KPMG submission

Board of Taxation
Consultation Guide

Corporate Tax Residency
Reform Options

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Executive Summary

KPMG welcomes the opportunity to comment on the Consultation Guide ("CG") *Corporate Tax Residency Reform Options.*

As we have set out previously, our over-arching position on the matter of reforming the corporate tax residency rules has three components:

1. Australia should adopt an "incorporation-only test" of corporate residency.

While concerns about administration, compliance and potential tax avoidance are worth canvassing in the manner done by the CG, ultimately implementing an incorporation-only test is the simplest and most efficient option for reform in this area. Any revenue risks that may concern the Board have already been adequately addressed by the current framework of tax base protection and anti-avoidance rules in Australia. However, we do concede that this path would pose some challenges, including in relation to our tax treaties, which is why we have offered support for alternative paths of reform.

2. The CMC test should be clarified as a second preference.

However, this is not preferable to an incorporation-only test. The existing voting power test should also be repealed.

3. A company that is solely resident of an overseas jurisdiction under one of Australia's bilateral tax agreements should be treated as non-resident for all purposes of Australian tax.

This would enhance simplicity and certainty regarding a foreign-incorporated company's tax position.

Detailed comments

Consultation question 1

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

In thinking about this question, are there any integrity concerns (such as the prospect of 'importation' of tax losses) that will arise in the event that the CMAC test is modified to ensure that it is applied in two steps?

1.1 KPMG's position remains that an 'incorporation-only' test is preferred. The CMC test and the voting power test should be repealed. Repealing the CMC test would remove the uncertainty of defining central management and control and ensuring it is defined separately to the meaning of 'carrying on a business in Australia' for tax residency purposes.

1.2 The current Australian tax rules are sufficient so that if a foreign incorporated company carries out business operations in Australia, it will still be taxable in Australia on profits as a non-resident. Similarly, if an Australian group incorporates foreign subsidiaries, then foreign sourced profits of subsidiaries are potentially attributed to the Australian parent for tax purposes under Australia's CFC regime, where Australia tax would otherwise be avoided through the subsidiary's non-resident status.

1.3 As noted in our previous submission, the increasing number of integrity rules in the Australian tax law since BEPS and the possibility of future changes under BEPS 2.0 places less emphasis on the need for complex corporate residence rules. In the event these rules are insufficient to address "stateless" income, Ireland is an example that has implemented specific anti-avoidance rules in 2014-15 to ensure 'stateless' income arising because of differences in CMC and residency tests between two countries does not go 'untaxed'.

1.4 If the CMC is retained, the principles in TR 2004/15 should be codified by legislation. The government should modify the legislation to ensure that where a company has its CMC in Australia but does not otherwise carry on business here, it should not be a resident of Australia for tax purposes. It should also reflect the impact of corporate governance and technology changes on the residence of companies. However, we do note that this provision would be open to the same complexities that were covered in TR 2004/15 in relation to the operations of passive investment entities which were generally treated as carrying on business where their CMC was located. As such, we consider that codifying this rule would

lead to additional interpretational complexities for taxpayers which would be obviated by the use of an incorporation-only test.

1.5 As a matter of administrative practice, taxpayers have applied the two-step approach to the CMC test since TR 2004/15. As such, merely clarifying the test to ensure that this interpretation is reverted to should not materially increase the availability of integrity 'gaps' for opportunistic taxpayers to exploit.

1.6 Our comments are confined to corporate structures and we recognise there are entities other than companies that are affected by CMC tests and should also be considered by the Board such as trusts and partnerships.

1.7 Finally, we do acknowledge that implementing an incorporation-only presents some complexities. In particular, we acknowledge that a number of Australia's current tax treaties rely on control-based tiebreaker tests to deal with cases of dual residency, which could override the resident status of Australian-incorporated companies under an incorporation-only test. However, we believe that these complexities are not insurmountable. The use of place of incorporation as a treaty tiebreaker is not unprecedented in Australia's treaties (e.g. it is used in the Australia-Canada DTA), or other global treaties, and the release of the Multilateral Instrument provides another example of a non-control-based test in the form of the competent authority tiebreaker.

Consultation question 2

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

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

- **What requirements/factors do you consider to be important for inclusion in the test in order to clarify what is meant by "carrying on business in Australia" and "central management and control"?**
- **Should the "carrying on business in Australia" aspect of the CMAC test also include a de minimis mechanism under which a company will be deemed not to satisfy the requirements of the first limb in the event that a certain threshold level (such as, for example, Australian turnover of the company as a percentage of global turnover) is not exceeded?**
- **Should the "carrying on business in Australia" test only have effect for the company residence rules?**

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

2.1 As noted above, our preference is to legislate a sole incorporation test to determine corporate residency as we acknowledge that the consultation points raised above are suggestive of the increased complexity that can arise from legislating a two-step test.

2.2 If the Board takes the path of recommending to legislate the CMC test into a two-step test we acknowledge that the lack of definition of CMC and 'carry on a business' in an environment where businesses have increasingly become complex with digitisation has meant these tests are becoming increasingly difficult for the taxpayers and the tax administration to apply. We also highlight the need to address whether existing 'business' definitions – such as the one set out by the ATO on Taxation Ruling TR 2019/1 on when a company carries on business for the purposes of the small business tax concessions – could be leveraged to help formulate a two-step CMC test, and, if not, whether having differing tests of a business for different parts of the tax law creates undue complexity.

2.3 At the same time, we generally think that enacting highly specific legislative decisions for the purposes of a reformed CMC rule carries a greater risk of future confusion and obsolescence as the nature of business continues to change over time and should therefore be avoided if possible. As such, while it is necessary to provide sufficient clarity on the meaning of "carrying on a business" for the purposes of an updated CMC rule, this should be confined to questions of company residence, and should be general in nature. It should take into account principles in TR 2004/15 and updated for the changing nature of businesses including digitalisation of business, the rise of cross border services and use of intangible assets, and a globalised workforce. Another approach would be adopt a modernised 'active income test' in the controlled foreign company (CFC) rules as an objective test to determine whether an 'active business' is being carried on outside of Australia. A more modern 'active income test' might, for example, accommodate a broader class of income such as, for instance, 'passive' income of businesses that regularly undertake investment activities.

2.4 On the CMC test, another approach would be to legislate exceptions to the test to allow existing specific integrity measures to operate such as the CFC rules. If a company is incorporated outside of Australia, the CFC rules should be allowed to operate and protect Australia's tax base even though CMC would otherwise be in Australia. Also if a foreign

incorporated company is in a listed country with a comparable tax system to Australia, then its residency should not be in Australia.

2.5 We would like to emphasise that we do not think that the best solution to this issue is drafting a new, highly-specific, two-stage CMC rule replete with carve-outs and thresholds as the above comments highlight the complexity involved in this regard. As we have set out, we think implementing an incorporation-only test is the simplest way of responding to adapting, global business practices in which the nature and location of CMC is liable to keep changing.

Consultation question 3

The Board seeks stakeholder comment on whether the adoption of an incorporation-only test will be more effective at reducing taxpayer uncertainty and better aligned with modern corporate governance practices, as compared with the retention of a modified version of the CMAC test.

3.1 Consistent with our previous statements on this point, our view is that the adoption of an incorporation-only test is the best option for reform generally, and the most fit-for-purpose when the value of certainty for taxpayers and modern corporate government practices are considered. It is our experience that modern corporate governance standards and communication tools have been significantly influential on the way Australian multinational groups have governed their foreign subsidiaries, and their adoption was enhanced by the certainty given to taxpayers in Taxation Ruling 2004/15. An incorporation-only test also removes issues with divided and multiple residence that comes with a CMC test.

3.2 The recent trend has been that commercial decisions have needed to be made with ever-greater speed. This is especially so in relation to the making of foreign investments through foreign controlled subsidiaries. This means that it is not possible for Australian resident board members of foreign subsidiaries to meet outside Australia to make critical divestment decisions. In this environment, incurring costs simply to satisfy the current CMC test is very costly.

3.3 A well-modified CMC test should theoretically address these concerns. However, the nature of modern corporate practices is not fixed and any modifications would be subject to a risk of obsolescence as business practices continue to evolve. The current trend line suggests that CMC will only become more and more mobile, and the physical parameters within which CMC is performed will only become more nebulous.

3.4 When the administrative simplicity and certainty provided by an incorporation-only test is considered alongside these conditions, it is clear that it is the most suitable and appropriate test of corporate residency, despite the improvements in this regard that would be achieved by sensible modification of the CMC test.

3.5 Furthermore, an incorporation-only test should, in the context of a broader tax regime including strong CFC rules, MAAL, the DPT, Division 832 and Part IVA, and other features mentioned on page 4 of the Board's options paper, not be susceptible to insurmountable integrity concerns.

Consultation question 4

The Board seeks stakeholder feedback on whether there are any technical or compliance considerations of concern that may arise if corporate residency is determined by an incorporation-only test.

4.1 Our position in response to this question remains that an incorporation-only test will be easier to comply with, and simpler to enforce administratively, with any material technical risks being mostly mitigated by the robust framework of anti-avoidance rules that now exist in Australia and globally.

4.2 We do acknowledge that an incorporation-only test will create compliance considerations insofar as it will become even more important for the ATO to maintain robust compliance practices that utilise the range of legislative tools there are to subject bad-faith taxpayers to appropriate levels of taxation. However this would be complimented by the overall simplicity with which incorporation-only could be administered with respect to compliant taxpayers.

Consultation question 5

The Board anticipates that some forms of corporate restructuring will take place in the event that an incorporation-only test is adopted. The Board seeks stakeholders' experience with, and views on, how corporate structures may change in response to such a significant amendment to the residency rules. How could the effects on Australia's corporate tax base be evaluated?

5.1 We do not anticipate widespread tax-motivated restructuring to occur in response to an incorporation-only test being legislated.

5.2 As we have previously commented, questions arise as to how an incorporation-only test would apply to the facts of *Hua Wang Bank Berhad v Commissioner of Taxation* and what

would prevent an Australian-resident taxpayer from incorporating an offshore company to avoid tax.

5.3 Our view here is that this question principally exposes deficiencies in Australia's CFC rules, rather than the incorporation-only test (which were previously highlighted by the Board of Tax in 2007).

5.4 Adding to our comments in response to Question 4, we think it would be consistent with current ATO practice to implement and evaluate robust compliance programs directed at the concerns raised by *Hua Wang Bank*-type structures. Further, multilateral reform on BEPS is also expected this year at the OECD/G20 level and will supplement existing regimes and practices for minimising opportunistic restructuring to the extent that it actually occurs as the result of a potential incorporation-only test.

5.5 In the event these rules are insufficient to address "stateless" income, Ireland is an example that has implemented specific anti-avoidance rules in 2014-15 to ensure 'stateless' income arising because of differences in CMC and incorporation-only residency tests between two countries does not go 'untaxed'.

Consultation question 6

The Board seeks stakeholder feedback on whether an integrity rule (or rules) would be required to supplement an incorporation-only test, and if so in what form? The Board is particularly interested in any observations that stakeholders may have on whether changes would need to be made to the controlled foreign companies rules in the event that an incorporation-only test is adopted, and if so what those changes would be. For example, should a new stateless income rule be introduced? Or should new measures similar to the "transferor trust" approach be introduced to apply to a transferor who has transferred property or services to a non-resident company?

6.1 Transitional rules would be required to address whether and how an existing foreign-incorporated company which has its CMC in Australia would continue to be an Australian resident, or would revert to being a non-resident.

6.2 Otherwise, the broader landscape of Australia's international tax rules, including those mentioned on page 4 of the Board's options paper means that issues concerning artificially "offshored" or "stateless" income have already been adequately addressed, subject to our previous comments about the CFC rules in the specific context of this consultation. However, as noted above, we would support consideration of a specific "stateless income"

integrity measure as a last resort if any other concerns emerged in spite of this integrity framework.

Consultation question 7

The Board seeks stakeholder feedback on whether it is necessary to introduce a transitional rule when implementing a change to the company residence rules.

It has been put to the Board that a transitional rule is only required if place of incorporation is the sole test for residence. Is this correct?

In thinking about this question, if you consider that a transitional rule is required what should it be?

The Board seeks stakeholder feedback on an appropriate commencement date for either reform option

7.1 A rule whereby overseas incorporated current Australian residents would be given a window in which to irrevocably opt-in to being treated as Australian-incorporated for the purposes of an incorporation-only rule should be considered.

7.2 We submit that transitional rules should provide sufficient time to enable affected taxpayers to adopt proper treatments for the purposes of lodging tax returns which fall due immediately following any potential change.