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By email: andrew.harnisch@ato.gov.au

Dear Andrew,

**Draft Taxation Ruling 2017/D2**

PricewaterhouseCoopers (PwC) welcomes the opportunity to make a submission in relation to the draft taxation ruling, TR 2017/D2 Income Tax: Foreign Incorporated Companies: Central Management and Control Test of Residency (D2 or the Draft Taxation Ruling), released for comment on 15 March 2017.

The Draft Taxation Ruling is intended to replace the withdrawn TR 2004/15 which has been updated following the High Court decision in *Bywater Investments Limited & Ors v. Commissioner of Taxation; Hua Wang Bank Berhad v. Commissioner of Taxation [2016] HCA 45; 2016 ATC 20-589* (*Bywater*).

PwC also welcome the opportunity for continued involvement throughout the consultation process prior to its finalisation.

**Summary**

The *Bywater* decision does not justify the withdrawal of TR 2004/15 and we strongly suggest that it be reinstated. This is principally because the Draft Taxation Ruling will disturb more than a decade of established practice by Australian based companies in relation to the management of tax residency and create uncertainty, complexity and compliance costs as well as an unknown impact on tax revenues. In our view, these difficulties with the Draft Taxation Ruling have not been adequately explored.

If a decision is made to finalise the Draft Taxation Ruling, then the operative date must be deferred until income years commencing on or after 1 July 2018 to allow taxpayers to assess the impact, and where necessary, adjust their affairs to ensure that unintended consequences do not arise. In addition, the Board of Taxation (BoT) should be asked to revisit the work undertaken in 2002 in relation to tax residency and (re)consider if a law change is required to restore certainty for all Australian companies.
with offshore investment. This is because the decision by the Government at the time not to implement law change recommended by the BoT was underpinned by the now withdrawn TR 2004/15.

General comments

PwC make the following general submissions in relation to the Draft Taxation Ruling:

1. **Time and cost unnecessarily increased**

   As an overarching observation, we expect taxpayers will understandably continue to manage their corporate residency status of their subsidiaries incorporated outside Australia (Foreign Subsidiaries). However, the change in view of the Commissioner on the application of the second statutory test 1 (the Relevant Test) of the definition of resident (the Commissioner’s New View) will lead to uncertainty for Foreign Subsidiaries where there are potential decision making influencers in Australia. The time and costs associated with managing corporate residency will substantially increase for most taxpayers with overseas operations and this is at odds with the Government’s commitment to reduce regulation and cut red tape 2 and, to our knowledge, there are no “integrity issues” that have instigated the Commissioner’s New View.

   Taxpayers with Foreign Subsidiaries that are trading and operating outside of Australia have in many cases relied upon TR 2004/15 3 to maintain foreign residency status with minimal additional compliance effort. However, taxpayers will now be forced to undertake substantially more work to assess (and evidence) where central management and control (CM&C) is located for all Foreign Subsidiaries.

2. **Bywater does not require TR 2004/15 to be withdrawn**

   The Draft Taxation Ruling expresses a view that it is not necessary for any part of the actual trading or investment operations from which a company’s profits are made to take place in Australia, as the CM&C of a business is factually part of carrying on that business. 4 On this view, a Foreign Subsidiary that has its CM&C in Australia (and nothing else) will be deemed an Australian resident as both elements of the Relevant Test are considered satisfied. The conclusion reached in the Draft Taxation Ruling is apparently 5 required following the Bywater decision.

   This Commissioner’s New View is a radical departure from the view expressed in TR 2004/15 (relied upon by taxpayers for more than a decade) which considers the business being “carried on” by the company and its CM&C as two separate requirements as reflected in the statutory

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1 Per paragraph 6(1)(b) of the ITAA 1936.
2 cuttingredtape.gov.au
3 Income tax: residence of companies not incorporated in Australia - carrying on business in Australia and central management and control.
4 D2, Paragraph 5.
5 Although not stated in the Draft Taxation Ruling, the Decision Impact Statement (dated 12 April 2017) states that “The approach the Commissioner took in TR 2004/15 in relation to the earlier High Court decision in Malayan Shipping can no longer be sustained”.

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language. As a result, TR 2004/15 confirmed that, even where CM&C was in Australia (second requirement), a Foreign Subsidiary “trading” company cannot be an Australian resident unless it also carries on its trading operations in Australia (first requirement). Example 2 (CM&C in Australia with trading outside Australia) of TR 2004/15 illustrates this clearly.

Case law establishes that issues concerning the existence of CM&C and whether a "business is being carried on" are necessarily determined by the specific facts and circumstances of each case. The question considered by the High Court in *Bywater* was not “what is the meaning of CM&C” but rather whether the particular facts lead to a conclusion that CM&C was in Australia. From our reading of *Bywater*, the taxpayer conceded that it was carrying on business in Australia (share trading) and therefore the first requirement of the statutory question was never in contention. For this reason, we do not accept that *Bywater* means that TR 2004/15 “can no longer be sustained” nor that a “revised view on how to apply the central management and control test” is necessary or justified.

Further, *Bywater* makes reference to *Malayan Shipping Co Ltd v Federal Commissioner of Taxation (1946) 71 CLR 156* (*Malayan Shipping*) which was referenced extensively in TR 2004/15. The facts of *Malayan Shipping* were cited (at paragraph 20) as being an example of a special circumstances where CM&C could also constitute carrying on business. Despite this caveat, the Draft Taxation Ruling extends this to be a broad statement of general principle.

In addition, due to the extreme facts involving elements of contrivance or worse, it is not surprising that the High Court found that CM&C was located in Australia and nowhere else.

Finally, we note that the Australian CFC regime (introduced after the *Malayan Shipping* decision) operates to protect the integrity of the Australian tax system by bringing to tax certain passive income of Foreign Subsidiaries controlled by Australian residents and presumably the CFC rules would have applied in *Bywater* if the Court had concluded that the relevant companies were not Australian residents. We highlight this point to support our view that the withdrawal of TR 2004/15 is not necessary nor justified.

In summary, *Bywater* does no more than remind us that the issue to be answered is a question of fact and that each case depends on its own facts and circumstances but it does not address the first requirement of the Relevant Test. As a result, TR 2004/15 can and should be reinstated.

3. **Draft Taxation Ruling will create extreme uncertainty in practice**

The replacement of TR 2004/15 with the Draft Taxation Ruling will create extreme uncertainty in many cases because, in simple terms, it provides inadequate practical guidance in relation to the location of CM&C. It will be difficult to draw the line in many cases - for

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6 TR 2004/15W, paragraph 2.
7 The judge made findings of fact that the, “real business was conducted from Sydney …” and everything else was “a crooked pantomime” “the role of [the apparent director] was fake”, his actions may even have amounted to “a sham” and the evidence he gave to deny this was dismissed as lies.
example, does an Australian parent of a Foreign Subsidiary merely influence the decision making of the board of directors of the Foreign Subsidiary, or do they actually dictate or control the decision making? The Draft Taxation Ruling does not address how much influence an Australian parent company can have over its Foreign Subsidiary before the latter becomes an Australian tax resident.

The Draft Taxation Rulings requires reference to whether directors follow advice that is “improper or inadvisable” as well as “the directors’ knowledge of the business”.

In practice, regardless of where they are located, parent companies will always ultimately have extensive influence over their Foreign Subsidiaries and it is quite common for directors to act on the instructions given from the parent company. Most multinationals also have systems of delegated authority in place as part of their corporate governance frameworks. For example, regional managers may be appointed to manage the day-to-day operations of a Foreign Subsidiary but may be required to seek approval from the group CEO for extraordinary or significant transactions above a certain thresholds prior to implementation. In these situations, regional management will be responsible for determining whether commercially viable, value accretive and commercially sound transactions should proceed but must ultimately receive “sign off” before proceeding.

Of course, under the very sensible approach set out in TR 2004/15, none of these difficulties existed because the trading company rule would allow Australian companies to be confident of the non-resident status of all foreign trading companies.

Compounding these difficulties is the fact that the Draft Taxation Ruling contains only general principles and, unlike TR 2004/15, does not contain any examples to illustrate, in practice, how the Commissioner’s New View will be applied. In addition, the Draft Taxation Ruling does not contain a non-binding “explanation” of the “preliminary but considered view on how to apply” the Commissioner’s New View.

This lack of practical guidance, particularly in relation to such a radical new view which will affect all Australian companies with overseas operations is disappointing. We strongly urge the Commissioner to provide examples and further explanation in either the final taxation ruling or in the Practical Compliance Guidelines (PCG) well before the operative date (see below). This guidance should address:

- The specific examples in TR 2004/15 where the outcome changes under the Commissioner’s New View. For example, it would seem that the Foreign Subsidiaries

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8 D2, paragraph 21.
9 D2, Paragraph 23.
10 D2, Paragraph 24.
11 Such as entering into substantial long-term contracts, making an acquisition, divestment of significant business operations, transactions involving significant business operations in a new country etc.
12 This is shorthand for the reference in TR 2004/15 to “…a company with operation activities (for example, major trading, service provision, manufacturing, or mining activities relative to the whole of its business)”. Refer paragraphs 9 and 44.
in Examples 2, 4, 5.2, 5.3 would be Australian residents under the Commissioner’s New View.

- The changing nature of commerce and circumstances of directors.13
- Distinction between a company’s business that involves minor operations (viz management of investment assets) with a business that involves more active and substantial operations.
- Distinction between parent companies that merely influence decision making versus those that dictate and control the decision making of the Board of directors of the Foreign Subsidiary.
- The level of documentation that will be required by the Commissioner (for example, in order to evidence decisions being made at a Board meeting, will the Commissioner require board minutes to record what decisions were made and why the directors made them? Any other alternatives or options considered (and discounted) by the Board? etc.).
- Standard processes and terms (for example, the Commissioner could suggest the kind of documentation that is expected to be maintained by Foreign Subsidiaries).
- Whether or not it will be sufficient for Board meetings to be held outside of Australia (and how frequently those meetings need to occur).
- The concept of “rubber stamping” of decisions “actually made by others”.

We would be happy to consult further with the ATO in relation to these common questions that our clients have been asking following the release of the Draft Taxation Ruling.

4. Other consequences not addressed

The Draft Taxation Ruling will create enormous uncertainty and, we expect, in many cases raise real questions about whether Foreign Subsidiaries (clearly not Australian residents pursuant to TR 2004/15) are now Australian tax residents. This will create a range of unanticipated and unintended consequences which we submit the Commissioner should address in any decision to finalise the Draft Taxation Ruling and to inform the need for urgent discussions with Treasury created by the Commissioner’s New View.

We are continuing to study the likely consequences of, in essence, the Commissioner’s New View which may mean that a number of Foreign Subsidiaries become Australian tax residents. These include:

- A need for CFCs to join the Australian tax consolidated group (for example, asset cost base resetting, ATO notification requirements etc.).
- Refunds of tax for income (for example, royalties and interest received from CFCs) rendered non-taxable as a result of the Commissioner’s New View; we observe that the Commissioner’s New View may generate arrangements involving permanent establishments of the kind described in TA 2016/7.
- Importation into the Australian tax system of foreign losses of Foreign Subsidiaries.

13 Consideration should be given to what skills the directors of the company are required to have; their experience and qualifications to perform their duties and sufficient knowledge of the business to make informed decisions etc.
• Adjustments required in relation to the Australian tax treatment of TOFA deductions, foreign exchange differences, withholding tax and CFI balances.
• Adjustment to procedures in relation to compliance with the CFC measures, International Dealings Schedule and CbC reporting.
• Dealing with other consequences of “dual residence” and change in residence including local country dual resident limitations, exit charges, relief from double taxation, access to tax treaties (for example, the multilateral instrument proposals to remove treaty residence tie breaker rules) and generation of new hybrid outcomes.

5. **Adverse impact on small business with offshore ambitions**

As a practical matter, the Commissioner’s New View is likely to affect many small business that have offshore operations. This is because, in general, they may devote relatively less attention to the management of tax residency and, in some cases perhaps inadvertently, rely on the “trader” rule in TR 2004/15. In simple terms, this is because for those inexperienced in international tax matters, the starting point is likely to be that Foreign Subsidiaries are not Australian tax residents.

6. **Date of effect and implementation**

It is proposed that the Draft Taxation Ruling will apply from 15 March 2017.

As noted above, there are likely to be numerous technical issues for many taxpayers to work through in applying the Commissioner’s New View. In simple terms, this may require taxpayers to:

(i) establish whether all Foreign Subsidiaries remain non-resident;
(ii) determine the consequences of becoming a dual resident from a particular date; and
(iii) where necessary, implement changes to ensure CM&C is not in Australia.

Given these challenges, we strongly recommend that the application date of the Draft Taxation Ruling is changed to income years commencing from 1 July 2018 (and reinstating TR 2004/15 for the transitional period). This will give taxpayers time to work through the tasks above and avoid the complexity of a change in residence part way through an income year.

In addition, given our expectation that some taxpayers will need to alter their arrangements to avoid potential additional Australian taxes and complexity, the Draft Taxation Ruling should stipulate that the Commissioner accepts that taxpayers may restructure their affairs to avoid a change in residency and that, in the circumstances, this is not a scheme to which Part IVA (including the Diverted Profits Tax) could apply.

For the sake of completeness, we state our expectation that Part IVA can have no application to a change of residence caused by the Commissioner’s New View. This may be relevant to taxpayers that, for example, achieve an Australian tax advantage as a result of a Foreign Subsidiary becoming an Australian tax resident due to the Commissioner’s New View.
7. A legislative amendment becomes new priority

Prior to the release of TR 2004/15, difficulties with the High Court’s decision in Malayan Shipping had been raised in the 2002 Treasury consultation paper, The Review of International Taxation Arrangements (RITA), particularly concerning application of the Relevant Test. The RITA consultation paper stated:

The case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test... 14

The BoT made recommendations in the following year to adopt a simpler and more certain test for corporate residency, that is a company would only be resident of Australia if it was incorporated in Australia. 15 This was on the basis that the CM&C test was difficult to practically apply and confusion as to whether CM&C was enough to be carrying on a business.

In the 2003-04 Federal Budget, the Treasurer announced the Government’s decision to defer consideration of legislative changes to the domestic tests of corporate tax residency recommended by the BoT 16 pending the release of a draft taxation ruling by the ATO clarifying the operation of these tests. TR 2004/15 was released the following year, confirming that the CM&C function does not constitute part of the business operations being carried on. This was on the basis that the Relevant Test had a “two element construction”. The Commissioner distinguished the High Court decision in Malayan Shipping on the basis that the two requirements in the Relevant Test were satisfied by the same set of facts and so the decision should be confined to the facts of the case.

Therefore, if, contrary to our recommendation above, TR 2004/15 is not reinstated, we submit that the ATO should, as a matter of priority, recommend a swift legislative change be implemented in order to avoid the unnecessary confusion and complexity outlined above. In the interim, as a matter of practical compliance, the principles of TR 2004/15 should continue to be followed by the Commissioner.

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16 Refer to recommendation 3.12 of RITA.
We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact Peter Collins on 0438 624 700 or Jayde Thompson 0403 678 059.

Yours sincerely

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Partner                Director
Global Tax             Global Tax

Cc.
Michael Andrew (Chair, Board of Taxation)
Maryanne Mrakovic (Deputy Secretary, Revenue Group, The Treasury)
Lachlan Molesworth (Taxation, Foreign Investment & Financial Services, Office of the Treasurer, The Hon. Scott Morrison MP)