THE APPLICATION OF AUSTRALIA'S DOMESTIC LAWS WHERE A FOREIGN COMPANY IS A RESIDENT

Presenter:

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Introduction

Motivation(s) for the paper

What is the paper about?

TR 2018/5 and potential for dual residence

What does it mean?

This presentation is limited to:

1. Central management and control (CM&C) test
2. Dual corporate residence issues and key tax implications where a foreign company is a resident

1. Background to CMC test

Definition of resident in s 6(1) of the *ITAA* 36

Bywater Investments & Hua Bank v FCT

Various Reviews of residency rules

- Taxation Review (Asprey) Committee (1975)
- Treasury Consultation Paper (2002)
- Board of Taxation recommendations (2003)

ATO Publications

- Taxation Ruling TR 2004/15 (withdrawn)
- Taxation Ruling TR 2018/5: Income tax: central management and control test of residency
- PCG 2018/9: Central management and control test of residency: identifying where a company's central management and control is located

Residency – definition

Section 6(1) of the ITAA 36

A company is a resident of Australia if:

It is incorporated in Australia; or

***Carries on business in Australia and has either its central management and control in Australia**, or its voting power controlled by shareholders who are residents of Australia.*

Residency test for companies not incorporated in Australia

- *CM&C test* – company carries on business in Australia and has its CM&C in Australia
- *Voting power test* - company carries on business in Australia and voting power controlled by shareholders who are residents of Australia

Parliament adopted “central management and control” from common law authorities concerning residency

Also included the concept of “carries on business” as potential words of limitation on the definition.

Defintion remained unchanged since 1930 despite considerable uncertainty as to application.

Bywater Investments v FCT

Facts

The shareholding structure in relation to each company was complex and was considered by the court to be a “ruse” to conceal the fact that Mr Gould was in control in Australia.

None of the shares were directly owned by Australian residents.

All board meetings took place offshore.

The companies’ officers were outside Australia, but they did no more than “rubber-stamp” the decisions made by Mr Gould in Australia.

The Commissioner contended that each company was an Australian resident and sought to tax the income derived by each company as assessable income under s 6-5(2).

Each company submitted that its central management and control was not in Australia.

Issue

Whether the four foreign incorporated companies were Australian resident taxpayers?

Bywater Investments v FCT

Held

The CM&C of each company was exercised in Australia and the exercise of the central management and control constituted the business they carried on in Australia and thus each company was an Australian resident.

Directors formal meetings outside Australia were an attempt to legitimise the actions of each company.

The High Court disregarded the role of those directors who were formally appointed but did not play any real role in the company affairs. This was on the basis that the directors did not exercise any independence or turn their mind to decisions made at the director meetings.

It was found that the decisions were not actually made by the directors but they acted merely as a rubber stamp for decisions made by Mr Gould in Australia notwithstanding that Mr Gould did not have legal power to control the directors.

Key points

The key point is that the central management and control is a question of fact and requires an inquiry as to where top level financial and policy decisions are in fact made.

The key factual element will be proving that the directors of the subsidiary exercised independent judgment.

Various Reviews of Residency Rules

Taxation Review (Asprey) Committee (1975)

- Two years after Esquire Nominees was decided, the Asprey Committee considered whether to extend the test for corporate residence to include the exercise of control and direction of the company's affairs otherwise than through the board of directors but did not recommend doing so.
- The Asprey Committee recommended against changing the test of residence to "include the exercise of control and direction of the company's affairs otherwise than in the formal proceedings of the board-room".
- This wide meaning would increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable: many wholly-owned subsidiaries of Australian resident companies, though incorporated in foreign countries and resident there, could become Australian resident companies.

Treasury Consultation Paper (2002)

- Uncertainty based on an interpretation in *Malayan Shipping* that mere exercise of CM&C 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 CM&C alone would not constitute the carrying on of a business. Option 3.12 for consultation: to consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business

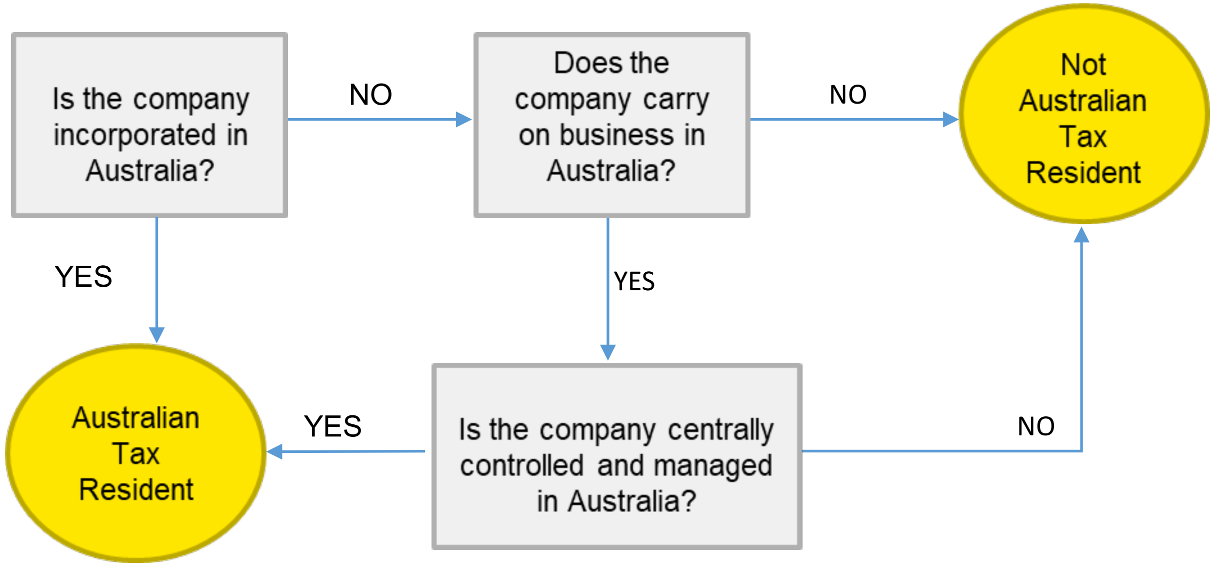
Board of Taxation recommendations (2003)

- Recognised the CM&C 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.

Residency for a company – TR 2004/15 (old ruling - withdrawn)

- The Commissions view in TR 2004/15 (until it was withdrawn effective 15 March 2017) was that for a company to be a resident under the CM&C test, two separate requirements must be met.
- The ‘carries on business in Australia’ requirement is additional to and separate from the requirement for central management and control.
- A company that has major operational activities carries on business wherever those activities take place and not necessarily where its central management and control is likely to be located.
- Where a parent company in Australia exercises central management and control in relation to a subsidiary (but does not conduct the daily activities of the business in the way that the managing director did in *Malayan Shipping*), the subsidiary would need to also be carrying on business in Australia in order to satisfy the CM&C test.

Residency for a company – TR 2004/15 (old ruling - withdrawn)



Residency for a company – TR 2018/5 (new ruling)

Does a company carry on business in Australia?

[6] To be resident under the central management and control test of residency, a company must carry on business in Australia

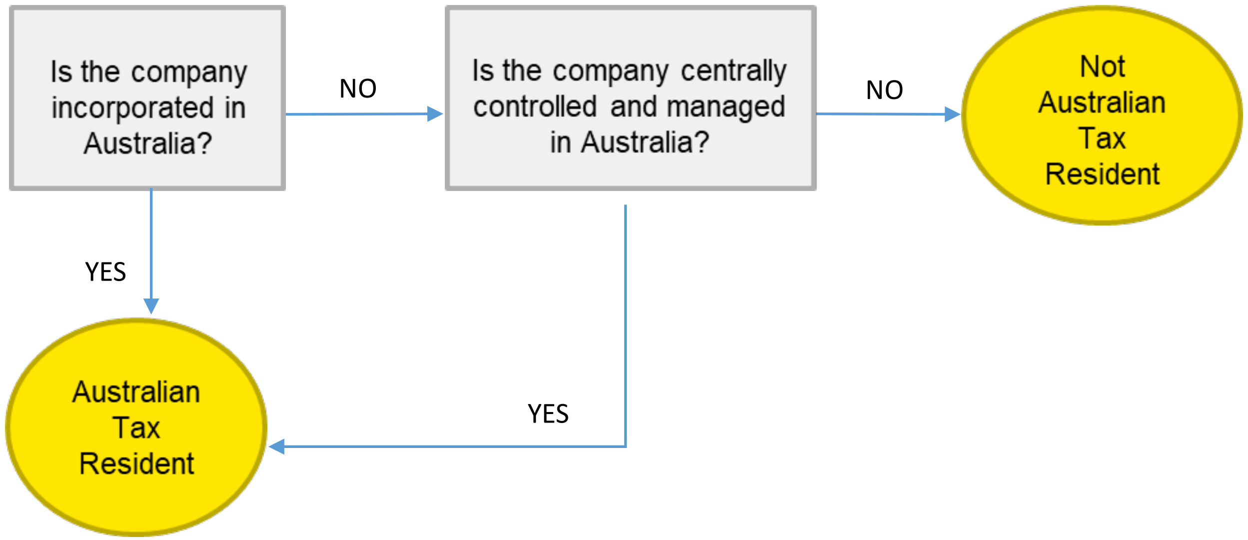
[7] If a company carries on business and has its central management and control in Australia, it will carry on business in Australia within the meaning of the central management and control test of residency.

[8] It is not necessary for any part of the actual trading or investment operations of the business of the company to take place in Australia. This is because the central management and control of a business is factually part of carrying on that business.

A company carrying on business does so both where its trading and investment activities take place, and where the central management and control of those activities occurs.

[9] Central management and control of a company is not necessarily exercised where the trading or investment activities of the company are carried on.

Residency for a company – TR 2018/5 (new ruling)



2. Dual corporate residence issues and key tax implications where a foreign company is a resident

Tax treaty implications

- Dual residence issues
- Application of the tie-breaker article
- Impact of the Multilateral Instrument (MLI) on a dual resident company
- Application of tax treaties with some examples

Domestic tax implications

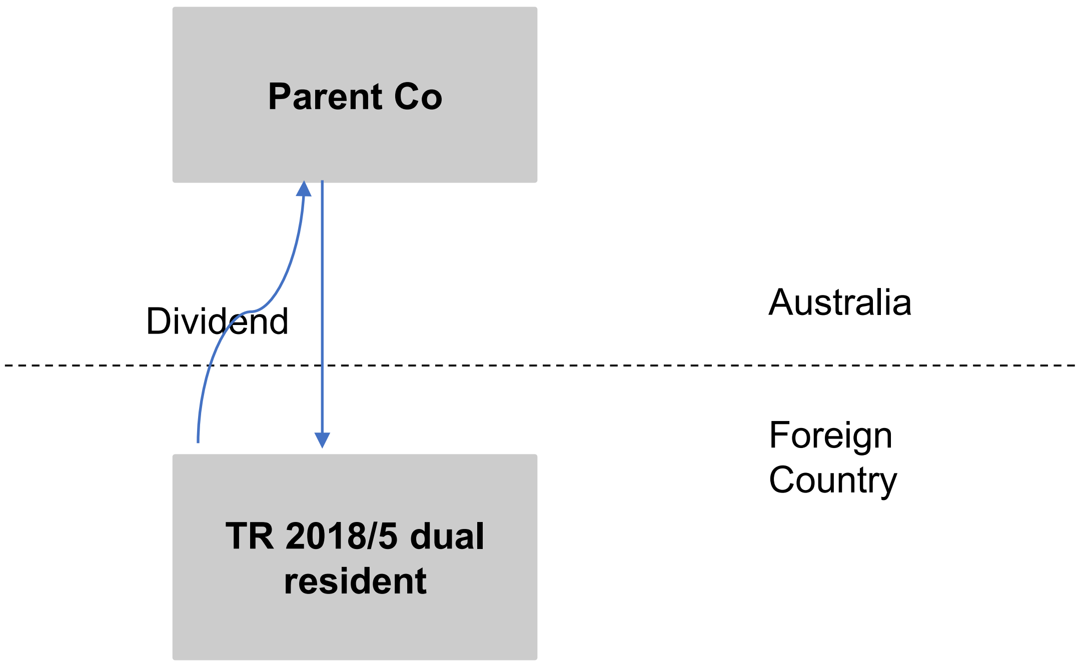
- Tax consolidation v non-tax consolidated
- Interaction with the Controlled foreign company (CFC) regime
- Capital Gains Tax (CGT) consequences

Tax treaty implications

Dual residence issues

- TR 2018/5 dual resident i.e. resident in foreign country and CM&C in Australia
- Potential for residence-residence taxation
- Most treaties contain a “tie-breaker” article - notable exception being the US treaty
- Application of the tie-breaker article to foreign country does not mean non-resident for domestic law purposes cf Canada & UK
- Limited number of targeted domestic rules impacted - e.g. “Prescribed dual resident” and “Part X Australian resident”

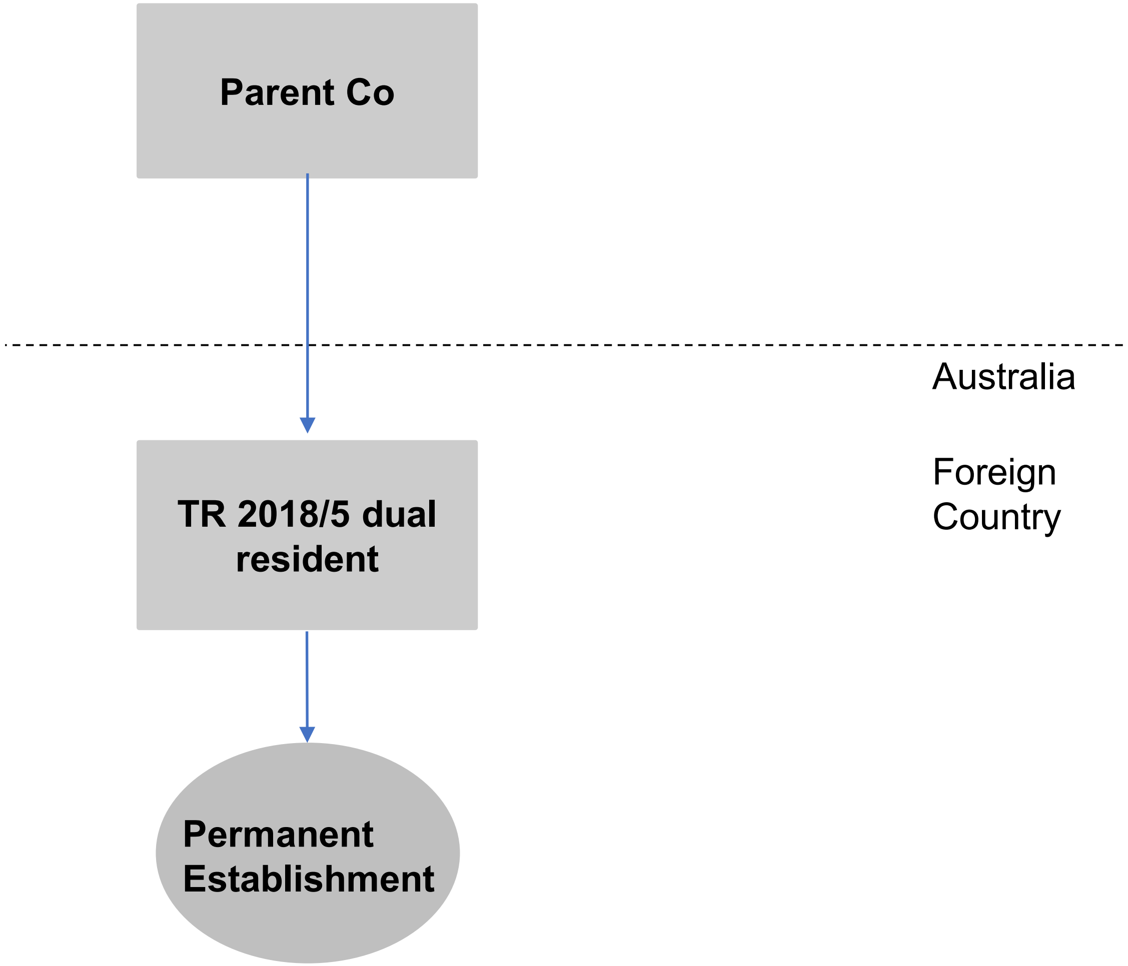
Dividend Example – TR 2018/5 dual resident



Dividend paid to Parent Co

- Tie-breaker applies to allocate residence to Australia
- Parent Co claiming treaty benefits and needs to be a resident under treaty
- Unfranked dividend assessable to Parent Co

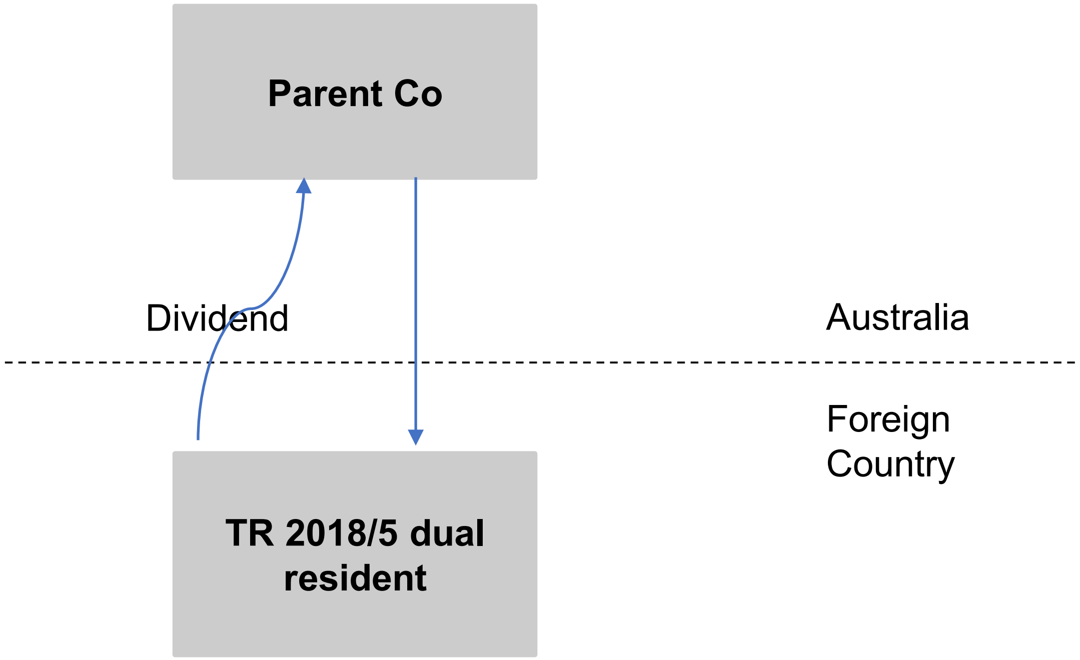
Domestic tax issues: non-consolidated



Branch profits exemption

- Consider whether TR 2018/5 dual resident company carries on business through a permanent establishment in the foreign country
- Consider requirements in 23AH to determine whether company qualifies for foreign branch profits exemption
- Capital gains should also be NANE where the asset is not taxable Australian property
- Treatment should be the same whether treat applies or not

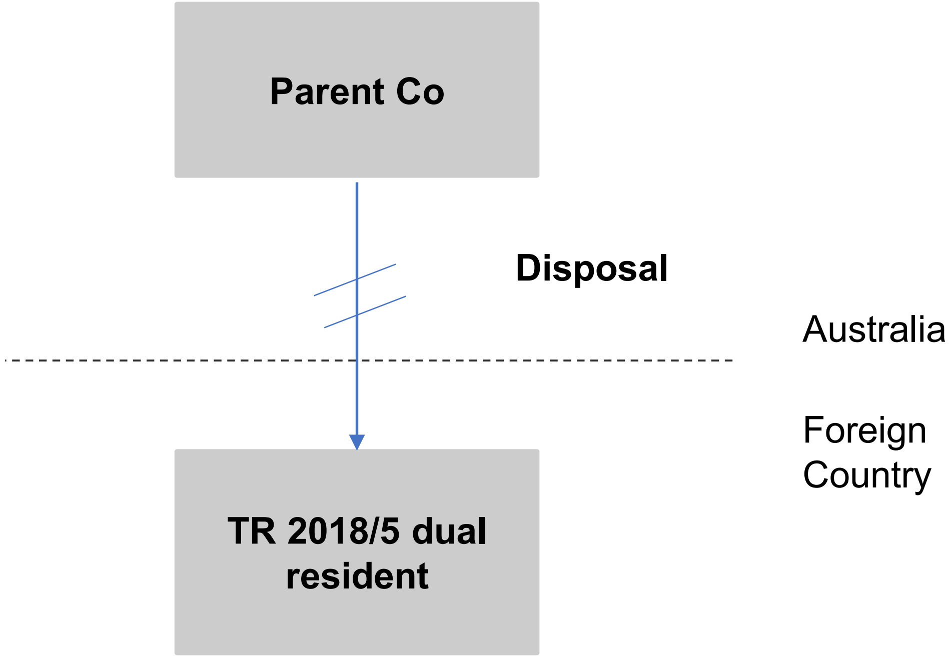
Domestic tax issues: non-consolidated



Unfranked dividend

- Assuming all branch income of the subsidiary is NANE then no tax paid in Australia. No franking credits available
- Payment of unfranked dividend to Australian parent potentially generate tax payable at Parent Co level
- Participation exemption in s 768-5 not available as TR 2018/5 dual resident not a foreign resident
- Interest deductions should be available where Parent Co capitalized subsidiary (compare with consolidation scenario)

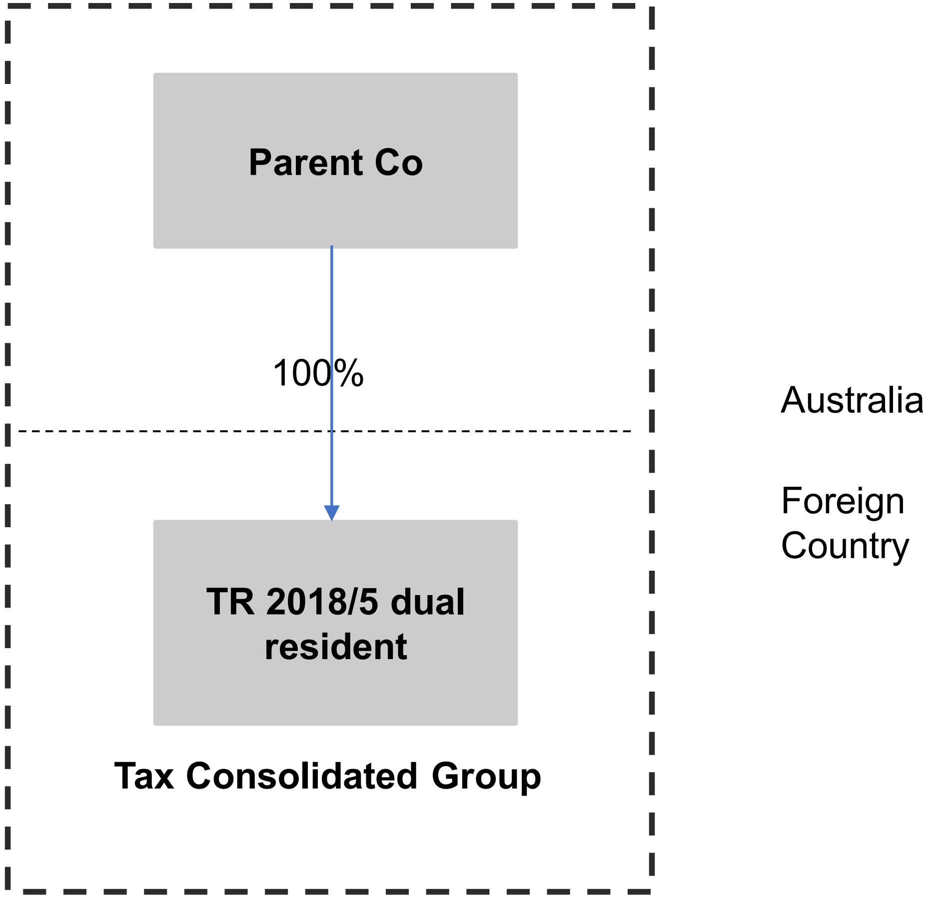
Domestic tax issues: non-consolidated



Disposal of subsidiary

- CGT event A1 arises where shares disposed of
- Active foreign company exemption in Sub 768-G is not available as TR 2018/5 dual resident is not a foreign resident
- Does not matter if treaty applies to allocates residence under the tie-breaker to foreign country

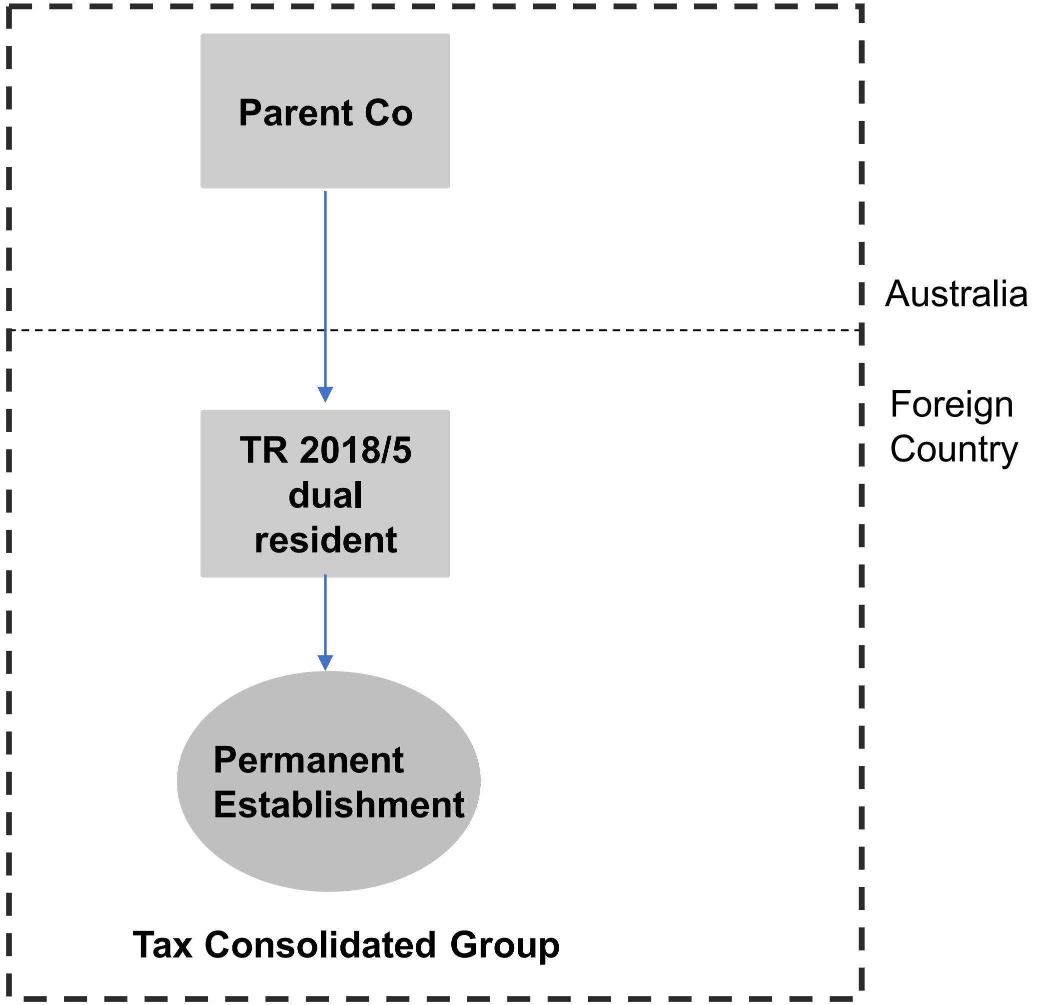
Domestic tax issues: consolidated



Eligibility to join

- Must satisfy ‘ownership requirements’ and ‘residence requirements’
- Must be an Australian resident but not a prescribed dual resident to be a member of TCG
- Definition of prescribed dual resident has a first condition and an alternative condition which could apply where central management and control is split between both countries
- This may mean that not eligible to be a member of the TCG

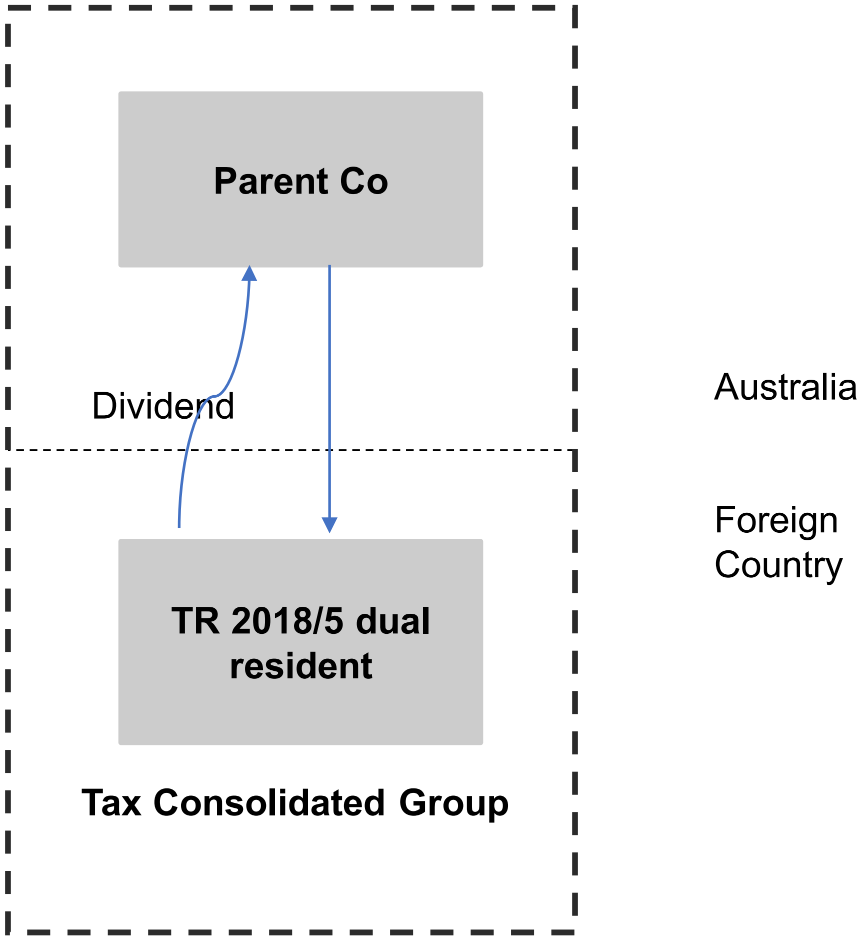
Domestic tax issues: consolidated



Branch profits exemption

- Consider whether s 23AH applies to determine whether the company qualifies for foreign branch profits exemption
- Single entity rule applies as subsidiary is part of TCG
- From an interest deductibility perspective, where TR 2018/5 dual resident is part of a tax consolidated group, it would seem that the interest would not deductible under s 25-90 or s 8-1

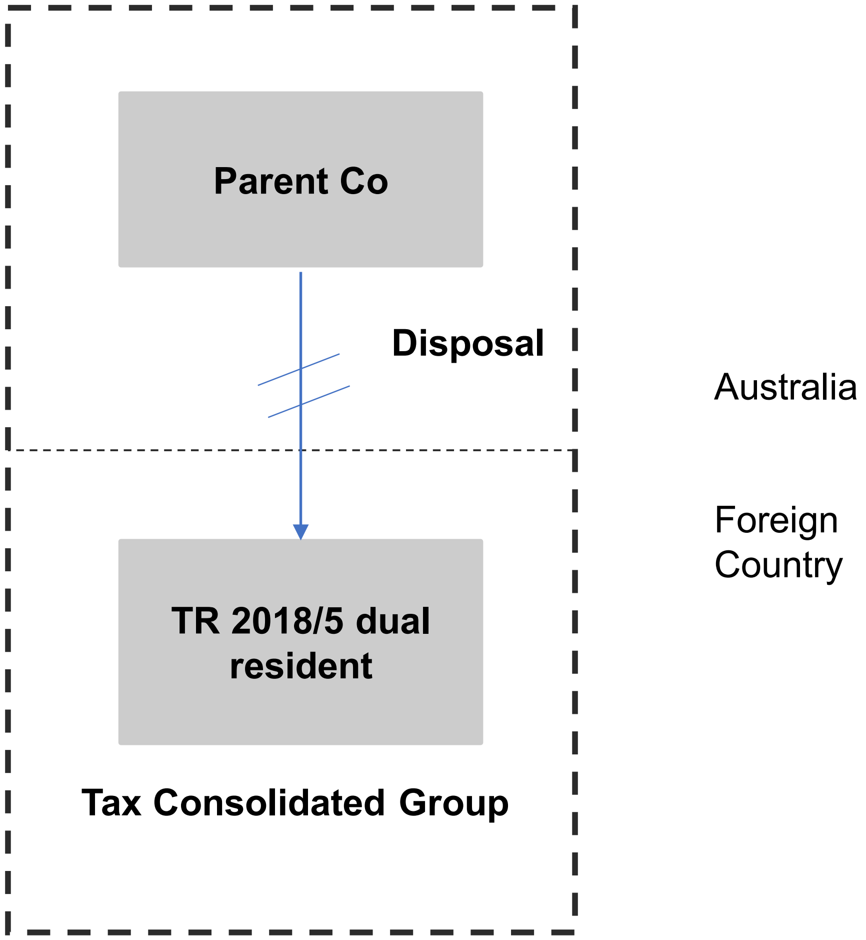
Domestic tax issues: consolidated



Dividends

- Where part of TCG the single entity rule applies as subsidiary is part of TCG and dividend will be ignored
- Where TCG in existence but subsidiary is a prescribed dual resident then it is not eligible to be part of the TCG
- The dividend would be unfranked as subsidiary would be considered a foreign resident to qualify for foreign participation equity exemption in s 768-5

Domestic tax issues: consolidated



Exit issues

- CGT event A1 for disposal cases
- Division 711 calculation required in order to ‘set’ the amount of the tax cost of the shares. Potential for CGT event L5 to arise
- Active foreign company exemption in Sub 768-G is not available as TR 2018/5 dual resident is not a foreign resident
- Also CGT event I1 when entity leaves TCG due to change in residence – time of the event is when company stops being an Australian resident

Mulitateral Instrument

MLI general application

- Australia signed the MLI on 7 June 2017. MLI was given the force of law in Australia by the *Treasury Laws Amendment (OECD Multilateral Instrument)* Act 2018. Royal Assent on 24 August 2018. Australia deposited its instrument of ratification with the OECD Depositary on 26 September 2018.
- Signatories of the MLI may choose which existing tax treaties they would like to modify using the MLI. Once a tax treaty has been listed by the two parties, it becomes an agreement to be covered by the MLI.
- Most provisions of the MLI are optional (only some are mandatory). Each country can choose which article to apply and make reservations to limit the adoption of the MLI, including the right for a provision not to apply at all.
- Synthesised text of the MLI and the Convention (Australia and NZ)
- **When the MLI takes effect in Australia**
- Withholding taxes: on income derived on or after 1 January 2019
- All other taxes: for income years starting on or after 1 July 2019
- Dispute resolution: generally after the MLI enters into force for each of the jurisdictions.

Mulitateral Instrument

MLI - Article 4

- Australia adopted article 4 which contains the tie-breaker for dual resident entities.
- Article 4 provides for the replacement of a tie-breaker rule in a Covered Tax Agreement with a tie-breaker test that provides that the two competent authorities would endeavour to determine by mutual agreement which of the jurisdictions the dual resident is deemed to be a resident.
- The competent authorities make this assessment by having regard to:
  - its place of effective management
  - its place of incorporation or constitution; and
  - any other relevant factors.
- No treaty benefits available where no agreement on single jurisdiction of residence