

ATO finalises controversial guideline on tax residency of foreign companies

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In brief

On 20 December 2018 and after almost two years, the Australian Taxation Office (ATO) released its final guidance ([PCG 2018/9](#)) in relation to the determination of tax residency of foreign incorporated companies.

Many taxpayers will be required to revisit their governance, systems and processes in relation to foreign incorporated companies and, in many cases, act quickly to make necessary changes before the transitional period ends on 30 June 2019.

These new requirements increase, unnecessarily in our view, the red tape and costs of doing business for Australian corporate groups that operate offshore. It remains to be seen whether this might be the catalyst for the Government to modernise Australia's test of corporate residency in accordance with recommendations of Treasury and the Board of Taxation more than 15 years ago.

In detail

On 20 December 2018, the ATO released its 19 page final Practical Compliance Guideline, [PCG 2018/9: central management and control test of residency: identifying where a company's central management and control is located](#) (the Guideline).

By way of background, for a company that is not incorporated in Australia, if either of the following tests are satisfied, the company will be a tax resident of Australia:

1. The company carries on a business in Australia and has its central management and control (CM&C) in Australia (the 'CM&C test').
2. The company carries on a business in Australia and its voting power is controlled by shareholders who are residents of Australia (the 'voting power test').

Critically, both of these tests have traditionally been viewed as composite tests with the requirement to carry on business in Australia *considered separately* from either the CM&C requirement or the voting power requirement. However, as explained below, the ATO has revised this long standing view.

Before considering the final guidance now provided by the ATO in relation to the CM&C test, we firstly summarise the background which led to the final Guideline.

ATO's interpretation of Bywater decision

In November 2016, the High Court of Australia handed down its decision in *Bywater Investments Limited and Ors v Commissioner of Taxation* and the related matter in *Hua Wang Bank Berhad v Commissioner of Taxation*¹ (the *Bywater case*). This case primarily concerned the residency of a foreign incorporated company, and specifically, the CM&C test of residency. This is the first time the High Court has considered this issue in over 40 years.

Subsequently, on 15 March 2017 the ATO released Draft Tax Ruling TR 2017/D2 concerning the CM&C test. At the same time, it withdrew TR 2004/15² which previously provided the ATO view on this test (including by way of explicit examples). A key element of TR 2004/15 was that a foreign incorporated company trading outside of Australia would not be a tax resident of Australia because it is not *carrying on business in Australia*³. It was accepted by the ATO that its board of directors could hold the majority of its meetings in Australia where decisions on major contracts, finance, policies and strategic directions are made⁴.

This approach, consistent with established law, simplified the management and corporate governance of foreign incorporated companies conducting trading business offshore. This “foreign trader” rule has been very helpful, for 15 years, to Australian companies endeavouring to expand their operations offshore.

For further background regarding the *Bywater case* and Draft Ruling TR 2017/D2, please see our previous [TaxTalk Alert](#).

ATO’s final ruling on CM&C

After more than 15 months of consultation, Taxation Ruling TR 2018/5 *Income tax: central management and control test of residency*, was released on 21 June 2018, together with a 21 page draft Practical Compliance Guide PCG 2018/D3. The ATO’s final taxation ruling included few changes, and no overall departure, from the controversial view outlined in its predecessor draft (TR 2017/D2). In particular, the ATO rejected various submissions to the effect that the decision in the *Bywater case* did not require the withdrawal of TR 2004/15 and that the foreign trader rule continues to be supported by Australian case law.

For further background regarding TR 2018/5 and the predecessor draft PCG 2018/D3, please see our previous [TaxTalk Alert](#).

ATO’s final practical compliance guideline on CM&C

[PCG 2018/9](#) aims to provide practical guidance (with examples) to assist foreign incorporated companies and their advisers to apply the principles set out in TR 2018/5, focusing particularly on the identification and location of a company’s CM&C.

Aside from an extension of the “transitional compliance approach” to 30 June 2019 (see below), there were no substantive changes from the draft.

In the background section of the Guideline it is explained that “[n]ormally, a company’s directors exercise its [CM&C] where they execute their duties and comply with the standards expected of directors under the

¹ *Bywater Investments Limited & Ors v. Commissioner of Taxation; Hua Wang Bank Berhad v. Commissioner of Taxation* [2016] HCA 45 (16 November 2016).

² TR 2004/15 *Income tax: residence of companies not incorporated in Australia - carrying on a business in Australia and central management and control* (withdrawn 15 March 2017).

³ TR 2004/15, paragraph 6.

⁴ TR 2004/15, paragraphs 71-73.

applicable Australian or foreign company law. This will normally be where its directors make their decisions. Most companies will have little difficulty identifying where it is located and little reason to consider the examples set out in this Guideline.”

However, the Guideline goes on to warn that “[t]he exceptions to this involve either some lapse in directorial standards or corporate governance, unusual facts such as the director’s role being usurped by outsiders, or the company’s control and direction being exercised in more than one place”.

In seeking to understand the Guideline, it is important to recognise that Practical Compliance Guidelines are not prepared for the primary purpose of expressing a view on the way a tax law provision applies. Instead, they represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws. In simple terms, the Guideline is endeavouring to provide taxpayers with an administrative safe harbour.

Highlighted below are some key observations from the Guideline:

- **Board minutes** - Board minutes are the starting point for identifying who exercises and where a company’s CM&C is exercised. Only when a company has not kept board minutes, it makes high-level decisions outside of board meetings, the board minutes do not disclose where directors are making a company’s high-level decision, or the board minutes are false (including where they record the rubber stamping of decisions made elsewhere), will it be necessary to look at other evidence of who makes and where they make the company’s high-level decisions. Therefore, if a company has board minutes showing a complete record of where all its high-level decisions were made and who made them, the Commissioner will accept them as prima facie establishing where the company’s CM&C is located. These materials should include evidence supporting matters recorded by the board but does not necessarily need to include board deliberations, why decisions were made and whether alternatives were considered or rejected.
- **Relevance of companies activities** - the more extensive a company’s business activities are, the more likely it is that high-level decisions that are an exercise of its CM&C will be distinct from day-to-day management decisions about business operations or transactions. The Commissioner accepts that boards may grant wide and extensive powers of management to employees, yet still retain and exercise CM&C of the company. The Commissioner also acknowledges that where a company has limited activities (e.g. a passive holding company or a dormant entity), it may not make any high level decisions in a given year. In this case, the taxpayer may need to look back to the last high level decision that was made.
- **Merely influential or the real decision maker** - if a person is “merely influential”, even if that influence is strong, that influence will not, of itself, amount to an exercise of CM&C. It must be determined who are “the real decision makers” in relation to “high-level decisions” of the foreign company. This may require consideration of, for example, whether the foreign company directors:
 - actively consider suggestions made by shareholders including seeking independent advice where necessary.
 - have the knowledge and experience to determine whether any decisions are illegal or improper and made in the best interests of the foreign company.
 - are rubber-stamping high-level decisions, following all proposals without deviation, mechanically implementing decisions or not making independent high-level decisions.
 - are subject to the exercise of veto rights by another person (e.g. an ultimate shareholder), where there is a practice of that other person exercising veto rights to override decisions that the foreign shareholders make.

- **Decision making within a corporate group** - directors of a foreign company do not cease to exercise its CM&C merely because, in making decisions, they conclude that it is in the best interest of the company to:
 - facilitate the plans and policies of its parent
 - comply with proper proposals advanced to it by its parent that are also in the interest of the company group, or
 - make decisions only after receiving approval from its parent to do so.
 - A foreign incorporated subsidiary of an Australian resident company may also have employees of its parent as directors. This is not, of itself, conclusive of where the subsidiary's CM&C is exercised.

- **Decision making in more than one place** - decisions can be made in more than one place in two basic situations:
 - directors physically meet in multiple different locations where they exercise CM&C (e.g. board meetings regularly held in more than one country), or
 - directors do not physically meet in person to make decisions (e.g. decisions are made by phone or video conference, written circular resolution or by email where they are physically in different locations).

The ATO does not accept that decisions are necessarily made in the place it is formalised, or where the last signature is placed on a resolution or a vote on it is cast.

Where board meetings are conducted via electronic facilities (rather than physical attendance), the focus is on where the participants contributing to the high-level decisions are located.

The question of where CM&C is located is determined by reference to how it is exercised over time. An occasional or one-off exercise of high-level decision making in a particular place outside the normal course of how a company's CM&C is exercised, does not cause it to be in that place for the purpose of the CM&C test, unless it is, by itself, 'substantial' in the context of the company, or it forms part of a 'regular pattern' of CM&C being exercised in that place that is substantial in the context of the company.

The Guideline endeavours to provide further assistance through 15 examples. However, the Guideline acknowledges that the examples cannot cover every circumstance. We echo this acknowledgment as the Guideline examples do not appear to provide the necessary guidance to be able to determine what the likely outcome (in the eyes of the ATO) would be in relation to many real life examples.

The Guideline encourages taxpayers to approach the ATO to discuss their circumstances if they are unsure whether they are a resident of Australia. However, given the fact-intensive, practical nature of many of the areas of uncertainty, and the constraints on the ATO in terms of the form of rulings that can be provided, seeking private tax rulings to resolve uncertainties may be of limited practical value in many cases.

Transitional compliance approach applies until 30 June 2019

In recognition that many foreign incorporated companies will be affected by the withdrawal of TR 2004/15 and the revised ATO view in TR 2018/5, the Guideline provides a transitional period ending on 30 June 2019 for taxpayers to make changes to governance arrangements so that CM&C is exercised outside Australia and, in effect, the foreign trader rule is grandfathered until 30 June 2019.

These changes to governance arrangements could be changes to the composition of boards (i.e. adding or removing directors), the conduct of meetings (e.g. by video-conference, circular resolution or in person)

and/or the location of meetings. Furthermore, these changes that are necessitated by the change in administrative approach to tax residency, could have flow-on consequences for corporate governance within corporate groups more generally (e.g. reporting lines, eligibility for employees to act as directors of subsidiary boards, etc.).

There are a number of strict conditions that must be satisfied before a foreign incorporated company can qualify for the transitional compliance approach and it will be important for companies to document compliance with these requirements.

Ongoing compliance approach - public companies only

The ATO also acknowledges that unintended or unplanned circumstances arise from time to time which may cause the location of central management and control to be subject to question.

For subsidiaries of public companies only, the Guideline also provides an ongoing compliance approach. According to the ATO, the ongoing compliance approach does not extend to private groups “as they have a lower level of public transparency and a greater level of diversity in the ways in which they are structured and how they operate”. In our view, it is unfortunate that the Guideline discriminates between public and private companies, particularly given the significant number of private groups which operate with high standards of tax and corporate governance.

If certain conditions are satisfied, the risk of residency arising under the CM&C test will be considered low and the Commissioner will not “normally” apply his resources to review or seek to treat a foreign incorporated company as a resident applying the CM&C test merely because part of the company’s CM&C is exercised in Australia, because directors regularly participate in board meetings from Australia using modern communications technology.

There are a number of strict conditions that must be satisfied before a foreign incorporated company can qualify for the ongoing compliance approach safe harbour. For example:

- The foreign company must be either of the following:
 - A subsidiary of an Australian public group (listed on ASX, SSX, NSX, Chi-X), that is an ‘ordinary company’, and which is treated in the Australian income tax returns and financial statements as a non-resident and a CFC. It cannot be a foreign hybrid (company or partnership).

Certain entities commonly used in the United States (US) that are transparent for US tax purposes or treated as companies for Australian tax purposes (e.g. limited partnerships) will not qualify for the ongoing compliance approach.

Various aspects of this requirement, for example, the situation for companies with dual/multiple listings and the definition of subsidiary, are far from clear.

- A foreign company (or wholly-owned subsidiary) listed on an approved stock exchange (one of the [71] exchanges in [51] countries) that is treated in the group’s income tax returns and financial statements as a resident of a listed country (i.e. Canada, France, Germany, Japan, New Zealand, United Kingdom and US). It cannot be a foreign hybrid (company or partnership).

The rules for companies listed offshore are far more restrictive.

- A substantial majority of the company's CM&C must be exercised in a foreign jurisdiction (that is not a tax haven) where it is treated as a resident for tax purposes under that jurisdiction's law through: (i) board meetings that are held outside Australia, or (ii) board meetings (including meetings undertaken by circular resolution or via the use of modern communication technologies

including teleconferencing) where the majority of directors are not present in Australia when such meetings take place.

The drafting of this critical condition is unclear. However, based on explanatory material released with the Guideline, it would seem that, for example, a majority of the directors of the foreign company should participate in board meetings from outside Australia (but not necessarily in the country where the foreign company is incorporated and/or tax resident).

- There are also ‘negative’ conditions, whereby the administrative safe harbour will not be available where there are artificial or contrived arrangements affecting the location of the company’s CM&C (including previous or subsequent ‘migration’ of residency), there is a ‘tax avoidance scheme’ which depends on the location of the entity’s residence, there are arrangements to conceal ultimate beneficial or economic ownership or there are arrangements involving abuse of board processes (including backdating of documents or the board not truly executing its functions).

At a general level, these exclusions from the administrative safe harbour appear to be appropriate. However, there is a level of subjectivity around some of the criteria (e.g. whether any change of residency automatically considered to be artificial or contrived and what does ‘the board not truly executing its functions’ mean in practice), which could create uncertainty around the ability to obtain access to this administrative safe harbour.

It is hoped that the ATO will seek to clarify the key requirements of the ongoing compliance approach safe harbour requirements because we anticipate some Australian listed company groups will seek to rely on this safe harbour.

Observations

Determining tax residency of a company is a critical first step in working out its Australian tax liability as it means the difference between paying Australian tax on worldwide income (for a resident company) and paying tax only on the company’s Australian sourced income (for a non-resident company).

It is also relevant in applying many other aspects of Australian tax law, such as determining the members of a tax consolidated group, applying Australia’s participation exemptions (i.e. for non-portfolio dividends, branch income or gains on the sale of shares in an active company), deemed capital gains tax (CGT) events, Australia’s controlled foreign company (CFC) rules, applying withholding tax to distributions, and ability to access foreign income tax offsets (FITOs).

The Guideline does not address any of these issues and it will be critical to carefully examine the application of the new ATO view and Guideline to all foreign incorporated companies well before 1 July 2019. This is because, in almost all cases, there will be complex Australian and foreign implications associated with a foreign company being an Australian tax resident or changing residency status for Australian tax purposes.

Furthermore, the Guideline does not address the interaction between the ATO’s view on CM&C and the application of Australia’s double tax agreements. This is particularly topical given the changes introduced by the Multilateral Instrument, which will remove the Article 4 residency tie-breaker rule from certain treaties and will instead require taxpayers to resolve residency issues through mutual agreement procedures (MAP).

Given that the Guideline may result in an increased likelihood of Australia asserting residency over a foreign entity, the requirement under the Multilateral Instrument to resolve the issue by way of MAP, could lead to uncertainty for taxpayers and a time-consuming process for resolution.

The Board of Taxation in 2003 recognised that the CM&C test created uncertainty which was contrary to the policy objective and recommended a test based solely on place of incorporation. At that time, the then Government deferred any further action pending the release of an ATO ruling. The ATO released that ruling (TR 2004/15) on 20 October 2004 before withdrawing it on 15 March 2017. After two years of

consultation on the ATO's replacement ruling, the final ATO approach has not materially changed from its initial draft. The new ruling (TR 2018/5) and finalised guidance is unlikely to provide taxpayers with the certainty afforded by TR 2004/15 (which warranted the previous Government decision to defer a decision on the need for legislative clarification in 2004).

Given this continued uncertainty, it may be that Australian business will once again push for reforms to modernise Australia's test of corporate residency in accordance with the initial recommendations of Treasury and the Board of Taxation that were made more than 15 years ago.

The takeaway

The ATO's change in view on the application of the CM&C test will create uncertainty of the tax residency of foreign incorporated companies for many multinational groups. We suggest that careful attention is given to tax residence where there are potential decision making 'influencers' in Australia, a taxpayer has relied on the foreign trader rule for companies with active trading businesses, a majority of directors have not participated in decision making from the place of incorporation of a foreign company, or decision making involved circular resolutions or other modern technologies.

Foreign incorporated companies will need, at a minimum, to review their governance arrangements to confirm whether CM&C is (and continues to be) exercised outside Australia. We anticipate that this will lead to additional costs and red tape for many Australian companies with offshore operations and aspirations. It will be necessary to pay particular attention to the location of real decision makers and ensure appropriate documentation and records are maintained of board meetings and key decisions made. As a practical matter, our experience has been that this will divert senior executives, unnecessarily in our view, from efficiently running international businesses.

Even with the extended transitional period (up to 30 June 2019), a very tight window of now less than six months is offered to taxpayers to consider the ATO's revised view on corporate residency, review existing governance protocols and, if required, make necessary changes.

Public companies will also need to decide if they should try to meet all of the conditions of the ongoing compliance approach safe harbour which, as noted above, is unclear in many important respects.

The burden on private companies will be more acute because they do not have access to the ongoing compliance approach safe harbour, and the administrative burden will be even more onerous for these taxpayers.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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