Australian resident has (directly or indirectly) at least a 40% of the interests in the foreign company, unless the person can show that another person controls the foreign company (it is unclear if there was any particular reason why 40% was selected as the relevant threshold)

In both tests of these tests, a person and their associates are, in effect, treated as one person. The relevant interests include an interest in share capital of a company, a right to vote or participate in decision making of the company; a right to receive distributions of capital or profits from the company. The additional non-mechanical test applies where an Australian resident controls the foreign company.

Practically, in a corporate group, it is unnecessary to go past the first test of control (five or fewer persons with 50% or more).

Less frequently, the second test is relevant (one person with 40% or more).

1.2 The *de facto* control rule in the CFC measures

The test for control in s. 340(c) will be satisfied if, irrespective of the extent of any interests in a foreign company, a group of five or fewer Australian entities nevertheless controls the company. Whether a group of five or fewer Australian entities controls a foreign company will be a question of fact to be answered according to the circumstances of each case.

Depending on the interpretation of "control" in the CFC context, the third test of control will have the effect that Australian residents cannot merely incorporate a foreign company and escape the CFC measures.

The meaning of control

Commonly it is argued that, under the general concept for "control" of a company, control arises where a person has the right to cast more than 50% of the votes at a general meeting.[37] However, the Courts

[37] *Mendes v Commissioner of Probate Duties (Vic)* [1967] 122 CLR 152, *WP Keighery Proprietary Limited v Federal Commissioner of Taxation* [1957] HCA 2 are commonly cited as authority

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have made it clear that in all circumstances legislation must be interpreted in accordance with the purpose and context,[38] and the term "control" might be affected by its statutory context.[39]

Courts have yet to consider the meaning of "control" in the context of the CFC measures, and the term control might mean something other than the right to cast more than 50% of the votes at a general meeting, since in these circumstances the foreign company would already be a CFC under the first test of control and the control test would not apply to indirect interests in a foreign company (this appears to have been the Parliamentary intention)[40]. It might also be something different to CMAC.

We note that there are relevant differences between the CMAC test and the control test. The CMAC test is focussed on the location of the CMAC and the carrying on business (i.e. Australia), whereas the CFC test is concerned with the residency of the controller and the place of control is irrelevant. Whether this is a relevant difference would need to be considered.

We suggest that this could be considered and clarified as part of a change to incorporation-only test.

1.3 Attribution interests

The control rules in the CFC measures turn, in part, on whether a person has or is "entitled to acquire" a direct or indirect interest or is entitled to acquire an interest in the CFC. The term "entitled to acquire" is widely defined. It is not clear whether the entitled to acquire was a systemic or specific integrity measure, but probably both.

The CFC measures recognise that a person might have an economic interest in a CFC notwithstanding that the resident does not itself hold the interest. To address this situation, a person was taken to have an interest in a foreign company if the person held or was "entitled to acquire" an interest in the CFC. This provision applies both to the control test and to determine the extent of attribution.

Whether or not "entitled to acquire" is defined too narrowly is an issue under the existing CFC measures. It does not go to either CMAC or to consideration of an incorporation-only test.

2. Listed country CFCs

The scope of the CFC measures is affected by whether the company is a resident of a listed country or a resident of an unlisted country, as defined in s.317 of the ITAA 1936 and the *Income Tax Assessment (1936 Act) Regulation 2015* (Canada, France, Germany, Japan, New Zealand, United Kingdom and United States of America. This can affect the scope of the CFC measures as an integrity measure.

The potential limitation of the CFC measures as a systemic integrity measure was recognised in the development of the original CFC measures, and again in subsequent modifications to the CFC measures.

[38] *Project Blue Sky v Australian Broadcasting Authority* [1998] HCA 28
[39] *Re The News Corporation Ltd and Others* (1987) 70 ALR 419
[40] The Explanatory Memorandum to the Bill introducing the CFC measures refers to the possibility of control "irrespective of the extent of any interests in a foreign company".

If the Government decides that there is might be a risk, the mechanisms to use the CFC measures as an integrity measures already exist. This is a simple matter of monitoring changes to the domestic law of seven countries and updating the law by Regulation.

In passing, we note that the list was previously developed on the basis that (amongst other things) Australia had DTAs with these countries and these countries had CFC measures. Since 1990, the number of countries with which Australia has a DTA has grown, the OECD policy has that countries should introduce CFC measures, and that CFC measures are now commonplace. There is therefore a case for adding to the list of listed countries.

2.1 Eligible designated concession income

The general exemption for a CFC resident in a listed country was limited for specific categories of income and gains derived by those countries (eligible designated concession income or EDCI) which can be adjusted in relation to each listed country by Regulation[41]. That list was developed in 1990 and then re-written in 2015 in accordance with "plain English" drafting, but minimal changes were made.

In almost 20 years no substantive changes have been made. We assume, but do not know, that the ATO, Treasury and Government have concluded that no real integrity risk exists.

2.2 The 2004 Regulations

In 2004 the CFC measures were amended to provide that income and profits could be subject to tax under the CFC measures where the following conditions were met:

- the amount was derived from a source outside of the listed country
- the listed country did not tax the amount
- the amount was recognised in Regulations

The income or gains still needed to be tainted income.

The relevant difference with the branch exemption was that the Regulation is based on the source of income and that the connection with a branch is irrelevant.

Regulations have never been made. Again, we assume, but do know, that they have not been used because the ATO, Treasury and Government have concluded that no real integrity risk exists.

If the Government decides that there is a risk, the mechanisms for to use the CFC measures as an integrity measures already exist. This is a simple matter of monitoring changes to the domestic law of seven countries and updating the law by Regulation.

2.3 Ongoing management of the systemic integrity risk

If the Government decides that there is a specific integrity risk, the mechanisms for to use the CFC measures as an integrity measures already exist. This is a simple matter of monitoring changes to the domestic law of seven countries and updating the law by Regulation.

[41] Section 385 which ultimately cross-references to the Regulations

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There is no reason to suppose there is a lack of information which would undermine the integrity of the CFC measures, or that any significant resources would need to be allocated to a necessary change to the law. The DTAs with the listed countries - Canada, France, Germany, Japan, New Zealand, United Kingdom and United States of America - impose an obligation for the Competent Authorities to advise of changes to their domestic tax laws.

We have explained in detail in Section 5 of our submission the many other sources of information now available and yet to come to the ATO.

Conversely, the resources allocated by the ATO to making enquiries regarding CMAC, and the resources allocated to companies responding to those enquires, would be far in access of monitoring the tax laws of only seven countries.