Australian Government
The Treasury

12 August 2020
File: 42783

Mr Jason Lange
Executive Director
Office of Best Practice Regulation
Department of the Prime Minister and Cabinet
1 National Circuit
BARTON ACT 2600

Dear Mr Lange

CLARIFYING THE AUSTRALIAN TAX RESIDENCE OF COMPANIES INCORPORATED OFFSHORE

I write regarding the regulation impact statement (RIS) requirements for a proposed legislative change that would clarify Australia's tax residency rules for companies incorporated offshore (OBPR reference: 42783).

As noted in recent discussions between Treasury and OBPR officials, the proposed legislative change would be consistent with the key recommendation made by the Board of Taxation as part of its recent review of Australia's corporate tax residency rules.

I am satisfied that, in completing its review, the Board consulted extensively with stakeholders and conducted a comprehensive analysis of all relevant issues. Accordingly, I certify that the process undertaken by the Board was the equivalent of the process required to complete a RIS as prescribed by the Australian Government. Supporting details addressing the Board's report in relation to the 'seven RIS questions' are provided in Additional Information.

I am also satisfied that the Board's review complies with OBPR's revised guidance concerning independent reviews and the 'relevance' test, as published in March this year. In my view, the Board's review satisfies this test on the basis that the proposed legislative change recommended by Treasury reflects the core recommendation (Recommendation 1) of the Board's final report.

I therefore seek to submit the Board's final report and consultation papers (attached) to meet the RIS requirements for this proposed measure. Please note that the Board's report has not yet been made public.

The purpose of the proposed legislative change is to provide clarity for affected taxpayers. Treasury has self-assessed the estimated regulatory burden of this change on business (and community organisations and individuals) using the Government's *Regulatory Burden Measurement* framework, and considers that it would have a negligible effect. Please see Additional Information for further details.

Yours sincerely

Paul McCullough
Acting Deputy Secretary
Revenue Group
The Treasury

ADDITIONAL INFORMATION

Board of Taxation: Corporate Tax Residency Review

The Board of Taxation is a non-statutory advisory body charged with contributing a business and broader community perspective to improving the design of taxation laws and their operation.

Question	Board of Taxation process
What is the policy problem to be solved?	The principal policy question being considered is: when is a foreign incorporated company, with operations in Australia, a resident for Australian tax purposes? In August 2019 the Treasurer wrote to the Board of Taxation asking the Board to conduct a review of the operation of Australia's corporate tax residency rules. The purpose of the review was to ensure that these rules are operating appropriately in light of modern, international and commercial board practices, and international tax integrity rules. In particular, the Board was asked to consider whether the existing rules: a) minimise commercial uncertainty and ambiguity; b) are consistent with and aligned with modern day corporate board practices; c) protect the tax system against multinational profit shifting; and d) otherwise support Australia's tax integrity rules as they apply to multinational corporations.
Why is Government action needed?	Tax residence is integral in determining a company's Australian income tax liability. Generally, Australian resident companies are taxed on their worldwide income while non-resident companies are only taxed on their Australian-sourced income. Section 6(1) of the *Income Tax Assessment Act 1936* treats a company incorporated offshore as an Australian tax resident if it carries on business in Australia and has either its central management and control in Australia, or its voting power controlled by shareholders who are Australian tax residents. In 2017, the Australian Taxation Office issued a taxation ruling reflecting a change in interpretation of this test; specifically, that the exercise of central management and control is tantamount to carrying on a business, effectively collapsing the former two-step test into a single-step test and potentially bringing more foreign-incorporated companies into the Australian tax net. The ruling responded to a 2016 High Court decision. Taxpayers signalled to Government that this approach did not align with the policy intent of the law, and that the law should be changed to clarify/provide certainty to industry. The central tenet of the Board's review was therefore to test whether legislative change to the central management and control test, or the corporate residency rules more generally, was required. The Board received strong feedback from stakeholders indicating that a legislative amendment was necessary, with stakeholders consistently raising three issues: • the impact of the Bywater case (2016) on the interpretation of the central management and control test; • changes in the way multinational groups operate in today's economy; and • how these factors were reflected in the ATO's written guidance on (and administration of) this test.

	Stakeholders indicated to the Board that these three issues, combined, had resulted in a level of uncertainty that could not be resolved through further administrative guidance (for example, Law Companion Rulings, or Practical Compliance Guidelines). Stakeholders proceeded to provide the Board examples of how this uncertainty was affecting commercial enterprise in multinational groups (largely related to start-up and small/medium sized organisations), and increasing red tape and compliance costs across all groups regardless of size (both inbound and outbound). Some stakeholders also highlighted concerns about adverse effects on their corporate governance, including the use of overly conservative practices, and labour market effects on directors of subsidiary companies.
What policy options were considered?	Having regard for the Board's consultation process, it released a Reform Options paper which focused on two potential policy options, both of which would require a legislative solution: 1. retention of the existing 'carrying on business and central management and control' test (collectively referred to as the CMAC test) but with some form of legislative modification; and 2. adoption of an incorporation-only test (establishing an alternative approach to the current rules).
What is the likely net benefit of each option?	As noted above (Question 1), the Board was asked to consider whether the existing corporate tax residency rules: a) minimise commercial uncertainty and ambiguity; b) are consistent with and aligned with modern day corporate board practices; c) protect the tax system against multinational profit shifting; and d) otherwise support Australia's tax integrity rules as they apply to multinational corporations. Option 1 (Question 4) focused on reinstating the two-limb test (essentially reverting to the former status quo). It sought to do this by clarifying that a company that is incorporated offshore will only be treated as an Australian tax resident if it has a 'sufficient economic connection to Australia', i.e. where both its core commercial activities are undertaken in Australia and its central management and control is in Australia. The Board noted this option would 'modernise' the existing test by 'updating' the concept of carrying on a business having regard for more modern business structures and economic markets. As it also reflected the status quo, it was considered to be consistent with current tax integrity rules. Having regard to these 'benefits', the 'costs' of this option were seen to be negligible. Option 1 was intended to adopt a principle-based approach to the legislation. Option 2 was framed as a simple approach to determining corporate residency – on the basis the question of fact as to where a company was incorporated was indisputable. It was intended to support predictability and certainty. However the Board noted that this approach may have adverse effects on tax integrity, with profit shifting and 'loss dumping' a particular concern, giving rise to potential revenue loss. On balance, and having regard for the Board's term of reference, the Board considered Option 1 would have a greater, overall net benefit.
Who was consulted and how was the	On 6 September 2019, the Board published a Consultation Guide on its corporate residency review project (attached). The Board posed a number of consultation questions for stakeholder comment that would inform their final report, including:

feedback incorporated?	• questions surrounding the difficulties associated with the central management and control test, and whether there were any other issues with the test that the Board should be aware of. • whether subsequent additions to the income tax law had affected the 'viability' of the central management and control test. • replacing the central management and control test with an alternative test of 'place of effective management', and if so, what effect it would have on commercial certainty, how would it align with modern corporate practices, and the interaction with the integrity of the current tax rules as they apply to multinational corporations. • considerations of alternative criteria – other than central management and control or place of effective management – that could be used to establish corporate residency. • the merits of an 'incorporation only' test as the sole basis for establishing corporate residency. • the 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. The Board received 13 written submissions from industry representatives and tax advisory firms. The Board also held roundtable discussions in Sydney, Melbourne and Perth. In December 2019, the Board released a Reform Options paper (attached), reflecting the comments and feedback received in the initial consultation stage (above). The Board indicated that they received strong feedback from stakeholders that reform was required to provide greater commercial certainty and better alignment with modern day board practices and corporate governance. In this regard, the Reform Options paper identified two principal reform options: a) retention of the existing 'carrying on business and central management and control' test (collectively referred to as the CMAC test) but with some form of legislative modification; and b) adoption of an incorporation-only test. Both options would require legislative change.
What is the best option?	In July 2019, the Board submitted its final report to the Treasurer for his consideration, recommending that the best option was to legislate a change to the central management and control test (option 1 above)
How will the chosen option be implemented and evaluated	The Board's core recommendation would require a legislative change to the income tax law. The Board also recommended that the legislative change be reviewed after three years to ensure the test was operating appropriately. Subject to the Government's response, the Treasury would release for public consultation exposure draft legislation and explanatory materials, as per standard practice.

Regulatory Burden Measurement

Estimate of regulatory costs

The proposed legislative change to clarify the operation of the corporate tax residency test for foreign incorporated companies, with operations in Australia, essentially reinstates the former status quo. Despite the ATO's change in interpretation of the law, no compliance resources had been applied to enforce the revised approach. For some affected taxpayers the proposed legislative change would be considered deregulatory (on the basis they no longer need to record 'special' minutes of strategic decisions, other than what is already required under the tax law). For a smaller group of taxpayers, there may be a sustained minor increase in record keeping costs, for reasons such as corporate governance risk aversion having regard for potential changes to legislative interpretation. However, for most effected taxpayers, there would be no change in business practice/operation. On balance, we have self-assessed this proposed change as having a negligible regulatory cost, rounded down to zero.

Average annual regulatory costs (from business as usual)				
Change in costs	Business	Community organisations	Individuals	Total Change in costs
Administration	$0	---	---	$0
Total, by sector	**$0**	**---**	**---**	**$0**