THE TAX INSTITUTE

CHARTERED ACCOUNTANTS AUSTRALIA + NEW ZEALAND

Law Council OF AUSTRALIA

Business Law Section

Corporate Tax Association

GROUP OF 100

25 July 2018

Mr Bruce Lee
Australian Taxation Office
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By email: bruce.lee@ato.gov.au

Dear Bruce,

Practical Compliance Guideline PCG 2018/D3 – Income Tax: central management and control test of residency: identifying where a company's central management and control is located

The Tax Institute, Chartered Accountants Australia and New Zealand, Corporate Tax Association, the Group of 100 and the Business Law Section of the Law Council of Australia (**Joint Bodies**) welcome the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the *Practical Compliance Guideline PCG 2018/D3 – Income Tax: central management and control test of residency: identifying where a company's central management and control is located* (**Draft PCG**).

Summary

Our submission addresses our main concerns in relation to the Draft PCG. In particular:

- The interpretation being given to the corporate residency test;
- Technical issues with the Draft PCG; and
- Requirement for a further review of the corporate residency test.

Discussion

1. Interpretation of the law

The Joint Bodies note their disagreement with the ATO's expression of the corporate residency test which applies to a company that is not incorporated in Australia but carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia[1].

The two limbs of the test appear to be conflated in paragraph 7 of the Draft PCG. This is consistent with the way the test is expressed in paragraph 7 of *Taxation Ruling TR 2018/5: Income tax: central management and control test of residency* (**TR 2018/5**) which provides:

> If a company carries on business and has its central management and control in Australia, it will carry on business in Australia within the meaning of the central management and control test of residency.

Consistent with earlier submissions on the draft version of TR 2018/5, the Joint Bodies consider that the test is a two-limb test and that it should be expressed that way in both TR 2018/5 and the Draft PCG. That is, the fact that a company has its central management and control in Australia does not necessarily mean it is carrying on business in Australia, although in some factual scenarios it is possible that the very activities of central management and control can be the carrying on of business in Australia.

The Joint Bodies believe that the interpretation of the corporate residency test adopted by the ATO in both TR 2018/5 and the Draft PCG are incongruous with the policy objectives of the corporate residency test and create uncertainty.

The ATO in *Taxation Ruling TR 2004/15 Income tax: residence of companies not incorporated in Australia - carrying on business in Australia and central management and control* (**TR 2004/15**) (now withdrawn) distinguished the 'Alternative view' of the High Court decision of *Malayan Shipping Co Ltd v. FCT* (1946) 71 CLR 156 (**Malayan Shipping**). The ATO in TR 2018/5 now relies on *Malayan Shipping* to conflate the tests. The High Court in *Bywater Investments Ltd v Commissioner of Taxation and Hua Wang Bank Berhad v Commissioner of Taxation* [2016] HCA 45 (**Bywater**) (at paragraph 57) said that *Malayan Shipping* "adds little of relevance". Further, in *Bywater* the taxpayer conceded that the relevant entities carried on business in Australia, so the Court only had to consider central management and control.

2. Technical issues with the Draft PCG

a) Foreign incorporated company inadvertently meeting the residency test

Certain foreign incorporated companies may exercise more caution and proper protocols to ensure they are not considered an Australian tax resident under the two-limb test involving the location of its central management and control. However, some foreign incorporated companies may inadvertently still meet this residency test. One of the

[1] Section 6(1) *Income Tax Assessment Act 1936* (Cth)

consequences of this is that if they pay an unfranked dividend, potentially double-taxation may apply.

The Joint Bodies request guidance on this issue from the ATO, including the consequences for a company that has unintentionally met the corporate residency test.

b) Application of ‘place of effective management’ test in treaties

As a result of the shift away from the view held in former TR 2004/15, the Joint Bodies consider that many more foreign incorporated companies are likely to be considered Australian residents for Australian taxation purposes based on the interpretation of the corporate residency test that is contained in the Draft PCG (and TR 2018/5). Consequently, these companies will become dual residents and be required to apply the “tiebreaker tests” contained in Australia’s tax treaties (where applicable), to determine their residency for treaty purposes. It would be useful to have further guidance from the ATO on how they interpret treaty concepts such as “place of effective management”.

We note that this point was raised during the consultation on TR 2018/5 and we note the ATO’s response to this in the Compendium to TR 2018/5 (Item 11) that consideration is being given to whether to provide public guidance. The Joint Bodies consider this to be a significant issue and seek guidance from the ATO on this point. We would be happy to discuss this matter further with the ATO in due course.

While the parties conceded in *Bywater* that central management and control was the same as the place of effective management, that will not always be the case as the place of effective management is a “tie breaker” test (and so cannot be in two places at the same time). If there is a single place of central management and control, then the place of effective management may well be the same. The ATO should confirm whether this is the case.

c) Decisions made in more than one place

Example 13 in the Draft PCG provides perhaps one of the most critical safe harbours in terms of practical guidance. However, the conclusion in paragraph 87 that the central management and control of the company is exercised to a “substantial degree in Australia” relies on, in part, that two of the four directors are located in Australia. The Joint Bodies suggest that a more useful example (or additional example) may be where only one of the four directors, all participating equally, are located in Australia. Having a minority of Australian directors on the board of a foreign company is common and so it would be useful to have clear guidance that such an arrangement will not result in central management and control being exercised to a substantial degree in Australia. Such an example would also provide clear guidance that it is not necessary that the single Australian director is required to physically attend board meetings overseas.

Such an approach is consistent with the position outlined in the “Ongoing Compliance Approach” section of the Draft PCG at paragraph 104, which refers to “the majority of directors attend board meetings while present in that jurisdiction”.

Our concern is that the Commissioner's approach to the different forms of communication as articulated in the Draft PCG will engender more awkward Australian participation in relation to foreign subsidiaries of Australian companies. Distinguishing between video conference, circular resolutions, teleconference and physical presence will tend to create inefficiency and artificiality. It may promote situations where an Australian resident director is required to physically travel to the foreign board meeting to avoid central management and control being at least partly in Australia. This raises questions as to whether the Australian resident director might travel to the nearest country outside Australia (for example, Singapore or New Zealand) and participate in the directors' meeting by video conference or teleconference from that jurisdiction. It might also lead to boards being constituted only with foreign resident directors, therefore making the corporate governance of offshore subsidiaries of Australian companies far more cumbersome. Requiring a minority Australian resident director, or indeed, a number of Australian resident directors to travel overseas to attend board meetings to avoid having a substantial degree of central management and control in Australia is not consistent with a desire to limit "red tape" and to promote business efficiency.

d) Ongoing compliance approach

As noted above, paragraph 104 provides significant comfort and operates to some extent to pull together the themes from the previous examples. However, the compliance approach is confined to a subsidiary of a "public group" (which needs to be defined).

The Joint Bodies submit that the compliance approach should not be limited to "public groups". If the Commissioner has a particular concern with private companies and groups then surely under the compliance approach such concerns are adequately dealt with by the requirements set out in (iii) that the company has not undertaken or entered:

- any artificial or contrived arrangement affecting the location of its central management;
- a tax avoidance scheme whose outcome depends, in whole or part, on the location of its residence;
- arrangements to conceal ultimate beneficial or economic ownership; or
- arrangements involving abuse of board processes including backdating of documents or the board not truly executing its functions.

There is no reason why the vast majority of private companies and groups should not be able to rely on the compliance approach because the Commissioner's concerns around the actions of a small minority of taxpayers.

Furthermore, foreign companies that are entitled to avail themselves of the place of incorporation "tiebreaker test" contained in Australia's tax treaties should also be able to rely on the compliance approach.

3. Further review required

The Joint Bodies consider that, in light of the issues that have been highlighted during the consultation process for TR 2018/5 and the Draft PCG, there would be significant merit in a further review of the corporate residency test by a body such as the Board of Taxation following on from the review undertaken in 2003. The review should take place 12 months after the final PCG has been put in place to allow consideration of the effectiveness of the PCG during that 12 month period. Should the outcome of the review result in similar findings to those from 2003, then legislative change would be required.

Please refer to the Appendix for our reasons for recommending a further review.

If you would like to discuss any of the above, please contact Tax Counsel (The Tax Institute), Stephanie Caredes, on 02 8223 0059 in the first instance.

Yours faithfully,

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President
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Michael Croker
Tax Leader Australia
Chartered Accountants Australia and New Zealand

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Marc Lewis
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Appendix

In 2003, the Board of Taxation (**Board**) issued its report following its *Review of International Tax Arrangements*. The Board considered the corporate residency rules (refer to pp106 – 111 in Volume 1) and made two recommendations:

- Recommendation 3.12 re residence of companies; and
- Recommendation 3.13 re dual resident companies.

The Board made numerous pertinent comments in relation to the issue of company residency which are still highly relevant today. Firstly, it noted the policy objective at paragraph 3.122 being "To assist in establishing Australia as a centre for internationally-focused companies, it is necessary to have clear, practical and internationally-acceptable rules for company residence".

In paragraphs 3.125 to 3.127, the problems with the "central management and control" test were identified and in particular referred to (at para 3.126) "an early High Court case which held that a company which is managed in Australia is likely to carry on business here." The Board went on to note that "This has the potential to make foreign subsidiaries of Australian companies resident in Australia, even though the subsidiaries are incorporated and operate outside Australia."

At paragraph 3.129, in considering the policy issues arising from the problems identified, the Board noted "The main objective of the company residence test should be to produce certainty and ease of operation." With this in mind, the Board considered Option 3.12 which was expressed as:

> Option 3.12: To consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.

The Board recommended that "a company should be regarded as resident in Australia only if it is incorporated in Australia" (Recommendation 3.12). The effect of adopting this recommendation would be to provide a clear and certain corporate residency test.

Subsequent to this review, the ATO issued the now withdrawn TR 2004/15. This ruling addressed some of the concerns raised by the Board and provided sufficient certainty to taxpayers on how the central management and control residency test would apply.

In light of the withdrawal of TR 2004/15 which contained the ATO's long-held views in relation to the central management and control test, and the change in the ATO's views which are now contained in TR 2018/5 and the Draft PCG in response to *Bywater*, the Joint Bodies consider that the Board of Taxation should review the corporate residency test again.

In the Joint Bodies' view, the issues identified by the Board are more relevant today given the change in the ATO's view of this corporate residency test. Based on the above, in the Joint Bodies’ view, a current review by the Board of the corporate residency rules is warranted.