



# NSW Tax Forum

## A Practical Look at Corporate Residency

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# 1. Introduction

Determining the tax residency of a company is an important consideration, as an Australian resident company will be taxed on ordinary and statutory income from all sources, whether in or out of Australia. Non-resident companies are generally only taxed on their Australian sourced income.

The concept of residency impacts on the application of a number of provisions in the *Income Tax Assessment Act (1936)* (“**ITAA 1936**”) and the *Income Tax Assessment Act (1997)* (“**ITAA 1997**”), as will be discussed later in this paper. It is also a key requirement in ascertaining whether a company can avail itself to relief available under Australia’s tax treaty network.

In this paper, I will recap recent developments impacting on the “resident” definition as it applies to companies that are not incorporated in Australia, and will then work through a number of practical examples to demonstrate how these developments impact on Australian outbound corporate groups in various scenarios.

## 1.1 The residency definition

The general law principles for determining the residence of a company require a consideration of the place where the real business of the company is carried on, which is where the central management and control of a company is based<sup>1</sup>.

The statutory definition of when a company will be a “resident” of Australia is contained in section 6(1) of the ITAA 1936, and includes:

- A company incorporated in Australia; or
- A company that is not incorporated in Australia, but carries on business in Australia, and either:
  - Has its central management and control (“**CMAC**”) in Australia (referred to as the CMAC test); or
  - Has its voting power controlled by shareholders who are resident of Australia (referred to as the voting power test).

This paper will focus specifically on the CMAC test included within the above statutory definition.

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<sup>1</sup> *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455

## 2. Recap of recent developments

### 2.1 Pre-*Bywater*

Before the judgement in the *Bywater*<sup>2</sup> case was handed down in 2018, the main sources relevant to the interpretation of the definition of a “resident” as it applied in the context of a company not incorporated in Australia, included Australian case law and Taxation Ruling 2004/15.

The case of *Malayan Shipping Co Ltd v Federal Commissioner of Taxation*<sup>3</sup> is one of the key Australian cases where the High Court was required to consider the statutory definition of “resident” in the context of a company. This case concerned a company that was incorporated in Singapore. The only business that it carried out during the relevant period was the charter of a Norwegian tanker.

In the *Malayan Shipping* case, Williams J noted that:

*The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situate or resident in Australia is, in my opinion, to make it clear that the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia.*

*But if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia. If, on the other hand, a company incorporated elsewhere is merely trading in Australia and its central management and control is abroad, it does not become a resident of Australia unless its voting power is controlled by shareholders who are residents of Australia.*

The ATO released TR 2004/15 to provide guidance on determining when a foreign incorporated company is resident in Australia under the CMAC test of the statutory definition.

Key observations on the ATO’s position as documented in TR 2004/15 are as follows:

- For a company to be resident under the CMAC test, two separate requirements must be met. The first is that the company must carry on business in Australia, and the second is that the CMAC of the company must be located in Australia.
- If the company does not carry on business in Australia, the company cannot meet the CMAC test and there is no need to consider the location of the company’s CMAC.
- There could be instances where the nature of the business or level of control over the business would result in the requirements of carrying on a business and CMAC converging. For example, in the case of an investment business.
- The ATO’s position on the *Malayan Shipping* case was that the two separate requirements in the CMAC test were met by the same set activities. The nature of the business and the managing director’s complete management and control over the business operations and internal

<sup>2</sup> *Bywater Investments Ltd & Ors v Commissioner of Taxation, Hua Wang Bank Berhad v Commissioner of Taxation* [2016]

HCA 45

<sup>3</sup> (1946) 71 CLR 156

administration of the company resulted in a situation where his powers and actions evidenced both CMAC and the carrying on of a business in Australia.

## 2.2 The *Bywater* decision

The key facts in the case of *Bywater* are as follows:

- The taxpayers in this case included four companies that had been incorporated outside of Australia (in Samoa, the Bahamas and the UK).
- Broadly, the four companies were held by various firms of accountants in a nominee capacity on behalf of other companies. These other companies were owned by Borgas, a Swiss tax resident, who was also appointed as a director.
- Borgas gave evidence that he made all the commercial judgments on behalf of the companies and exercised all his powers as an appointed director to decide on the actions of the businesses whilst based in Neuchâtel.
- However, documentation showed that Mr Gould, an accountant in Sydney, ultimately owned and controlled all of the companies.
- The companies derived profits from the sale of shares in companies listed on the ASX over the course of the 2000 to 2007 income years, which was assessed as taxable income by the Commissioner, in addition to levying substantial penalties and interest.

It was held that a company cannot be taken to be resident where its board meetings are held if the meetings are a “*window dressing comprised of rubber-stamping decisions actually made elsewhere by others, and held in that place in the hope of avoiding tax liability in the place where the decisions are actually made.*”

The *Bywater* judgement confirmed the long-standing principle established in earlier precedent that the residence of a company is a question of fact and degree to be answered according to where the central management and control of the company actually abides. This is determined, not by reference to the constituent documents of the company, but upon an assessment of the course of business and trading.

In fact, the judges in the *Bywater* case did not consider the requirement of carrying on a business as a separate and distinct requirement to CMAC, which was consistent to most of the precedents referenced throughout the judgement. For example, with reference to the *De Beers*<sup>4</sup> case, it was noted:

“... a company resides for income tax purposes “where its real business is carried on”; that “**the real business is carried on where the central management and control actually abides**”; and that the question of where central management and control actually abides is “a pure question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading”.

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<sup>4</sup> *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455

Furthermore, in reference to the case of *Waterloo Pastoral*<sup>5</sup>, it was said: “... the crucial test is where the real business of the company is carried on, not in the sense of where it trades, but in the sense of from where its operations are controlled and directed”.

Based on the above, the CMAC requirement is synonymous to carrying on the “real business” of an entity. This leads to the conclusion that the mere trading in Australia should not result in a foreign company establishing Australia tax residency. However, where the “real business” or CMAC of a foreign incorporated entity is carried out in Australia, this is sufficient to establish tax residency per section 6(1), irrespective of where the trading activities might be located.

It is perhaps unsurprising then that after the *Bywater* judgement was handed down, the ATO withdrew TR 2004/15 and replaced it with Taxation Ruling 2018/5, which saw the ATO change its long-held views in TR 2004/15.

## 2.3 Taxation ruling 2018/5 and Practical Compliance Guide 2018/9

### 2.3.1 The updated interpretation of the CMAC test

In TR 2018/5, the key change in the ATO’s approach to the corporate residency of foreign incorporated companies is that a company that has its CMAC in Australia will be viewed as carrying on business in Australia, irrespective of where its trading activities occur.

This position is contrary to the view in 2004/15, in terms of which it was concluded that if a foreign company was not carrying on its business in Australia (in the form of its trading activities), then it could not be regarded as resident in Australia, even where its CMAC occurred in Australia.

TR 2018/5 then goes on to discuss the general concepts of:

- What is CMAC?
  - CMAC is the control and direction of a company’s operations, which envisages the high-level decision making that sets general policies, and determines its directions and the transactions it will enter into.
  - CMAC is separate and distinct to the day-to-day conduct and management of a company’s activities and operation.
- Who exercises CMAC?
  - The starting point is that it is the directors of a company that will control the company and direct its operations.
  - The Ruling discusses various scenarios where an appointed director would not be exercising CMAC. This would include for example, directors who are formally appointed but do not play any real role in managing the company (as was the case of Borgas in the *Bywater* case). Or where is a person who is not appointed as a director, but who tacitly controls the company.
- Where is CMAC exercised?

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<sup>5</sup> *Waterloo Pastoral Co Ltd v. FCT (1946) 72 CLR 262*

- CMAC will arise at a place where the high-level decisions of the company are made in substance, and not where they are merely recorded or formalised.
- It is possible to have multiple places of CMAC, but in order to establish CMAC for purposes of the residency definition, CMAC must be operated in a particular place to a substantial degree.

### 2.3.2 Transitional compliance approach

Given the change in approach in TR 2018/5, the ATO provided a transitional compliance approach to ascertaining the tax residency of foreign incorporated companies in PCG 2018/9.

Under the transitional compliance approach, the ATO undertook not to apply resources to disturb a foreign incorporated company's status as a non-resident if it met the requirements to apply the transitional compliance approach, and changed its governance arrangements, such that its CMAC would be exercised outside of Australia by the end of the transitional period.

Initially, the transitional period was from 15 March 2017 to 30 June 2019. However, this was extended up to the period ending 30 June 2023 (ending 31 December 2022 for early balancers with a December year-end). The ATO has confirmed that the transitional period will not be extended further.

In order to qualify for the transitional compliance approach, the following requirements must be met:

- The foreign company must have been relying on TR 2004/15 immediately prior to its withdrawal;
- The foreign company must not be party to any contrived arrangements related to the location of its CMAC, nor party to any avoidance arrangements dependant on the company being treated as non-resident;
- The company must be ordinarily incorporated under the corporate laws of a foreign country;
- The company must not be a foreign hybrid company as envisaged in Division 830 of ITAA 1997; and
- The company would become resident under the CMAC test solely because its CMAC is located in Australia.

The transitional compliance approach provided some much-needed relief due to the uncertainty caused by the change in the ATO's approach, and especially during the COVID-19 pandemic, when Australian based individuals acting as directors on the boards of foreign companies were unable to travel and attend board meetings overseas.

However, it is important to note that the above transitional compliance approach would not apply to foreign companies incorporated after 15 March 2017.

### 2.3.3 Ongoing compliance approach

The ongoing compliance approach is an undertaking by the ATO to treat the governance arrangements of certain foreign incorporated companies as low risk of establishing tax residency in Australia under the CMAC test, where certain conditions are met.

This is an "ongoing" compliance approach, unlike the transitional compliance approach, and so there is currently no scheduled end date to this concession.

In order to qualify for the ongoing compliance approach, the foreign incorporated company must be:

- A subsidiary of an Australian public group, a listed holding company of a foreign public group, or a subsidiary of a foreign public group;
- Incorporated in a foreign country, not a foreign hybrid company and treated in the group's Australian income tax return as a controlled foreign company;
- A substantial majority of the company's CMAC must be exercised in a foreign jurisdiction (not a tax haven) via board meetings held outside of Australia, board meetings using teleconference facilities, where the majority of directors are not present in Australia, or decisions made by circular resolution where majority of directors are not present in Australia when the decision is made;
- The company must not be party to any artificial or contrived arrangements, including previous 'migrations' of residency, tax avoidance schemes, arrangements to conceal ultimate beneficial or economic ownership, or arrangements involving abuse of board processes (e.g. backdating documents).

There are several conditions that need to be fulfilled to fall within the ongoing compliance approach, however, it is questionable why this approach is provided at all. If a foreign incorporated company has a substantial part of its CMAC exercised in a foreign country, then arguably it should not be viewed as having its CMAC in Australia under existing precedent and the views presented in TR 2018/5.

## 3. The Board of Taxation Review

As a result of the uncertainty arising following the *Bywater* case and the withdrawal of TR 2004/15, the Government requested the Board of Taxation to undertake a review of the corporate residency rules in 2019. The Board completed its report in 2020, and in the FY2020-2021 Federal Budget, the Morrison Government adopted the Board's recommendations and undertook to amend the laws to clarify the application of the rules.

The purpose of the Board of Taxation, in undertaking its review, was to ensure that a company's place of residence is 'sticky', and not volatile or subject to short-term changes. It also wanted to accommodate developments in technology that have impacted on corporate governance processes.

The Board of Taxation recommends that foreign incorporated companies should have the option for the new rules to apply from 15 March 2017 (when TR 2004/15 was withdrawn).

The Board of Taxation considered two potential reform alternatives:

- Changing the tax residency test to include only the place of incorporation test. This means that the CMAC test and voting power test would be removed and any company not incorporated in Australia would never be considered to be an Australian tax resident.
- The "carrying on business" requirement in the current definition will be replaced with the requirement that a foreign entity must "carry on its core commercial activities" in Australia, which is included as a separate and distinct requirement to the carrying on of CMAC. In other words, the two-pronged test would be reinstated, but it will refer to the core commercial activities carried on in Australia rather than the carrying on of business.

The Board's view was that the first alternative (i.e. place of incorporation only test) should not be adopted. Although this test is a bright-line test that would provide absolute certainty, there were concerns adopting this approach would create new integrity concerns. Given the higher corporate tax rate in Australia, there were concerns that many Australian companies would move their businesses offshore via foreign incorporated companies.

The Board's preference was to follow the second alternative.

### 3.1 Carrying on the core commercial activities

The paper released by the Board of Taxation does not go into much detail as to what the "carrying on of core commercial activities" would include, or how this might differ from the current test of "carrying on a business". The test will continue to require an assessment of the facts and circumstances of each case.

Factors that would be relevant when assessing whether the core commercial activities of a foreign incorporated company are undertaken in Australia include:

- the nature of the business carried on by the company;
- the location of staff and assets employed in the conduct of the core business activity of the company in both Australia and abroad;
- the size of the company;

- the sophistication of the company's corporate governance practices;
- any separation between strategic management and operational control of the business;
- the composition of the company's board and any additional roles held by directors; and
- the distinction between activities that are core to the conduct of the business and those that are preliminary or ancillary, such as general support functions.

The Board noted that the circumstances under which the core commercial activities of a company can be said to be undertaken in Australia must be clarified, either in the legislation itself, or other extrinsic material such as an explanatory memorandum.

At the very least it must "*involve something more substantial than the post Bywater administrative interpretation of "carries on business in Australia" to include some form of operational or trading activity.*"

In addition, the Board recommended including a de minimis threshold, in terms of which ancillary or incidental activities should not result in the carrying on of core commercial activities in Australia; as well as the inclusion of specific rules as to how pure holding companies would be treated.

### 3.2 Next steps?

The Board of Taxation had already undertaken a review of the corporate residency rules in 2003, in terms of which it was their recommendation to remove the CMAC test due to its uncertainty, which would leave the place of incorporation as the sole basis for determining corporate residency.

This was never acted upon, with the ATO instead releasing TR 2004/15 in 2004.

Following the change in Governments, it is uncertain as to whether the Board recommendations will be implemented.

In the absence of draft amending legislation, and with any ATO transitional compliance approach coming to an end, the reality is that foreign incorporated companies will need to fundamentally change their governance processes where they have Australian tax residents acting as directors for these companies.

Either non-Australian directors will need to be appointed to hold a majority of the seats on the board, or if this is not viable, Australian directors will need to travel outside of Australia to attend board meetings.

Where high-level decision making is required outside of the scheduled board meetings, this will need to be carefully navigated. And importantly, documentary evidence will need to be maintained at all times to demonstrate what the CMAC of these foreign companies entails, who is carrying out CMAC, and that CMAC occurs outside of Australia.

## 4. Interaction with Double Tax Agreements

If the Australian tax rules seek to classify a foreign incorporated company as an Australian tax resident, the next matter requiring consideration is whether any relief is available for these entities under Australia's network of Double Taxation Agreements ("DTAs" or "tax treaty").

Australia currently has over forty tax treaties in place with other jurisdictions. The aim of a tax treaty is to prevent double taxation and fiscal evasion outcomes. Double taxation outcomes can arise either where, for example, there is a residence / residence conflict (e.g. two jurisdictions view an entity as being tax resident in both states), or a residence / source conflict (e.g. the residence state seeks to tax its residents on worldwide income, and the source country wishes to tax an amount as it is derived from a source of that state).

In the case of corporate residency, most of Australia's tax treaties have a tie-breaker test, aside from those with the USA, Türkiye and Chile. The tie-breaker test seeks to award residency to one jurisdiction based on a process or test agreed in the relevant tax treaty. However, it is important to note that these tie-breaker rules apply only for purposes of the relevant treaty, and do not impact on whether the company is a resident of a state for domestic law purposes<sup>6</sup>.

This means that the tax treaty will only treat a company that is dual resident as resident solely in one of the jurisdictions for purposes of allocating the taxing rights in the tax treaty. Otherwise ordinary domestic rules will apply to that entity in Australia. This approach is consistent with OECD commentary on the application of the residency article in the *Model Tax Convention on Income and Capital, 2017*.

Generally, the key factor that is considered when applying the tie-breaker rules in a DTA is the "place of effective management" test or "POEM". According to OECD commentary<sup>7</sup>, the POEM test requires a consideration of the place where key management and commercial decisions that are necessary for the conduct of the company's business as a whole are in substance made. This requires an analysis of all relevant facts and circumstances.

The OECD view is that whilst a company may have more than one place of management, it can have only one place of effective management.

It is important to note that certain tax treaties have a tie-breaker different to the POEM test. For example, the Australia-Philippines DTA has a tie-breaker test based on the place of incorporation.

### 4.1 Impact of the MLI on the approach to dual residency

The Multi-Lateral Instrument ("MLI") was introduced by the OECD as part of its Base Erosion Profit-Shifting ("BEPs") framework, which aims to tackle tax avoidance and improve international tax rules and transparency.

The MLI allows each signatory country to amend all of their tax treaties quickly and easily based on a selection of choices made by each country in respect of the various articles targeted under the MLI.

Specifically with regard to corporate residency, dual resident companies under a tax treaty that has been modified by the MLI may need to apply to the Competent Authorities of the relevant jurisdictions

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<sup>6</sup> TR 2001/13

<sup>7</sup> Commentaries on the *Model Tax Convention on Income and on Capital 2017*

for a determination of their residency. A dual tax resident may not be granted any treaty relief unless and until the competent authorities have made their determinations.

There is an exception to this position under an Australia-New Zealand administrative approach, whereby Australia and New Zealand will allow taxpayers to self-assess their tax residency under the POEM test, where certain eligibility requirements are met, notwithstanding that the tax treaty requires a determination of the competent authorities in the event that a company is a dual resident entity.

Whether or not the residency article of a tax treaty has been amended to include the provisions set out above will depend upon the selections made by each country with regard to the application of this article under the MLI notification and ratification process, and thus each tax treaty will require its own assessment.

## 4.2 Other considerations

It is important to note that there are several variations to the definition of a “resident” in section 6(1), which includes the definition of a “prescribed dual resident” under section 6(1) of ITAA 1936, and the concept of a “Part X Australian resident” in Part X of ITAA 1936, which sets out the rules applicable in respect of Controlled Foreign Companies (“CFCs”).

These definitions effect how a particular measure within the tax rules applies, which is illustrated in the practical examples discussed below.

### 4.2.1 Prescribed dual resident

The intention behind this measure is to preclude particular entities that are dual resident from being able to access certain concessionary tax measures.

A prescribed dual resident is defined as a company that satisfies either of the following conditions:

- A company that is resident in Australia under section 6(1), but which is treated as resident solely in a foreign country under one of Australia’s tax treaties (**“first condition”**); or
- A company that is resident under section 6(1) because it carries on business and has its CMAC in Australia, it is also a resident of a foreign country, and its CMAC is also in another country, i.e. there is a split of CMAC between two countries (**“alternative condition”**).

Based on the above, a company that is resident in Australia, but has had its tax residency tie-broken into a foreign country under a tax treaty will be a prescribed dual resident under the first condition. This could apply to companies incorporated in Australia or foreign incorporated companies.

The alternative condition applies to foreign incorporated companies that are resident in Australia under the CMAC test, but also resident in a foreign country and have CMAC in that foreign country. It is interesting to note that the alternative condition does not refer to any outcome ascertained under an applicable tax treaty. The Explanatory Memorandum<sup>8</sup> released when this definition was introduced, notes that these measures may apply where a tax treaty is in operation, where for example:

- The tax treaty does not apply to dual tax residents;

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<sup>8</sup> Taxation Laws Amendment Bill (No. 2) 1997

- Where there is no tie-breaker provision for companies, or
- Because CMAC is generally synonymous with the place of effective management tie-breaker test, the tiebreaker may be ineffective where the company has multiple places of CMAC.

Based on the above, it appears that the alternative condition would apply to a foreign incorporated company that establishes residency in Australia due to CMAC but remains a dual resident entity either because there is no treaty, the tax treaty does not apply, or is ineffective in allocating the tax residency of a company.

Where an entity is a prescribed dual resident, it will be precluded from (amongst others) applying the CGT rollover relief measures in section 126-B of ITAA 1997, or from being eligible to join a tax consolidated or multiple-entry consolidated (“**MEC**”) group.

#### 4.2.2 Part X Australian resident

A Part X Australian resident is defined as a resident as envisaged in section 6(1), but excludes an entity where there is a tax treaty in place that has a tiebreaker in respect of residency and under the tiebreaker, the entity has been determined to be a resident solely of the foreign country.

This means that any Australian resident under section 6(1), that is also treated as a resident of a foreign country under the tie-breaker clause of a tax treaty is excluded from being a Part X Australian resident.

This definition applies in the context of the CFC rules, as well as in section 768-A of ITAA 1997, which provides an exemption to Australian companies on the taxation of dividends received in respect of non-portfolio shareholdings in foreign companies.

Section 768-A applies to “foreign equity distributions” which are defined as distributions or non-share dividends made by a company that is **not** a Part X Australian resident. In other words, foreign incorporated companies that carry on business and have their CMAC in Australia will be considered to be Part X Australian residents, unless the relevant tax treaty has a tiebreaker that results in the foreign entity being considered to be resident solely in that foreign country.

A foreign incorporated company that meets the CMAC test, where there is no tax treaty, no tiebreaker or there is a tiebreaker that allocates taxing rights solely to Australia; will be included in section 6(1) and thus will be a Part X Australian resident.

## 5. Practical examples

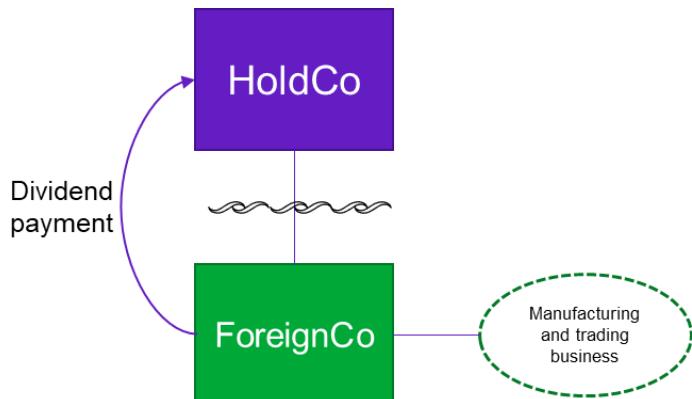
Below are a number of scenarios that are based on an Australian outbound corporate group. In these examples, an Australian holding company (HoldCo) will hold 100% in a foreign incorporated company (ForeignCo).

The examples are necessarily generalised. It will always be important to consider the specific details of any scenario you are dealing with.

### 5.1 Base scenario

The base scenario sets out how the Australian rules apply to an Australian holding company with a wholly owned foreign subsidiary that is considered to be tax resident only in the foreign jurisdiction (i.e. assuming that the foreign entity carries on business and exercises CMAC outside of Australia).

In this base case, we have assumed that ForeignCo undertakes manufacturing and trading activities in the foreign jurisdiction and does not hold any assets that constitute taxable Australian property.



Key tax considerations in the base scenario include:

Considerations	Outcome
The taxation of business profits of ForeignCo in the foreign jurisdiction	The profits of ForeignCo will be subject to corporate tax in the foreign country.
The taxation of business profits of ForeignCo in Australia	The profits should not be subject to tax in Australia on the basis that ForeignCo is not tax resident in Australia, and the profits are not sourced from Australia (and assuming no attribution under the CFC rules)
Whether withholding taxes may arise when ForeignCo pays a dividend to HoldCo	A dividend paid by ForeignCo may be subject to dividend withholding tax in accordance with the domestic withholding rules of the foreign country.  However, any modification to these rules by a tax treaty (if applicable) would apply. For example, the domestic rules might state that all dividends paid offshore are subject to withholding tax at 15%, but this rate could be reduced under the tax treaty to 5%.
The taxation treatment of dividend income in the hands of HoldCo	Foreign dividends should be treated as non-assessable non-exempt (“NANE”) income under the provisions of Division 768-A of ITAA 1997, and thus not subject to tax in Australia in HoldCo’s hands.

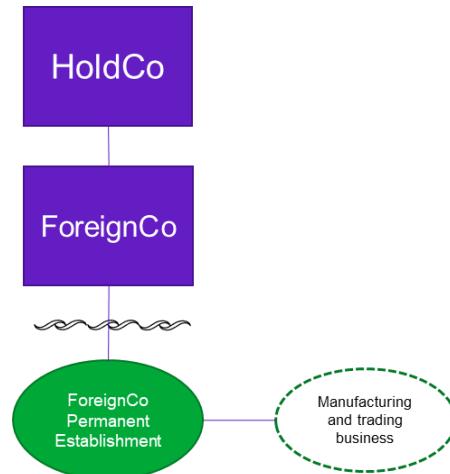
The ability to claim a Foreign Income Tax Offset (“ <b>FITO</b> ”) for foreign taxes paid	No foreign tax credit would be available to HoldCo for any dividend withholding tax paid as the dividend is exempt from tax in Australia.  The dividend is only subject to tax once (via the withholding mechanism) in HoldCo’s hands.  No FITO is available to HoldCo for corporate tax paid by ForeignCo as this tax is imposed on and paid by ForeignCo, not HoldCo.
The tax treatment of capital gains or losses derived by HoldCo on a future sale of shares in ForeignCo	On a future disposal of shares in ForeignCo, any capital gain or loss derived by HoldCo could be reduced (in part or full) under the provisions of section 768-G of ITAA 1997, to the extent that the business of ForeignCo is ‘active’ as determined under these rules.
Whether consolidation into the Australian group may arise	If HoldCo is a head company or subsidiary of an existing tax consolidated or MEC group, ForeignCo is not able to join the Australian tax consolidated group as it is not an Australian resident taxpayer.

## 5.2 Scenario A – no treaty or no tie breaker

Scenario A assumes that ForeignCo has its CMAC exercised in Australia and would thus be viewed as a company resident in Australia in terms of section 6(1) under the post-Bywater ATO interpretation.

ForeignCo is based in a country that either (i) has no tax treaty in place with Australia, or (ii) has a tax treaty with Australia that has no tie breaker clause in respect of corporate residency, and because of this, ForeignCo is not able to qualify for tax treaty relief.

Key tax considerations in this scenario include:



Considerations	Outcome
The taxation of business profits of ForeignCo in the foreign jurisdiction	The profits of ForeignCo will likely be subject to corporate tax in the foreign country.
The taxation of business profits of ForeignCo in Australia	If ForeignCo is considered to be Australian tax resident due to its CMAC but is carrying on manufacturing and trading operations in the foreign country, it is likely that the profits of ForeignCo are attributable to the carrying on of business at or through a permanent establishment in the foreign country.

	These will be treated as NANE for Australian tax purposes in the hands of ForeignCo, if derived from an active business.
Whether withholding taxes may arise when ForeignCo pays a dividend to HoldCo	A dividend paid by ForeignCo may be subject to dividend withholding tax in accordance with the domestic withholding rules of the foreign country.  Treaty relief may not be available to reduce the rate of withholding.
The taxation treatment of dividend income in the hands of HoldCo	The payment of a dividend by ForeignCo would comprise payment of an unfranked dividend by one Australian tax resident company to another.  The dividends received by HoldCo would no longer be treated as NANE under Division 768-A of ITAA 1997 as they are not paid by a foreign subsidiary company.
The ability to claim a FITO for foreign taxes paid	A foreign tax credit should be available to HoldCo for any dividend withholding tax paid.  No FITO would be available to HoldCo in respect of the branch profits where they are treated as exempt under section 23AH of ITAA 1936.
The tax treatment of capital gains or losses derived by HoldCo on a future sale of shares in ForeignCo	On a future disposal of shares in ForeignCo, any capital gain derived by HoldCo would be taxable, with no ability to reduce the gain under section 768-G.  However, where ForeignCo instead chooses to sell its assets, any gain or loss may be treated as exempt under section 23AH if the assets are attributable to the foreign permanent establishment of ForeignCo.
Whether consolidation into the Australian group may arise	ForeignCo may be a prescribed dual resident under the alternative condition. If so, it would be precluded from joining the income tax consolidated group of HoldCo.

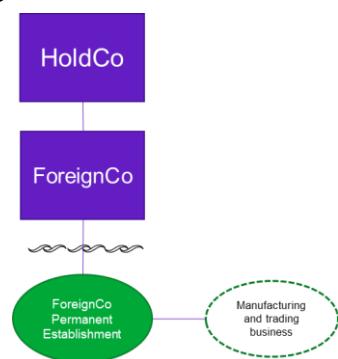
The key difference between the base scenario and scenario A is that any dividends paid by ForeignCo would become taxable in Australia, but HoldCo should get a tax credit if any withholding tax is imposed on the dividend in the foreign country.

It is important to note that if the activities of ForeignCo were such that they did not give rise to a permanent establishment in the foreign country, Scenario A would more likely give rise to double taxation outcomes.

### 5.3 Scenario B – tie breaker applies breaking residence into Australia

In Scenario B, the assumptions remain the same as the previous examples. However, ForeignCo is based in a jurisdiction that has a tax treaty with Australia with a tie-breaker clause, and corporate tax residency is awarded to Australia.

Key tax implications in this scenario are as follows:



Considerations	Outcome
The taxation of business profits of ForeignCo in the foreign jurisdiction	The profits of ForeignCo will be subject to corporate tax in the foreign country.
The taxation of business profits of ForeignCo in Australia	If ForeignCo is considered to be Australian tax resident due to its CMAC but is carrying on manufacturing and trading operations in the foreign country, it is likely that the profits of ForeignCo are attributable to the carrying on of business at or through a permanent establishment in the foreign country.  These will be treated as NANE for Australian tax purposes in the hands of ForeignCo.
Whether withholding taxes may arise when ForeignCo pays a dividend to HoldCo	A dividend paid by ForeignCo may be subject to dividend withholding tax in accordance with the domestic withholding rules of the foreign country.  Treaty relief should be available and ForeignCo should be viewed as an Australian resident for treaty purposes. As a result, the foreign jurisdiction may be precluded from imposing foreign dividend withholding on a dividend paid by ForeignCo to HoldCo under the relevant tax treaty. This would be dependent on the tax rules of the relevant country.
The taxation treatment of dividend income in the hands of HoldCo	The payment of a dividend by ForeignCo would comprise payment of an unfranked dividend by one Australian tax resident company to another.  The dividends received by HoldCo would no longer be treated as NANE under Division 768-A of ITAA 1997 as they are not paid by a foreign subsidiary company.
The ability to claim a FITO for foreign taxes paid	No foreign tax credits should be available to HoldCo if it does not incur any foreign tax on the dividend (noting the above comments on withholding tax).  No FITO is available for ForeignCo on the branch profits where they are treated as exempt under section 23AH of ITAA 1936.

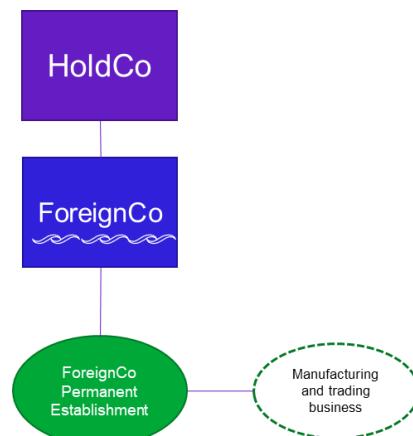
The tax treatment of capital gains or losses derived by HoldCo on a future sale of shares in ForeignCo	<p>On a future disposal of shares in ForeignCo, any capital gain derived by HoldCo would be taxable, with no ability to reduce the gain under section 768-G.</p> <p>However, where ForeignCo instead chooses to sell its assets, any gain or loss may be treated as exempt under section 23AH if the assets are attributable to the foreign permanent establishment of ForeignCo.</p>
Whether consolidation into the Australian group may arise	<p>If HoldCo is a head company or subsidiary of an existing tax consolidated or MEC group, ForeignCo would join the Australian tax consolidated group as, it is an Australian resident taxpayer under section 6(1).</p> <p>ForeignCo should not be a Prescribed Dual Resident. This is on an assumption that the applicable tax treaty tiebreaker awarded residence to Australia under the POEM test, which is substantially similar to the CMAC test.</p> <p>In this case, it may be that CMAC is not exercised in the foreign country as is required by the alternative condition. This would need to be assessed on the facts of each case.</p>

The key difference in this scenario is that ForeignCo may end up joining the tax consolidated group of HoldCo as it does not meet the first requirement or alternative condition to be a prescribed dual resident. In addition, the foreign jurisdiction may be limited in levying a withholding tax on dividends paid by ForeignCo to HoldCo.

## 5.4 Scenario C – tie breaker applies breaking residence into foreign country

In Scenario C, ForeignCo is based in a jurisdiction that has a tax treaty with Australia and that includes a tie-breaker clause for assigning corporate tax residency, and residency is awarded to the foreign country.

In this instance, ForeignCo would continue to be treated an Australian tax resident for purposes of applying Australian domestic tax laws but would be treated as a non-resident entity for purposes of applying the relevant tax treaty.



Considerations	Outcome
The taxation of business profits of ForeignCo in the foreign jurisdiction	The profits of ForeignCo would be subject to corporate tax in the foreign country.
The taxation of business profits of ForeignCo in Australia	ForeignCo is considered to be a foreign tax resident in terms of the tax treaty. The business profits would be taxable only in the foreign state under the tax treaty, unless ForeignCo has a PE in Australia.
Whether withholding taxes may arise when ForeignCo pays a dividend to HoldCo	<p>A dividend paid by ForeignCo may be subject to dividend withholding tax in accordance with the domestic withholding rules of the foreign country.</p> <p>However, any modification to these rules by a tax treaty (if applicable) would apply. For example, the domestic rules might state that all dividends paid offshore are subject to withholding tax at 15%, but this rate could be reduced under the tax treaty to 5%.</p>
The taxation treatment of dividend income in the hands of HoldCo	The entity is excluded from being a Part X Australian resident, and thus where this entity pays dividends to HoldCo, these should be treated as NANE under section 768-A of ITAA 1997.
The ability to claim a Foreign FITO for foreign taxes paid	<p>No foreign tax credits would be available to HoldCo if the dividend is treated as NANE under section 768-A of ITAA 1997.</p> <p>No FITO is available to ForeignCo for corporate tax paid by ForeignCo as this tax is imposed on and paid by ForeignCo, not HoldCo.</p>
The tax treatment of capital gains or losses derived by HoldCo on a future sale of shares in ForeignCo	<p>Section 768-G applies where an Australian resident company disposes of a “share in a company... that is a foreign resident”. This is not a defined term and so it is not clear whether an Australian resident company that is treated as a foreign company in accordance with the tie-breaker clause in a tax treaty would qualify.</p> <p>One would expect that where section 768-A can apply to an entity that is not a Part X Australian resident, a reasonable position is that section 768-G should follow suite.</p>
Whether consolidation into the Australian group may arise	The first condition of the prescribed dual resident definition would be met and thus ForeignCo is precluded from joining an Australian tax consolidated group.

## 5.5 Scenario D – foreign hybrid company

Under this scenario, ForeignCo is a limited liability company in the foreign jurisdiction that is treated as a disregarded entity for foreign tax purposes. This means that in the foreign country, ForeignCo is not subject to tax in its own right. Rather, tax is imposed on the owner of ForeignCo.

From an Australian tax perspective, ForeignCo will be treated as a company for Australian tax purposes, unless it qualifies as a “foreign hybrid company” in Division 830 of ITAA 1997.

There is similar treatment for foreign limited liability partnerships, which are also treated as a company for Australian tax purposes unless Division 830 applies.

Under section 830-15 of ITAA 1997, in order to qualify as a “foreign hybrid company”, the following requirements need to be met:

- ForeignCo must not be a resident of the foreign country for foreign income tax purposes;
- ForeignCo must not be an Australian resident (per the section 6(1) definition);
- In the absence of Division 830, ForeignCo would be treated as a CFC, and HoldCo would be an attributable taxpayer in relation to the CFC with an attribution percentage greater than nil.
- The “partnership requirements” are satisfied. This requires that ForeignCo is treated as a partnership or eligible disregarded entity in the foreign country.

Based on the above, where CMAC of a foreign hybrid company occurs in Australia, resulting in this entity being viewed as an Australian resident, the entity will no longer be afforded partnership treatment for Australian tax purposes.

The ATO transitional compliance approach was not available in respect of foreign hybrid companies, and thus foreign hybrid companies with CMAC occurring in Australia will have been subject to the post-*Bywater* ATO approach from 15 March 2017.

Where a foreign hybrid company establishes residency in Australia due to meeting the CMAC test, a detailed analysis of the resulting tax implications would be required that should include, amongst others, an assessment of the application of the CFC provisions, availability of relief under the tax treaty, as well as how profits derived by HoldCo from ForeignCo would be taxed in Australia.

