Corporate Tax Residency Review – Options Paper

Review of Australia's corporate tax residency rules
Board of Taxation Secretariat
C/-The Treasury
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About the Business Law Section of the Law Council of Australia

The Business Law Section was established in August 1980 by the Law Council of Australia with jurisdiction in all matters pertaining to business law. It is governed by a set of by-laws adopted by the Law Council and the members of the Section. The Business Law Section conducts itself as a section of the Law Council of Australia Limited.

The Business Law Section provides a forum through which lawyers and others interested in law affecting business can discuss current issues, debate and contribute to the process of law reform in Australia, as well as enhance their professional skills.

The Law Council of Australia Limited itself is a representative body with its members being:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Operating as a section of the Law Council, the Business Law Section is often called upon to make or assist in making submissions for the Law Council in areas of business law applicable on a national basis.

Currently the Business Law Section has approximately 900 members. It currently has 15 specialist committees and working groups:

- Competition & Consumer Law Committee
- Construction & Infrastructure Law Committee
- Corporations Law Committee
- Customs & International Transactions Committee
- Digital Commerce Committee
- Financial Services Committee
- Foreign Corrupt Practices Working Group
- Foreign Investment Committee
- Insolvency & Reconstruction Law Committee
- Intellectual Property Committee
- Media & Communications Committee
- Privacy Law Committee
- SME Business Law Committee
- Taxation Law Committee

- Technology in Mergers & Acquisitions Working Group

As different or newer areas of business law develop, the Business Law Section evolves to meet the needs or objectives of its members in emerging areas by establishing new working groups or committees, depending on how it may better achieve its objectives.

The Section has an Executive Committee of 11 members drawn from different states and territories and fields of practice. The Executive Committees meet quarterly to set objectives, policy and priorities for the Section.

Current members of the Executive are:

- Mr Greg Rodgers, Chair
- Mr Mark Friezer, Deputy Chair
- Mr Philip Argy, Treasurer
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- Professor Pamela Hanrahan
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- Mr Frank O'Loughlin
- Ms Rachel Webber
- Dr Richard Dammery
- Dr Elizabeth Boros
- Mr Adrian Varrasso

The Section's administration team serves the Section nationally and is based in the Law Council's offices in Canberra.

For Further Information

This submission has been prepared by the Taxation Law Committee of the Business Law Section.

The Section would be pleased to discuss any aspect of this submission.

Any queries can be directed to the chair of the Committee Clint Harding on charding@abl.com.au or 02 9226 7236,

With compliments

Greg Rodgers
Chair, Business Law Section

Executive Summary

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity of commenting on the Consultation Guide released by the Board of Taxation in September 2019 entitled *Corporate tax residency - Consultation Guide* (**Consultation Guide**) and now on the second consultation paper released by the Board of Taxation in December 2019 entitled *Corporate tax residency – Options Paper* (**Options Paper**).

This submission is intended to build and expand on the Committee's comments on the Consultation Guide dated 20 October 2019 (**First Submission**). It addresses each of the seven consultation questions posed in the Options Paper.

Submission

Summary

Modification of the central management and control (CMAC) test

1. As noted in the First Submission, clarification of the CMAC test within the legislation itself should be preferred, indeed, we now say is required, to address the potential risk and implications of a future change in interpretation and/or administrative guidance. Clarification could involve including a statutory definition of the two limbs, supported by examples in the explanatory memorandum. There are precedents for this approach, which may assist with re-designing the definition/s and the CMAC test.[1]

2. With respect to the content of the definition/s of the first and second limb, rather than being overly prescriptive, simplicity and an approach of "less is more" should be preferred. The extent of any modifications and tailoring of the definition/s should inform whether they should apply just to the revised CMAC test, to other "residence" tests or more broadly.

3. It may be considered that the revision of the CMAC test may reduce, rather than increase, compliance risks associated with the corporate residence test, such as the importation of losses. However, if concerns around potential abuse of the revised CMAC test remain, these should be addressed through the application of the existing general anti-avoidance provisions, or if necessary, through specific and targeted integrity measures, rather than seeking to over-engineer the CMAC test.

Adoption of the incorporation-only test

4. An incorporation-only test should be more effective at reducing taxpayer uncertainty and would appear to be better aligned with modern corporate governance practices, as compared with the retention of a modified CMAC test.

5. Consideration of whether this test should be adopted should take into account the effect of the proposed change on Australia's network of tax treaties, as well as the potential behavioural risks such as corporate restructures, integrity concerns and what transitional provisions may be necessary.

6. While beyond the scope of this submission, it may be beneficial for the Board to consider the experience of other countries that have adopted the incorporation-only test, the United States being the obvious example, but also Chile, the Philippines and Thailand.

[1] See under discussion of Consultation question 2

General observations on the potential way forward

7. As a general observation, any corporate residence test has its critics.[2] Despite being previously recommended by the Board in 2003 as part of the *Review of International Tax Arrangements* (**RITA**),[3] the incorporation-only test was not adopted by the previous Government. Instead, the approach adopted was for the Australian Taxation Office (**ATO**) to issue a taxation ruling, 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**) setting out its interpretive approach to the CMAC test which was intended to allow taxpayers and the ATO to operate effectively. Unfortunately, the ATO withdrew that ruling and replaced it with the current approach, which is problematic and requires legislative reform.

8. Adopting an incorporation-only test would reflect a significant change to the corporate residency test and has only been adopted by a handful of Australia's tax treaty partners. Therefore, the decision to adopt this test should not be made lightly. Our First Submission queried if using this as the only test may not be considered appropriate in a post-BEPS environment.[4]

9. The Committee also notes the move by the OECD and Australia away from the use of mechanical dual residence tie-breaker rules in tax treaties because of integrity concerns arising from dual residence and international tax planning, to case-by-case solutions for treaty purposes.[5]

10. It may be that a modified CMAC test in the short term, with a view to moving to an incorporation-only test in the long term, may be more palatable from a tax policy perspective. This may be preferable due to the other developments occurring in the international tax space arising from the responses to BEPS, and the current development of an international tax policy to deal with the digitalisation of business. A staggered approach might address the risk of the reform process being delayed while further consideration is given to an incorporation-only test, to allow addressing the immediate issues and uncertainty in relation to the CMAC

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[2] For example, refer Omri Marian, Jurisdiction to Tax Corporations, 54 B.C. L. Rev. 1613 (2013), accessible at <http://scholarship.law.ufl.edu/facultypub/359>. The abstract provides: "Unfortunately, tax scholars seem to agree that the concept of corporate tax residence is "meaningless." because taxpayers can easily manipulate corporate tax residence tests. Commentators try to deal with the perceived meaninglessness by either trying to identify a normative basis to guide corporate tax residence determination, or by minimizing the relevance of corporate tax residence to the calculation of tax liabilities. Instead, this Article suggests a functional approach, under which corporate tax residence models are designed to support the policy purposes of corporate taxation."

[3] RITA recommendation 3.12.

[4] First Submission at [61].

[5] For example, refer OECD BEPS Action 6: 2015 Final Report "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" at [47]: "the view of many countries was that cases where a company is a dual resident often involve tax avoidance arrangements. For that reason, the current rule found in Article 4(3) should be replaced by the alternative found in the Commentary, which allows a case-by-case solution of these cases."
This is accessible at <https://www.oecd.org/tax/beps/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>. This was building on the previous work of the OECD, e.g. refer the 2003 OECD Discussion Draft "Place of effective management concept: suggestions for changes to the OECD Model Tax Convention" accessible at <http://www.oecd.org/tax/treaties/2956428.pdf>.

test, which the Committee understands require attention. However, the Committee recognises that such an approach would over time result in significant duplication of tax policy and legislative development.

Discussion

Consultation question 1

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

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

How the CMAC test may be modified

11. The Committee refers to its comments in the First Submission in paragraphs [34] to [55], in response to Consultation question 3, in relation to how the CMAC test may be modified.

12. Clarification of the CMAC test within the legislation itself, rather than through an administrative guide is now required. This approach will provide greater ongoing certainty and reduce the risk of a change in ATO administrative guidance and implications thereof (as reflected in the submissions in relation to TR 2017/D2 and PCG 2018/D3). In the case of tax disputes, courts are not bound by administrative guidance, and seek to give meaning to and apply the statutory text as enacted, having regard to extrinsic materials, such as the explanatory memorandum. In this regard, as set out in paragraphs [38](c) – (e) of the First Submission, the clarification and codification of the CMAC test should include examples in the explanatory memorandum.

13. In terms of a possible approach for ensuring that CMAC in Australia cannot, by itself, be taken to also constitute the carrying on of business in Australia for tax residency purposes, as discussed in the First Response, the concept of CMAC could be defined to specifically exclude "carrying on a business in Australia" and, vice versa, the concept of "carrying on a business in Australia" could be defined to specifically exclude "CMAC." Further or in the alternative, the concept of CMAC could be defined by including and/or excluding certain activities, as discussed in more detail in response to Consultation question 2.

Integrity concerns

14. In terms of integrity concerns, the Committee reiterates that the corporate residency test should be confined to determining Australia's jurisdiction to tax, rather than playing a broader role in maintaining the integrity of the tax system. The Options Paper identified the large array of Australian tax laws which deal with

the operation of foreign companies, including Australia's extensive and robust anti avoidance provisions and laws for controlled foreign corporations (**CFCs**).

15. It is recognised that the application of the general anti-avoidance provisions in Part IVA[6] to the artificial or contrived change of corporate residence may be difficult in some circumstances. This is due to the potentially significant commercial implications associated with such a change, as the intended operation of Part IVA involves an exercise in evaluation.

16. At this stage, it is difficult to determine whether a revision of the CMAC test, to require a two-step process, would increase or reduce integrity risks. However, we observe that the ATO did not appear to consider that its issue of TR 2004/15 created unacceptable integrity risks at the time of issue. Also, the period from 2004 until 2018 did not appear to create any flood of integrity issues arising from the use of foreign incorporated companies which would have been highlighted in ATO, government and/or international documentation as requiring urgent attention. This contrasts with other policy issues which did require legislative intervention in that period.

17. Therefore, the Committee would like to think that the decisions *in Bywater Investments Ltd v Federal Commissioner of Taxation*; *Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45 (**Bywater**) and *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156 (**Malayan Shipping**) are outliers (in terms of facts and circumstances) rather than reflective of general commercial practice. Further, the Committee is of the view that the revenue and integrity issues in Bywater also could have been addressed by applying Australia's CFC rules and/or Part IVA, as well as specific action being taken in relation to the Australian controller of the relevant entities.

18. Responding to the question about the prospect of the importation of tax losses, the Committee understands that this risk has increased under the current interpretation of the law, since the High Court's decision in Bywater and the response to this decision by the Commissioner of Taxation (**Commissioner**) and the ATO in Taxation Ruling TR 2018/*5 Income tax: central management and control test of residency* (**TR 2018/5**) *and Practical Compliance Guideline PCG 2018/9 Central management and control test of residency: identifying where a company's central management and control is located* (**PCG 2018/9**). This is because, as a result of these developments, it may now be easier for companies to change their corporate residence to Australia, and in turn, easier to import their historical losses (i.e. the threshold for establishing residence in Australia has reduced). Therefore, the risk of loss importation should reduce, if the corporate residency test operates in a way that is like the position in the withdrawn TR 2004/15.

19. If there are concerns around potential abuse of the revised CMAC test, this should be addressed through, in the first instance, the application of Part IVA, or if

[6] Unless stated otherwise, all legislative references are to provisions in the *Income Tax Assessment Act 1936* (Cth) or the *Income Tax Assessment Act 1997* (Cth), as the context requires.

necessary, through specific and targeted integrity measures, rather than seeking to over-engineer the CMAC test. For example, if there is a concern regarding the risk of a deliberate change of residence for the purpose of importing losses, and Part IVA does not apply, then this could be addressed by a measure that operates by quarantining imported losses, so that these can only be offset against foreign source income. This approach would be consistent with the function of the CMAC test within the income tax system.

Consultation question 2

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

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

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

Whether it is necessary to define the first and/or the second limb

20. The Committee refers to its response to Consultation question 1 above and its comments in the First Submission in paragraphs [34] to [55], in relation to how the CMAC test may be modified, and codified.

21. Clarification of the CMAC test within the legislation itself, rather than through an administrative guide is required, as this will provide ongoing guidance (noting the comments above). This could involve a statutory definition of the two limbs, supported by examples in the explanatory memorandum.

22. There are already precedents with respect to a statutory definition of "carrying on a business in Australia". For example, s 94T(2) provides that in determining whether a partnership carries on business in Australia, a particular business is disregarded:

94T Residence of corporate limited partnership

(1) For the purposes of the income tax law, the partnership is:

(a) a resident; and

(b) a resident within the meaning of section 6; and

(c) a resident of Australia; and

(d) a resident of Australia within the meaning of section 6;

if and only if:

(e) the partnership was formed in Australia; or

(f) either:

(i) the partnership carries on business in Australia; or

(ii) the partnership's central management and control is in Australia.

(2) In determining whether the partnership carries on business in Australia for the purposes of subparagraph (1)(f)(i), if, for the year of income, the partnership is an IMR entity (within the meaning of the *Income Tax Assessment Act 1997*, but disregarding paragraph 842-220(a) of that Act), disregard business that:

(a) is carried on by the partnership (either by itself directly or by another entity on its behalf); and

(b) solely relates to IMR financial arrangements (within the meaning of that Act).

[emphasis added]

23. In a similar way, s 21 of the *Corporations Act 2001* (Cth) (**Corporations Act**) provides a definition of the concept of "carrying on business in Australia" by including and excluding certain activities:

21 Carrying on business in Australia or a State or Territory

(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, as the case may be.

(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

(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.

(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

(b) holds meetings of its directors or shareholders or carries on other activities concerning its internal affairs; or

(c) maintains a bank account; or

(d) effects a sale through an independent contractor; or

(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

(f) creates evidence of a debt, or creates a security interest in property, including PPSA retention of title property of the body; or

(g) secures or collects any of its debts or enforces its rights in regard to any securities relating to such debts; or

(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

(j) invests any of its funds or holds any property.

[emphasis added]

24. While beyond the scope of this submission, the Board may be assisted by considering the experience with the application of these provisions.

25. The expression "carrying on a business" may have different meanings in different contexts.[7] Absent a specific definition, the threshold for meeting this requirement may be quiet low.

26. For example, the *Competition and Consumer Act 2010* (Cth)(CCA), and in particular s 5(1)(g) of the CCA, extends the operation of the Act to conduct occurring outside of Australia by a company which is "carrying on business within Australia". Whether this requirement is satisfied is a question of fact and does not require the foreign company to have a fixed place of business.[8] In *ACCC v Valve Corp (No 3)* [2016] FCA 196, Edelman J found that a US internet gaming company that was not registered in Australia, had no subsidiaries here, but supplied online internet games from servers in the USA was nevertheless carrying on business in Australia because, among other things, in Australia - it had many customers, three servers, personal property, a bank account, contractual relationships with third party providers based in Australia, and incurred substantial expenses. However, in the context of the CCA, the mere fact that a foreign company's operations may have been subject to supervision or control from its Australian parent, may not be enough for the purposes of s 5(1)(g) of the CCA.[9]

27. In a similar way, in *BHP Petroleum Pty Ltd v Oil Basins Ltd (1985)* VR 725, in the context of the service of court documents, a foreign company was considered to carry on a business in Australia, as a result of the work done on behalf of the company by its accountants and solicitors in Melbourne. The work included the receipt of royalty payments, the ascertainment of the appropriate taxation retention, the apportionment of the payments and the transmission of payments to persons beneficially entitled. In this instance, these activities were considered to constitute the essence of the company's business.[10]

28. The low threshold for "carrying on a business" noted above, appears to be shared by the Commissioner. For example, in Taxation Ruling TR 2019/1 *Income tax: when does a company carry on a business?* (**TR 2019/1**), in Example 1, the Commissioner considers that a company whose only activities include the

[7] *Luckins v Highway Motel (Carnarvon) Pty Ltd* (1975) 133 CLR 164 at 178.
[8] *Manhattan (Asia) Ltd v Dymocks Franchise Systems (China) Ltd* [2014] FCA 1143; (2014) 225 FCR 508 at [28].
[9] Ibid.
[10] *BHP Petroleum Pty Ltd v Oil Basins Ltd* (1985) VR 725 at 733-734.

derivation of interest from a bank account deposit will be carrying on a business, at [62]-[64]:

> ***Example 1 – inactive company with retained profits***
>
> 62. InactiveCo is a company incorporated in Australia. InactiveCo carried on a trading business that was wound up in the 2015–16 income year. InactiveCo has $400,000 of retained earnings which it holds in a bank account.
>
> 63. In the 2016–17 and later income years, the company's income has consisted solely of interest of $12,000 a year. InactiveCo has no intention of resuming its trading business. InactiveCo pays an annual company review fee of $254 to ASIC84. The company's income is consistently greater than its expenses. As a result, the company has made a profit in each income year from 2016–17.
>
> 64. InactiveCo's activities have both a purpose and prospect of profit. InactiveCo is carrying on a business.

29. In short, the above indicates that a statutory definition of either one or both limbs in some form is possible and should assist with providing greater clarity and certainty, than if the concepts are left undefined.

Requirements/factors for inclusion in the test – general observations

30. In defining the first and/or second limbs, simplicity should be preferred, rather than trying to be overly prescriptive. The test should be defined in a way which provides a enough flexibility to cater for the various circumstances which may occur now, and also in the future. An approach of "less is more" – doing just enough to deal with the identified issues – should assist with this, as well as reducing the scope for any friction and inconsistencies with other provisions and future developments, which may arise in the future.

31. As a litmus test, the definitions should allow Australian residents to set up a company in a foreign jurisdiction, and for Australia based directors to make CMAC decisions in Australia, without giving rise to Australian tax residence for the company (except where that company also carries on a business in Australia). To the extent that there are concerns about revenue risks, including deferral of Australian tax, these should be addressed by the CFC provisions and potentially by future reforms arising from the work being done by the OECD in relation to a global minimum tax and digital taxes.

32. Subject to input from the financial services / funds management sector (particularly in relation to widely held managed investment funds), the definitions should also apply to treat as an Australian resident an "investment company" which, by virtue of the scale of its operations, is clearly carrying on a business, where these investment decisions are made by management and/or the directors in Australia, even though the investments and/or the source of income may be outside of Australia.

33. In terms of considering the requirements/factors that should be included, the Board may be assisted by considering the experience with s 94T, s 21 of the Corporations Act and s 5(1)(g) of the CCA, as well as TR 2004/15 and TR 2019/1.

34. With respect to the first limb, it is important to keep in mind that the present requirement is not just to "carry on a business", but to carry on a business "in Australia". This requires a nexus with Australia, which appears to be broader in scope from provisions which refer to carrying on business in Australia "at or through a permanent establishment." The latter nexus is defined in the context of tax treaties or s 6(1) and in a more prescriptive manner. In this regard, the Board may consider whether the nexus with Australia for the first limb may be narrowed, in a similar way.

35. The Committee highlights that this policy development needs care, to avoid the continuation of the issues and concerns which have been raised with respect to the current interpretation and administration of the CMAC test, which it understands discourages Australian companies, directors and staff from undertaking governance activities in relation to their foreign subsidiaries, from participating in business planning and development of growth strategies for their foreign subsidiaries. This has the negative effect of impeding the development and expansion of Australian businesses internationally. As noted below, the corporate residency test should operate in a way which encourages, rather than discourages, Australia based boards and directors in participating in companies within the group.

Impact on the SME segment - trusts

36. The issue of how to determine corporate residence is relevant to the small to medium enterprises (SME) market segment, including the residence of trusts.

37. In this regard, the Committee understands that the question of the residence of trusts has become of particular significance recently, due to the issue of Draft Taxation Determination TD 2019/D6 *Income tax: does Subdivision 855-A (or subsection 768-915(1)) of the Income Tax Assessment Act 1997 disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident non-fixed trust makes because of subsection 115-215(3)?* (**TD 2019/D6**).

38. In broad terms, in TD 2019/D6, the Commissioner sets out his preliminary view that a foreign resident (or temporary resident) beneficiary of a discretionary trust who is presently/specifically entitled to a capital gain, relating to non-TAP assets, would be taxed on the gain received from the trust. This is in contrast to an individual foreign resident, who, if they invested directly in non-TAP assets would not be liable to pay capital gains tax in Australia, or a presently/specifically entitled foreign resident beneficiary of a fixed trust, who also would not be taxed on such a gain.

39. The Committee understands that the consequences of the Commissioner's view of CMAC in TR 2018/5 in combination with his view in TD 2019/D6 may have the consequence of drawing foreign trusts and beneficiaries into the Australian tax net, which may be considered to be inconsistent with the view and approach adopted by taxpayers over the years and tax policy. For example, where there is a foreign discretionary trust, with:

a) a corporate trustee incorporated outside of Australia;

b) multiple directors, one of which is an Australian resident; and

c) foreign beneficiaries,

d) this trust can be drawn into the Australian tax net, purely by virtue of the involvement of the Australian director – even in circumstances where the trust is otherwise wholly foreign.

40. This could occur because:

e) CMAC can be in more than one location, such that the one Australian director may be sufficient to make the corporate trustee an Australian resident (regardless of where else CMAC might be located);

f) practically, it may be considered that there is no longer a requirement for the corporate trustee to carry on a business in Australia; and

g) if the trustee is a resident of Australia at any time in an income year, the trust will be an Australian resident for CGT purposes.

41. The Committee understands that the application of TR 2018/5 and TD 2019/D6 may discourage foreign investment in SMEs structured using non-fixed trusts, particularly those which might expand within the Asia-Pacific region. This is because of the risk of being subject to Australian tax on distributions which would not otherwise be taxable had the investment been made by the foreign investor directly.

42. The Committee appreciates that the question of how foreign beneficiaries of a discretionary (non-fixed) trust are and/or should be taxed, is a matter for separate consideration. However, the above highlights the importance of certainty and clarity to determining the tax residence of corporate trustees, in particular in light of recent developments. It should also be noted that further clarity that such non-fixed trusts should continue to be treated as non-resident, should not be considered to give rise to a revenue risk, due to the operation of the transferor trust provisions in Division 6AAA (Special provisions relating to non-resident trust estates etc.).

43. It should also be noted that certainty and clarity in relation to the residence of a trust is also relevant in the inverse situation, namely the risk that an Australian resident trust may become a foreign trust, in the context of the taxation of capital gains. The issue is highlighted by Taxation Determination TD 2017/23 *Income tax: does the residency assumption in subsection 95(1) of the Income Tax Assessment Act 1936 (ITAA 1936) apply for the purpose of section 855-10 of the Income Tax Assessment Act 1997 (ITAA 1997), which disregards certain capital gains of a trust which is a foreign trust for CGT purposes?* (**TD 2017/23**) and Taxation Determination TD 2017/24 *Income tax: where an amount included in a beneficiary's assessable income under subsection 99B(1) of the Income Tax Assessment Act 1936 (ITAA 1936) had its origins in a capital gain from non-taxable Australian property of a foreign trust, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset') or access the CGT discount in relation to the amount?* (**TD 2017/24**). In particular, different outcomes may arise for Australian resident beneficiaries, in relation to capital gains of the

trust, depending on whether the trust is a "resident" or a "foreign" trust for CGT purposes under s 995-1. For example, in the former case, Division 115 may apply, and in the latter, s 99B. If Division 115 applies, Australian resident beneficiaries may be able to reduce the gain by capital losses and/or the CGT discount. However, this would not be the case if s 99B applies.[11]

Should there be a "de minimis"?

44. The Committee notes that *de minimis* tests are a feature of the income tax legislation and can be effective in balancing compliance costs and revenue measures.

45. The Committee understands that the consultation question envisages that a *de minimis* test would not replace the more extensive reform relating to the CMAC test, the question asking:

> 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?
>
> [emphasis added]

46. An optional *de minimis* test, at the election of the relevant company, would be useful.

47. However, the Committee would advise against the introduction of a *de minimis* test if it were to operate as the only reform response without more comprehensive reform, for example to allow some percentage of the foreign company's business to be carried on in Australia, such as 10% of the foreign company's overall business. Such a policy response would raise many issues about the computation of turnover and any other relevant commercial factors to be adopted, the risk of potential tax adjustments to the commercial factors, and the volatility of any such test given the possibility of variable business conditions in Australia or overseas for any foreign company. Any such *de minimis* if operating on a standalone basis would be "arbitrary" and could have a different impact depending on features of the company, including the nature and size of its business, the type of industry it operates in and its stage of growth (e.g. start-up versus mature). If different thresholds were considered to provide for these variations, they would add to complexity. The *de minimis* could give rise to capricious and uncertain outcomes, causing foreign companies to switch from being Australian resident, to non-resident, and back again to resident, in an uncontrollable manner, depending on the formula's outcomes each year, with many complex tax consequences as outlined in the Options Paper. This risk would require tax planning where a company is close to the *de minimis* threshold.

48. Furthermore, it may be considered that the function, purpose and consequences of the corporate residence test within the broader income tax system (e.g. in relation

[11] Based on the Commissioner's view in TD 2017/24.

to the obligation to lodge an income tax return) indicate that this requires a greater level of certainty and stability, than other income rules, which rely on a de minimis.

Should the "carrying on a business in Australia" test only apply to the corporate residence test?

49. Several matters should be considered in determining whether the definition of "carrying on a business in Australia" should only apply to the corporate residence test.

50. Firstly, this concept is not currently defined in the Income *Tax Assessment Act 1936* (Cth), the *Income Tax Assessment Act 1997* (Cth) and/or *the Taxation Administration Act 1953* (Cth). This is consistent with the position adopted in s 5(1)(g) of the CCA, discussed above, where the concept of "carrying on business within Australia" is also left undefined. The rationale and benefit this approach, should inform the present analysis. It would appear that this is intended to provide a degree of flexibility, across various provisions. If this is the case, then, in the absence of an identified need for a general definition, the status quo should remain, or the definition should be limited to provisions dealing with residency.

51. Second, the way in which this concept is ultimately defined, including the extent of the statutory modifications, will be relevant. The greater the number of modifications, and the more precise and tailored the definition of corporate residence is, the more this should point away from the definition applying to other income tax provisions which also use this concept.[12]

52. Thirdly, it is necessary to consider where this concept is used in the income tax provisions, and the effect and purpose of any "variations". For example, carrying on a business "at or through a permanent establishment" reflects a similar, but different test, with a higher threshold, which also arises in the context of Australia's tax treaties. Therefore, it would not be appropriate for the definition to also apply to this, as it may affect the operation of a different test.

53. Fourthly, it may be desirable for the definition to apply to those provisions which also refer to "central management and control". This is also not defined, and used in several other parts of the income tax legislation, including provisions which refer to "carrying on a business in Australia" such as s 94T, s 102Q and the definition of "resident trust for CGT purposes" in s 995-1. This may assist with achieving consistency.

54. The Committee notes that the above highlights and supports the view that there is no simple and straight-forward solution to the reform of the CMAC test. Presumably, this was a significant factor in the Board's finding in its 2003 RITA report that "[t]he simplest solution would be to adopt the place of incorporation as

[12] For example, it may not be appropriate to use the tailored definition in s 23AA(3)(a) (23AA Income of persons connected with certain projects of United States Government).

the sole residence test in Australia"[13] and recommendation that a company should be regarded as resident in Australia only if it is incorporated in Australia.[14]

Requirements/factors for a legislative tie-breaker test

55. The Committee refers to its comments on a potential tie-breaker in paragraphs [40] to [42] of the First Submission, including that this could provide for a single location for CMAC. A tie-breaker is required because of the many interactions between Australian parent companies and their foreign subsidiaries, in order to avoid multiple "CMAC locations" and a continuation of the current problems with the CMAC test.

56. The Committee also notes that the design of any legislative tie-breaker may be informed by and should take into account the approach adopted in tax treaties, and to the extent possible, seek to achieve consistency with Australia's tax treaty policy on this issue.

57. In this regard, there are several variations in the approach adopted in Australia's tax treaties, for dealing with dual residence. Many treaties follow the "place of effective management" approach, including the Australia-Switzerland treaty signed in 2013, and which has been a feature of the OECD model for some time. Other treaties provide for dual residence to be resolved by reference to the place of incorporation (e.g. the treaties with Canada, Denmark, Finland, Kiribati, Philippines, Taiwan and Thailand). Some treaties adopt a different test, such as the location of the head office (treaty with China) or where the company is managed and controlled (treaty with Singapore). Certain treaties contain special provisions dealing with dual listed company arrangements, determining residence by reference to incorporation (treaties with New Zealand and the United Kingdom). Several treaties do not contain a tie-breaker at all (treaties with Chile, Turkey and the United States).

58. More recently, article 4 of several of Australia's treaties has been amended by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (**MLI**), so that this now provides for dual residence to be resolved by mutual agreement (e.g. treaties with India, Japan, Netherlands, New Zealand, Poland, the Slovak Republic and the United Kingdom). This mechanism has also been adopted in the treaty with Germany and Israel, although not via the MLI.

59. With respect to the treaty with New Zealand, as modified by the MLI, the ATO has agreed an administrative approach with the New Zealand Inland Revenue, which provides for companies to self-assess[15] residence, by reference to "place of effective management". This is intended to provide certainty and reduce compliance for taxpayers. The Committee understands that it is intended that an administrative approach will only be implemented between Australia and New

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[13] RITA at [3.130].
[14] RITA Recommendation 3.12.
[15] The administrative approach refers to this as a taxpayer "self-determining" place of effective management, under the treaty.

Zealand at this stage. Also, the administrative approach applies only where a company meets certain eligibility criteria, such as in relation to revenue (less than A$250m), passive income being less than 20% of the total income, and intangible assets (other goodwill) being less than 20% of the total assets.

60. The approach adopted by the MLI, and in the treaty with Germany and Israel, indicates a move away from mechanical tie-breakers, which now appears to be a feature of the new international tax landscape. While this is intended to improve the integrity of the tie-breaker rule, it may also increase uncertainty and compliance costs for taxpayers, which is something that the administrative approach pursuant to the joint agreement with New Zealand seeks to address.

61. The design of a tie-breaker should take into account these various approaches in Australia's tax treaties, as well as circumstances where a treaty does not apply. While the MLI indicates a move away from mechanical tie-breakers, the joint agreement with New Zealand indicates that certainty and reduced compliance costs are desirable, and that provided integrity risks can be addressed, a mechanical tie-breaker and/or allowing a company to self-assess CMAC (as opposed to relying on mutual agreement by tax authorities) may be appropriate. However, the eligibility criteria, which restrict access to this mechanism, evidence the current difficulties with managing compliance and integrity risks in relation to corporate residence.

Consultation question 3

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

62. The Committee refers to its comments in paragraphs [58] to [61] of the First Submission, in relation to the implications of having an incorporation-only test.

63. An incorporation-only test should be more effective at reducing taxpayer uncertainty and would appear to be better aligned with modern corporate governance practices, as compared with the retention of a modified CMAC test. It may also address the concerns in relation to the residence of trusts, discussed above.

64. As noted above, there are difficulties associated with making modifications to the CMAC test. Complexity and uncertainty in relation to the application of the test is likely to remain, even with the benefit of examples in the explanatory memorandum and administrative guidance from the Commissioner. There is a risk that the uncertainty may be exacerbated, rather than reduced, with increased "tweaking" of the definitions, including providing for a list of "inclusions" and "exclusions", similar to the approach adopted in s 21 of the Corporations Act.

65. The corporate residency test should operate in a way which encourages, rather discourages, Australia based boards and directors in participating in companies

within the group. The incorporation test clearly facilitates this, a modified CMAC test less so.

66. The corporate residency test should also operate in a way which reduces the need for detailed administrative guidance, and scope for disagreement between the Commissioner and taxpayers, on how the test applies. With a modified CMAC test, the Committee anticipates that detailed administrative guidance, similar to PCG 2018/9, would still be desirable or even necessary. This would carry the risk of associated concerns and issues where there is disagreement with the Commissioner's views, similar to those which arose in the context of Draft 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.* This should not be the case with an incorporation only test.

Consultation question 4

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

67. Consultation questions 5, 6 and 7 deal with issues of corporate restructures, integrity concerns and transitional provisions which all are matters that warrant consideration from a technical and compliance perspective.

68. In addition to this, the effect of the change in the corporate residence test should also be considered from the perspective of Australia's tax treaties, including the MLI. Any change should be consistent with and comply with Australia's international obligations under these agreements and be consistent with Australia's tax treaty policy. The above discussion regarding the approach adopted with respect to tie-breakers in Australia's tax treaties outlines that the trend is to allow country competent authorities to resolve any issues arising from dual resident outcomes in respect of dual resident companies, so the place of incorporation test would not appear to create difficulties in relation to the application of tax treaties.

69. While beyond the scope of this submission, it may be beneficial for the Board to consider the experience of other countries that have adopted the incorporation-only test. The United States is an obvious example, but also relevant would be the experience of Australia's other treaty partners such as Chile, the Philippines and Thailand. This could extend beyond literature review to, for example, engaging with overseas experts on these issues.

70. It needs to be recognised that the adoption of an incorporation-only test would be consistent with the Board's recommendation 3.12 in RITA. However, since 2003, there have been numerous relevant developments, both from a domestic and international tax perspective, which are of sufficient magnitude to warrant closer examination, to confirm that the basis for this recommendation still holds.

71. As noted above, the adoption of the incorporation-only test should be considered not just from the perspective of a corporate group, but also from the perspective of

structures used in the private groups and SME segment, such as trusts, and how they are managed and controlled and used in Australia and overseas.

Consultation question 5

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

72. The Committee is not in a position to provide detailed and specific examples of potential integrity risks. However, one way in which such integrity risks could be identified, could be through an analysis of aggressive tax planning strategies that have been identified in the past, details of which are available in the public domain, such as through taxpayer alerts, issued by the ATO.

73. The Committee understands that a potential type of restructure that may occur is a corporate "inversion". Usually this involves changing the residence of the parent company of a group. The RITA considered the experience of the United States at that time with inversions and noted that several of the drivers for these restructures were not present in Australia. Inversions have also been a feature of the UK tax system prior to changes to its international tax system in 2010, with inversions occurring to lower tax jurisdictions such as Ireland.

74. As part of the RITA, the Board considered the risk of potential restructures, in response to changes to the adoption of the incorporation-only test, including inversions. The Board found that the risk of this occurring was reduced due to Australia's imputation system, as well as several differences between the Australian and United States tax systems.

75. The Committee notes also that Australia's tax policy settings already allow for foreign CFCs which carry on active businesses not to have their foreign income attributed to Australian attributable taxpayers.[16] In a similar way, the income of Australian companies operating through active foreign branches is non-assessable non-exempt income. Furthermore, an Australian company which sells a foreign subsidiary conducting an active business is not taxable pursuant to the participation exemption in Division 768.

76. Therefore, given that Australia still has an imputation system, and the differences between the two tax systems remain, this finding would appear to be still valid, namely that there is no attraction for inversion of Australian companies conducting business activities.

77. The Options Paper considers an example of a possible situation where a Singapore company controlled by Australian residents realises a capital gain in New Zealand, which is not taxable in either Singapore or New Zealand. However,

[16] In broad terms, "passive" or "tainted" income of CFCs which operate in low tax countries, which are not "listed" countries, is attributed to Australian taxpayers under the CFC rules.

the Committee notes that Singapore is not a “listed” country for the purpose of the CFC rules, and therefore the Singapore company would be a CFC, and its New Zealand capital gain would appear to be “tainted” income and therefore attributable to the Australian attributable taxpayers.

78. With respect to the risks of restructures, the Board may be assisted by considering the steps and anti-avoidance provisions adopted by the United States since 2003, to address the issue of “inversions” such as the Tax Cuts and Jobs Act, as well as the changes to the UK tax system, in relation to the same.

79. The Committee refers to its comments in paragraphs [56] to [57] of the First Submissions, in relation to the ways in which the effect of changes to the test may be modelled.

Consultation question 6

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

80. The Committee would caution against introducing specific anti-avoidance rules, in the absence of evidence that the present anti-avoidance rules would not be sufficient to deal with this and a clear risk to the revenue. The reason for this is that Australia already has several anti-avoidance provisions, and the introduction of another such measure may create unnecessary complexity and risk of the rule applying to ordinary commercial transactions.

81. It needs to be recognised that the foreign source income attribution rules have been the subject of numerous previous reviews and reforms, such as the *Board’s Review of the Foreign Source Income Anti-Tax-Deferral Regimes in 2008*, and the analysis of any potential changes, should draw on previous work in this area.

82. To the extent that integrity issues are identified with respect to the foreign income attribution rules, unless these specifically arise as a consequence of or are otherwise exacerbated by the adoption of the incorporation-only test, these should not hold-up or affect the implementation of revisions to the corporate tax residency test. This is particularly relevant given previous experience, such as the proposed reforms of the CFC rules in 2010 and the absence of a replacement of the FIF rules.

83. The Committee highlights that some of the behavioural and integrity concerns and issues may be addressed through the increased supply of information available to the ATO arising from the global initiatives relating to mutual exchange of information among the ATO and revenue agencies as detailed below. These

systemic improvements, involving “big data” and analysis are in addition to occasional disclosures such as those which arose under the Panama Papers or Lux Leaks disclosures.

84. The “Common Reporting Standard” (**CRS**) provides 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. In particular, the CRS may assist with identifying non-compliance with foreign income attribution rules.

85. Countries are currently adopting 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 disclosures are gradually being implemented, with the UK already providing beneficial ownership data and EU countries to do so in 2020.[17] Australia has commenced policy development in relation to the establishment of a Beneficial Ownership Register as summarised at section 1.2 of the Open Government Partnership Australia[18] and in a Freedom of Information Treasury response.[19]

86. The ATO is an active participant through the Global Forum on Transparency and Exchange of Information[20] created in 2000 pursuant to which countries exchange information including in relation to beneficial ownership, engage in peer reviews and improve their national systems.

87. Australia is also 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 group brings together leaders of tax enforcement authorities from Australia, Canada, the Netherlands, the UK and the US.[21] These initiatives enable use of ownership data in relation to company beneficial ownership to counter tax evasion.

88. The work of the J5 appears to be yielding results. In mid-January 2020, the J5 undertook its first major operational activity (expected to be one of many), which involved an unprecedented multi-country day of action to tackle international tax evasion.[22] The action occurred as part of a series of investigations in multiple

[17] For example, refer the following extract from the UK August 2019 briefing to the House of Commons: “Registers of beneficial ownership provide transparency and play an important role in the fight against corruption, tax evasion and money laundering. The UK has registers of beneficial ownership for three different types of assets: companies, properties and land, and trusts. Information on the beneficial ownership of companies is publicly available. For properties owned by overseas companies and legal entities, the Government plans to launch a public beneficial ownership register in 2021. The register for trusts is not public. Around the world, many countries have created or have plans to create registers. In the EU, member states have until January 2020 to make public the beneficial ownership of legal entities such as companies….” accessible at < https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8259>.
[18] Accessible at <https://ogpau.pmc.gov.au/commitment/12-beneficial-ownership-transparency>.
[19] Accessible at <https://treasury.gov.au/foi/2528>.
[20] Refer the OECD website for the Global Forum on Transparency and Exchange of Information for Tax Purposes accessible at <https://www.oecd.org/tax/transparency/>.
[21] ATO website “Joint Chiefs of Global Tax Enforcement” accessible at <https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Joint-Chiefs-of-Global-Tax-Enforcement/>.
[22] ATO website “Global tax chiefs undertake unprecedented multi-country day of action to tackle international tax evasion” accessible at < https://www.ato.gov.au/Media-centre/Media-releases/Global-tax-chiefs-undertake-unprecedented-multi-country-day-of-action-to-tackle-international-tax-evasion/>.

countries into an international financial institution located in Central America, whose products and services were believed to be facilitating money laundering and tax evasion for customers across the globe.

89. Following the J5 operation, Deputy Commissioner and Australia's J5 Chief, Will Day, said that this operation showed 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 ATO has commenced investigations into Australia based clients of this institution who are suspected to have undeclared income.[23]

90. In addition to the above-mentioned current, already operative, international reform processes which are enhancing the supply of information to the ATO as administrator of Australia's tax system, a major international tax base reform project is under way. The current international OECD/G20 Inclusive Framework initiatives, under the loose title of addressing digitalisation of the international business environment, are likely to see multilateral agreement developed in 2020, potentially involving the concepts currently referred to as "Pillar 1" and "Pillar 2." As these come to fruition, they will also operate to alleviate some of the integrity concerns associated with corporate residence.

Consultation question 7

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

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

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

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

91. A transitional rule should be developed as part of a legislative proposal. This would be required if an incorporation only test is adopted as the sole test for residence. Depending on the nature of the changes to the CMAC test, this may also be required if the CMAC test is revisited.

92. The transitional rule should address issues in relation to both, compliance and integrity, relevant to companies likely to be affected by the change to the residence test (e.g. because they will commence or cease to be Australian residents under the new test).

[23] Ibid.

93. Some of the issues the rule should provide for include:

a) a prospective commencement date (e.g. from the start of an income year after the legislation is enacted) to provide certainty;

b) the option of a deferred commencement date (e.g. if the change may have significant implications for the company and/or result in a dispute or uncertainty with an overseas revenue authority, including due to the operation of a tax treaty and/or the MLI);

c) the effect of different accounting periods (e.g. 30 June year-end versus 31 December year-end, or another substituted accounting period);

d) income tax consequences arising from the change (e.g. the occurrence of deemed CGT events, such as CGT event I1 (Individual or company stops being an Australian resident));

e) change of residence part-way through an income year; and

f) assessments with respect to prior income years, where a company did not lodge on the basis that it was not a resident of Australia under the current test.

Thank you again for the opportunity to prepare this, and the First Submission, which the Committee hopes will assist with Board with its review.