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Lynn Kelly
Review of Australia's corporate tax residency rules
Board of Taxation Secretariat
C/-The Treasury
Langton Crescent
Parkes ACT 2600
CorporateResidency@taxboard.gov.au
Dean.Lynch@treasury.gov.au

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By Email

Dear Lynn

Corporate tax residency rules

Thank you for the opportunity to comment on the Board's Consultation Guide and to participate in the Board's Consultation Roundtable. Our submission on this issue in contained in this letter. We first discuss the policy underlying corporate tax residence rules and then address the consultation questions raised by the Board.

1 Policy

Although tax legislation adopts a concept of residence for corporations as it does for individuals, the purpose of the test in relation to corporations is quite different to individuals. For individuals residence gives rise to worldwide taxation which is necessitated by the redistributive nature of the personal income tax progressive rate scale. To judge an individual's ability to pay it is necessary to take account of all their income, not just the income from one country, and personal residence is the appropriate means to determine which country should undertake this task.

The corporate tax is in essence a source based tax, with residence performing two main functions in relation to corporate income tax:

- First it identifies a country where important management activities of the company take place and establishes the right of that country to tax income from those activities.
- Secondly, it helps to ensure that mobile income is taxable somewhere.

The first purpose in substance is a sourcing rule while the second is an integrity rule. The way in which the corporate tax system achieves these outcomes is multilayered (eg, participation exemptions, transfer pricing rules, tax treaties and integrity rules such as the controlled foreign company regime to ensure that tax planning around residence is controlled).

The existence of increasing numbers of integrity rules in the Tax Act in recent times around these issues (eg, MAAL, DPT, treaty PPT) with more in prospect under BEPS 2.0 means that the need for complex corporate residence rules to perform the sourcing and integrity functions is decreasing rather than increasing. On the other hand, increasing regulatory rules around corporate governance and many other areas of law combined with advances in technology mean that corporate groups have to maintain a significant

ANZ Tower 161 Castlereagh Street Sydney NSW 2000 Australia
GPO Box 4982 Sydney NSW 2001 Australia
T +61 2 9225 5955 F +61 2 9221 6516
DX 361 Sydney www.greenwoods.com.au

range of policies to ensure that all parts of the group are complying with their obligations and to perform real-time oversight of all parts of the group. In this environment facts-and-circumstances tests of residence based on management and other activities are increasingly difficult for tax administrations and taxpayers to apply.

Hence two directions of reform are possible:

1 remove such facts-and-circumstances tests and replace them with a clear and easily applied test (place of incorporation); or

2 specify in various possible ways other clear tests which simplify facts-and-circumstances tests based on management. We take these up at various points below.

Given that the Board is already familiar with many of the practical issues, we present the points below in bullet point form and concentrate of matters which have not been raised or elaborated to date in the discussions between the Board and stakeholders.

2 Consultation question 1

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

- Modern corporate governance structures extend far beyond board members and so increase the risk of central management and control (**CM&C**) being found outside the board.
- In many overseas countries, it is effectively required for legal, regulatory or practical reasons to incorporate a company there even though the need for management functions there may be low.

  Most countries include place of incorporation or its equivalent as at least one of their tests of residence, and so if management functions are performed in part from Australia then dual residence is likely to arise as a result of the CM&C test as now interpreted by the Australian Taxation Office (**ATO**). This problem is made more pressing by the difficulty in locating suitably qualified persons to act as directors of local subsidiaries in many countries.
- Special purpose vehicles incorporated in foreign jurisdictions are used for a variety of legitimate practical purposes such as liability protection, to satisfy local licensing requirements or be able to receive payments from local customers. Again dual residence is likely to arise.
- The dual resident tie-breaker being inserted in Australia's tax treaties by the multi-lateral instrument (**MLI**) means that various unfair treaty and domestic law consequences can arise, eg in relation to withholding taxes.[1]
- While TR 2004/15 was far preferable and usable than current ATO guidance, even that ruling requires interference in sensible corporate management practices, eg flying directors to meetings rather than using technology, avoidance of circular resolutions.
- Other entities besides companies are affected by the CM&C issue and they should also be considered by the Board, eg commercial trusts and limited partnerships.

[1] For example, if the foreign subsidiary of an Australian parent has leased equipment from a foreign lessor resident in the same foreign country as the subsidiary and is treated as an Australian resident due to CM&C in Australia, then Australian royalty withholding tax at 30% will likely be payable on the lease rentals without treaty relief even though Australia has a treaty with the other country. To avoid withholding tax it would be necessary to show that the royalty was entirely attributable to a foreign permanent establishment of the lessee, which may be difficult if any part of the decision to lease was made in Australia. No treaty relief would be available if the treaty has been modified by the MLI to exclude dual residents from treaty benefits.

- In the funds management area there are real difficulties with management based tests in an in-bound setting. This was recognised by the government with an announcement to change residence rules in this context, see http://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime but nothing seems to be happening with this announcement.
- In order to receive venture capital funding or be accepted into US accelerator programs, Australian startups may be required to 'flip up' to the US, inserting a US holding company between shareholders and the Australian company, although the company may retain entirely Australian based directors. At a later date following further rounds of VC funding, the board meetings may then be held in the US, causing the US holding company to cease to be an Australian resident and CGT event I1 to arise for the US holding company.

3 Consultation question 2

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

- We have noted briefly above some of the many parts of domestic tax law which take the weight of the corporate residence test. We consider that the Board should take note of the treaty changes that are occurring under the MLI and in prospect under BEPS 2.0 as part of its consideration of this issue.

4 Consultation question 3

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

- The main improvement from this change would be elimination of the possibility of place of effective management (**POEM**) being in two countries but POEM is even less of a known quantity than CM&C and would involve similar uncertainty.
- Challenges arise with POEM when dormant or less active companies are considered. In fact, in light of modern governance protocols (as outlined in the Consultation Guide), a POEM test is arguably more likely to trigger residence in the country in which its parent is based for a dormant company than a CM&C test.

5 Consultation question 4

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

- We think there are several avenues which could be explored if the judgment is made that it is necessary to retain some form of test other than place of incorporation.
- One possible mechanism for providing more certainty within the existing or a modified CM&C test would be the legislative examples route that the Board advocated and the government proposed to implement in relation to the debt-equity rules and related schemes.

This approach could be used in effect to restore TR 2004/15, codify a simplified version of the multinational exception in PCG 2018/9, or (preferably) improvements to the general approach in the TR/PCG which take account of the impact of corporate governance and technology changes on the residence of corporations.

- Another approach would be to legislate exceptions to the CM&C test to prevent duplication with existing integrity measures designed to prevent tax planning with corporate residence:

  1 if a foreign incorporated company is a controlled foreign company (**CFC**) – the rationale being that the CFC rules should protect Australia's tax base and bring to taxation in Australia the right amounts of income;

  2 if foreign incorporated company is not a CFC but

    (A) passes the 'active income test' in the CFC rules – the rationale being that this is an objective test aimed at excluding a company where it does not carry on a business in Australia, and relies on the CFC rules rather than the subjective test about when a company is carrying on business in Australia; or

    (B) is incorporated in a listed country – the rationale being that, as for CFCs, there is minimal risk to the revenue for entities located in a listed countries; or

  3 is subject to a rate of tax that is at least 80% of the Australian tax rate, the rationale being that this aligns with the 'MAAL' tax rate threshold, and removes the opportunity for base erosion arbitrage.

6 Consultation question 5

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

- As noted above, if a facts-and-circumstances management test is abandoned the only real alternative is place of incorporation. In our view, the tax system and corporate governance has moved on since the Board last addressed this issue in 2003 to the point where this possibility should once again be seriously considered by the Board.
- It would be necessary to deal with existing companies incorporated outside Australia that treat themselves as resident in Australia and file tax returns accordingly. This could be handled by grandfathering such companies, providing them with a one-time irrevocable election to be treated for tax purposes as incorporated in Australia, or by a suitably long transition period (say 3-7 years) to allow them to restructure to be Australian incorporated.

7 Consultation question 6

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

- While this test (ie third test of corporate residency) to date has not generated the same kind of uncertainty as CM&C, it could do so if it remained along with place of incorporation as the test of residence, eg what does carrying on business mean?
- This test can interact with the second test of corporate residency now that, in the view of the ATO, CM&C can amount to carrying on business in Australia.

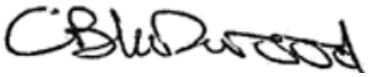
That is. the carrying on business part of the third test can be satisfied by CM&C and ownership by Australian residents.

If two resident tests are thus satisfied there are then flow-on consequences, eg into para (b) of the definition of prescribed dual resident and the consolidation regime. Clarification of such matters would be appropriate if the test is retained.[2]

- If the third test is abandoned transitional arrangements are also necessary as discussed above for CM&C.

Please let us know if you wish to discuss in more detail the points summarised above.

Yours sincerely



Cameron Blackwood
Director
Greenwoods & Herbert Smith Freehills

+61 2 9225 5950
0421 046 803
cameron.blackwood@greenwoods.com.au

Julian Pinson
Director
Greenwoods & Herbert Smith Freehills

+61 2 9225 5994
+61 458 729 264
julian.pinson@greenwoods.com.au

[2] As a result of TR 2004/15 a similar approach has been applied by taxpayers to the carrying on business element in the third test, ie it meant carrying on business apart from CM&C. Assuming that CM&C is in Australia as well as the foreign country, now the ATO view is that the company is carrying on business in Australia and that must apply for both the second and third test. Accordingly, if an Australian company directly owns the shares in the foreign subsidiary both the second and third test will be satisfied. Para (b) of the prescribed dual resident test will not be satisfied as the dual CM&C is not the only reason why the company is resident in Australia. The foreign company will therefore join the Australian tax consolidated group of the parent, which would not have occurred if the shares in the foreign subsidiary were indirectly owned by another foreign subsidiary.