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Tax Insights

Corporate residency test - ATO's new approach increases risk for foreign companies to be treated as Australian tax residents

Snapshot

On 21 June 2018, the Australian Taxation Office (ATO) released three guidance documents in relation to the central management and control (CMAC) test of corporate residency:

1. Taxation Ruling TR 2018/5 (the Ruling), previously publicly released as draft TR 2017/D2, sets out the Commissioner's views on how to apply the CMAC test of corporate residency. The revised ruling has some minor clarification but is in line with the public draft TR 2017/D2;

2. The draft Practical Compliance Guideline PCG 2018/D3 (the draft PCG), previously released on a confidential basis as draft PCG 2017/D##, contains ATO guidance to apply the principles set out in the Ruling; and
3. A finalised Compendium on TR 2018/5.

The Ruling sets out the Commissioner's new approach on the CMAC test: if a company has its CMAC in Australia, and it carries on business, whether in Australia or not, it will be taken to carry on business in Australia as a result of its CMAC being in Australia. The ATO considers that it is not necessary anymore for any part of the actual trading or investment operations to take place in Australia, as the CMAC activities are themselves a part of carrying on the business. The Ruling, overturns the approach the ATO took in TR 2004/15 (former Ruling).

The draft PCG largely seeks to provide guidance by reiterating, in some cases in more detail, the core concepts set out in the Ruling and then provides examples. Whilst the draft PCG compared to the draft PCG 2017/D## is less categorical, it has left much ambiguity instead.

The Ruling and draft PCG have the potential to treat a significant number of foreign incorporated companies as Australian tax resident. The Ruling applies from 15 March 2017. There is a grand fathering of the former Ruling approach until six months after the release of the Ruling (conditions apply).

Who is impacted by ATO's new approach?

The ATO's new approach of the CMAC test of corporate residency impacts:

- Foreign operating companies of Australian groups (i.e. outbound);
- Foreign intermediate holding companies controlled by Australian groups (i.e. outbound); and
- Foreign holding companies of foreign controlled Australian groups (i.e. inbound).

The draft PCG states that the Commissioner will not apply his resources to review corporate residency of foreign companies that are Controlled Foreign Companies of an Australian public group (i.e. outbound public group subsidiaries) subject to specific conditions being satisfied on an on-going basis. However, some of these conditions may be subject to interpretation which may cause the location of CMAC of these Australian public group foreign companies to still be questioned by the ATO (see further detail below).

> The impact of ATO's new approach is extremely problematical in relation to foreign operating subsidiaries of Australian groups, with business operations, activities and directors overseas.

Background

There are three alternative tests in the corporate residency definition under section 6(1)(b) of the *Income Tax Assessment Act 1936* (*ITAA 1936*):

1) Incorporation in Australia (the incorporation test);
2) Carrying on business (CoB) in Australia and CMAC in Australia (the second statutory test); and
3) Carrying on business in Australia and voting power controlled by shareholders who are residents of Australia (the third statutory test).

The second statutory test has been subject to much comment since its legislative introduction in 1930. In 1975, the *Taxation Review Committee* called for a clarification of the meaning of the CMAC. In 2002, the Treasury Consultation Paper on the *Review of International Taxation Arrangements* (Treasury Consultation Paper) acknowledged the uncertainty about applying the second statutory test, and noted that some argued, based on an interpretation of the High Court Case *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* [1946] 71 CLR 156 (*Malayan Shipping*) that the mere exercise of CMAC may itself constitute the carrying on of a business.

The Consultation Paper emphasised that *"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".* At this time, Treasury proposed to consider options to clarify the test so that exercising CMAC alone would not constitute the carrying on of a business.

The Board of Taxation in 2003 recognised that the second statutory test created uncertainty which was contrary to the policy objective of the corporate residency and recommended that the test for corporate residency be based solely on incorporation. The Government in place at that time decided to defer any law changes to the corporate residence definition until the ATO released a ruling clarifying the operation of the corporate residency definition. The ATO released Taxation Ruling TR 2004/15 in 2004.

ATO's approach in TR 2004/15

The ATO's view in TR 2004/15 was in broad terms as follows:

- The second statutory test is a two limb test, i.e. CoB in Australia and CMAC in Australia. Each limb was a question of fact and had to be examined against relevant facts and circumstances.
- The "nature of the business" of a foreign incorporated company was key in determining corporate residency under the second statutory test. The Commissioner drew a distinction between two types of companies:
  - Where a company's business activities consisted of operational activities, such as trading, provision of services, manufacturing or mining activities, the location of the company's business would be where the main operational activities took place, not necessarily where the CMAC was located; and
  - Where a company's business activities consisted of passive dealings, such as investment management, the location of the company's business would be where major decisions were made, i.e. often where the CMAC was located.
- The ATO rejected the approach that the mere exercise of CMAC would itself constitute the carrying on of a business. Paragraph 37 of TR 2004/15 stated that "the reference to *Mitchell v Egyptian Hotels Ltd (1915) AC 1022* indicates that mere trading is not sufficient and that there also has to be CMAC in order for a company to be resident in Australia under the second statutory test. However, it does not necessarily support the further proposition that if you have *CMAC* you are also invariably carrying on a business in that jurisdiction".

TR 2018/5 overturns ATO's approach in TR 2004/15

ATO's new approach

The Ruling sets out the Commissioner's views on how to apply the CMAC test of company residency. The Commissioner concludes at paragraphs 7 and 8 of the Ruling that if a company has its CMAC in Australia, and it carries on business, whether in Australia or not, it will be taken to carry on business in Australia as a result of its CMAC being in Australia.

ATO's new approach - Justified?

The Commissioner relies on paragraph 57 of the *High Court decision in Bywater Investments Ltd v Commissioner of Taxation and Hua Wang Bank Berhad v Commissioner of Taxation* [2016] HCA 45 (*Bywater*) which refers to the *Malayan Shipping* decision, to justify his position to revisit his views on the second corporate residency statutory test.

As explicitly explained in the Joint Submission the *Bywater* decision did not require the Commissioner to revisit the principles of CMAC. The contention in *Malayan Shipping* was solely in respect of the CoB test, i.e. there is no inference to be drawn from the CoB test with respect to the CMAC test or vice versa.

Importantly, *Malayan Shipping* and *Bywater* cases involved extreme set of facts, far removed from the reality of multinational business and both essentially involved passive / investment type-activities.

Noticeably, Australia intentionally adopted a definition of residency in 1930 that differed from the Common Law test which was exclusively based on CMAC. Australia adopted three alternative tests of residency, and in respect of the second test, that test was both CMAC in Australia and CoB in Australia. The inference could be drawn from the express statutory language adopted by Australia in the second corporate residency statutory test, that in respect of a company not incorporated in Australia, the 'carry on business' test is a limitation or a narrowing of the scope of residency, as compared to the Common Law test.

The underlying reasoning associated with paragraphs 7 and 8 of the Ruling is not fully articulated. The Ruling is essentially taking a wider view of carrying on business (per *Malayan Shipping*) and is doing away with the operating company versus passive/ investment company split in TR 2004/15.

Central Management & Control

The Ruling identifies the following three matters in determining whether a company is a resident of Australia under the secondary statutory test:

1. What does CMAC mean?

The Ruling states at paragraph 11 that the key element of the CMAC "is the making of high-level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter".

TR 2018/5 removes the distinction between CoB and CMAC in Australia, such that CMAC can cover both requirements in the residency test for companies. The Ruling overturns the approach the ATO took in TR 2004/15.

We agree with the Ruling statement. It is well established in case law that CMAC is the highest level of management of a company. The first case law decision to refer to the CMAC concept was a UK case *De Beers Consolidated Mines Ltd* in 1907. Prior to De Beers, the UK case *Cesena Sulphur company Ltd v Surveyor of Taxes* in 1876 referred to the "central point of business", "the real place where the business is carried on".

It is the "real place of business", where high level management decisions are taken, e.g. major decisions on policy directions or/and on significant financial matters, where strategic recommendations are made, where strategic decisions are taken. This is to be contrasted with the lower level decision making, i.e. the day-to-day conduct and management of a company's activities and operations.

2. Who exercises CMAC?

The Ruling states at paragraphs 19 to 29 that when determining who exercises a company's CMAC all relevant facts and circumstances must be considered: the CMAC will normally be exercised by the Board, and there is no presumption that the Board will exercise CMAC.

We agree with the Ruling that the focus of the CMAC analysis is on what is the role of the Board and whether the role of the Board has been usurped or the Board has abrogated its decision making role – whether involving an outsider or an insider.

3. Where is CMAC exercised?

- General statements

The Ruling states at paragraph 31 that a company's CMAC "will only be exercised in a place for the purpose of the CMAC test if it is exercised in that place to a substantial degree, sufficient to conclude the company is really carrying on business there".

We agree that for the CMAC to be located in a particular place, the exercise of the control and direction of the company must be to some "substantial degree" found in such a place. Paragraph 31 relevantly refers to the *Union Corporation* case where Sir Raymond Evershed effectively concludes that a company resides in a country if the company's CMAC is to "some substantial degree" found in that country.

- Interaction between the place of CMAC location and the place of actual operations

As seen above, the ATO considers that if a company, incorporated offshore, carries on business, wherever, including solely offshore, has its CMAC located in Australia, then it is a resident of Australia. For example, where a company is incorporated in (say) Malaysia and is conducting substantial business in Malaysia, such a company could also be held to reside in Australia if the CMAC of the company is in Australia i.e. a dual resident.

Importantly, the ATO acknowledges at paragraphs 32 and 33 that the nature of a company's activities could be such that the CMAC will be located where the actual business operations take place. This is a critical point as it could mean that in many cases, the conclusion under the Ruling will be the same as the conclusion that arises under TR 2004/15. That is, a company that carries on its actual business operations wholly outside Australia could be taken to be a non-resident of Australia, under both the Ruling and TR 2004/15, albeit for different reasons.

The application of this principle is critical for a foreign incorporated company that carries out substantial operational activities offshore in determining its residence status under section 6(1)(b) of *ITAA 1936*. However, it is not clear how this principle will be applied in practice.

The draft PCG leads to ambiguity

As stated above, the draft PCG provides guidance by reiterating, in some cases in more detail, the core concepts set out in the Ruling and then providing examples. Accordingly, to a significant extent it will require taxpayers to "analogize" from the examples in the draft PCG (when finalised) to their factual pattern. When finalised, the PCG will apply from 21 June 2018. Submissions on the draft PCG are due on 13 July 2018.

Board minutes – when will these be disregarded by the ATO?

Paragraph 10 of the draft PCG suggests that, where there are Board minutes that disclose the high level strategic decision-making of the company and where those decisions were made, it will not be necessary to look beyond this unless the Board minutes are false, or the Board minutes do not disclose where directors are making a company's high level decision or the company makes high-level decision outside of Board meetings.

Accordingly, the ATO will disregard the Board minutes where the Board decision is the mere implementation of decisions made by others elsewhere. This implies that the ATO could potentially disregard the Board minutes based on inferences that there may be individuals who, while not being directors of the company, have a role in making the company's high level decision.

Board - real decision maker versus mechanically implementing decisions made by others

Paragraphs 27 to 50 of the draft PCG seek to discuss issues around the Board of the foreign company being the real decision maker as compared to merely mechanically implementing a decision already made by others. The draft PCG seeks to do this by way of examples. These situations could include a listed Australian Parent holding company's relationship with the Board of its foreign subsidiaries.

Whilst this is useful, the draft PCG sets out no definitive indicia as to what indicates when the Board is actually the real decision maker versus when the Board is mechanically implementing a decision made by others.

Split exercise of CMAC – "substantial degree" of exercise

Paragraphs 70 to 98 of the draft PCG seek to address the split exercise of CMAC, giving rise to CMAC in two or more jurisdictions for the one company. Most of the guidance proceeds by way of example. Whilst the revised draft PCG has avoided being as categorical on what is sufficient to constitute "a substantial degree" of exercise of CMAC in Australia (so as to represent the exercise of CMAC in Australia), it has left a gap in the analysis which leads to ambiguity instead.

The gap relates to Australian residents sitting on Boards and not attending in person overseas. That is, attending by electronic means or by circular resolution in Australia. Example 13, Possibility A of the Draft PCG indicates that a regular 50% presence in Australia of the decision making power (that is, two out of four equal directors) will represent the exercise to a substantial degree in Australia of CMAC. Whereas, a 50% presence in Australia of the directors (that is two out of four directors) who have no input on decision making, will not represent the exercise to any substantial degree in Australia of CMAC (Example 13, Possibility B of the draft PCG).

The two examples are quite polarised examples. It is unfortunate that the draft PCG does not provide "in between" examples to clarify the tipping point when the participation by Australian resident directors on foreign Boards (by electronic means and circular resolution) will represent the exercise of CMAC to a substantial degree in Australia. This lack of clarity creates ambiguity.

Funds management industry – Example

Paragraphs 66 to 69 of the draft PCG seek to provide some certainty in terms of corporate residency for the funds management industry. The draft PCG seeks to do this by way of an example: where an Investment Fund (ForInvest Co), incorporated in a foreign jurisdiction, carries on business and delegates its investment fund management to Australian Fund Managers (AusManager Co), ForInvest Co will not be an Australian resident under the CMAC test provided AusManager Co's decisions are limited to ForInvest Co's day-to-day business and that these decisions are taken under the authority and supervision of ForInvest Co's Board of directors.

When will the ATO apply resources to review corporate residency?

The Ongoing Compliance Approach in the draft PCG indicates the Commissioner will not apply resources to review corporate residency where directors regularly exercise part of the company's CMAC in Australia by attending in Australia Board meetings of the foreign company by modern communications technology. This is provided that part (i.e. the "Australian part") is no more than the residual after the substantial majority of CMAC is exercised in the foreign jurisdiction where it is treated as tax resident. In addition, the foreign company needs to be a controlled foreign company (CFC) of an Australian public group (i.e. outbound, public group subsidiary).

It is not clear what the residual participation in CMAC is after the substantial majority is exercised elsewhere (i.e. overseas) means. However, a more than insubstantial part of CMAC being exercised is a potential interpretation.

Transitional Compliance Approach

The transitional period is the period between and including the date TR 2004/15 was withdrawn (15 March 2017) and 6 months from the date the Ruling is issued (the draft PCG states 13 December 2018 but it is expected to be about 21 December 2018).

The transitional provisions apply to a non-resident company (not a foreign hybrid) that:

- Immediately prior to the withdrawal of TR 2004/15 had relied on this ruling and had not entered into any artificial or contrived arrangements to affect the location of its CMAC, or, any tax avoidance scheme whose outcome depends on, in whole or in part, on being a non-resident, and,
- The foreign company would become a resident under the ATO's new approach in the Ruling solely because its CMAC is located in Australia.

The Commissioner will not apply his resources to review the non-resident company's residency status provided that during the transitional period the non-resident company:

- Changes its governance arrangements so that the CMAC is exercised outside Australia by the end of the transitional period,
- Does not commence carrying on business in Australia (other than because its CMAC is exercised in Australia), and
- Does not enter into any artificial or contrived arrangements to affect the location of its CMAC, or, any tax avoidance scheme whose outcome depends on, in whole or in part, on being a non-resident.

Ramifications of the ATO's changed approach

The Ruling significantly expands the scope of the second statutory test. This expansion is likely to affect foreign incorporated companies that carry out operational activities and may result in adverse tax consequences for Australian groups. The ATO Compendium on TR 2018/5 explicitly states that any guidance on the broader consequences of becoming a resident is beyond the scope of the Ruling.

The complications identified below highlights some of the adverse tax implications that may arise for Australian outbound groups triggered by the ATO's changed approach. This list, which is not an exhaustive list of complications, provides an insight into the difficulties that corporate Australia will face with the new approach and why this is an important issue to them.

Subdivision 768-A may no longer be available – giving rise to double taxation

Dividends of a foreign incorporated company treated as an Australian tax resident are unlikely to be entitled to Non-Assessable Non-Exempt treatment under sub-division 768-A of the *ITAA 1997*. Sub-division 768-A requires that the distribution or non-share distribution is made by a company that is a foreign resident.

Prescribed dual resident entities cannot be a member of a consolidated group

Membership of Australian consolidated tax groups will be an issue. In particular, for 100% owned foreign subsidiaries of an Australian consolidated group, in many situations where CMAC results in Australian tax residency, the foreign incorporated company will be a prescribed dual resident under the definition in section 6-1 of the *ITAA 1936*. This will not

The Ruling and draft PCG has the potential to treat a significant number of foreign incorporated companies as Australian tax residents. This expansion is likely to result in adverse tax consequences for Australian groups. Therefore, special consideration should be given to the way that foreign subsidiaries Boards are run.

only be possible because of the application of the "tie breaker rule" in the relevant double tax treaty (paragraph (a) of the definition of prescribed dual resident) but also because the ATO's approach is more likely to result in situations with "split" CMAC across two jurisdictions, which is covered by paragraph (b) of the definition of prescribed dual resident. As a prescribed dual resident, the 100% owned foreign subsidiary will remain outside the tax consolidated group.

For non-Prescribed Dual Resident entities – other issues

In the possibly less likely scenario where the foreign incorporated company is not a prescribed dual resident[1], the foreign entity, if 100% owned could become a member of an Australian tax consolidated group. This could cause issues of allocation and denial of deductions, including interest deductions (section 25-90) in relation to the newly found branch of the consolidated group.

Double Tax Treaty tie breaker rules may become inoperative

The ATO's approach is more likely to result in multiple places of CMAC causing *prima facie* Australian residency being more prevalent. That is, whilst some situations may involve CMAC of the foreign company being exercised in Australia only, many situations are likely to involve the proposition that "to a substantial degree" the exercise of CMAC occurs in Australia (as well as, say, the jurisdiction of incorporation of the foreign company).

In part this is a result of the ATO's approach to the participation in Board meetings by modern communication methods which facilitates participation in various locations. This raises issues under the tie breaker provisions of some of Australia's double tax agreements (DTAs).

Whilst each DTA will have its differences, many of Australia's tie breaker provisions rely on the concept of "place of effective management" ("POEM"). Whilst it is acknowledged that POEM is a different concept to CMAC, there is a great deal of overlap. However, the OECD notes in its Model Tax Treaty that there can only be a single POEM at any one time. Hence, in situations of multiple CMAC (e.g. refer to Example 13A of the draft PCG) it may not be clear where there is a single POEM and the tie breaker may not operate.

Tie breaker rules under the Multilateral Convention may also become inoperative

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

> "The competent authorities of the Contracting Jurisdictions shall endeavour to determine by mutual agreement the Contracting

[1] This is likely to involve where there is not a tax treaty tie breaker, or the tie breaker does not result in the foreign company being treated as a resident only of the other jurisdiction and that CMAC is not being exercised in the jurisdiction of incorporation.

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

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

Corporate residency status stability at risk

The new PCG stays ambiguous on what is sufficient to constitute "a substantial degree" of exercise of CMAC in Australia. Thus there is a risk that companies may "flip flop" in and out of Australian corporate residency due to this ambiguity. This may cause further complications with matters such as deemed disposals and unused section 23AI of the *ITAA 1936* balances.

New compliance obligations for dual resident entities under the proposed anti-hybrid rules

The proposed foreign hybrid rules will present a new compliance obligation in relation to the dual resident entity not only in relation to the dual resident entity itself but also in relation to its foreign branch.

Practical considerations

When can a Board be considered as the real decision maker?

Special consideration should be given to the way that foreign subsidiaries Boards are run. The ATO appears to be looking for the Boards of foreign subsidiaries to "comply with the standards expected of directors under the applicable Australian or foreign company law" and "which observes normal corporate governance". Whilst this statement and the examples provided in the draft PCG are useful, no definitive indicia are set out in the draft PCG to indicate when a Board is actually the real decision maker versus when a Board is mechanically implementing a decision made by others.

To demonstrate that the Board is the real decision maker, it may be appropriate that the directors, in particular:

- Independently determine a proposal to be in the best interest of the company
- Review all relevant material
- Seek external expert advice where appropriate
- Are presented with detailed information sufficient to enable them to consider proposals
- Are able to refuse to follow the advice or the directions of outsiders
- Have sufficient knowledge of the business to determine if the advice or instructions would be improper

- Have the required qualifications and skills to make informed decisions.

The Board could be said to be mechanically following directions and implementing decision made elsewhere where the directors:

- Have followed recommendations from external party without deviation
- Have not proactively considered merits of proposals
- Have not been provided with sufficient information to understand merits of proposals and whether it is in best interests of the company
- Are unable to articulate merits and implications of a transaction or a proposal and whether it is in the company's best interest.

It is recognised that the relevance of the above considerations will depend on the importance and magnitude of the proposal or transaction before the Board. The Board minutes should keep track of any evidence that shows that the Board is the real decision maker.

Is a parent company merely influential or the real decision maker?

When will the Australian Parent influence over its non-resident subsidiary qualify as a mere influence versus the exercise of CMAC. Again, the examples provided in the draft PCG are useful but no definitive indicia are set out to indicate more clearly how much influence an Australian Parent can have before its non-resident subsidiary becomes a resident. To demonstrate that the parent company is merely influential and not the real decision maker, it may be appropriate that the directors of the non-resident subsidiary, in particular:

- Have considered the merits of the transactions and whether they were in the best interest of the subsidiary
- Have the power to deviate from the instructions received from their Parent company
- Have made some independent high-level decisions relating to the subsidiary
- Have sufficient knowledge of the subsidiary's business, financial position or the implications of the transactions they claim to have decided to enter
- Have met frequently to independently consider directions given by their Parent company
- Are able to clearly articulate why the Board decisions were made
- Are able to determine whether any of the decisions were illegal or improper.

The Board minutes should keep track of any evidence that shows that the Board is the real decision maker, not its Parent.

Decisions made in more than one place – is CMAC exercised in Australia?

Where decision makers are located in more than one place, the key question is to determine where the company's control and direction is being exercised in 'substance'. As stated above, the examples provided in the draft PCG are quite polarised examples leaving unclear what is the tipping point when the participation by directors in Australia on foreign Boards (by electronic means and circular resolutions) will represent the exercise to a substantial degree of CMAC in Australia.

In determining if to some "substantial degree" the exercise of CMAC of a company is to be found in Australia, careful consideration must be given to the following:

- What is done in Australia in terms of "superior or directing authority" in its own right, irrespective of what is happening in the other jurisdictions?
- How is this "superior or directing authority" exercised over time by looking at the company's overall pattern of decisions making? and,
- Do those activities of direction and control in Australia (and only those activities) form a substantial part of the CMAC of the company?

The lack of clarity in the draft PCG in terms of what represents the exercise to a "substantial degree" of CMAC in Australia creates ambiguity. Therefore, special care should be given to review current companies' "superior or directing authority" arrangements to exclude the risk for companies to "flip flop" in and out of Australian corporate residency due to this ambiguity.

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