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31 January 2020

Reform of Australia's corporate tax residency rules
Reform option 1 - legislative modification of the CMAC test

Dear all

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

EY welcomes the opportunity to respond to the issues raised by the Board of Taxation in *Corporate Tax Residency Reform Options* December 2019 (**Options Paper**) which seeks input on the two reform options for setting the corporate residency of a foreign incorporated company for Australian tax purposes.

This submission addresses reform option 1 focused on 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, responding to questions 1 to 4 in the December Options Paper.

Our separate submission today covers our preferred reform option 2 – adoption of an incorporation-only test.

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.

EY stated in our 9 October 2019 submission (**first submission**) after the Board of Taxation consultation guide (**Consultation Guide**) that:

- our preferred reform option is the incorporation-only test.
- adjusting the existing CMAC-derived rules will not produce the required clarity and certainty for government, the Australian Taxation Office (**ATO**) or affected taxpayers, and is therefore not the preferred reform policy in our opinion.[1]

Executive Summary

We submit that an incorporation-only test will be more effective in reducing taxpayer uncertainty, recognise corporate governance practices, and ensure that compliance considerations are reduced. We reiterate that EY would not support an incorporation-only test if that test would give rise to leakage in revenue or systemic avoidance of Australian tax.

Nevertheless, if the Board or government were to decide to modify the CMAC test, then we respond in this submission to questions 1, 2 and 3 of the December Options paper. In summary:

[1] We emphasise that we are not suggesting that Australia adopts a pure territorial basis for taxation under which residence is immaterial. We have not considered the question of residency of a trust, which might have different tax policy considerations.

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A. Before the CMAC test is modified, it is important that the policy process recognises that the CMAC test is not intended as an integrity measure. Rather its role is to specify when a corporation is prima facie subject to Australian taxation as a resident. This complements Australia's comprehensive rules which specify when a non-resident is subject to tax in Australia.

B. The concern raised about whether adjusting the CMAC test will require additional integrity measures to counter behaviours such as loss importation is appropriate and useful. The question illustrates that the CMAC test and the overly broad interpretation of CMAC currently applied by the ATO has increased integrity risks by making it easier than previously for a foreign company to assume Australian resident status in inappropriate circumstances. Such risks might be lower had the changed interpretation not been adopted.

   We submit that any CMAC adjustments would not by themselves alter the issues requiring attention under Australia's controlled foreign company (**CFC**) laws. We comment on these.

   In our view, any consideration of corporate residency rules should consider the information available to the ATO in relation to foreign companies' ownership as well as the many other tax rules in operation. We identify some information sources available under Australia's and the ATO's participation in various international initiatives including the internal measures to identify ultimate beneficial ownership of foreign companies.

C. Question 2 involves a more detailed analysis of the two limbs of the CMAC test. We submit that if any legislative clarification of the CMAC test was identified as the reform strategy, it would need to cover a large range of factors which apply in today's global business environment, with companies operating in multiple jurisdictions. We submit the CMAC amendments would need to be quite detailed, to:

   - refer to multiple factors (as the *Corporations Act* 2001 did in another context).
   - focus on revenue streams of the companies (rather than their business inputs, back-office functions, and corporate governance activities).
   - ensure there is the capacity for companies to make self-assessment determinations under double tax treaty as well as domestic tax law. We identify the useful experience of the 2019 administrative approach introduced by the ATO and the New Zealand Inland Revenue to help some companies to self-assess their corporate residence status under the Australia – New Zealand double tax treaty. While the administrative approach is not free of problems, it is a practical response to similar issues, taking into account the need for certainty and commercial efficiency and given "that our respective tax systems and administrations are comparable and both countries are committed to adopting measures to address BEPS risks, this joint approach represents **a measured risk-based approach that seeks to provide certainty and minimise compliance costs** for taxpayers." (emphasis added).
   - provide some administrative flexibility to cover very early stage foreign companies, which are operating in overseas locations exploring business opportunities, but which have not yet started to generate income. Such very early stage companies will have minimal foreign directorial or fixed business bases, but should not automatically be treated as Australian resident.

D. We agree there would be merit in considering a potential de minimis rule to operate as an adjunct to more substantial reform, that is, that "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 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." We support the use of turnover as the basis of measurement – that is, the revenue generated by the foreign company as distinct from business inputs or assets – for a supplementary de minimis test.

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We submit, for the avoidance of doubt, that a formulaic de minimis test would not be viable if it were to be **the only legislative modification to the CMAC rules, without any other changes to the current law**. If a de minimis test were to operate as a standalone corporate residency modification without amending the rest of the legislation, to provide that if the foreign company carried on in Australia no more than some threshold percentage of its business (say an Australian business limit of 10% of its total business) there would be three key types of problems:

- Such a test would not achieve certainty or clarity, even if it were focused on turnover. It would require complex and uncertain calculations, require consideration of what the de minimis threshold should be, be problematical or impossible to measure during a financial year and not be appropriate for all circumstances in any event. It would introduce a new uncertainty into the tax system, with potentially arbitrary outcomes which would invite constant supervision by and approaches to the ATO. The potentially volatile outcomes would make it impossible to function to provide a foreign company with certainty during a financial year.
- If the allowable Australian business activity to avoid CMAC was limited to some small or de minimis Australian business percentage say 10% of the foreign company's business, and the measures were based on indicia other than turnover (reported sales), this would continue to discourage Australian parent companies from activity in relation to governance or other involvement with their foreign incorporated subsidiaries for fear of triggering Australian resident status arising from potential transfer pricing adjustments relating to Australian-supplied governance, R&D or strategic input or the foreign company's involvement in contributing to its group's business. Thus if the relevant indicia were broadened beyond turnover then the trigger percentage to result in resident status would need to be raised to say 49%.
- So, if a mechanical "carveout" which was to be the only legislative reform, a significant policy development process would be required, and the formulary approach would not properly cover all scenarios anyway. Thus an optional de minimis exemption might form part of a potential CMAC reform but does not replace the task of reforming the corporate residency test.

E. In our response to question 3, we restate our view of October 2019, that the actions providing the greatest certainty would be in summary that:

- The sole test for corporate residency should be the incorporation-only. All the reasons that the Board of Taxation gave in 2003 during the RITA review for this recommendation still hold true today (For the convenience of stakeholders reviewing these policy issues, we reproduce extracts from the Board's 2003 report). Australia's tax system is also stronger given the many integrity measures introduced since then, especially for Significant Global Entities (**SGEs**).
- We do not at this stage see any fundamental obstacles to adoption of an incorporation-only test to reduce the uncertainties under the CMAC and POEM tests.
- The voting power alternative test of corporate residency, which as the Consultation Guide notes is seldom resorted to, should be removed from the definition.
- To provide certainty to the corporate sector, it would be desirable for the Commissioner to take administrative action pending a law change. That action might be developed using an approach somewhat like the "transitional compliance approach" at paragraphs 102 to 104 of PCG2018/9. We welcome the Commissioner's extension of the transitional compliance approach until 30 June 2020, but we suggest that will need further extension once the reform approach is settled (say to 30 June 2022).

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Yours sincerely

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EY submission

1. Consultation question 1 – How to best modify the CMAC test

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 Rationale for reform

The CMAC test contains two elements or limbs for a foreign company to be resident in Australia:

1. that the foreign company is carrying on business in Australia.
2. that its CMAC is in Australia.

The need for reform has been identified before. The Board of Taxation Review of Australia's International Tax Arrangements (**RITA**)[2] considered the issues and recommended adopting an incorporation-only test to determine corporate residency.

The need for reform arises because the judicial consideration of the test and particularly what is meant by CMAC has been based on facts and circumstances which do not represent the commercial operations and governance processes of globalised companies in the modern world. Additionally the ATO has also changed its interpretation. In 2002, the Board's RITA consultation paper stated:

> Largely, difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. **However, the case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this**." (emphasis added)

Judicial consideration of Australia's corporate residency rules has tended to involve extreme and unrepresentative facts, not reflecting real multinational businesses undertaking real business activities in multiple jurisdictions in the modern world[3].

The judicial consideration of the Australian statute has tended to conflate the two limbs of the test, with the outcome that a company with CMAC in Australia is considered then to automatically be carrying on business in Australia. This has been seen also in the recent decisions including of the High Court in the Bywater case, which involved an extreme scenario of a private group undertaking tax avoidance activities, which have attracted appropriate criminal sanctions.

[2] http://taxboard.gov.au/consultation/international-taxation-arrangements/
[3] As we outline below and in our first submission, we submit that the Australian tax law contains ample powers for the ATO to have taxed the foreign income in that case under the controlled foreign company, sham, general anti-avoidance and criminal law rules.

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Therefore, If the chosen reform approach was to be to modify the CMAC test, the key objectives include, as outlined further in our response to question 2, to:

- increase certainty by reducing the risk of findings of residency in multiple jurisdictions at one time
- the first limb concept of carrying on a business needs to properly encompass:
  - globally integrated businesses (e.g. an IT or medical technology or fintech company with Australian researchers)
  - avoiding corporate residence in multiple jurisdictions. A tie-breaker rule should operate so that corporate residence should not arise if the foreign company is accepted as carrying on a business in a foreign jurisdiction
  - allow for foreign companies in a preparatory or start-up phase, negotiating the establishment of businesses but not yet employing many employees
  - allow for the use of a holding company in a foreign location as a holding company, that is a company which does not have operational activities
- the second limb, stand-alone CMAC, test should align with modern corporate communications practices and governance

1.2 The policy role of the corporate residency rule to identify the taxpayer

Before considering the detailed reform of the two limbs and any resulting additional integrity measures, it is important to understand the historical **function** of the test of the CMAC tests. The majority in *Bywater* described the history of the test as follows:

> "The latter part of that definition, first legislated in 1930, **represents a statutory adoption of the test of residence**, formulated by Kelly CB and Huddleston B in *Cesena Sulphur Company v Nicholson* …" (footnote omitted, emphasis added)

The intended function of the CMAC test was as a statutory recognition of what was understood to be the range of circumstances in which, under the common law, a company's residency might be established, and regard might have been had to Australian states' income tax legislation. It can best be described as a taxpayer **nexus** rule.

The corporate residency law preceded the development of transfer pricing laws and concepts and rules for the taxation of non-residents.

As the Board identified in its 2003 RITA report:

> "3.129 … residence tests for companies necessarily represent a departure from the policy ideal — an ideal which would be based on ultimate ownership of companies. As a result, countries generally adopt residence tests based on incorporation and/or management **and then use various other measures to deal with problems to which these tests give rise. The main objective of the company residence test should be to produce certainty and ease of operation**." (emphasis added)

Therefore, the need for integrity measures needs to be carefully considered and the measures should be developed independently, as noted in the Board's 2003 report.

As well, any adjustment of the CMAC legislation must recognise that Australia has adopted in recent years many integrity measures applicable to non-residents (especially SGEs), including:

- multinational anti-avoidance law (**MAAL**) and diverted profits tax (**DPT**)
- expanded world-leading transfer pricing rules
- revision of the Part IVA general anti-avoidance law
- non-resident CGT law in Division 855 of the ITAA1997
- stapled trust-company tax rules

- country by country reporting tax disclosure rules.

In our view, these rules (individually as well as collectively) provide Australia with significant and appropriate integrity rules applicable to non-residents which have Australian business activities, in the absence of any Australian tax residency finding.

A current international tax reform is being conducted by the OECD/G20/inclusive framework, under the "programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy" (**digitalisation project**). This saw discussion papers issued in 2019, current development and meetings of the Inclusive Framework of over 135 countries, G20 finance ministers and leaders. It is likely to see materially changed tax rules for multinational business activities and groups, including (at the date of this submission):

- A "first pillar" which might see changed rules for the allocation of profits within multinational business activities (including potentially changed nexus rules, and apportionment of profits)
- A "second pillar" which might give countries powers to impose additional taxes in situations where multinational business activities conducted by a company operating in that country involve arrangements with the companies associates in a low tax jurisdiction whereby profits are extracted into a low tax jurisdiction;

with a goal of a new system being agreed by the end of 2020.

The outcome of this project will add to the integrity of the Australian corporate tax system in the context of adjustment of the corporate residency law.

1.3 Would clarifying the CMAC test require resulting integrity measures?

The December options paper asks for input on whether a CMAC legislative clarification would require any new integrity measures "for example to guard against loss importation."

1.3.1 Balancing the benefits of certainty against any integrity issues

It is important not to create integrity risks in the Australian tax system from any reform process.

However our proposition is that the Australian international tax law contains strong integrity rules, including:

- multinational anti-avoidance law (**MAAL**) and diverted profits tax (**DPT**)
- expanded world-leading transfer pricing rules
- revision of the Part IVA general anti-avoidance law
- non-resident CGT law in Division 855 of the ITAA1997
- stapled trust-company tax rules
- country by country reporting tax disclosure rules.

We highlight judicial support for the ATO use of Part IVA.

That being the case, we strongly suggest that the policy process needs to occur in a balanced macroeconomic manner. So, any "opportunities" provided to aggressive taxpayers and advisors would be materially outweighed by the benefits to the balance of taxpayers and indeed the ATO from clearer laws. We note that the ATO 2018 tax ruling TR2018/5 is over 4,500 words long and the ATO practical compliance guide PCG 2018/9 is over 9,000 words long, yet they do not properly cover the key issues for Australian businesses in any event, resulting in the current uncertainty for all stakeholders and the Board policy examination).

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As the ATO and New Zealand Inland Revenue stated in an administrative approach concerning a related matter, discussed below, their joint approach "represents a measured risk-based approach that seeks to provide certainty and minimise compliance costs for taxpayers." Such a measured approach is appropriate in this policy process.

1.3.2 Considering the loss importation risk

We observe that the lack of clarity in the current CMAC law, which conflates the first limb "carries on business" and second limb CMAC limbs, lead to ambiguity in the ATO interpretation, and have contributed to problematic behaviour.

The Board's question about "loss importation" by foreign incorporated companies reflects that it is relatively simple under the current Australian tax law and ATO changed interpretation to change foreign companies' CMAC and activities to be Australian resident and thereby import foreign losses into Australia's tax system. If actions were taken to hold a foreign company's:

- directors meetings in Australia
- circulating directors' resolutions to be undertaken in Australia
- corporate governance practices undertaken using Australian directors operating in Australia

then the ATO interpretation places the corporate residency of the foreign company in Australia.

We observe also that the general anti-avoidance rule of Part IVA would be relevant.

We submit that Australia's tax law should **not** make it easy for foreign companies to be resident in Australia, from an integrity perspective, because Australia also has strong rules governing the taxation of nonresident companies deriving income from Australia. Therefore:

- A reform approach to adjust the CMAC test should be balanced, and should not have a strong focus on importing the residence of foreign companies into Australia.[4]
- This is an additional reason in favour of the incorporation-only, because that test would make it much more difficult to import the residency of foreign companies into Australia.

Therefore, if the Australian policy response by policymakers was to merely to clarify the CMAC tests, then to enhance the integrity of Australia's tax system such a policy response should:

(a) amend the first limb requirements about carrying on business in Australia to require a foreign company to have real operational activity in Australia

(b) if the foreign company was also carrying on business in a foreign jurisdiction, the Australian residency rules should constrain an inbuilt tiebreaker rule to prevent dual residency arising for Australian domestic tax purposes (we understand the UK has such a tiebreaker rule as does Canada). Such an approach, outlined in relation to question 2, would make it more difficult for a foreign company generating foreign losses to change its residency and import those losses into Australia.

(c) if the mere Australian conduct of foreign companies' governance activities in Australia (that is, reporting to directors, supervisory activities not constituting operational activities) did not of

[4] We reiterate that Australia has strong rules for taxing the Australian-sourced income of foreign residents. Therefore this reform approach would not detract, in our view, from Australia's capacity to collect taxation from business activities in Australia. This is demonstrated by numerous ATO and government announcements of taxation collections arising under the Tax Avoidance Taskforce, and arising from the MAAL, the DPT, the transfer pricing laws and other recent reforms.

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themselves constitute Australian residency status, that would reduce the scope to import the residency and losses of foreign companies.

1.3.3 Considering information sources available to the ATO in relation to foreign companies

We highlight that Australian tax system integrity in relation to foreign income in foreign entities such as foreign companies is influenced not merely by Australia's tax legislation, but also by the information sources available to the ATO, and also by the ATO willingness to apply analytical tools to those information sources.

It appears to us that the Bywater cases, which appear to have resulted in Australian difficulties in the administration and interpretation of Australian rules around corporate residency, could have been resolved by applying Australia's existing CFC and tax avoidance legislation as well as, as is now being undertaken, Australia's criminal law.

We note that 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).

- 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[5]
- 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[6] 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[7], a Freedom of Information Treasury response identifies the next step required by the government[8]
- 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
- 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. This brings together leaders of tax enforcement authorities from Australia, Canada, the UK, US and the Netherlands as outlined on the ATO website[9]. These initiatives enable ownership data in relation to company beneficial ownership to counter tax evasion
- this included, as per the ATO[10], 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

[5] https://www.ato.gov.au/General/International-tax-agreements/In-detail/Common-Reporting-Standard/?=redirected
[6] https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8259
[7] https://ogpau.pmc.gov.au/commitment/12-beneficial-ownership-transparency
[8] https://treasury.gov.au/foi/2528
[9] https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Joint-Chiefs-of-Global-Tax-Enforcement/
[10] https://www.ato.gov.au/Media-centre/Media-releases/Global-tax-chiefs-undertake-unprecedented-multi-country-day-of-action-to-tackle-international-tax-evasion/

> …Australian Tax Office (ATO) 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.

Consultation question 2 – whether legislative amendment is required

If the CMAC test is modified to be a two-step test … 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 Legislative reform is needed

Given that the conflation of the two concepts has arisen due to judicial interpretation, over many years, parliamentary legislative action is required. As recent experience shows, judicial considerations are influenced by looking to precedent and the requirement here is for new policy to be developed.

More importantly, it seems clear to us that ATO interpretive action in conflict with the history of decided cases would create a real risk of courts not following any such ATO innovation to resolve the confusion on the part of accumulated judicial interpretation.

2.2 What is needed in any legislative reform

We outline below our submissions on:

- the need for a taxpayer self-assessment (tiebreaker), including potentially relevant recent experience involving the Australia-New Zealand tax treaty
- the first limb "carrying on business in Australia" rule
- the second limb CMAC rule

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2.2.1 Tiebreaker rules and self-assessment to avoid multiple residency

First, any CMAC amendments need to recognise that a business which is operating in multiple jurisdictions, which may potentially be resident in multiple countries, should be treated as a resident of one jurisdiction.

International tax treaty practice and tax policy has sought to result in taxpayer certainty in ultimately having a single tax residence jurisdiction. This is achieved using tiebreaker rules, common in double tax treaties, and are used for example in the UK to ensure that a corporate tax residence outcome under a double tax treaty is used for domestic purposes also.

So we submit that:

- any legislative revision which involved CMAC should recognise the possibility of producing corporate residency in multiple jurisdictions, and should identify in what circumstances the principal CMAC will be in Australia
- the legislation should contain a tie breaker rule, to enable corporations to identify a single country of residence
- the ATO and the New Zealand Inland Revenue (**IR**) administration of the recent modification to the Australia and New Zealand double tax treaty (modified under the Multilateral Instrument (**MLI**)) confirms the benefit of taxpayer self-assessment of the corporate residency under the tiebreaker rule - the ATO and IR allow certain taxpayers to self-assess their corporate residency status
- we identify certain factors should be identified expressly in setting a tiebreaker rule
- Australian reform should consider adoption of the UK style approach that, where a company has its corporate residency determined under a tax treaty, including outcomes under a tax treaty tiebreaker rule, then the tax treaty outcome should be adopted for Australian domestic tax determination of the corporate residency of the company

This issue, of corporate residency status of companies undertaking business activities in multiple jurisdictions, is familiar in international tax, particularly for tax treaty purposes. As a result policymakers have introduced tiebreaker rules to enable a company conducting business in two jurisdictions (and being a dual resident) to determine, and self-assess, which of the two jurisdictions constitutes its country of residence.

We submit that tiebreaker rules to determine a single residency outcome do not impair Australia's or other countries' taxing powers to tax the income of foreign resident companies under their rules dealing with permanent establishments, income sourced in the market country, and numerous integrity rules. As we have outlined, Australia has strong rules to this effect.

There is no single tax treaty best practice in relation to tax residency tiebreaker rules. Most treaties use an entity's place of effective management (**POEM**) as the key tiebreaker test to determine a dual resident's jurisdiction of tax residence for tax treaty purposes. Some tax treaties have no tiebreaker rules, and some tax treaties use different approaches.

Significantly, the MLI, the most recent multilateral reform initiative in relation to treaties, moves away from mechanical, self-assessed rules and leaves the resolution of residence to an individual agreement between the competent authorities of the two jurisdictions. This arose following the OECD base erosion and profit shifting (**BEPS**) multi-year project, and arising from Action 6[11].

[11] https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page34

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The Australian Treasury website states[12]:

> "Article 4 — Dual resident entities (optional article)
>
> Most treaties use an entity's place of effective management as the key tiebreaker test to determine a dual resident's country of tax residence for tax treaty purposes. This test will be expanded to include other factors and authorise the two tax administrations to agree on a single country of residence. Australia has adopted Article 4 …"

Unfortunately, this MLI approach of moving away from primary or mechanical rules to authorise tax administrations' agreement on a case by case basis is in our view inefficient. The experience of Australia and New Zealand, in relation to their tax treaty, is relevant. The Australia and New Zealand tax treaty contained a tiebreaker rule in article 4. When Australia and New Zealand adopted the MLI article 4, the tiebreaker rule was removed, and it became necessary for every dual resident company to approach the competent authorities for an individual determination on its resident status.

This has proved challenging, given the large number of New Zealand companies which have significant directorial involvement of Australian directors or governance activities. As a result, the ATO and the New Zealand IR have released a temporary administrative approach in May 2019[13]:

> "For taxpayers that satisfy all of the eligibility criteria outlined below for the relevant year, the Australian Taxation Office (ATO) and New Zealand Inland Revenue (IR) jointly determine that:
>
> - Where an eligible taxpayer reasonably self-determines its place of effective management (PoEM) to be located in Australia, it will be deemed to be a resident of Australia for the purposes of the Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion (Australia-New Zealand tax treaty).
> - Where an eligible taxpayer reasonably self-determines its PoEM to be located in New Zealand, it will be deemed to be a resident of New Zealand for the purposes of the Australia-New Zealand tax treaty."

This arises:

> "in recognition of the Single Economic Market agenda between Australia and New Zealand, which seeks to create a seamless trans-Tasman business environment, and the fact that our respective tax systems and administrations are comparable, and both countries are committed to adopting measures to address BEPS risks, **this joint approach represents a measured risk-based approach that seeks to provide certainty and minimise compliance costs for taxpayers.** It is envisaged that this approach will only be implemented between Australia and New Zealand at this stage." (emphasis added)

We summarise the conditions for the administrative approach below because:

- the administrative approach conditions outline a range of circumstances which could be usefully be considered in the context of Australian corporate residency rule if the CMAC reform option is chosen (although the range of factors permitting taxpayer self-assessment is to narrow and is problematical to apply for larger companies)
- the ATO and New Zealand IR recognise that taxpayer self-assessment is an appropriate mechanism in the corporate residency context

[12] https://treasury.gov.au/tax-treaties/multilateral-instrument
[13] https://www.ato.gov.au/General/ATO-advice-and-guidance/In-detail/Private-rulings/Supporting-documents/MLI-Article-4(1)-administrative-approach/

- this discussion may also be useful if a de minimis rule was being developed as an adjunct to the rewriting of the CMAC legislation. We consider the proper function of a de minimis rule below

The administrative approach is subject to a range of conditions, some of which would be useful in an Australian domestic tiebreaker rule. We summarise these as follows:

Structure
- taxpayer is an ordinary company (not a trust, partnership, co-operative or similar vehicle, or trustee company)
- taxpayer has reasonably self-determined its place of effective management to be solely in either Australia or New Zealand

Financials
- taxpayer's group annual accounting income is less than AUD $250 million in financial statements for the most recent period
- taxpayer's gross passive income is less than 20% of its total assessable income for the most recent income tax year ('passive income' uses the definition adopted in 2019 as "base rate passive income" which also drives the lower Australian tax rates for small to medium companies, as defined in section 23AB of the Income Tax Rates Act 1986[14] It includes dividends other than non-portfolio dividends, franking credits on such dividends, non-share dividends, interest income (some exceptions apply), royalties, rent, gains on qualifying securities, net capital gains and income from trusts or partnerships referable (either directly or indirectly) to an amount that is otherwise base rate entity passive income
- the total value of intangible assets (under Australian Accounting Standard AASB 138 Intangible Assets), other than goodwill, held by the taxpayer is less than 20% of the value of its total assets based on prepared financial statements for the most recent reporting period

Compliance activities
- no current, or within last five years, exposure to compliance activity undertaken by either the ATO or IR which relates to the determination of residency for taxation purposes
- no current objection, challenge, settlement procedure or litigation in either Australia or New Zealand in relation to a dispute with either the ATO or IR
- capacity to approach the ATO or IR in some failure circumstances

No taxpayer or group member involvement in a
- tax avoidance scheme whose outcome depends on the location of its residence, or
- a tax avoidance scheme affecting the location of its CMAC, including previous or subsequent 'migration' of residency
- arrangements to conceal ultimate beneficial or economic ownership
- arrangements involving abuse of board processes (including backdating of documents) or the board not truly executing its functions, or
- arrangements under which any benefits under the tax treaty would be potentially denied under the conditions of the Principal Purpose Test in the MLI Article 7

Taxpayer ongoing obligations, in the event of a material change, to re-assess their eligibility and approach either competent authority if the practical administrative approach no longer applies to their circumstances.

This analysis shows that CMAC and POEM are ambiguous concepts, difficult to prescribe in a simple set of rules. In passing, that is why we prefer an incorporation – only test, as did the Board of Taxation in 2003.

Additional factors which need to be articulated in a CMAC primary or tiebreaker rule, to properly deal with globally integrated businesses (e.g. an IT company with Australian researchers) include:

(a) the primary focus in determining whether the company carries on business in Australia should be ideally on the revenue streams of the company, not just its business inputs such as R&D or

[14] http://classic.austlii.edu.au/au/legis/cth/consol_act/itra1986174/s23ab.html

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product development activities. So if an Australian company has a foreign subsidiary, and the two companies share intangible property and product design activities, but the overwhelming majority of revenues are generated by the foreign subsidiary in its licensing and operational activities in foreign countries, we suggest that the prime focus on for residency determination should be on the revenue stream, and the foreign subsidiary should not be treated as carrying on business in Australia.

This determination of non-resident status should not adversely affect Australia's revenue base, because the Australian supply of IP and services to the foreign subsidiary should remain subject to Australia's transfer pricing rules and all the other rules applicable to international business activities - the Australian supplier of services and goods should be expected to generate Australian taxable revenues from the supply[15].

(b) The carrying on business test should allow for early-stage foreign companies – whether they are exploring for mineral resources in overseas countries, or undertaking market research and sourcing IP in overseas jurisdictions in a preparatory phase ahead of developing and releasing their products. The early-stage policy consideration would recognise the foreign company's nil or negligible revenue in this early phase.

(c) The carrying on business in Australia test should be carefully calibrated to synchronise with Australia's funds management sector and its practices. For example, PCG 2018/9[16] identifies a not-uncommon situation:

"Example 11 - For Invest Co

1. ForInvest Co is an investment company incorporated in Foreignland which carries on business running an investment fund. Its directors are based in Foreignland.
2. ForInvest Co engages another entity, AusManager Co, to manage its investment fund. AusManager Co's authority to make decisions, negotiate and conclude contracts is limited by the authority granted to it by ForInvest Co's board of directors, including the investment framework they set. It manages the investment fund under that authority and the ongoing supervision of ForInvest Co's board of directors. The decisions it makes are the conduct of ForInvest Co's day-to-day business under the authority and supervision of ForInvest Co's board of directors. They do not constitute the exercise of ForInvest Co's central management and control.
3. The minutes of ForInvest Co's board meetings record that the board of directors meet in Foreignland where they:
   - Determine the operational policy and investment strategies of ForInvest Co
   - the overarching policy for how the assets of each of the company's funds are to be invested, and whether to establish other investment funds
   - decided to appoint AusManager Co to manage its investment fund, and
   - review and exercise oversight of the performance of the investment fund and AusManager Co.

There is no evidence that the board minutes are false or misleading in any respect. The Commissioner accepts that ForInvest Co's high-level decisions are made by its directors in Foreignland, that its central management and control is located in Foreignland and that ForInvest Co is not an Australian resident under the central management and control test of company residency.

[15] ATO Taxpayer Alert TA 2020/1 "Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets (DEMPE)" notes the issues. Further ATO guidance is expected in 2020 to outline the issues related to intangibles migration, evidence the ATO expects that taxpayers should maintain and the practical application of the transfer pricing law to those high-risk arrangements.

[16] https://www.ato.gov.au/law/view/view.htm?PiT=99991231235958&docid=COG%2FPCG20189%2FNAT%2FATO%2F00001

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2.3 First limb: Whether the foreign company "carries on business in Australia"

It would be highly desirable to clarify the "carries on business in Australia" for the purposes of the definition of "resident".

A statutory definition of carrying on business appears in the Corporations Act Section 21[17] in relation to Australian registration of a foreign company, which includes certain business indicators and also states a foreign company is not to be carrying on business merely because certain indicia arise.

Not all of these positive or negative indicia are appropriate for corporate residency purposes, because they need consideration in relation to permanent establishment (**PE**) or source issues and we provide some brief comments in the table below. The factors illustrate the complexity of a legislative definition.

[17] https://www.legislation.gov.au/Details/C2017C00129

Corporations Act 2001	**Useful to mirror in tax residency?**
"21 Carrying on business in Australia or a State or Territory	Yes
(1) A body corporate that has a place of business in Australia, or in a State or Territory, carries on business in Australia, or in that State or Territory…	
(2) A reference to a body corporate carrying on business in Australia, or in a State or Territory, includes a reference to the body:	
(a) establishing or using a share transfer office or share registration office in Australia, or in the State or Territory, as the case may be; or	Yes
(b) administering, managing, or otherwise dealing with, property situated in Australia, or in the State or Territory, as the case may be, as an agent, legal personal representative or trustee, whether by employees or agents or otherwise.	Yes
(3) Despite subsection (2), a body corporate does not carry on business in Australia, or in a State or Territory, merely because, in Australia, or in the State or Territory, as the case may be, the body:	
(a) is or becomes a party to a proceeding or effects settlement of a proceeding or of a claim or dispute; or	Yes
(b) holds meetings of its directors or shareholders or carries on other activities concerning its internal affairs; or	Yes
(c) maintains a bank account; or	Yes
(d) effects a sale through an independent contractor; or	PE/ source issues
(e) solicits or procures an order that becomes a binding contract only if the order is accepted outside Australia, or the State or Territory, as the case may be; or	PE/source issues
(f) creates evidence of a debt, or creates a security interest in property, including PPSA retention of title property of the body; or	PE/source issues
(g) secures or collects any of its debts or enforces its rights in regard to any securities relating to such debts; or	PE/source issues
(h) conducts an isolated transaction that is completed within a period of 31 days, not being one of a number of similar transactions repeated from time to time; or	Maybe
(j) invests any of its funds or holds any property.	PE/source issues

2.4 Second limb: Australian governance and management not to result in business carried on in Australia

We observe that the Corporations Act Section 21 expressly has had little difficulty in separating directorial or governance activities from carrying on business, namely:

- "is or becomes a party to a proceeding or effects settlement of a proceeding or of a claim or dispute; or
- holds meetings of its directors or shareholders or carries on other activities concerning its internal affairs; or
- maintains a bank account"

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We suggest that the governance activities expressly not constituting the carrying on of a business in Australia might also include Australian:

- administration including preparation of periodic management reports and financial statements (certainly for early-state companies)
- governance and management stakeholders not limited to the directors, that is, precluding CMAC if the group chief financial officer, secretary and other group officers not being directors in the foreign subsidiary perform duties consistent with their global governance activities
- reporting including customers, stakeholders, risks, contract documentation, etc.
- oversight of staffing, and
- management

2.5 Considering a discretion or concession administered by the ATO, notably in relation to infant companies, to avoid "residence flipping"

We submit that, in addition to the above-mentioned rules, that there will need to be:

- a regulation – making power to enable flexibility to adjust the rules as circumstances arise and
- some discretion allowed in the Commissioner of Taxation

to cover particular scenarios which might otherwise see companies' residence changing from year to year as their facts and circumstances change.

For example, a newly incorporated foreign company, which might be exploring business opportunities overseas, and which might be described as an infant company with a profit-making intention in the foreign jurisdiction but as yet no defined product, or service, or (if relevant) mineral prospect might be difficult to specify unambiguously in a legislative measure. Under the current CMAC analysis, the company may well be a resident of Australia, and might then (when it develops sufficient foreign scale, operations and governance) become a non-resident - having to endure a change of residence in that year, and might in later years converts to be a resident of Australia again.

Such "residence flips" can be reduced by introducing a taxpayer self-assessment regime, but we suggest they will never be eliminated entirely. That being the case, we see the need for the law to provide a mechanism for a company to approach the ATO, to have a binding determination in relation to its residency status.

To achieve this outcome, we suggest it would be useful for the legislation to provide for appropriate discretion in the Commissioner of Taxation to deal with such rules, provided that the relevant factors for exercise of the discretion are specified.

2.6 De minimis Australian business exclusion is useful element but would be insufficient on a standalone basis

The Options Paper asked:

> "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?"

This question looks to a provision that if the foreign company carried on in Australia no more than some "trigger percentage" of its business based on some business allocation key (the question looks to turnover but only as an example, so we consider the issues more broadly). The Options paper does not suggest the trigger percentage or limit of Australian business of a foreign company, but we explore a trigger of say 10% of its total business.

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We agree there is some benefit in having an optional de minimis exemption which might form **part** of a potential CMAC reform option 1 response as a secondary or backstop exclusion.

We submit that such a de minimis approach **could not operate as a standalone test to replace the task** of reforming the corporate residency test. Our analysis found three key groups of problems with such an approach:

a. Such a de minimis Australian business rule would not achieve certainty or clarity. As we outline below it would:
   - Unless the index or "key" was turnover from third parties, it would involve a highly complex and highly uncertain calculation
   - require much consideration of what the de minimis threshold should be
   - be problematical or impossible to measure during the course of a financial year
   - consume a lot of policy development time
   - not be appropriate for all circumstances in any event
   - introduce a brand-new uncertainty into the tax system, with potentially arbitrary outcomes which would require constant supervision or issue of private binding rulings by the ATO.

   A formulaic approach using such an algorithm or method statement would potentially generate volatile outcomes, making it impossible to function to provide a foreign company with certainty during a financial year.

b. Second, if the allowable Australian business activity to avoid CMAC was some minimal Australian business percentage say 10% and was applied to anything other than turnover, this would continue to discourage Australian companies from being involved in activity in relation to governance or other involvement with foreign incorporated subsidiaries for fear of triggering the trigger ratio and resulting in Australian resident status. So this idea would be inconsistent with broader Australian tax policy unless the mechanism or turnover was not influenced by any transfer pricing or other adjustments such as Australian inputs of parent company governance, R&D or business engagement – but that is already identified as a separate reform option. If the prospect of tax-only adjustments to turnover was to be used, then the trigger ratio would need to be raised to allow say 49% Australian activity.

c. So, if it were contemplated that a mechanical de-minimis rule was to be the only legislative reform recommended in order to achieve a "quick fix", a huge amount of effort would be required to resolve the abovementioned issues, so this option is unattractive compared with, introducing an incorporation-only rule, or to rewrite the CMAC law to separate carrying on business and central management and control into two standalone rules.

d. Nonetheless, an optional de minimis exemption might form **part** of a potential CMAC reform option 1 response as a secondary or backstop exclusion, provided it did not replace the task of reforming the corporate residency test.

The analysis below provides more detail on why a de-minimis approach is unworkable as a standalone primary modification to CMAC without addressing the core problems of the CMAC law.

A factor other than turnover would discourage Australian involvement

We outlined in our first submission that a key concern that the existing CMAC law operates as a disincentive to Australian groups performing governance and having commercial interactions with their foreign subsidiaries, creating commercial risk and also shutting out Australian employees and businesses from the activities of their foreign subsidiaries.

If the de minimis approach operated on the basis of turnover, that is, if it looked to actual revenue streams of the foreign company from Australian and from foreign sources respectively, that would be a useful optional carveout (subject to calculation issues, discussed below).

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But we would be very concerned if the de minimis approach had a formulary factor other than turnover, for example if it included transfer pricing adjustments to recognise issues such as costs to, and business inputs to, the foreign company in relation to issues such as deemed turnovers or adjustments for:

- Governance activities provided by the Australian parent company, directors and staff
- Assistance in setting corporate and business strategy
- Assistance in product and concept development

and the de minimis Australian-business threshold was minimal. If that was the policy approach, then companies would seek to minimise the Australian involvement in their foreign subsidiaries so as not to result in Australian resident outcomes. Such a "minimum involvement" outcome is no different to the problems which have arisen under the ATO current interpretation, and would perpetuate the very problem which we suggest the policy should be seeking to overcome.

De minimis rule will be a useful adjunct to CMAC reform but not a replacement

In assessing whether a de minimis approach might be useful, we outline the issues which would need to be considered. These issues are relevant if the de minimis approach was an optional, elective, compliance aid. If the de minimis approach were considered as the only policy response then the issues would view be extremely problematical.

a. What factor defines the company's "carrying on business" (denominator in the formula)?
   - the use of turnover, that is, sales revenue from third parties, is at first sight attractive. If the turnover approach was subject to transfer pricing adjustments in relation to any suppliers actually made to associates that would raise complexity, volatility and compliance issues
   - if the factor was anything other than turnover it would raise issues of whether gross or net income is the relevant factor)
   - turnover would include one-time capital gains or abnormal income which might distort the outcome for a year when the denominator is considered
   - how to treat an early-stage company which does not have any turnover? Should a specific allowance be introduced for early-stage companies which might be exploring for mineral resources overseas or for business opportunities overseas where no revenue currently arises or operating business has been commenced. Does a forward budget of potential turnover have any relevance?
   - we are not attracted to a factor being the value of the company's assets. This would raise many issues such as what value is relevant – the book value, the arms-length value, smoothed value (thin capitalisation experience shows the problems here)
b. What is the measurement platform, the source of the data?
   - are the calculations based on the management accounts or financial statements? Single entity accounts of the foreign company involved or consolidated accounts? Which accounting standards - those applicable to the foreign incorporated company in its home country or those for the parent company which might be Australia (these issues arise in relation to SGE/CBCR/GPFS and are being examined as the OECD/G20/Inclusive Framework is working through BEPS 2.0 Pillar 1 and Pillar 2)
   - what about changes in accounting standards, in the jurisdiction of the foreign company or its parent company (refer SGE, GPFS and BEPS 2.0 issues)?
c. What is the foreign company's relevant Australian business activity (the numerator)?
   - the issues will depend on the measurement key
   - turnover from third parties appears attractive
   - will the test look to income from an Australian permanent establishment of the business on in Australia, issues of "carried on" or "carried out" or "carried on or carried out" – see comments in Thiel's Case

- is the turnover / sales revenue inclusive of sales by the foreign company from overseas locations to Australian parties not through an Australian permanent establishment)? These issues arise in relation to Digital Sales Taxes and setting the taxable nexus
- if the foreign company participates in the global development of IP by the parent company it would be highly desirable to eliminate the prospect of disputes (including in later years) arising from the prospect of transfer pricing adjustments arising from its contribution to activities conducted by the Australian or global group
- it would be highly desirable to eliminate issues arising from any applicable double tax treaties to avoid volatility and uncertainty, including issues the MLI and its principal purpose test
- it would be highly desirable to eliminate uncertainties under the source of income rules tie in? For investment companies, are transactions in ASX securities which are undertaken or booked overseas designated as Australian or foreign for these purposes? If there are varying accounting standards relating to investment companies trading on the ASX and inclusion in gross turnover how is this to be covered? Would gross income or net income recording in financial reports make a difference?
- it would be highly desirable to eliminate uncertainties relating to foreign loans made from foreign funds sourced overseas
- it would be highly desirable to eliminate uncertainties relating to MAAL concepts
- it would be highly desirable to eliminate uncertainties, to exclude business inputs into the foreign company relating to Australian back-office functions, including Australian R&D, Australian governance, charges and services from the parent company, or the entire group in Australia, or the entire group globally
- it would be highly desirable to eliminate uncertainties relating to the application of Australian transfer pricing rules to the numerator and impact the formula?

d. What period is selected for measurement?
   - if the de minimis rule was based on the financial statements for the financial year determined after it has ended, the outcome will be unknowable until after year-end. As well any abnormal turnover (notably capital gains, disposals of assets, disposal of businesses, M&A activity) will create the uncertainties which arise in defining land-rich companies, small business entities, indirect Australian real property interests etc.
   - it would be highly desirable to eliminate uncertainties relating to the prospect of adjustments by the ATO or other revenue authorities and changes relating to prior years
   - it would be highly desirable to eliminate uncertainties relating to the different accounting periods in Australia and the overseas jurisdiction and substituted accounting periods, if the possible outcome was a change in resident or non-resident status might change in a year as a result of application of the formula.

e. Does the formulaic approach work for high margin and low-margin foreign companies, and years of business-entry low-price strategies?

f. If the Australian-business de minimis threshold was set too low (eg 10%) how would it work with amalgamations of foreign operations or separating business in two companies (one Australian, one foreign business) for efficiencies or for foreign tax or legal compliance reasons.
   - is the Australian leg of the company forced to remain inefficient for Australian tax residence purposes?
   - would management of the de minimis rule be tax avoidance, excluded from Part IVA / DPT? How does the onus of proof work?

g. If the Australian-business de minimis threshold was set too low (eg 10%) it would not allow for volatile business conditions year to year including
   - varying business turnover –e.g. the foreign company has a particularly good Australian year, or a particularly bad Australian income year, or a new Australian business is acquired which boosts Australian revenues in that year)
   - it would be highly desirable to eliminate one-time gains (e.g. a capital gain realised in one year in Australia or not in Australia, which has been building up for several years, or conversely a large capital loss) which would cause a one-year abnormal distortion in the formulary ratio

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- if smoothing was not allowed for, if the de minimis rule was the only reform approach (as distinct from an optional carveout) and the Australian-business threshold was set too low (eg 10%) this might result in volatile year-to-year outcomes and changes of corporate residence "residence flips". This would recreate the very same issues which this reform process is to eliminate, relating to CGT, DTAs, tax consolidation, tax losses, non portfolio dividend exemption of the foreign company, non portfolio CGT exemption, inbound CGT exemption

h. Could a company seeking to use the formulary de minimis rule go to the ATO for a ruling? Is the onus still on the taxpayer in a wholly uncertain environment? Will the ATO issue rulings that have any practical value?
i. How would a company using this carveout be treated if its shares were being disposed of by its shareholders? Warranties? Indemnities?
j. If the de minimis rule was the only policy response then how exactly would formulaic approach prevent stateless income and add to Australian tax system integrity?
a. If the de minimis rule was the only policy response then how would such a volatile residence outcome interact with other countries' treatment?

We highlight that any carveout focusing on an annual determination of "carrying on business" involves activities and flows of income. This is more challenging than a different to CGT discount issues (e.g. discount CGT, small business) which operate on point of disposal and doesn't need to be determined from year to year.

In conclusion, we submit that the de minimis approach is useful but is incapable of operating as a primary reform option for Australian CMAC reform. It is nonetheless useful as a second-string carveout operating on an optional basis for some scenarios that fall within the relevant terms.

3. Consultation question 3 - Is an incorporation-only test more effective than CMAC adjustment

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 Incorporation rule will produce greater certainty

We submit that 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.

We highlight again that the difficulties in the CMAC test are long-running, identified as long ago as the 1975 Asprey review, were examined in the Board's RITA review, and the Board recommended an incorporation-only test as the preferred reform option. For the convenience of readers, we set out extracts from these documents in the attached Appendix.

As set out in our accompanying submission regarding the Incorporation-only reform option:

- as far as is possible any test of 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 residency test and must also be consistent with the basic requirement for certainty and should not result in arbitrary outcomes.[18] An incorporation-only meets these basic requirements
- the CMAC test is inherently flawed

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

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- 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 regional headquarters or regional holding companies
- 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 outcome can then result in arbitrary tax outcomes, which might favour the taxpayer or the revenue. The possible changes raised in Reform option 1 of the December Options Paper (including any optional de minimis or any other bright line test), and other changes we have considered, will introduce new and different uncertainties
- the incorporation-only test is consistent with a self-assessment system. The CMAC test (in its current or modified form) is not
- an incorporation-only test does not give rise to any *systemic* integrity. Further, an incorporation-only test does not of itself raise any significant new *specific* integrity concerns and reduces existing integrity concerns. 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
- if the Board decides that some additional specific integrity issues arise, these issues can be addressed by specific integrity measures. Restructure possibilities are unlikely to give rise to integrity issues
- a change to incorporation-only test is not inconsistent with Australia's Double Tax Agreements (**DTAs**) or the MLI, and would not require renegotiation of Australia DTAs or a change in Australia's position under MLI
- 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 8 below). In any event, transitional measures will be necessary if there is a change to an incorporation-only test

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

We do not at this stage see any fundamental obstacles to its adoption.

3.2 Impact on Australia's double tax treaties

In our view, an Australian adoption of an incorporation-only rule would not appear to cause difficulties in relation to the operation of Australia's double tax treaties. While we provide more detail on this issue in our separate submission, we highlight that:

- while tax treaty practice in relation to corporate residence varies, the typical approach in Australia's tax treaties modelled on the OECD standard calls for Australian residents of companies to be determined in accordance with Australia's domestic tax law principles
- it has long been understood that application of domestic rules for determining corporate residence will often result in a company being treated as potentially a resident of both tax treaty parties, and therefore the OECD model tax treaty contained a provision for dual resident companies to have their residence in only one of the tax treaty jurisdictions, using the tiebreaker rules, previously based on place of effective management (POEM). Many of Australia's tax treaties contain such tiebreaker rules, but not all
- as noted earlier, the OECD has more recently identified that this policy approach creates uncertainty (as this submission outlines, CMAC and POEM are challenging concepts) so the OECD proposed and recommended in the multilateral instrument (MLI) that the tiebreaker rule be recast to provide for resolving the status of dual resident companies by mutual agreement between the tax treaty parties' competent authorities. This is the position adopted by Australia in relation to the MLI, adopted for example in relation to New Zealand as outlined above
- we submit that if Australia is to adopt an incorporation-only rule for determining corporate residency of companies, will prima facie see fewer foreign company is treated as Australian residents, and they will therefore be less likely to raise issues of dual resident status

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- Australia's domestic law, and Australia's double tax treaties, provide significant powers for Australia to impose taxation on Australian sourced income of all types particularly where a foreign resident company has a permanent establishment in Australia. In fact the powers to Australia and other jurisdictions under the MLI modification is to tax treaties strengthen Australia's taxing rights in relation to non-resident companies
- Australia's controlled foreign company, controlled foreign trust and related rules are not restricted pursuant to double tax treaties. Not are Australia's anti-avoidance rules restricted pursuant to double tax treaties, and these anti-avoidance powers extend to Australia's Part IVA, Diverted Profits Tax or Multinational Anti Avoidance Law

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Appendix

Previous Australian public policy analysis of the CMAC test

The challenges of the CMAC test were identified as long ago as the 1975 Commonwealth Taxation Review Committee (the Asprey Committee) which stated[19]:

> "17.15. The meaning of central management and control calls for clarification. It would bring some tax-haven companies within the jurisdiction of Australian tax if these words were held to be wide enough to include the exercise of control and direction of the company's affairs otherwise than in the formal proceedings of the board-room. **It might be thought to be enough to give a residence in Australia that the board of directors habitually responds to instructions formulated in Australia, even though the board meets elsewhere. This wide meaning would, however, increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable: many wholly-owned subsidiaries of Australian resident companies, though incorporated in foreign countries and resident there, could become Australian resident companies.** On the other hand, the objective of bringing tax-haven companies within the jurisdiction of Australian tax should not be lightly abandoned. Some compromise might be possible which would involve identifying tax-haven countries, either in the Act or, preferably, in regulations, and would provide that a company incorporated in such a country would be deemed to have an Australian residence if effective control and direction of the company's affairs are exercised in Australia, regardless of where the board of directors meets or other formal corporate proceedings take place." [emphasis added]

The Asprey Committee reform proposals are not directly relevant as it reported before Australia introduced its Controlled foreign Company rules, which addressed the issue in the latter section of paragraph 17.15, before Australia introduced its dividend imputation law or the complete array of rules governing taxation of foreign residents.

The Board of Taxation itself, in its 2002 RITA reviewed the CMAC rules in its August 2002 consultative document[20], noting:

> "Applying residency concepts to companies, particularly when they are part of a multinational corporate group is difficult. Consequently, the test of residence of a company for tax law purposes needs to be pragmatic, balancing factors such as compliance and administrative costs, integrity of the tax system, and the assertion of Australia's taxing rights against other nations' taxing rights.
>
> Moving to a test of company residence based solely on incorporation-only, as in the United States, would address some business concerns. It would be simple for both taxpayers and tax administrators and provide a level of certainty in arranging corporate affairs. However, it may be relatively easy to use an incorporation residence test to minimise tax. In the United States some major corporate groups have used the incorporation residence test to change the location of their parent company (without any substantive changes in their operations, place of management or listing) to minimise US company tax liabilities, and start-up companies have been established in tax havens for the same reason.
>
> Some features of Australia's tax system would reduce the risk to Australia of relying on incorporation-only as the sole test of residency. In particular, the dividend imputation system is only available to resident companies and Australia's taxation of the foreign source income of resident companies is arguably less aggressive than the United States. As in the United States, changing residence could also trigger CGT liabilities for the company as well as for shareholders. However, the events in the United States still justify caution in adopting an incorporation-only.

[19] https://trove.nla.gov.au/version/45811797

[20] http://taxboard.gov.au/consultation/international-taxation-arrangements/

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Largely, difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. **However, the case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this**." (emphasis added)

"The residency of a company also is an issue for Australia's tax treaties. Only residents of tax treaty partners directly benefit from a particular tax treaty. Which tax treaty partner a company is resident of, in turn, affects the company's particular tax treatment.

Because countries use various tests of company residency, a company can be a resident of both tax treaty partners (for example, where it is incorporated in one country but has its central management and control in the other). Typically, treaties insert tie-breaker rules to deal with these cases. However, a few Australian treaties do not include a tie-breaker, resulting in dual resident companies being denied tax treaty benefits.

Australia's tax treaties generally follow the OECD model approach for tie-breaker rules, giving preference to the country of the company's place of effective management. However, Australia has agreed in certain treaties, such as with Canada, to a company residence tie-breaker that looks primarily at incorporation-only. Where countries have a tax system comparable to Australia the revenue risk of an incorporation-only tie-breaker test may be reduced. However, many of Australia's current or prospective tax treaty partners prefer a tie-breaker focusing on the place of effective management.

Where a company is resident under Australia's domestic tax law but is then treated as not being a resident under a tax treaty tie-breaker provision, the company is not a resident of Australia only for the purposes of the tax treaty. For other purposes of Australia's tax law, the company continues to be treated as a resident. However, in certain cases, the application of the domestic tax rules is modified for dual resident companies to prevent them obtaining possible tax advantages from that status.

Dual resident modifications could be avoided if the domestic definition of residency was altered so that it was overridden where a company was taken to be a non-resident as a consequence of applying a tax treaty tie-breaker. That is, a company resident under Australia's domestic tax law that is resident of a tax treaty partner under the relevant tax treaty tie-breaker would be treated as non-resident for all income tax purposes. The United Kingdom and Canada adopt this approach. While it could benefit some businesses, it has wide-ranging implications."

We observe that in this Board of Taxation consultative document, the ATO was cited as treating the first limb carrying on a business in Australia test as being separate to the second limb central management and test. Even then, the uncertainty of judicial interpretation because the board to consider the CMAC test unsatisfactory.

The position is even more apparent since the ATO have now conflated the first limb and the second limb of the corporate residency tests.

After undertaking its consultations and review, The Board of Taxation concluded in its February 2003 report about the preferred reform option, by recommending an incorporation-only rule:

"Potential solutions
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

3.123 The simplest solution would be to adopt the incorporation-only as the sole residence test in Australia. The recommendations in the earlier part of this chapter, and in other chapters make the test of corporate residence much less of a concern in ensuring the proper operation of the international tax system. The US adopts an incorporation-only test, but it is currently having some concerns as a result of corporate inversions — tax motivated transactions which substitute a tax haven incorporated parent for the US incorporated listed parent company, often at some tax cost. The result is to move residence of the parent out of the US even though it is still managed there and its operations otherwise remain unchanged.

3.124 The incorporation-only test would equally apply to the initial incorporation of a company outside Australia where the company is managed and controlled from Australia.

3.125 The problem arises in the US for three key reasons. First, foreign branch profits and dividends derived by the US parent from its foreign subsidiaries are subject to US tax (with a credit for foreign taxes paid). Second, the US has a comprehensive CFC regime. Third, because the US has no imputation system, the dividends paid by the US parent to its US individual shareholders are taxed. Factors one and three do not exist in Australia.

3.126 The shareholders of the Australian parent currently gain imputation benefits for Australian tax paid by the Australian parent. If the Australian parent company is moved offshore, the shareholders will lose those benefits.

3.127 …

3.128 On balance, there would be little incentive to moving offshore. There would also be substantial disincentive in the form of loss of imputation benefits. Thus, for Australian based companies the US concerns with "inversions" are largely unfounded. For this reason, the Board recommends that in the interests of certainty for taxpayers and ease of administration, the test for residency be based solely on incorporation.

Residence of companies Recommendation 3.12:

The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia."

Option 3.13: To consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual residency provisions

3.129 Various tax-planning possibilities arise when a tax treaty tie-breaker applies to a dual resident company. Australian law currently deals with a number of these through specific provisions in domestic law. A number of other countries deal with the issues by projecting the tax treaty tie-breaker into domestic law — that is, a dual resident company ceases to be a resident under domestic law if a tax treaty allocates it to another country. This is a simpler and more comprehensive solution than Australia's current law provides.

3.130 However, as the tie-breaker is based on a management test, it can create the same kind of uncertainty mentioned above for DLCs and listed companies with directors distributed around the world. The OECD is currently working on a solution for this problem, which Australia should consider in due course. In the meantime, problems arising from the management test for DLCs and other listed companies could be dealt with by tax treaty as necessary. At the moment, the problem arises mainly in relation to the UK.

3.131 The submissions made very few comments on this issue. However, those submissions which did discuss the issue favoured excluding dual resident companies from resident status if the tax treaty allocated their residency to the other country. Given the Board's Recommendation 3.12, this is likely to be an issue mainly where an Australian incorporated company is managed from offshore. Such circumstances tend to be rare in practice and may often be motivated by the tax advantages of obtaining Australian tax residency. In these circumstances, if the relevant tax treaty treats the entity as a non-resident of Australia, it would seem appropriate to do so for all income tax purposes. Moreover, this is generally consistent with the intent of the existing dual residency

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rules."

Option 3.13: Dual residents
Recommendation 3.13:
The Board recommends that a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions."

We submit that the exhaustive analysis and conclusions of the Board of Taxation in 2002-2003 remain relevant. All the reasons that the Board of Taxation gave in 2003 during the RITA review for this recommendation still hold true today, all the more so given the many integrity measures introduced since then.