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4 October 2019

Review of Australia's Corporate Tax Residency Rules
Board of Taxation Secretariat
C/- Treasury
Langton Crescent
Parks Act 2600

By email: CorporateResidency@taxboard.gov.au

Dear Sir,

REVIEW OF AUSTRALIA'S CORPORATE TAX RESIDENCY RULES

Deloitte Australia appreciates the opportunity to provide a submission to the review of Australia's Corporate Tax Residency rules. Deloitte, as a big four accounting firm with an international network of firms, assists corporate groups with overseas subsidiaries from both an inbound and outbound perspective in relation to Australia. As such, we have both the experience and a relevant interest in this issue.

We provide our submission in the format of the six questions set out in the Consultation paper.

EXECUTIVE SUMMARY

In relation to the first consultation question, we share the concerns in relation to the central management and control (CMAC) test as currently administered by the ATO in the current business environment. However, we note that this is not due, in isolation, to a recent change in modern corporate governance or business environment. Rather, it is due in a large part to the reconsideration in approach to the application of the CMAC test in practice, particularly split CMAC, from the approach in TR 2004/15 to the approach in TR 2018/5.

In relation to the second consultation question, we agree that Australia's CFC and foreign branch taxation rules have reduced the difference in taxation of foreign source income between resident and non-resident companies within Australian-headquartered corporate groups. However, the test of Australia residency of foreign incorporated companies still has many important implications particularly due to the increased risk of split CMAC under TR 2018/5 and PCG 2018/9. It is submitted that the wider view of residency adopted by the ATO will have a compliance and management cost, even in circumstances where there is no additional Australian revenue to be gained. Worse, there are significant risks of unrelieved double taxation and other unintended consequences, which will cause management to adopt less than optimal governance arrangements or incur additional costs to prevent such inappropriate outcomes. As such it is necessary to provide certainty to business on the issue of corporate residency to ensure international competitiveness and prevent distortion of normal economic behaviours, and to do so in a way that does not impose unnecessary compliance costs.

In relation to the third consultation question, we agree that place of effective management has similar characteristics to CMAC and could suffer similar practical issues, unless specifically clarified in the legislation (e.g. it is stipulated in the legislation that there can only be one place of effective management). For this reason, we prefer the approach outlined under our response to Consultation Question 4.

In relation to the fourth Consultation question, we recommend amending the existing statutory CMAC test of corporate residence so as to clarify that:

(a) It is a two-limb test, with two separate requirements (that is, the "carries on business in Australia" test is a separate requirement to CMAC); and

(b) That there can only be one location of CMAC being where it is predominately exercised over time.

This would restore the interpretation and practice that existed under TR 2004/15. As such, it would produce less disruption to existing interpretations, and is less likely to lead to unexpected outcomes or avoidance opportunities compared to a new residency concept. If there remain specific integrity concerns that the ATO has with such an approach, these could be identified and specifically targeted.

In relation to the fifth Consultation question, we support an incorporation only test, based on simplicity and certainty grounds. However, we recognise that there may be integrity concerns and issues with the interaction with other provisions of the Tax Acts that will need to be examined before implementing an incorporation only test.

In relation to the sixth Consultation question, we support the removal of the "voting power test".

Consultation Question 1

The Board seeks stakeholder comment on the difficulties associated with the central management and control test that have been discussed in Chapter 5 so far, and whether there are additional difficulties with the test that the Board's attention should be drawn to (particularly if such difficulties are attributable to matters other than board practices and if they arise in the context of an inward investing corporate structure).

As the consultation paper acknowledges, the central management and control ("CMAC") test was originally formulated in the United Kingdom due to the different taxation treatment of residents of the UK to non-residents under the Income Tax Act, 1853. The CMAC test was formulated by the Privy Council in *De Beers Consolidated Mines Ltd v Howe A.C. [1906] 455*. Applying the principle of *Cesena Sulphur Co. v Nicholson (1876) 1Ex.D. 428* that a company resides for the purposes of income tax where its real business is carried on. *De Beers* case clarified that "the real business is carried on, where the central management and control actually abides".

At the time of judgement in *De Beers* case in 1906, it is understood that cross border telephone communication was in its infancy and that it did not exist between the UK and South Africa, although telex communication was possible.

We believe Evershed M.R. appropriately summarised the CMAC test in this quote from *Union Corporation Ltd v Inland Revenue Commissioners* ALL ER [1952] 646 at 648:

> *"The question in any particular case, whether or not the test is satisfied, whether such part of the "superior and directing authority" of a limited liability company is found in any country as will*

> *justify the conclusion that the company is really doing business there, and is, accordingly, there resident, is one of degree, and, therefore, one of fact, on which, if there be evidence to support it, the conclusion of the Special Commissioners will be final"*.

Union Corporation case is a leading authority on "split" CMAC situations.

In the following comments, we will echo the concerns that the Board of Tax has set out in Chapter 5 about the application of CMAC as a test for corporate residency in the modern world of instant cross border communication and "single global markets". However, this does not mean that we consider the CMAC test is a fundamentally flawed criterion for determining the residency of a corporate entity in 2019. We consider that where the strategic decision making of a corporate is made, in legal substance, is an important and still relevant factor in determining the residency of a corporate in 2019. This is supported by the fact it is relevant to alternate residency tests such as POEM (other than for residency concepts such as place of incorporation or legal seat). As you note, Gordon J observed in *Bywater Investments Ltd v FC of T [2016]* HCA 45 that whilst different concepts "… the place of effective management may "ordinarily" be the place where the board of directors makes its decisions". Similar, as will be mentioned later, in a more encompassing concept, like the place of closest economic connection, where the strategic decision-making is conducted should, we consider, be an important factor.

1. MODERN CORPORATE GOVERNANCE

We agree with the Consultation Paper's comments on the impact upon the CMAC test of modern cross border communications methods and the increased globalisation of business (encouraging the use of expertise, including at the Board level (and other levels), of personnel across the globe). To be internationally competitive in a global market, Australian groups need to use personnel from Australia and various foreign jurisdictions on their foreign subsidiary Boards. It is unrealistic to require all the Board members to always fly (in the case in point, the Australian resident Directors) to the foreign country.

However, this has not suddenly occurred since, say, 2017. The use of modern communication methods (e.g. teleconference and video conference) has been common for several decades as has the (very appropriate) use of Directors from different countries on the same board.

So what has brought this issue to the forefront? It was not the *Bywater* decision itself, as clearly the Courts at every level considered that CMAC was being exercised at one place only: that is, in Sydney Australia due to the controlling mind of one individual. Bywater was treated as an Australian resident under the law and practice prior to TR 2018/5.

The issues of concern have arisen due to the withdrawal of TR 2004/15 and its replacement with TR 2018/5 which has the view that:

> "*8. It is not necessary for any part of the actual trading or investment operation of the business of the company to take place in Australia. This is because the central management and control of a business is factually part of the carrying on that business."*

As the Consultation Paper notes, this was on the basis of the obiter in the *Bywater* case relating to the decision in the *Malayan Shipping* case. Whilst the view set out in paragraph 8 of TR 2018/5 (above) is a necessary condition for the issue to arise, it is not sufficient. It is only when coupled with the withdrawal of the view in TR 2004/15 set out in paragraphs 15, 16 and 50 in relation to "split CMAC":

> *"15. The location of the company's CM&C is a question of fact to be determined in light of all the relevant facts and circumstances. In order to reduce uncertainty, the Commissioner as a matter of practical compliance will accept for those companies whose CM&C is exercised by a board of directors at board meeting that the CM&C is in Australia if the majority of the board meetings are held in Australia. The exception to this is cases where the circumstances indicate an artificial or*

contrived CM&C outcome. For example, where there is no business reason for the location of the meeting or where the decisions are made by someone other than the Board.

"16. For the purposes of paragraph 15, a board meeting is treated as being held in Australia when the majority of directors of the company meet in Australia. If the location of the directors at board meeting is evenly split within and outside Australia, then the location of any directors with special powers may be decisive. This is also subject to the exception for cases where the circumstances indicate an artificial or contrived CM&C outcome.'

"50. Where board meetings are conducted via electronic facilities (rather than physical attendance) the focus is on where the participants contributing to the high level decisions are located rather than where the electronic facilities are based. The fact that a majority of these high level decisions makers regularly participate from a jurisdiction other than Australia would support a conclusion that the CM&C is not located in Australia, particularly where the majority of decision makers usually undertake their company duties and participate in the company's high decision making processes in that other jurisdiction. Where the range of locations using electronic means makes this judgement difficult, regard may need to be had to other factors, for example, where the key functions of the board are undertaken, where the decision makers usually undertake their company duties and participate in the company's high level decision making processes, where the high level decision makers are resident and where the secretariat is located."

We note that the decision in *Bywater's* case itself did not involve split CMAC and hence, does not "necessitate" the change of view from these paragraphs in TR 2004/15. In relation to the three cases[1] involving split CMAC discussed in the High Court judgement in the *Bywater* case, we do not consider (and we are unaware of any suggestion to the contrary), that the obiter comments of the High Court on those three cases support changing the approach to split CMAC set out in TR 2004/15. The most relevant observation to the current discussion was in relation to the *Koitaki Rubber* case at paragraph 47 of the High Court's decision:

"Dixon J held that, although it was possible for a company to reside for tax purposes in more than one place, the better view was that such a finding should not be made unless the control of the general affairs of the company is not centred in one country, but is in fact divided or distributed among multiple countries."

We believe this observation is consistent with the above quoted comments in TR 2004/15.
Whilst paragraph 31 of TR 2018/5 appropriately refers to the exercise of CMAC to a substantial degree, its "application" in Practical Compliance Guideline 2018/9 is problematic and is, in our view, difficult to comply with given the modern corporate governance environment detailed in Chapter 5 of the Consultation Paper.

The discussion in paragraphs 73 to 80 of the PCG is not necessarily controversial. The difficulty with the PCG's approach to multiple or split CMAC arises with the examples accompanying the discussion in the PCG of "Decisions made in more than one place" and the resultant "ongoing compliance approach".

Example 13, Possibility A in PCG 2018/9 involves a foreign company with three Directors who normally meet in the foreign jurisdiction. However, a one off attendance in Australia by one of the directors occurs because the director is injured and cannot fly. This seems to suggest that but for unforeseen circumstances outside the Directors control, the intermittent (indeed one off) attendance by one of three directors (with no special powers) in Australia could cause CMAC to arise here. In our view, the one off attendance in Australia of 1 of 3 directors, of itself with no other "circumstances", should not be considered the substantial exercise of CMAC in Australia. This is irrespective of the reason that the director is in Australia (e.g. personal convenience).

[1] *Koitaki Rubber, North Australian Pastoral*, and *Waterloo Pastoral* cases.

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In Example 14, Possibility A makes clear that the attendance by two of four "equal" directors always in Australia by video conference or circular resolution is the substantial exercise of CMAC. Unlike TR 2004/15, there is no consideration of the factors such as who is the Chairman with the casting vote.

Finally, the ongoing compliance approach is premised that a "concessional practical" approach will be permitted not to investigate the residency of a company:

> *"merely because part of the company's central management and control is exercised in Australia, because directors regularly participate in board meetings from Australia using modern communications technology, where all of the following criteria are satisfied on an ongoing basis..."*

One of which criteria is that,

> *"a substantial majority of the company's central management and control is exercised in a foreign jurisdiction (that is not a tax haven) where it is treated as a resident for tax purposes under that jurisdiction's law".*

This clearly suggests that the regular minority participation of directors in Australia by modern communication technology could be viewed by the ATO as the exercise of CMAC. However, it will be viewed as low risk of underpayment of tax where certain stringent conditions are met on an ongoing basis. Given the low risk of underpayment of tax, the Commissioner "will not normally apply his resources" to seek to establish Australian residence to what otherwise may have been an instance of Australian residency, under the views in TR 2018/5.

We submitted to the ATO in response to the draft PCG that a minority of directors in Australia with no special powers (or peculiar circumstances) on video conference should not be considered the substantial exercise of decision making so as to be considered CMAC in Australia.

In response, the ATO indicated that they disagreed with this view of the comments in the *Union Corporation* and *Koitaki Rubber* cases.

It is acknowledged that the Courts have not addressed the fact pattern of Board meetings being held simultaneously by modern communication technology in two (or more) jurisdictions. As such, the application of the comments in *Koitaki Rubber* and *Union Corporation* cases to such a situation is open to debate.

However, this does not alter the conclusion that the recent residency issues arising from the use of modern communication methods and directors living in multiple jurisdictions is largely due to applying a low threshold for the test, as to whether "CMAC is being exercised to a substantial degree sufficient to conclude the company is really carrying on business there" in PCG 2018/9 as compared to the approach in TR 2004/15.

It has sometimes been suggested that split CMAC resulting in dual residence is a rarity. For example, Lord Radcliffe in *Unit Construction Co. Ltd. v Bulloch* [1960] AC 351 commented that "Though such instances must be rare, the management and control may be divided..."

The apparent lowering of what is required in terms of level of "superior and directing authority" in Australia for it to be "substantial" and represent CMAC in Australia in TR 2018/5 and PCG 2018/9 from that in TR 2004/15 raises the prospect of split CMAC causing dual residency being commonplace unless rigid corporate governance rules are followed.

By rigid rules we mean that Australian groups will be reluctant to put any Australian residents on Boards of foreign subsidiaries for justified concern that they will not always be able to travel overseas to attend Board meetings. Such attendance at Board meetings via modern communication methods raises the prospect that the foreign incorporated company may be viewed by the ATO as an Australian resident, with potentially severe consequences (see response to Question 2 below), unless the stringent criteria in the ongoing compliance approach apply. This is possibly despite the Australian resident being most eligibly qualified to assist in the foreign company's Board deliberations.

Such reluctance to put Australian residents on foreign Boards is inimical to Australian business participation in global markets and may impede proper oversight and governance of foreign subsidiaries.

Another outcome from this approach, and again not amenable to Australia's participation in global markets, is a reluctance to hold Board meetings in Australia. In the past, a listed foreign holding company with an Australian subsidiary with significant current or future operations in Australia may have conducted a Board meeting in Australia to better understand the Australian business environment (including the Australian capital market, if the company maintains a listing on the ASX). Under the approach in TR 2018/5 and PCG 2018/9 such a practice may be fraught with concerns, notwithstanding that it makes good commercial sense.

Indeed, major Australian companies will often hold a physical Board meeting overseas as part of an investigation into market conditions and practices in foreign countries. The current approach is effectively preventing the reverse situation and hence the increased understanding by foreign groups of Australian market conditions.

2. RELEVANT TIME FRAME

We simply wish to acknowledge that we agree with the principle set out by the ATO that where CMAC is located is determined by how it is exercised over time.

Question 2

The Board seeks stakeholder comment on the primary theme that has informed the discussion under Part 4 of Chapter 5, being whether certain subsequent additions to the income tax legislation have imported at least some degree of redundancy into the central management and control test. The Board also seeks stakeholder assistance in identifying instances in which any other part of the income tax legislation produces different tax outcomes that are dependent on whether a foreign incorporated subsidiary company is, or is not, an Australian resident under the central management and control test.

We acknowledge the comments in your paper that with the CFC and foreign branch (section 23AH of the ITAA 1936) rules, the distinction between taxing of foreign sourced income to a resident corporate and to an Australian controlled non-resident corporate is not as pronounced as it was say, forty years ago.

However, the treatment of foreign incorporated company under Australia's tax residency rules does have consequences, which may be particularly severe if they occur inadvertently or unexpectedly. In addition to the matters raised in the consultation paper, we note the following:

(a) <u>Subdivision 768-A may no longer be available</u>

Currently, dividends from a foreign incorporated company treated as an Australian tax resident are not entitled to Non-Assessable Non-Exempt (NANE) treatment under Subdivision 768-A of the ITAA 1997. This can have the result that the expanded view of Australian resident, under the ATO approach, can result in unrelieved double taxation of the underlying profits[2] including in subdivision 768-A's application to CFCs under Section 404 of the ITAA 1936.

[2] Assume that

The Government in Exposure Draft Treasury Laws Amendment Bill 2019 (Miscellaneous Amendments) proposes to revert to the use in subdivision 768-A of not a Part X Australian resident (as defined in the *ITAA 1936*) when testing the foreign status of the dividend payer. This proposed amendment to subdivision 768-A should have the effect that a dividend from a dual resident entity that, under a double tax treaty tiebreaker is solely a resident of the foreign country will be eligible for NANE treatment. Whilst this will assist in some situations with Subdivision 768-A, this does not entirely resolve the issue. Unrelieved double taxation can still arise with respect to non-treaty country entities and where the tiebreaker treats the entity as solely Australian resident[3] or is inconclusive (see below).

(b) Prescribed dual resident entities cannot be a member of a consolidated group

Membership of Australian consolidated tax groups will be an issue. In particular, for 100% owned foreign subsidiaries of an Australian consolidated group, in many situations where CMAC results in Australian tax residency, the foreign incorporated company will be a prescribed dual resident under the definition in section 6-1 of the *ITAA 1936*. As a prescribed dual resident, the 100% owned foreign subsidiary will remain outside the tax consolidated group.

(c) For non-prescribed dual resident entities – other issues

In the scenario where the foreign incorporated company is not a prescribed dual resident, the foreign entity, if 100% owned, could become a member of an Australian tax consolidated group. This could cause issues of allocation and denial of deductions, including interest deductions in relation to the "newly found" section 23AH exempt branch of the consolidated group.

(d) Double tax treaty tiebreaker rules may become inoperative

The ATO's approach in PCG 2018/9 (as compared to TR 2004/15) is more likely to result in multiple places of CMAC causing (*prima facie*) Australian residency being more prevalent. More situations are likely to involve the proposition under TR 2018/5 that "to a substantial degree" the exercise of CMAC occurs in Australia (as well as, say, the jurisdiction of the foreign company). This raises issues under the tiebreaker provisions of Australia's double tax agreements (DTAs).

Whilst each DTA will have its differences, many of Australia's tiebreaker provisions rely on the concept of "place of effective management" ("POEM"). Whilst it is acknowledged that POEM is a different

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- Ausco owns 100% of Foreignco which is resident in a foreign country which has a tax treaty with Australia;
- The operating profits of Foreignco are subject to normal company tax in the foreign country;
- Foreignco is also treated as an Australian resident under the expanded view in TR 2018/5, such that the company is not a "foreign resident"; and
- Under the treaty tiebreak, the company is "resident solely of the foreign country", such that the company is a "prescribed dual resident".

Section 23AH should operate to exempt from Australian tax the operating profits of Foreignco, such that double taxation is prevented at that stage of the analysis.

However, double taxation arises upon dividend payment. Foreignco:

- is a "prescribed dual resident" and is excluded from an Australian tax consolidated group;
- is not a "foreign resident", such that the dividend will not be eligible for NANE treatment.

The profits will therefore be subject to full company tax in the foreign country, and the after tax profits will also be subject to full company tax in Australia.

[3] If the treaty tiebreak treats the company solely as an Australian resident, it will be a Part X Australian resident and likely not a prescribed dual resident. In that case, the dividend is not eligible for Subdivision 768-A, even under the proposed ED changes, however, if the company is 100% owned by its Australian parent, the dividend may be disregarded under the single entity rule applicable to tax consolidated groups. However, if the Australian shareholder does not own 100% of Foreignco, tax consolidation will not be available, and the dividend will be an unfranked dividend, resulting in unrelieved double tax.

concept to CMAC, there is a great deal of overlap. However, the OECD notes in its Commentary that there can only be single POEM at any one time. Hence, in situations of multiple CMAC (e.g. refer to Example 13A of the draft PCG) it may not be clear that there is a single POEM and the tiebreaker may not operate.

(e) Tiebreaker rules under the Multilateral Convention may also become inoperative

As a result of Australia's adoption of Article 4 of the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, the tie breaking rules for non-individual taxpayers under many of Australia's DTAs are currently changing. Coupled with the paragraph 4 (3)(e) reservation the tiebreaker will become:

> *"The competent authorities of the Contracting Jurisdictions shall endeavour to determine by mutual agreement the Contacting Jurisdiction of which such person shall be deemed to be a resident for the purposes of the Covered Tax Agreement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the Covered Tax Agreement."*

How this approach will play out in practice is yet to be seen and will obviously depend upon the facts of each case. However, we have a concern that the current ATO view could create many situations of dual residence due to CMAC in Australia (especially split CMAC) and significant volumes of referrals to the competent authorities that may not result in a resolution, resulting in loss of treaty protection.

(f) Corporate residency status stability at risk

PCG 2018/9 approach is ambiguous on what is sufficient to constitute "a substantial degree" of exercise of CMAC in Australia. Thus, there is a risk that companies may drift in and out of Australian corporate residency due to this ambiguity. This may cause further complications with matters such as deemed disposals of assets, entry or exit from consolidated groups and unused section 23AI of the *ITAA 1936* balances.

(g) Australian withholding tax

Dividends paid by a foreign incorporated company that becomes Australian resident due to CMAC may be subjected to Australian withholding tax. Such dividends may also be subject to withholding tax in the foreign country, resulting in risks of double taxation.

(h) Exposure to unexpected penalties for failures to lodge

Unexpected Australian residency of foreign subsidiaries that are members of SGE groups may result in substantial penalties for each failure to make required to lodgements (e.g. tax return, GPFS). These could build up to very large amounts over multiple years and companies, including in situations where the underlying profits are not subject to Australian income tax on the basis of the Section 23AH branch exemption.

(i) Tax issues in foreign jurisdictions

The increased Australian residency risk under the expansive approach in TR 2018/15 and PCG 2018/9 means the foreign jurisdiction will tax the locally incorporated company as a domestic resident corporation and Australia will treat the same entity as an Australian resident corporation with a foreign branch. This dual residence can lead to problems in the foreign jurisdiction.

By way of example, in consultation with our New Zealand colleagues, we have identified the following issues from a New Zealand perspective where a New Zealand incorporated company is also treated as an Australian resident:

1. The company may be ineligible to be a member of a NZ tax consolidated group;
2. There would be a need to have made a trans-Tasman imputation election in order to be eligible to maintain an imputation credit account;
3. Potential for Australian dividend withholding tax on unfranked dividends paid to New Zealand shareholders;
4. The company may not be able to undertake a residents restricted amalgamation; and
5. The company may not be able to share losses with other New Zealand companies.

The above is not intended to be comprehensive list in relation to New Zealand. Similar analysis could be done for multiple jurisdictions. Accordingly, the wider view of residency has flow-on consequences in foreign jurisdictions.

Summary

Accordingly, we believe that correctly determining, and appropriately limiting, when a non-Australian incorporated entity should be considered an Australian resident is important. Otherwise it exposes taxpayers to uncertainty and risk, increases compliance costs and reduces the international competitiveness of Australian corporate groups and the Australian business environment.

Indeed, depending upon the facts, it could be that if a foreign incorporated entity is also treated as an Australian resident there is no additional Australian taxation liability or there should not be as a matter of policy, suggesting that there is no underlying revenue concern. The Australian parent group will nonetheless be required to expend additional costs and resources to manage the residency issue, so as to prevent the possibility (now or in the future) of inadvertent dual residency and unexpected Australian or foreign tax liabilities. This results in additional compliance costs and efforts in circumstances where there is, as a matter both of policy and law, little or no Australian revenue at risk.

Worse, there will be situations where there are potential cases of additional Australian (or foreign) taxation liabilities, that result in unrelieved double taxation, which will cause management to adopt less than optimal governance arrangements or incur additional costs to prevent such inappropriate outcomes.

If the ATO has specific fact patterns that it considers result in inappropriate Australian tax outcomes, integrity concerns or significant loss of Australian revenue, we suggest that an analysis should begin at that point. That is: what are the areas of revenue concern that are at risk under the ATO approach prior to TR 2018/5, and what targeted responses could be adopted to address those concerns without having wider and unnecessary flow-on costs and consequences.

Consultation question 3

The Board seeks stakeholder comment on whether the central management and control test should be replaced with an alternative test that features place of effective management. The Board is particularly interested in how place of effective management would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

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As the consultation paper indicates, the “place of effective management” (“POEM”) is not defined in the OECD’s Model tax Convention but the OECD Commentary on the Model provides a description that it “is the place where key management and commercial decisions that are necessary for the conduct of entity’s business are in substance made.” This description is generally accepted as representative of the meaning of POEM.

We agree with Gordon J comments outlined in the Consultation Paper that whilst the concepts are different and can lead to different outcomes “the place of effective management may “ordinarily” be the place where the board of directors makes its decision”. We note, for completeness that Gordon J’s comments would seem to acknowledge that the use of “in substance” in the OECD’s commentary should be taken to be the legal substance.[4]

Left there, the POEM test would suffer from the concerns and ambiguities applying to the CMAC test as interpreted in TR 2018/5 and PCG 2018/9 and as outlined in Chapter 5 of the Consultation Paper. POEM is, left there, simply too similar to the CMAC test, and suffers the same risks of split POEM.

However the phrase such as “resident only of the State in which its place of effective management is situated”, or similar, as used in residency tiebreaker provisions in Australia’s Double tax treaties, as the OECD has commented, lends itself to the view that there can only be one POEM.

We agree with this interpretation of place of effective management for the purposes of a tiebreaker where there needs to be only one place of residence. A “tiebreaker” which permits two places of residence is not really a tiebreaker.

However, this may not necessarily be true if the POEM is used in a general residence test. For example, the phrase “a foreign incorporated company which has its place of effective management in Australia shall be an Australian resident” would be open to the interpretation that there could be more than one POEM, one of which could be in Australia. Accordingly, unless care is taken in drafting the use of POEM in a general residence test, it could be interpreted as permitting split POEM just as there is split CMAC.

Accordingly, we consider that if the POEM is to be used as test of Australian residency for foreign incorporated companies, the definition should stipulate that there can be only one place of effective management. Otherwise, a POEM test will suffer from the same interpretation issues and uncertainties as CMAC.

We acknowledge that in situations where “management” is dispersed between two or more locations and there can only be one POEM there may be no POEM producing a “null” conclusion on this Australian residency test.

However, if POEM needs to be so clarified or qualified, it appears to us that it is simpler, and less disruptive to existing interpretations (for example, existing case law on CMAC would largely still remain in place) to similarly clarify the CMAC test. We discuss such an approach in response to Question 4.

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[4] The distinction we are referring to is between “legal” and “commercial” substance. Legal substance can be thought of as where, according to the constitution of the company, the appropriately authorised and constituted body which is legally empowered to do so (i.e. the Board) makes the key management and commercial decisions. Commercial substance of the decision-making can be thought of as a businessperson’s perspective and is perhaps less well defined. However, it is a broader perspective but may include the management teams which investigate and build the business case and recommendations leading to the “key management decision necessary for the company’s business”.

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Consultation question 4

The Board seeks stakeholder comment on whether there are criteria other than central management and control or place of effective management that could be used to establish corporate residency. The Board is particularly interested in how alternatives would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

CMAC still pertinent

As mentioned in relation to Question 1, the concept of "central management and control", in the sense of the place of superior directing authority, is and remains a pertinent criterion to determine residency of a corporate. This is reflected in the fact that the concept of POEM largely overlaps with CMAC; and other possible residency tests, such as "place of closest economic connection" would include the place of strategic decision making and management as an important consideration.

Reinstatement of two elements to the test (carrying on a business and CMAC)

As noted in consultation question 1, the ATO's reconsidered stance in TR2018/5 effectively conflated the two elements in the corporate residency test - Central management and control (CMAC) and carrying on a business - into the one element of CMAC.

The ATO also effectively lowered, in TR 2018/5 and PCG 2018/9, the threshold as to what is a "substantial" exercise of the superior directing authority of the company that represents CMAC in Australia.

We submitted to the ATO in response to the draft PCGs that this approach is not the correct application of the principle in the *Koitaki Rubber* case and the *Union Corporation* case. We consider that the correct principle from those cases is:

- considering only the activities undertaken in Australia;
- only where the superior and directing authority of the company is to some substantial degree to be found in Australia,

will justify the conclusion that the company is really carrying on business in Australia.

As the consultation paper notes:

> *"it is perhaps arguable, therefore, whether Malayan Shipping or Bywater can necessarily be taken as clear and indisputable authority for the proposition that the exercise of a company's central management and control in Australia is sufficient, by itself, to establish that a business has been carried on in Australia, even in the event that the operational activity of the company in question takes place exclusively outside Australia."*

We concur with the comments in the Consultation paper. In particular, we reiterate that in arguing that the requirement in the definition of resident company that the company "carries on business in Australia" is a separate requirement to having CMAC in Australia the validity of the decision in *Malayan Shipping* case was never doubted. Hence, William J's judgement in Malayan Shipping is "unsurprising" even if you accept that CMAC in Australia is not automatically carrying on business in Australia.

Further, as we have detailed in our comment on Question 1, the *Bywater* decision did not involve a question of split CMAC (with CMAC being exercised solely in Sydney). As such, the *Bywater* decision does not support the changed approach from that taken in TR 2004/15 in relation the split CMAC and the approach to the conduct of Board Meeting's by modern communication methods evidence in TR 2018/5 and, particularly, PCG 2018/9.

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Nonetheless, we consider a legislative fix is required to settle these contentious issues. Accordingly, we submit that the CMAC statutory test of corporate residency in Section 6(1)(b) of the ITAA 1936 should be amended to clarify that:

(a) The CMAC statutory test is a two-limb test with two separate requirements. That is the “carrying on business requirement” is a separate requirement to having “its central management and control” in Australia, and that the “carrying on business requirement” refers to operational business activities. This approach acknowledges and permits, that there will be cases where the nature of the business is such that the exercise of CMAC is required where the business is carried on. That is, in some cases many of the facts that demonstrate the carrying on of (operational) business in Australia, may also demonstrate that CMAC is in Australia (as may have been the case in the *Malayan Shipping* case). This may be particularly pertinent for smaller businesses with fewer business decisions; and

(b) There can only be one site or location of CMAC and that is where CMAC is predominately exercised over time. There are other ways to phrase this requirement to achieve a similar outcome that we would be happy to discuss with you. The Explanatory Memorandum could include appropriate examples similar to those in TR 2004/15 to support this principle in any proposed amending legislation.

We believe that by these two relatively simple amendments, the ambiguity and uncertainty with the current approach to CMAC in TR 2018/5 and PCG 2018/9 can be largely removed.

This would require less adjustment to existing tax concepts and practices (as compared to a new concept such as POEM). This would ensure further certainty and minimise the risk that the change in concept of corporate residency could produce unexpected outcomes.

Finally, as the Bywater case was litigated against the backdrop of TR 2004/15 there should be little concern that such a restoration of the previous position would lead to avoidance opportunities.

For completeness, we note that we considered a corporate residence test based on a broad-based enquiry, such as the place where the company “has the closest economic and commercial connection”. The intention would be that the residence of the corporate would be determined by considering certain criteria such as having regard to:

(i) Where the Board of Directors meet;

(ii) The CEO and other senior executive carry on their activities;

(iii) Where senior day to day management of the company is carried on;

(iv) Where the company’s headquarters is located;

(v) Where the legal domicile of the company is; and

(vi) Where the company’s corporate Secretarial and accounting records are kept.

These criteria are based on the criteria mentioned in relation to the tiebreaker provision in the Multilateral Instrument. However, they are not intended to be definitive or exhaustive.

We do not favour such a multifaceted approach, as it is potentially subject to disputation and uncertainty based on differing views as to the weight to be given to each of the criteria. Whilst this may be appropriate as a tiebreaker discussion between Competent Authorities in a DTA context, this uncertainty is not appropriate in the context of a taxpayer under a self-assessment regime assessing its residence.

For completeness, we note that this approach would permit only one place of closest economic and commercial connection.

Consultation question 5

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

We support the use of an incorporation only test on the basis of simplicity and certainty. It would resolve the ambiguity in the residency test around the current approach to CMAC. As your paper indicates there is less distinction between taxation of a resident and non-resident company on income from foreign operations (and indeed, Australian sourced operations) than there was say 30 years ago.

For completeness, we note that a foreign incorporated company will usually be resident of the foreign jurisdiction in which it is formed. In addition, Section 333 of the ITAA 1936 defines a company to be resident of an unlisted country if it is not a Part X Australian resident nor a resident of a particular listed country. Hence, a company resident nowhere is treated as a resident of an unlisted country for CFC purposes.

However, we expect that the ATO may have concerns as to a corporate residency test based solely on incorporation permitting taxpayers too much flexibility to use a foreign incorporated company as tax resident outside Australia (even if controlled from Australia). Whilst these concerns may be overstated, we accept there are still issues with a foreign incorporated company tax resident overseas being controlled from Australia. We also appreciate that Bywater Investments would have won its case in respect to residency[5]; indeed there would appear to be no real residency issue for Bywater Investments on an incorporation only test.

Also such a substantial change to the residency test could have unintended consequences to other tax provisions (such as CFC rules) and eligibility to Australia's DTA which were all drafted on the basis that Australian corporate residency has a control based test (i.e. CMAC). As such, such interactions should be examined before implementing an incorporation only test.

Anticipating those concerns, we have recommended clarifying the CMAC residency test to reinstate the approach evident in TR 2004/15. We note that the *Bywater* case was not impeded by TR 2004/15 (as *Bywater Investments*, based on the Court findings, was no doubt carrying on business in Australia) and hence any avoidance concerns should not arise with our preferred approach.

Consultation question 6

The Board also seeks stakeholder comment on whether there is a compelling basis for retaining the second limb of the test for corporate residence (under which a company is a resident if it carries on business in Australia and has its voting power controlled by stakeholders who are residents of Australia) in the event that the central management and control test is replaced with an alternative test.

[5] We note that it is plausible that the ATO could have asserted that Bywater Investments, if treated as a non-resident of Australia, was nonetheless subject to Australian tax based on the source of income being in Australia; or alternatively, an Australian tax may have arisen via the CFC provisions in Part X of the ITAA 1936 (the ATO would need to establish the attributable taxpayer's attribution percentage). Further, in respect of a resident of a treaty country, it may be possible for the ATO to assert a permanent establishment in Australia, and apply a deemed source rule to the income of the permanent establishment.

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The second limb of the test for corporate residency based on voting power is rarely invoked or raised in practice. We are unaware of any case decided on the basis of this test.

Retention of the test just adds ambiguity for no apparent integrity for the tax system. Given Australia's taxation of all Australian source income and our CFC rules, we consider that the second limb of the corporate residency test involving direct Australian voting control is unnecessary for the integrity of the tax system.

Accordingly, we support its repeal.

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We appreciate the opportunity to make a submission on this important matter. We would be happy to discuss any aspect with you should it require clarification.

Yours sincerely

DWatkins

David Watkins
Partner

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Partner