The Application of Australia's Domestic Tax Laws and Tax Treaties Where a Foreign Company is a Resident

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The Application of Australia's Domestic Tax Laws and Tax Treaties Where a Foreign Company Is a Resident

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This article provides an examination of the Australian income tax implications that may arise if the Commissioner is successful in applying TR 2018/5 such that a foreign incorporated company is considered an Australian tax resident on the basis of central management and control. Many of the foreign incorporated companies caught by TR 2018/5 will also be regarded as resident in their country of incorporation and thus a "dual resident". Although Australia has a tax treaty network that is available in some cases to potentially resolve the issue of dual residence for treaty purposes, a range of domestic tax law implications will arise when a foreign incorporated company is a dual resident. This article highlights the Australian tax issues faced by a dual resident, including the importance of the relationship between tax treaties and domestic law in addressing these issues.

I. Introduction

It is possible for a company to be a dual resident company where it is a resident in Australia for Australian tax purposes and a resident in the foreign country for the purposes of that country's tax law.[1] This conflict arises as various countries have different tests and administrative approaches for determining residence of a company. For example, one country may base residence on incorporation in that country while another may base it on a management and control test. Dual residence cases may also arise where central management and control is exercised in two countries. In these circumstances, there is a real risk the dual resident company may be subject to international juridical double taxation because tax is imposed in two countries on the same taxpayer in respect of the same subject matter and for identical periods.[2]

Where applicable, some tax treaties seek to solve the problem of dual residence through the operation of a tie-breaker article that allocates the residence of a company to either one of the countries party to the treaty. Importantly, Australia has adopted Art 4 of the Multilateral Instrument[3] (MLI), which contains the tie-breaker article for dual resident entities. The position from 1 January 2019 for Australia's affected treaties is that the two competent authorities would endeavour to determine by mutual agreement which of the jurisdictions the dual resident is deemed to be a resident. In the absence of this competent authority agreement on treaty residence, benefits under the treaty will be denied for a dual resident company. Obvious difficulties arise when central management and control is exercised in more than one country and this may pose further problems for the effective operation of the tie-breaker under the MLI.

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[1] For example, see *Koitaki Para Rubber Estates Ltd v Commissioner of Taxation (Cth)* (1940) 64 CLR 15, which was the first High Court of Australia case to consider the question of corporate residence for income tax purposes in the context of dual tax residence. The High Court held that the taxpayer was not a resident in Papua on the basis that the company's operations fell into an auxiliary or subordinate position of purely local as opposed to central nature. In other words, the daily operations of production and shipment of rubber took place in Papua. The real business was carried on in New South Wales and it was found to be a resident there.

[2] Klaus Vogel, "Double Tax Treaties and Their Interpretation" (1986) 4(1) *Berkeley Journal of International Law International Tax and Business Law* 6.

[3] Multilateral Instrument, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, opened for signature 31 December 2016 (entered into force 1 July 2018).

Where a country is allocated residence under a tax treaty, the allocation is for treaty purposes only. Specifically, the effect of the tie-breaker is that the company is a resident of a foreign country for treaty purposes but is still treated as a resident for the purposes of Australia's domestic law. A recommendation was made by the Board of Taxation that a foreign resident for treaty purposes should be treated as a foreign resident for all purposes of the Australian income tax law.[4] However, this recommendation was not adopted.

The prevalence of findings of dual resident companies is likely to rise significantly in light of the renewed focus on corporate residence by the Commissioner and through the release of Taxation Ruling TR 2018/5 and Practical Compliance Guideline PCG 2018/9.[5] Following the decision in *Bywater Investments Ltd v Federal Commissioner of Taxation*,[6] the Commissioner's current view is that, where a company has its central management and control in Australia, it will also carry on business in Australia within the meaning of the central management and control test (CMC test) of residence and thus be a domestic law resident.[7] In the Commissioner's view, no part of the actual trading or investment operations of the business of the company is required to take place in Australia because the central management and control of a business is factually part of carrying on that business.[8] It follows that TR 2018/5 and the PCG 2018/9 have the potential to result in a significant number of companies that are incorporated in a foreign jurisdiction being treated as Australian tax residents.

The key objective of this article is to evaluate what tax treaty and Australian domestic income tax implications arise for TR 2018/5 dual residents (a company that is a resident in the foreign country is also an Australian resident company for tax purposes under the definition in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (*ITAA36*)).[9] This article does not seek to provide a full critique of the Commissioner's views on residence but instead proceeds on the basis that the Commissioner may be successful in finding that foreign incorporated companies will be considered Australian tax residents on the basis of central management and control, even in less extreme factual circumstances than the *Bywater* case.

This article is predominately focused on the implications for an outbound multinational group that is headquartered in Australia, where the parent company is the head company of an Australian tax consolidated group. It is assumed that there are various wholly owned foreign incorporated subsidiaries in both treaty and non-treaty countries. These companies generally carry on active businesses in their local jurisdiction or may operate as holding companies such that they are tax resident in their country of incorporation. It is assumed that elements of the central management and control of these foreign companies are exercised in Australia such that they are TR 2018/5 dual residents.[10]

This article is structured as follows. Part II provides background to the Commissioner's current view on the CMC test of residence, with a particular focus on some of the key concepts and issues in TR 2018/5. Part III examines the application of the United Kingdom (UK), United States (US) and Singapore treaties[11] to a TR 2018/5 dual resident company.[12] Part IV considers the relationship between tax treaties

[4] Board of Taxation, "International Tax: A Report to the Treasurer: The Board of Taxation's Recommendations" (Australian Government, 2003) Vol 1, [109].

[5] The Commissioner withdrew ATO, *Income Tax: Residence of Companies Not Incorporated in Australia – Carrying on Business in Australia and Central Management and Control*, TR 2004/15, 15 March 2017.

[6] *Bywater Investments Ltd v Federal Commissioner of Taxation* (2016) 260 CLR 169; 104 ATR 82; [2016] HCA 45.

[7] ATO, *Income Tax: Central Management and Control Test of Residency*, TR 2018/5, 21 June 2018, [7].

[8] TR 2018/5, n 7, [8].

[9] All references in this article are to the *Income Tax Assessment Act 1997* (Cth) unless otherwise noted. Where references are made to the *Income Tax Assessment Act 1936* (Cth), the abbreviation *ITAA36* is used.

[10] This article does not consider any of the possible implications under the transfer pricing rules (Div 815).

[11] In this article the term "treaty" is used as a reference to Australia's bilateral tax agreements instead of other commonly used expressions such as tax treaty, double tax agreement, convention or agreement.

[12] These treaties were chosen to highlight the different corporate residence tie-breakers. In the case of the UK Treaty, a "place of effective management" is adopted, which is clearly the dominant test in many of Australia's other treaties including its treaties

and domestic tax law, before examining the application of the treaty to some specific examples pertaining to a TR 2018/5 dual resident. As many of the domestic law implications are dependent on the outcome of applying the treaty, this discussion proceeds the implications that arise under domestic law, which is set out in Part V. Part VI contains the conclusions reached in this article.

II. Central Management and Control Test of Residence

A. Background and TR 2004/15

A company is resident in Australia if it is incorporated in Australia or, if not incorporated in Australia, if it carries on business in Australia and has either its central management and control in Australia, or its voting power is controlled by shareholders who are residents of Australia.[13]

Although there are three ways for a company to be a resident in Australia, this article is concerned only with the CMC test. There are two legislative requirements to this test: first, the company must carry on business in Australia; and secondly, the company must have its central management and control in Australia. The effect of the two requirements means that foreign incorporated companies that carry on business in Australia are not resident here under that fact alone. That is, central management and control must also be exercised in Australia.[14] There is case law authority that stands for the proposition that central management and control of a company is part of the business of the company.[15] Under this proposition, a company will be carrying on a business where its central management and control is located.

Until *Bywater*, some of the leading authorities in Australia that considered the CMC test were the decision of Gibbs J in *Esquire Nominees Ltd as Trustee of Manolas Trust v Commissioner of Taxation (Cth)* and the decision of Williams J in *Malayan Shipping Co Ltd v Commissioner of Taxation (Cth)*.[16] The case of *Esquire Nominees* involved a company that was incorporated in Norfolk Island and acted as corporate trustee as part of a tax avoidance scheme. The board of directors met in Norfolk Island but took advice from the Australian accountants that devised the scheme. The company was held to be resident in Norfolk Island as that is where its board chose to meet as part of that scheme. Gibbs J found that the board exercised independent judgment in making substantive decisions and would not have acted upon something they considered "improper or inadvisable".[17]

In *Malayan Shipping* it was held that central management and control of a company incorporated in Singapore was exercised in Melbourne, where the managing director Mr Sleigh resided. The submission that the company should not be regarded as resident in Australia even though its central management and control was exercised from Australia because the company was not carrying on its business operations in Australia was rejected. Williams J found that the central management and control of the company amounted to carrying on the business of the company in Australia.[18] Importantly, the plurality in *Bywater*

with Malaysia, Romania, South Africa, Vietnam and Switzerland. The Singapore Treaty was chosen as it has a "management and control" tie-breaker, whereas the US Treaty does not have a tie-breaker article. There are other variations of tie-breaker articles. For example, the Papua New Guinea Treaty uses a place of central management and control and where this is not situated in either contracting state then the company is deemed to be a resident where it is incorporated. The Canada Treaty uses an incorporation test and failing that where its place of effective management is situated. The Thai Agreement uses a test of incorporation.

[13] "Australian resident" is defined in *Income Tax Assessment Act 1997* (Cth) s 995-1(1) by reference to the definition in *Income Tax Assessment Act 1936* (Cth) s 6(1).

[14] *Malayan Shipping Co Ltd v Commissioner of Taxation (Cth)* (1946) 71 CLR 156, 159 (Williams J) provides that "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".

[15] Various early authorities that support this proposition include *Cesena Sulphur Co Ltd v Nicholson* [1876] 1 Ex D 428; *De Beers Consolidated Mines Ltd v Howe* [1930–1911] 5 TC 198, 213; *North Australian Pastoral Co Ltd v Commissioner of Taxation (Cth)* (1946) 71 CLR 623; *Esquire Nominees Ltd as Trustee of Manolas Trust v Commissioner of Taxation (Cth)* (1973) 129 CLR 177; 4 ATR 75; *Koitaki Para Rubber Estates Ltd v Commissioner of Taxation (Cth)* (1941) 64 CLR 241; *Koitaki Para Rubber Estates Ltd v Commissioner of Taxation (Cth)* (1940) 64 CLR 15.

[16] *Malayan Shipping Co Ltd v Commissioner of Taxation (Cth)* (1946) 71 CLR 156.

[17] *Esquire Nominees Ltd as Trustee of Manolas Trust v Commissioner of Taxation (Cth)* (1973) 129 CLR 177, 190–191; 4 ATR 75.

[18] *Malayan Shipping Co Ltd v Commissioner of Taxation (Cth)* (1946) 71 CLR 156, 160.

regarded *Malayan Shipping* as an authority of little relevance[19] and seemed to want to confine its ratio to the explanation for the dual requirement in s 6(1) of the *ITAA36*.

The Commissioner's view in TR 2004/15 (until it was withdrawn effective 15 March 2017) was that for a company to be a resident under the CMC test, two separate requirements must be met.[20] Support for the view that the "carries on business in Australia" requirement is additional to and separate from the requirement for central management and control came from a basic rule of statutory interpretation that the plain words of an Act must be given full meaning and effect.[21] The Commissioner's view was that, for the purposes of the CMC test, a company that has major operational activities carries on business wherever those activities take place and not necessarily where its central management and control is likely to be located.[22]

TR 2004/15 also provided that where a parent company in Australia exercises central management and control in relation to a subsidiary (but does not conduct the daily activities of the business in the way that the managing director did in *Malayan Shipping*), the subsidiary would need also to be carrying on business in Australia in order to satisfy the CMC test. Post the decision in Bywater, TR 2004/15 was withdrawn effective 15 March 2017 and replaced with TR 2018/5 and PCG 2018/9.

B. Bywater and TR 2018/5

The issue in *Bywater* was whether four foreign incorporated companies were Australian resident taxpayers.[23] The shareholding structure in relation to each company was complex and was considered by the court to be a "ruse" to conceal the fact that Mr Gould (an Australian resident) was in control in Australia. None of the shares were *directly* owned by Australian residents. All board meetings (at least on paper) took place offshore. The companies' officers were outside Australia, but they did no more than "rubber-stamp" the decisions made by Mr Gould in Australia. The Commissioner contended that each company was an Australian resident and sought to tax the income derived by each company as assessable income under s 6-5(2). Each company submitted that its central management and control was not in Australia.

The High Court held that the central management and control of each company was exercised in Australia and the exercise of the central management and control constituted the business they carried on in Australia and thus each company was an Australian resident. This was so even though the directors held formal meetings outside Australia in an attempt to legitimise the actions of each company. The High Court disregarded the role of those directors who were formally appointed but did not play any real role in the company affairs. This was on the basis that the directors did not exercise any independence or turn their mind to decisions made at the director meetings. It was found that the decisions were not actually made by the directors but that they acted merely as a rubber stamp for decisions made by Mr Gould in Australia, notwithstanding that Mr Gould did not have legal power to control the directors. The High Court clearly rejected the proposition that where a board of directors meets is enough to establish central management and control and in doing so rejected this interpretation of *Esquire Nominees*.[24]

In summary, it was held in *Bywater* that the residence of a company is a question of fact and degree to be determined according to where the central management and control of the company actually abides,

[19] *Bywater Investments Ltd v Federal Commissioner of Taxation* (2016) 260 CLR 169, 198 [57]; 104 ATR 82; [2016] HCA 45.

[20] ATO, *Income Tax: Residence of Companies Not Incorporated in Australia – Carrying On Business in Australia and Central Management and Control*, TR 2004/15, 20 October 2004, [5]. In 2003, the Board of Taxation considered various options to clarify the operation of the CMC test including a residence test based solely on incorporation. The government did not act on the recommendations but the ATO issued TR 2004/15 in the following year, which relaxed the requirements of the CMC test as articulated by Williams J in *Malayan Shipping Co Ltd v Commissioner of Taxation (Cth)* (1946) 71 CLR 156.

[21] TR 2004/15, n 20, [28].

[22] TR 2004/15, n 20, [10].

[23] The countries of incorporation were as follows: Chemical Trustee and Derrin in the United Kingdom; Bywater in the Bahamas; and Hua Wang Bank in Samoa.

[24] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 202–207; 104 ATR 82; [2016] HCA 45.

which is to be determined not merely by reference to its constituent documents[25] or the location of its formal organs of government,[26] but upon a scrutiny of the course of business and trading.[27]

Based on the decision in *Bywater*, the new approach adopted by the Commissioner in TR 2018/5 is that if a company has its central management and control in Australia, it also carries on business in Australia. The Commissioner considers that the most relevant factors relating to where central management and control is exercised include: where those who exercise central management control do so, rather than where they live; where the governing body of the company meets; where the company declares and pays dividends; the nature of the business and whether it dictates where control and management decisions are made in practice; and minutes or other documents recording where high-level decisions are made.[28] Further, a company's central management and control will be exercised in a place for the purpose of the CMC test if it is exercised in that place to a substantial degree, sufficient to conclude the company is really carrying on business there.[29] PCG 2018/9 provides some guidance on identifying central management and control, including examples where decision-making is equally split between more than one place.

One major change from the previous position adopted in TR 2004/15 is that it is not necessary for a finding of central management and control for any part of the actual trading or investment operations of the business of the company to take place in Australia. This is because the central management and control of a business is factually part of carrying on that business. A company carrying on business does so both where its trading and investment activities take place, and where the central management and control of those activities occurs.[30] It follows that TR 2018/5 and PCG 2018/9 have the potential to result in a significant number of companies that are incorporated in a foreign jurisdiction to be treated as Australian tax residents.

C. Issues with TR 2018/5

As acknowledged by the Australian Taxation Office (ATO) during the ruling process, there is no doubt that *Bywater* was concerned with an extreme set of facts. The case involved a contrived arrangement where deliberate steps were taken in an attempt to manipulate the residence of a company. All of the decisions of the company were made by Mr Gould in Australia and the role of Mr Borgas was to make it appear that he had transacted the business on their behalf.

To what extent the Commissioner will pursue the residence of foreign subsidiaries of an Australian group that had previously adopted the position in TR 2004/15 is unknown. Indeed, many external parties have raised a number of concerns in relation to TR 2018/5, which emphasises the significance of the change in approach, especially for larger multinational groups.[31] In that light, it is also worthwhile to note some observations that were made during the course of proceedings in *Bywater*. At one point French CJ made the following remark to the Commissioner's counsel: "I do not want to tax you with a large hypothetical case but there was a kind of consequentialist argument put about the sort of multinational group companies with their headquarters in Australia and various subsidiaries tightly controlled from head office around the world." In response, Mr Slater QC stated that the case was not about the boards of multinational subsidiaries carrying on real businesses and making real decisions but was about "steps taken to manipulate the residence of a corporation".[32]

[25] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 208 [77]; 104 ATR 82; [2016] HCA 45.

[26] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 220 [123]; 104 ATR 82; [2016] HCA 45.

[27] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 208 [79]; 104 ATR 82; [2016] HCA 45.

[28] TR 2018/5, n 7, [36].

[29] TR 2018/5, n 7, [31].

[30] TR 2018/5, n 7, [7].

[31] See TR 2018/5EC, which is a compendium of responses to the issues raised by external parties to the draft ATO, *Income Tax: Foreign Incorporated Companies: Central Management and Control Test of Residency*, TR 2017/D2, 15 March 2017.

[32] *Bywater Investments Ltd v Commissioner of Taxation; Hua Wang Bank Berhad v Commissioner of Taxation* [2016] HCATrans 184 (25 August 2016).

While it may be arguable that the decision in *Bywater* does not provide the basis for the Commissioner to pursue the residence of foreign subsidiaries of an Australian group (that previously relied on TR 2004/15), the decision in *Bywater* should be regarded as reinforcing the principle that the place of CMC is a question of fact and requires an inquiry as to where top level financial and policy decisions are in fact made. Accordingly, for an Australian corporate group that is impacted by TR 2018/5, the key factual element in establishing that the foreign incorporated subsidiary is a non-resident will be proving that the directors of the subsidiary exercise independent judgment offshore.

It would make for an interesting case to see how a court would approach a residence case where TR 2018/5 was applied to a foreign subsidiary of a multinational group that had real business operations and whether the decision in *Bywater* may be read down. If so, this may cast doubt over the application of TR 2018/5, which would then lead to further uncertainty and implications for companies that have taken the view that they are Australian residents in accordance with TR 2018/5.

III. Tax Treaties and Dual Resident Companies

This part examines the application of a residence tie-breaker rule under the UK Treaty and Singapore Treaty to a TR 2018/5 dual resident company. The implications for a US incorporated dual resident company are also addressed but it is noted that the US Treaty does not contain a tie-breaker. The application of Art 4 of the MLI is also addressed. Importantly, Art 4 provides for the replacement of a tie-breaker rule in a covered tax agreement[33] under which the two competent authorities would endeavour to determine by mutual agreement which of the jurisdictions the dual resident is deemed to be a resident.[34]

A. Residence under the Tie-breaker Article

One method a tax treaty may use to allocate taxing rights and seek to avoid double taxation where a company is resident in both countries is through a residence tie-breaker rule. If the tie-breaker applies and is effective, then for the purpose of the treaty the company is treated as a resident of only one of the countries under the treaty. A tie-breaker article may not always be effective in resolving dual corporate residence issues.[35]

For Australian tax purposes, the residence tie-breaker rule is only applicable for the purposes of the tax treaty and it does not mean that the company is a non-resident for domestic law purposes. This is in contrast to various other countries such as Canada[36] and the United Kingdom,[37] which contain provisions

[33] The expression "Covered Tax Agreement" replaces the term "Convention" in the *OECD Model Tax Convention on Income and on Capital*.

[34] Recent treaties are clearly influenced by the base erosion and profit shifting (BEPS) project. For example, Australia and Israel signed a new treaty on 28 March 2019, which adopts the multilateral instrument approach to the tie-breaker as set out in Art 4(3). The German Treaty (*Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with respect to Taxes on Income and Capital and the Prevention of Fiscal Evasion and Avoidance*, signed 12 November 2015, [2016] ATS 23 (entered into force 7 December 2016)) is another recent treaty, signed on 12 November 2015 (entered into force on 7 December 2016), which has a slightly different approach in the tie-breaker article but would seem to have been influenced by BEPS. In the German Treaty, where the place of effective management cannot be determined, the competent authorities shall endeavour to determine by mutual agreement the residence of the company by reference to its places of management, the place where it is incorporated or otherwise constituted and any other relevant factors. Failing this, the company would not be eligible for treaty benefits.

[35] See RJ Vann and J Oliver, "The New Australia-UK Tax Treaty" (2004) 3 *British Tax Review* 194. Vann and Oliver explain that the issue arises where place of effective management and control is in a third state. For example, the tie-breaker would not be effective in circumstances where a company incorporated offshore is controlled by Australian resident shareholders and carries on business in Australia but has place of effective management in a third country.

[36] In Canada, *Income Tax Act*, RSC 1985 (5th Supp), c 1, s 250(5) provides that notwithstanding any other provision of the Act (other than s 126(1.1)(a)), a person (which includes a corporation) is deemed not to be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada.

[37] *Corporation Tax Act 2009* (UK) s 18(1) applies to a company that is treated as resident in a territory outside the United Kingdom, and is a non-UK resident for the purposes of any double taxation arrangements. Under s 18(2), for the purposes of the Act the company is (1) resident outside the United Kingdom and (2) is a non-UK resident. Further, s 18(3) provides that s 18(2) applies even if the company would otherwise be a UK resident for the purposes of the Act by virtue of ss 14, 15, 16 or 17 or another rule of law.

in their domestic law that deem the company to also be a non-resident under the domestic law where the treaty allocates residence to the other contracting state.

However, there are a limited number of targeted rules in Australian domestic law, the application of which is dependent on the outcome of the treaty tie-breaker. For example, dual resident companies are known as "prescribed dual residents", which are in substance non-resident companies and are effectively treated as non-residents for the purposes of specified benefits and anti-avoidance measures.[38] The concept of "Part X Australian resident" for controlled foreign company (CFC) purposes is another example where the implications under the treaty tie-breaker are built into its definition. These aspects of the domestic law are discussed further below.

If the residence tie-breaker does not apply or is not effective, then the dual resident would typically not be a "resident of a contracting state", which is a prerequisite to the treaty definition of "resident". This means that the dual resident would not be entitled to any benefits under the treaty. However, the dual resident company would still be considered "resident of one of the contracting states for the purposes of its tax". This is a domestic law concept and has the effect that, if the other party to the treaty is a resident under the treaty definition, then depending on which article is being considered, the other party may be entitled to treaty benefits. This important concept is discussed in Part III(B)(3) below in the context of the US Treaty.

B. Dual Resident Company and Tax Treaty Resident Tie-Breaker

1. UK Treaty

The UK Treaty is important as it is representative of a number of Australia's tax treaties. It also serves as a useful precedent of how the residence tie-breaker rule, which utilises the concept of "place of effective management" operates. The dual residence article in the MLI, which applies from 1 January 2019, also utilises the concept of place of effective management so the discussion below is relevant for these purposes.

For the purposes of applying the UK Treaty, the definition of "resident of the United Kingdom" and "resident of Australia" follow the definitions under each of the countries' respective domestic law.[39] Consider a UK incorporated company that is a UK resident for UK tax purposes[40] but is also a tax resident in Australia under TR 2018/5.

The possibility of dual residence may arise where a company's central management and control is divided between places. Even in traditional business operations, this possibility exists as noted by Lord Ratcliffe in *Unit Construction Co Ltd v Bullock (Inspector of Taxes)*:

> So far as I am able to perceive, only two qualifications have since appeared which mar at all the simplicity and generality of this test. One is that the facts of individual cases have not always so arranged themselves as to make it possible to identify any one country as the seat of central management and control at all. Though such instances must be rare, the managements and control may be divided or even, at any rate in theory, peripatetic. Situations of this kind do not arise just to tease the minds of judges; they are the product of some peculiar necessity, political or otherwise.[41]

Where the company is a dual resident, it is necessary to consider the tie-breaker rules in the UK Treaty. Article 4(4) of the UK Treaty sets out the tie-breaker rules for residence of a company, which provides that it "shall be deemed to be a resident only of the state in which its place of effective management is situated".

[38] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 2) 1997* (Cth) [3.9].

[39] *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains*, opened for signature 21 August 2003, [2003] ATS 22 (entered into force 17 December 2003), Art 4(1).

[40] A company is resident in the United Kingdom if it is incorporated in the United Kingdom (*Corporation Tax Act 2009* (UK) s 14). It is also a resident where its business is centrally managed and controlled in the United Kingdom (*De Beers Consolidated Mines v Howe* (1906) 5 TC 198). Alternatively, if its business is de facto centrally managed and controlled in the United Kingdom then it is also a resident (*Bullock (Inspector of Taxes) v The Unit Construction Co Ltd* (1959) 38 TC 712).

[41] *Unit Construction Co Ltd v Bullock (Inspector of Taxes)* (1959) 38 TC 712.

The issue then becomes whether the place of "effective management" is in the United Kingdom or Australia. In *Hua Wang Bank Berhad v Federal Commissioner of Taxation* Perram J at first instance resorted to the OECD commentary,[42] which provides that:

> The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.[43]

The High Court in *Bywater* also referred to the same passages of the OECD commentary. In particular, Gordon J commented that while the place of effective management may ordinarily be the place where the board of directors makes its decisions, all relevant facts and circumstances must be examined to determine where the place of effective management of a company is located.[44] It was also held that central management and control and place of effective management are different concepts. The meaning of each turns on the interpretation of the phrase as it appears in the relevant instrument – the *ITAA36* for "central management and control" and the UK Treaty for "place of effective management". Each of these concepts must be examined to determine the applicability of each in any given case. It cannot be assumed that if one test is satisfied, then it will automatically follow that the other is satisfied.[45]

Accordingly, for the purposes of applying the UK Treaty, a single place of effective management must be ascertained where central management and control is split between two places. As noted above, the position from 1 January 2019 is that the residence tie-breaker in the MLI will apply in an attempt to resolve dual corporate residence, and place of effective management is only one of the factors taken into account.

2. Singapore Treaty

This section examines how a dual resident company that is a "resident in Singapore" and "resident of Australia" is treated under the Singapore Treaty. It is important to note at the outset that the terms "resident in Singapore" and "resident of Australia" adopt the internal domestic law meaning of resident in each country,[46] whereas the terms "Singaporean resident" and "Australian resident" refer to the respective treaty definition.[47]

In Singapore, the domestic law definition of resident is different to that of Australia (and other countries such as the United Kingdom and United States), in that the place of incorporation does not have a bearing on determining residence of a company for tax purposes. Under the *Income Tax Act* (Singapore), unless the subject or context otherwise requires, a resident in Singapore in relation to a company[48] or body of persons means a company or body of persons the control and management of whose business is exercised in Singapore.[49]

The Singapore Treaty provides that the term "Singaporean resident" means any "Singapore company" and any person (other than a company) who is resident in Singapore.[50] A "Singaporean company"

[42] *Hua Wang Bank Berhad v Federal Commissioner of Taxation* (2014) 100 ATR 244, [429] (Perram J); [2014] FCA 1392. The OECD commentary is a legitimate interpretative material: *Thiel v Commissioner of Taxation* (1990) 171 CLR 338, 344, 356–357; *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* (2011) 193 FCR 149, 184–185 [114]; [2011] FCAFC 74.

[43] OECD, *Model Tax Treaty on Income and on Capital* (9th ed, 2015) [24].

[44] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 228 [169]–[170]; 104 ATR 82; [2016] HCA 45; *Hua Wang Bank Berhad v Federal Commissioner of Taxation* (2014) 100 ATR 244; [2014] FCA 1392.

[45] *Bywater Investments Ltd v Commissioner of Taxation* (2016) 260 CLR 169, 227 [163]; 104 ATR 82; [2016] HCA 45.

[46] *Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,* opened for signature 11 February 1969, [1969] ATS 14 (entered into force 4 June 1969) (hereinafter Singapore Treaty), Art 2(1)(l).

[47] Singapore Treaty, Art 3(1)(c), (d).

[48] *Income Tax Act* (Singapore, cap 134, 2014 rev ed) s 2 defines a company to mean any company incorporated or registered under any law in force in Singapore or elsewhere.

[49] *Income Tax Act* (Singapore, cap 134, 2014 rev ed) s 2.

[50] Singapore Treaty, Art 3(1)(c).

means any company that is managed and controlled in Singapore and that is not an Australian company.[51]

The concept of management and control is not defined under the Singapore Treaty, nor is it discussed in any of the associated explanatory memorandum that accompanied the introduction of the Singapore Treaty or the amending protocols. However, this test was used as a residence tie-breaker in the earlier UK Treaty in 1967, until it was replaced with a test of place of effective management. The "management and control" language is derived from the 1966 UK-New Zealand Treaty.[52] This test was described by Perram J as, in effect, similar although not identical to the CMC test.[53] It may be arguable that the test seems to imply a lesser degree of control and management of the company's business when compared with the notion of central management and control that requires a higher threshold. However, Magney was of the view that the concept in the Singapore Act of "control and management" of the business of a company is virtually identical with the concept of "central management and control" in Australia's domestic law.[54]

Even where management and control of the company is in Singapore, it is not a Singaporean company under the treaty where it is an Australian company. An "Australian company" is defined to mean any company that being a resident of Australia is managed and controlled in Australia.[55] If the company is a resident because of TR 2018/5 then it should satisfy the requisite threshold of management and control. Accordingly, in circumstances where there is split management and control between Australia and Singapore, the company would be considered an Australian company under the Singapore Treaty. Therefore, it does not qualify as a Singaporean company and is not a Singaporean resident under the Singapore Treaty.

It may be the case that it is an "Australian resident" that is defined as any Australian company and any other person (other than a Singaporean company) that is a resident of Australia.[56] Here, the company is an Australian company and is not a Singaporean company. It is also a "resident in Australia" for tax purposes. This means that the company is an Australian resident under the Singapore Treaty. It would seem that, based on the facts in this example, the specific treaty tie-breaker may not apply on the basis that the issue of dual company residence is resolved by the mutually exclusive definitions of Singaporean company and Australian company.

It is noted that the tie-breaker provides that, if by reason of Art 3(1), a person other than an individual is both a Singaporean resident and an Australian resident it shall be treated solely as a resident where it is managed and controlled.[57] This may not seem to cover a dual resident company situation, but instead apply to cover dual residence situations in relation to "any body of persons, corporate or not corporate" who are also considered persons for the purposes of the Singapore Treaty.[58]

3. US Treaty

This section examines whether a TR 2018/5 dual resident company incorporated in the United States is a resident for the purposes of the US Treaty in light of the fact that there is no treaty residence tie-breaker.[59]

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[51] Singapore Treaty, Art 3(1)(b).

[52] See C John Taylor, "The Negotiation and Drafting of the 1967 United Kingdom – Australia Tax Treaty" in John Tiley (ed), *Studies in the History of Tax Law* (Hart, 2012) Vol 5.

[53] *Hua Wang Bank Berhad v Federal Commissioner of Taxation* (2014) 100 ATR 244, 251 [3]; [2014] FCA 1392.

[54] TW Magney, "Australia-Singapore Taxation Aspects of Carrying on Business in Singapore: Part II" (1975) 4 AT Rev 67, 82.

[55] Singapore Treaty, Art 3(1)(a)(ii). Also note that under Art 3(1)(a)(i) an Australian company is defined to mean any company which being a resident of Australia is incorporated in Australia and has its centre of administrative or practical management in Australia whether or not any person outside Australia exercises or is capable of exercising any overriding control or direction of the company or of its policy or affairs in any way whatsoever.

[56] Singapore Treaty, Art 3(1)(d).

[57] Singapore Treaty, Art 3(3).

[58] Singapore Treaty, Art 2(1)(j).

[59] The Turkey Treaty (*Convention between the Government of Australia and the Government of the Republic of Turkey for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fiscal Evasion*, opened for signature 28

A person is a resident of the United States if it is a "US corporation", which is defined as a corporation that, under US law relating to US tax, is a domestic corporation (ie taxable in its own right) and which is not, under the law of Australia relating to Australian tax, a resident of Australia.[60] In this example, the company is incorporated in the United States and is therefore a domestic corporation. However, it is also an Australian resident for domestic tax law purposes, which means it does not satisfy the definition of a US corporation.

A person is a resident of Australia under the US Treaty if the person is an Australian corporation.[61] The term "Australian corporation" means a company, as defined under the law of Australia, relating to Australian tax, which, under that law, is a resident of Australia, and which is not, under US law relating to US tax, a domestic corporation.[62] As the company is a US domestic law corporation then it is not a resident of Australia under the US Treaty.

Accordingly, the dual resident company is not a treaty resident for the purposes of the US Treaty and would not be entitled to benefits under the US Treaty. In the absence of moving central management and control to the United States, it is theoretically possible that the company would be subject to two worldwide tax claims.

C. Impact of the MLI on a Dual Resident Company

On 7 June 2017, representatives of over 70 jurisdictions participated in the initial signing ceremony of the MLI in Paris. The MLI was signed by 67 countries, covering 68 jurisdictions. Signatories of the MLI may choose which existing tax treaties they would like to modify using the MLI. Once a tax treaty has been listed by the two parties, it becomes an agreement to be covered by the MLI.[63]

The MLI was ratified by Australia on 26 September 2018 through deposit of its instrument of ratification with the OECD.[64] The *Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018* (Cth) amended the *International Tax Agreements Act 1953* (Cth) (Agreements Act) to give the MLI the force of law according to its tenor from the date that the MLI entered into force for Australia.[65] The MLI took effect in Australia at 1 January 2019 for withholding taxes on income, and 1 July 2019 in respect of all other taxes.

Most of the provisions of the MLI are optional (only some are mandatory) and each country can choose which article to apply and make reservations to limit the adoption of the MLI, including the right for a provision not to apply at all.[66] Australia has adopted Art 4 of the MLI, which contains the tie-breaker for dual resident entities. Article 4 provides for the replacement of a tie-breaker rule in a covered tax agreement with a tie-breaker test that provides that the two competent authorities would endeavour to determine by mutual agreement which of the jurisdictions the dual resident is deemed to be a resident.

April 2010, [2013] ATS 19 (entered into force 5 June 2013)) and the Chile Treaty (*Convention between Australia and the Republic of Chile for the Avoidance of Double Taxation with respect to Taxes on income and Fringe Benefits and the Prevention of Fiscal Evasion, and Protocol,* opened for signature 10 March 2010, [2013] ATS 7 (entered into force 8 February 2013)) are the only other tax treaties that do not contain tie-breaker rules for entities that are not individuals. In the case of Chile, a person (other than an individual) shall not be entitled to any benefits under the treaty except that the provisions of Art 24 (non-discrimination) apply.

[60] See *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, opened for signature 6 August 1982, [1983] ATS 16 (entered into force 31 October 1983 (hereinafter US Treaty)), Arts 4(1)(b)(i), 3(1)(g)(i).

[61] US Treaty, Art 4(1)(a)(i).

[62] US Treaty, Art 3(1)(g)(ii).

[63] OECD, "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Information Brochure, 22 March 2018).

[64] OECD, "Australia: Status of List of Reservations and Notifications upon Deposit of the Instrument of Ratification, Acceptance or Approval" (26 September 2018).

[65] See *International Tax Agreements Act 1953* (Cth) s 5(1). Also, s 3AAA(1) defines the "Multilateral Convention" to mean the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (done at Paris on 7 June 2017).

[66] Explanatory Memorandum, *Treasury Laws Amendment (OECD) (Multilateral Instrument) Bill 2018* (Cth) [1.48].

The competent authorities make this assessment by having regard to its place of effective management, its place of incorporation or constitution, and any other relevant factors.[67]

Australia has indicated it will make the reservation contained in Art 4(3)(e) to deny a dual resident entity's entitlement to any treaty benefits where the relevant competent authorities have not reached an agreement on a single jurisdiction of residence.[68] This means that treaty benefits will be denied for a dual resident company (ie no entitlement to any relief or exemption from tax) unless there is a competent authority agreement on treaty residence. Subject to the development of administrative procedures between competent authorities to allow self-assessment of the tie-breaker rules for dual residents, achieving a treaty tie-breaker outcome could become administratively burdensome in practice.

It is noted that under the MLI the other party to a covered tax agreement can opt out of the application of Art 4 entirely where another party (ie Australia) has made the reservation in Art 4(3)(e).[69] As a side issue, Art 4 will not affect existing provisions that deal with the tax residence of a company that is participating in a dual listed company arrangement.[70] In these circumstances, the existing treaty will remain unaffected.

Article 4 of the MLI is an integrity measure with the aim of stopping a dual resident company from obtaining tax benefits of some sort.[71] However, the fact that a company that is a dual resident will need to apply to either competent authority for a determination of their residence for the purposes of the treaty is not ideal from an administrative perspective and raises various practical considerations. This inability to self-assess is a cause for concern because to go through the competent authorities is likely to be an arduous and time-consuming process with no guarantee of an outcome. The possible repercussion is that many TR 2018/5 dual residents that were not intentionally trying to establish dual resident status (eg for a hybrid mismatch purpose) may be denied treaty benefits where the competent authorities cannot reach an agreement. This is not ideal from a tax policy perspective, especially where many of these companies operate genuine businesses that are far removed from the *Bywater* scenario.

As the MLI is still in its early stages there are likely to be further emerging issues and developments. One particularly important development is that the ATO and New Zealand Inland Revenue (IR) have recently formalised a practical administrative approach for Australia/New Zealand non-individual dual residents impacted by Art 4(1) of the MLI. For taxpayers that satisfy all of the eligibility criteria (related to structure, financial and compliance) the ATO and the IR will allow for an eligible taxpayer to self-determine its place of effective management for treaty purposes where it is reasonable to do so.[72] It could be advantageous to extend such a practical approach to Australia's other treaty partners affected by the MLI, even if this is limited to TR 2018/5 dual-resident situations.[73]

IV. Application of Tax Treaty to Specific Examples

This part provides an overview of how the domestic law is incorporated into the tax treaty. This discussion serves as background to some specific examples of how the UK Treaty and US Treaty might apply to a TR 2018/5 dual resident and its Australian parent.

[67] Explanatory Memorandum, *Treasury Laws Amendment (OECD) (Multilateral Instrument) Bill 2018* (Cth) [3.31].

[68] Explanatory Memorandum, *Treasury Laws Amendment (OECD) (Multilateral Instrument) Bill 2018* (Cth) [3.27].

[69] Multilateral Instrument, Art 4(3)(f).

[70] Multilateral Instrument, Art 4(2).

[71] See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing, 2015) [72]–[90]. With respect to tax avoidance cases involving dual resident companies, it was concluded that a better solution to the issue of dual residence of entities was to deal with each situation on a case-by-case basis. That is, the competent authorities shall endeavour to resolve by mutual agreement cases of dual corporate residence.

[72] ATO, "MLI Article 4(1) Administrative Approach" (Australian Government, 2019) <https://www.ato.gov.au/General/ATO-advice-and-guidance/In-detail/Private-rulings/Supporting-documents/MLI-Article-4(1)-administrative-approach/>.

[73] See Inland Revenue, "Australia-NZ Tax Treaty – Administrative Approach to Article 4(1) of the MLI" (NZ Government, 20 December 2018) <http://taxpolicy.ird.govt.nz/news/2018-12-20-australia-nz-tax-treaty-administrative-approach-article-41-mli>.

A. Domestic Law Incorporated into Tax Treaty

Section 4(1) of the *Agreements Act* operates to incorporate the provisions of the *Assessment Act* into the *Agreements Act* as follows:

(1) Subject to subsection (2), the *Assessment Act* is incorporated and shall be read as one with this Act.
(2) The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the *Assessment Act* (other than Part IVA of the *Income Tax Assessment Act 1936*) or in an Act imposing Australian tax.

The effect of s 4(1) of the *Agreements Act* is that both that Act and the *Assessment Acts* are to be interpreted and read as one for the purposes of the application of the treaty.[74] While the *Assessment Acts* still retain their own identity,[75] to the extent of any inconsistency between the provisions of the *Agreements Act* and the provisions of the *Assessment Acts* (other than Pt IVA) the provisions of the *Agreements Act* have effect and override the provisions of the *Assessment Acts*.[76] As noted by Middleton J in *GE Capital Finance Pty Ltd v Federal Commissioner of Taxation*, the "obvious purpose of s 4(2) is to ensure that the *Agreements Act* is to prevail, but only in respect of its field of operation and according to its provisions".[77]

Further, s 5 of the *Agreements Act* provides that the provision of each agreement has the force of law according to its tenor. The effect of s 5 of the *Agreements Act* giving the particular agreement the force of law according to its tenor for Australian tax law purposes is to enact the treaty into Australian law.[78]

So while it is now generally accepted that the treaty overrides and is incorporated into the domestic law for the purposes of the application of the treaty, the question is what effect does a treaty definition of resident or the result of a treaty tie-breaker have for purposes of the application of the domestic law unaffected by the application of the treaty? The general position is that when one is considering the domestic law in respect of a matter that does not involve the application of the treaty then what happens under the treaty is irrelevant, as the treaty does not automatically change the status of Australia's domestic tax law. For example, if the tie-breaker article applies to allocate the residence of the company to another jurisdiction, the company is still an Australian resident for domestic law purposes not associated with the application of the treaty, and the consequences of the allocation of residence to the other country is only for application of the treaty.

However, in some instances, a result may arise under the domestic law solely by virtue of the operation of the tax treaty. An "unusual" example of this is the rule under some of Australia's treaties that deem income to have an Australian source that it would not otherwise have under domestic law. According to Taylor, this practice originated with the 1967 UK Treaty and has expanded in subsequent Australian tax treaties.[79] *Satyam Computer Services Ltd v Commissioner of Taxation* confirms that the treaty sourcing

[74] As noted by Lockhart J, it is not uncommon to find in an Act a provision that an earlier Act has incorporated and shall be read as one with the later Act. The effect of such a provision is to transpose the earlier into the later Act or to write every provision of the earlier Act into the later Act as if they had been printed into it. It is a rule of construction of statutes, but it cannot be used in effect to amend the provisions of the earlier Act that is to be read as one with the later Act. Sometimes an Act provides that it is incorporated and shall be read as one with an earlier Act. The effect is the same – namely, to transpose the later into the earlier Act: *Amalgamated Television Services Pty Ltd v Australian Broadcasting Tribunal* (1984) 1 FCR 409, [413].

[75] *GE Capital Finance Pty Ltd v Federal Commissioner of Taxation* (2007) 159 FCR 473, [40]; [2007] FCA 558.

[76] However, each Act retains its own identity and the imposition of the relevant tax is still imposed by and at the rates declared by the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) and the *Income Tax Rates Act 1986* (Cth) by reference to the *Income Tax Assessment Act 1997* (Cth).

[77] *GE Capital Finance Pty Ltd v Federal Commissioner of Taxation* (2007) 159 FCR 473, [44]; [2007] FCA 558.

[78] Where an instrument is set out in full in legislation and given the force of law by it, it is clearly the intention of the legislature that the transposed text should bear the same meaning in the domestic statute as it bears in the treaty: *Bywater Investments Ltd v Federal Commissioner of Taxation* (2016) 260 CLR 169, 224 [147]; 104 ATR 82; [2016] HCA 45.

[79] C John Taylor, "Some Distinctive Features of Australian Tax Treaty Practice: An Examination of Their Origins and Interpretation" (2011) 9 *eJournal of Tax Research* 294, 309. Taylor also noted that there was a source rule in the 1946 UK Treaty but the 1967 UK Treaty involved the extensive discussions on why the source rules were there that reflected concerns by the Australian negotiators about the implications of the High Court decision in *Commissioner of Taxation (Cth) v Mitchum* (1965) 113 CLR 401.

rule in Art 23 of the Indian Treaty has effect for domestic tax law purposes with the result that royalties are taxable under domestic law pursuant to s 6-5.[80]

B. TR 2018/5 Dual Resident and Tax Treaties

This section considers the application of various tax treaties where the Australian parent company has a TR 2018/5 dual resident subsidiary. The examples were chosen to illustrate the impact of the tie-breaker on various articles within the treaty.

1. Income from Real Property in the United Kingdom

Consider a TR 2018/5 dual resident subsidiary that derives rental income from a property that it owns in the United Kingdom. The activities do not constitute a permanent establishment for the subsidiary in the United Kingdom. Assume the company is allocated residence to the United Kingdom under the tie-breaker article because its place of effective management is in the United Kingdom.

Article 6(1) of the UK Treaty provides that income from real property "may be taxed" by the country in which such real property is situated. The phrase "may be taxed" typically means that the source country has a non-exclusive entitlement to tax the income and that the residence country may also continue to tax its residents under its domestic law on the income, wherever sourced, unless the tax treaty explicitly prevents it from doing so.[81]

In this example, the United Kingdom has a non-exclusive taxation right to tax the rental income at source. Article 6 does not expressly address Australia's right to tax the income and Australia should be able to tax the income derived by the company, wherever sourced, unless the tax treaty explicitly prevents it from doing so. The Commissioner's view is that the effect of the tie-breaker allocating residence to the United Kingdom would mean that Art 6(1) would prevent Australia from taxing the rental income. This is because both the country of source and country of residence for treaty purposes are the same, which means that the other contracting state (Australia) is prevented from taxing the income on the basis that it has not been allocated a taxing right.[82]

However, another view is that Art 6 does not prevent Australia's right to tax the rental income under its domestic law even where the tie-breaker allocates residence to the United Kingdom. This is on the basis that the company is a resident under domestic law and accordingly can tax its worldwide rental income under domestic law. If this were the case, the company should be entitled to a foreign income tax offset (FITO) for the foreign income tax paid in the United Kingdom, subject to satisfying the FITO rules in Div 770. If the company is allocated residence to Australia under the treaty tie-breaker article, it does not affect the UK's taxing rights and the income is still taxable in the United Kingdom. In these circumstances, Australia may also tax the rental income.

2. Business Profits in the United Kingdom

Consider a TR 2018/5 dual resident incorporated in the United Kingdom that conducts an active business deriving income from UK sources. The business is sufficient to constitute a permanent establishment in the United Kingdom. Assume the dual resident is allocated residence to Australia under the UK Treaty tie-breaker article on the basis that place of effective management is in Australia.

Article 7(1) of the UK Treaty provides Australia sole taxing rights over the company's business income unless the company carries on business through a permanent establishment in the United Kingdom. As the company has a permanent establishment in the United Kingdom, the profits of the enterprise that are attributable to that permanent establishment "may be taxed" in the United Kingdom. From Australia's perspective, the treaty does not prevent Australia from taxing the income. The income may be exempt in Australia if it qualifies for the foreign branch exemption. This is discussed in further

[80] *Satyam Computer Services Ltd v Commissioner of Taxation* [2018] ATC 20-671; [2018] FCAFC 172.

[81] ATO, *Income Tax: Interpreting Australia's Double Tax Agreements*, TR 2001/13, 19 December 2001, [23].

[82] This example was based off the facts in ATO ID 2005/207: Assessability of Rental Income Received from Real Property Situated in the United Kingdom (UK) By a Dual Resident of Australia and the UK.

detail in Part V(B) below. As a side issue, where the activity in the United Kingdom is not sufficient to constitute a permanent establishment (PE), the United Kingdom would not be able to tax the income in such circumstances under the UK Treaty.

Where the tie-breaker allocates residence to the United Kingdom, it has sole taxing rights over the income derived by the company (which is now deemed to be a UK company for the purposes of the treaty) under Art 7 of the UK Treaty. Australia has no taxing rights in respect of the company and its profits cannot be taxed in Australia as there is no enterprise being carried on in Australia through a PE.

3. Dividend Paid By UK Dual Resident Company

Consider a TR 2018/5 dual resident incorporated in the United Kingdom that pays a dividend to its Australian parent. In this example, the tie-breaker is effective in allocating residence to the United Kingdom on the basis that place of effective management is in the United Kingdom.[83]

Article 10(1) of the UK Treaty provides that dividends derived by the taxpayer from a UK resident company for the purpose of its tax, may be taxed in Australia. Secondly, Art 10(2) provides that the United Kingdom may also tax the relevant dividends but this rate shall not exceed 5% if the taxpayer owns more than 10% in the company paying the dividends. In all other cases the rate of tax shall not exceed 15%. Further, a nil rate applies subject to satisfying inter alia an 80% holding requirement.[84]

Accordingly, the Australian company, being a "resident of the other contracting state" for the purposes of the treaty, should be entitled to a reduced rate of withholding under Art 10. The same result would also apply if the paying company was allocated residence to Australia under the tie-breaker article or if the tie-breaker was ineffective in allocating residence to one of the contracting states.

4. Dividends and US Dual Resident Company

Consider a TR 2018/5 dual resident incorporated in the United States that pays a dividend to its Australian parent.

As noted above, the US Treaty does not have a tie-breaker and so the dual resident is not a resident for treaty purposes. However, in regards to a dividend, it is the recipient who is the relevant person entitled to the benefit of the treaty and not the company paying the dividend. Accordingly, the Australian company receiving the dividend can still claim treaty benefits under Art 10(2) or (3) of the US Treaty on dividends paid by the dual resident even though the dual resident is not a resident under the treaty. This is because Art 10(1) and (2) applies where the company paying the dividend is a "resident of one of the contracting states for the purposes of its tax". As the dual resident US company is still a resident in the United States under its domestic law, then this requirement is satisfied.

If the facts were in reverse, and the Australian company paid a dividend to the US dual resident, it would not be entitled to claim treaty benefits under Art 10 of the US Treaty as it is not "a resident of the other contracting state". That is, the treaty definition of residence is the requirement as the words "resident of the other contracting state" are used rather than the words "resident of the contracting state for the purposes of its tax". In this case, the base rate of withholding on dividends in Australia is 30%.[85] However, this is subject to the extent to which the dividend is franked, in which case the rate of withholding will be reduced accordingly.[86]

V. Domestic Tax Law and Dual Resident Company

This part of the article considers Australia's tax rules that deal with a dual resident company. The issues are vast and vary in complexity. The discussion also seeks to highlight the relationship between the outcomes under a tax treaty (where relevant) and the implications under Australia's tax laws. The discussion below is by no means exhaustive.

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[83] Bearing in mind it is Multilateral Instrument, Art 4 that will apply in this example from 1 January 2019.

[84] UK Treaty, Art 10(3).

[85] The rate declared by the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth).

[86] *Income Tax Assessment Act 1936* (Cth) s 128B(3)(ga).

The general position is that when one is considering the domestic law in respect of a matter that does not involve the application of the treaty, then what happens under the treaty is irrelevant, as the treaty does not change the status of Australia's domestic tax law. For example, if a company has its residence allocated to another jurisdiction under the tie-breaker article, the company is still an Australian resident for domestic law purposes not associated with the application of the treaty, and the consequences of the allocation of residence to the other country is only for application of the treaty.

There are certain exceptions to this general position such as the definition of "Part X Australian resident" and "prescribed dual resident". These definitions may be directly affected by the treaty position.

A. Tax Consolidated Group

Consider a tax consolidated group that owns various foreign incorporated TR 2018/5 companies in the United Kingdom, United States and Singapore that are now dual resident.[87] These entities were previously not considered residents under TR 2004/15.

An entity is a member of a consolidated group where the entity is the head company of the group or a subsidiary member of the group.[88] At a particular time in an income year, the entity must satisfy certain income tax and ownership requirements, as well as Australian residence requirements.[89] Specifically, with respect to a company, the entity must be an "Australian resident" but not a "prescribed dual resident" to be a member of a tax consolidated group.

1. Prescribed Dual Resident

A prescribed dual resident means a company that satisfies *either* of the following conditions:

(a) the first condition is that:

- (i) the company is a resident of Australia within the meaning of subsection 6(1); and
- (ii) there is an agreement (within the meaning of the *International Tax Agreements Act 1953*) in force in respect of a foreign country; and
- (iii) the agreement contains a provision that is expressed to apply where, apart from the provision, the company would, for the purposes of the agreement, be both a resident of Australia and a resident of the foreign country; and
- (iv) that provision has the effect that the company is, for the purposes of the agreement, a resident solely of the foreign country;

(b) the alternative condition is that the company:

- (i) is a resident of Australia within the meaning of subsection 6(1) for no other reason than that it carries on business in Australia and has its central management and control in Australia; and
- (ii) it is also a resident of another country; and
- (iii) its central management and control is in another country.[90]

In relation to the first condition, the Explanatory Memorandum states that these types "of companies are those that have their Australian residence status effectively revoked for the purposes of the application of a bilateral DTA applying to Australia and another country".[91] Under the first condition, the residence is usually allocated a tie-breaker provision according to the place of effective management of the company, but can also be based on the place of incorporation, or variations or combinations of these two elements.[92]

[87] In this example, the company is a resident in Singapore as some control and management of the business is exercised in Singapore *not* because of incorporation.

[88] *Income Tax Assessment Act 1997* (Cth) s 703-15(1).

[89] Refer to table in s 703-15(2) for the specific requirements. It is also noted that the single entity rule does not apply in determining whether an entity satisfies the "Australian residence requirements" in column 3 of item 2 of the table in s 703-15(2). ATO ID 2009/8, Income Tax: Consolidation: Eligibility to be a Subsidiary Member of a Consolidated Group – residence and the single entity rule confirms that the satisfaction of the Australian residence requirements for subsidiary membership of a consolidated group is a "condition precedent" to the application of the single entity rule.

[90] As defined under *Income Tax Assessment Act 1936* (Cth) s 6(1).

[91] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 2) 1997* (Cth) [3.10].

[92] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 2) 1997* (Cth) [3.11].

As a side issue, if a tie-breaker ceases to be effective because of the MLI, this would mean that the company could not satisfy the first condition of the definition of a prescribed dual resident.

The second type of resident companies that are covered by the alternative condition are those whose central management and control forms the only basis for their Australian residence, but that also have central management and control and residence outside Australia. Specifically, they are residents of Australia because they satisfy the carrying on of a business and CMC test, while also having central management and control in another country.[93] This alternative condition is highly relevant to companies that are dual residents under TR 2018/5 because their central management and control is split between two countries.

The alternative condition may apply in circumstances where there is no treaty in place. The alternative condition may also apply where a treaty operates because the treaty might not apply to dual residents, might not have a tie-breaker provision for companies, or because central management and control is generally synonymous with the tie-breaker test of place of effective management it might not operate to treat the company as a resident solely of one of the contracting states in cases of multiple central management and control.[94]

Some practical examples of the application of the definition of prescribed dual resident are considered below.

2. Eligibility to Join Tax Consolidated Group

With respect to the UK dual resident, if the tie-breaker allocates residence to Australia on the basis that its place of effective management is in Australia, then the company should not be considered a prescribed dual resident under the first condition. It follows that the company is eligible to be a member of the tax consolidated group because it satisfies the Australian residence requirements provided the alternative condition does not apply. Where the company has its place of central management and control in both Australia and the United Kingdom there is a question as to what stops the alternative condition from applying to make the company a prescribed dual resident. Where the tie-breaker operates to allocate residence of the company to the United Kingdom, then it will be considered a prescribed dual resident and consequently will not be eligible to be a member of the tax consolidated group.

Drawing on the discussion in Part III(B)(2), it would seem that the alternative condition is of most relevance to the Singapore dual resident company. This is on the basis that the residence tie-breaker was not enlivened due to the respective definitions of Australian company and Singaporean company. As a result, the company was not a Singaporean company and so did not qualify as a resident of Singapore for the purposes of the treaty. Instead, the company qualified as a resident in Australia as defined under the Singapore Treaty and not under the tie-breaker. Accordingly, the company should not be considered a prescribed dual resident under the first condition. In relation to the alternative condition, careful consideration should be given as to whether central management and control is located in Australia or Singapore or both. Issues may arise in falling out of the alternative condition where central management and control is split between Australia (on the basis that TR 2018/5 applies) and Singapore (noting that a company is resident in Singapore on the basis of management and control and not incorporation), which could result in the Singaporean company being a prescribed dual resident and not entitled to be a member of the tax consolidated group.

In relation to the United States, as there is no tie-breaker in the US Treaty, a US-Australian dual resident company cannot be a prescribed dual resident under the first condition. However, it is still important that the alternative condition is also not satisfied on the basis that central management and control is not split between Australia and the United States, for the US company to satisfy the Australian residence requirements to be eligible to become a member of the consolidated group.

In summary, real practical difficulty arises in respect to whether a company with split central management and control is able to fall out of the alternative condition, which may well lead to many

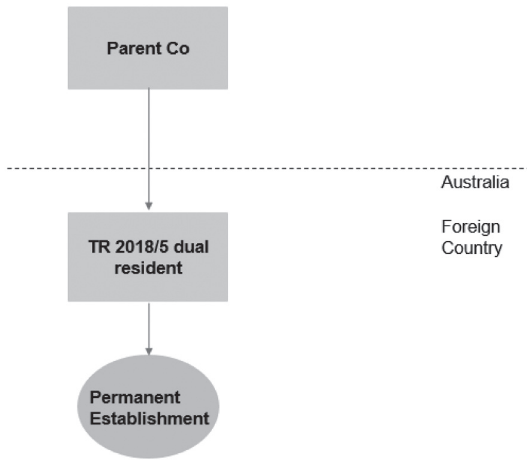
[93] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 2) 1997* (Cth) [3.12].

[94] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 2) 1997* (Cth) [3.15].

such companies being regarded as a prescribed dual resident and hence being ineligible to be members of a tax consolidated group.

3. Foreign Branch Exemption

Where TR 2018/5 applies to a company that was previously treated as a foreign resident company, it is necessary to examine whether the now Australian (and dual) resident company carries on a business at or through a PE in the foreign country. This is illustrated as follows. Whether a company is actually carrying on a business at or through the PE is a question of fact and degree. This enquiry must objectively support the conclusion that actual business activities are being carried on.[95] Where actual trading activities are taking place in the foreign country with a degree of permanence then it is likely that the PE threshold (as per the relevant treaty or domestic law definition) is satisfied.



Where the TR 2018/5 dual resident is a member of a tax consolidated group, and the activities of the subsidiary constitute a PE in the foreign country, then the income derived from the business operations carried on may be "not assessable and not exempt income" (NANE) for the head company of the consolidated group.[96] Where the amount is NANE, no further income tax is payable in respect of these amounts in Australia.

However, NANE treatment is not automatic and is subject to notional application of the CFC rules, in that types of income that would not be attributable under the CFC rules would generally qualify for the foreign branch profits exemption. For unlisted company PEs, therefore, there must be minimal "bad income" (ie passive tainted sales or services income). If not, that net amount is taxable and not treated as NANE, although a FITO may be available.

4. Intra-group Dividends

It is possible that the foreign company may be eligible to become a member of a tax consolidated group. For example, as discussed above, a TR 2018/5 US dual resident that does not have its central management and control split between Australia and the United States would be eligible to be part of the consolidated group on the basis that it satisfies the Australian residence requirements for membership and is not a prescribed dual resident. In this case, the dividends paid by the US subsidiary to the Australian parent will be ignored for income tax purposes under the single entity rule.[97] However, if the foreign company

[95] ATO, *Income Tax: Satisfying the "Carrying on a Business At or Through a Permanent Establishment" Requirement in Section 23AH of the Income Tax Assessment Act 1936 Where a Company Is Taken to Have a Permanent Establishment (PE) in Relation to Substantial Equipment*, TR 2014/3, 11 June 2014, [9].

[96] Under *Income Tax Assessment Act 1936* (Cth) s 23AH.

[97] *Income Tax Assessment Act 1997* (Cth) s 701-1.

is a prescribed dual resident so that it is not eligible to be a member of a tax consolidated group then intra-group dividends would prima facie be taxable as unfranked dividends.

5. Disposal of TR 2018/5 Dual Resident Company

When a subsidiary is disposed of by a tax consolidated group it is regarded as leaving the group immediately before the disposal. The disposal of shares in the TR 2018/5 dual resident will result in capital gains tax (CGT) event A1 and a capital gain or capital loss may arise, depending on the amount of capital proceeds and cost base of the shares (or reduced cost base).[98]

The Australian parent company that disposed of the shares in the company would not be entitled to reduce any capital gain or capital loss made in relation to the disposal under Subdiv 768-G. This is because one of the key requirements is that the CGT event must happen in relation to a share in a company[99] that is a "foreign resident". As the company satisfies the definition of an Australian resident, then it is not a foreign resident. This is so even where a treaty applies to allocate residence under the tie-breaker to the foreign country.

6. Interest Deductibility

Subject to thin capitalisation limitations in Div 820, where an Australian parent has borrowed and invested equity into the foreign subsidiary, a deduction should be available for interest incurred in deriving NANE income under s 768-5 of the *ITAA97*, ss 23AI or 23AK of the *ITAA36*.[100] This treatment changes where a TR 2018/5 dual resident is involved.

Where the TR 2018/5 dual resident is part of a tax consolidated group it would seem that the interest would not be deductible under either the specific provision (s 25-90) or the general provision (s 8-1).

First, under s 25-90 one of the key requirements is that the income derived by the Australian company is NANE under s 768-5. As concluded in Part V(B)(4) above, the distributions from the TR 2018/5 dual resident do not qualify as foreign equity distributions (ie NANE) on the basis that the company is an Australian resident and not a foreign resident. Therefore, as this element is not satisfied, a specific deduction is not available. This will be the case even in a treaty context where the tie-breaker allocates residence to the foreign country.

Secondly, as noted in Part V(A)(3) above, it may be the case that the activities in the foreign country constitute a PE. Where this is the case, no deduction should be available under s 8-1 as the interest is incurred in relation to gaining or producing NANE income under s 23AH of the *ITAA36*.[101] Section 8-1(2)(c) precludes deductibility in these circumstances.

B. Non-Tax Consolidated

This section examines the tax implications in a non-tax consolidated environment.

1. Foreign Branch Exemption

The following comments consider a TR 2018/5 dual resident that is owned by a single Australian company that has not elected to form a tax consolidated group or where the TR 2018/5 dual resident is a prescribed dual resident such that it is not eligible to be a subsidiary member of a tax consolidated group.

From an Australian perspective, the foreign income derived by the foreign incorporated Australian resident company that is carrying on a business at or through a PE of the company in a listed country or

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[98] *Income Tax Assessment Act 1997* (Cth) s 104-10; it is assumed that the shares are post-CGT shares as they were not acquired before 20 September 1985.

[99] Referred to in *Income Tax Assessment Act 1997* (Cth) Subdiv 768-G as the "foreign disposal company".

[100] *Income Tax Assessment Act 1997* (Cth) s 25-90. The "TOFA equivalent" is in s 230-15(3).

[101] The view of the Commissioner in TD 2016/6 is that income that satisfies both s 23AH of the *Income Tax Assessment Act 1936* (Cth) and s 768-5 of the *Income Tax Assessment Act 1997* (Cth) is not "non-assessable non-exempt income under s 768-5 for the purposes of s 25-90". Accordingly, the amount is not deductible under s 25-90 where it is incurred in deriving income that meets both requirements.

unlisted country is NANE.[102] Capital gains derived from these business operations should also be NANE where the asset is not taxable Australian property (TAP).[103] This treatment applies in Australia whether a tax treaty applies or not.

2. Intra-group Dividends

Assuming that all the branch income is NANE then the company would not have paid tax in Australia and consequently there would be no franking credits available. As such, the payment of a dividend to its Australian parent would prime facie be an unfranked dividend.

3. Conduit Foreign Income

An Australian corporate tax entity's conduit foreign income (CFI) includes the income that it derives from the foreign branch of the company that is NANE.[104] There is a special rule in the CFI provisions that allows for an amount declared to be CFI to be treated as NANE where it is paid from one Australian corporate tax entity to another Australian corporate tax entity. However, the receiving entity must then distribute and declare that amount of the unfranked part to be CFI after the start of the income year but before the due date for lodging its income tax return for that income year.[105] Here, this rule may only be useful in practice where the Australian parent is owned by a foreign company. Where the amount is declared to be CFI, from the perspective of the foreign resident (that owns shares in the parent Australian company), the amount is NANE and not subject to withholding tax.[106] The foreign hybrid rules would also need to be considered as the CFI rules effectively allow for a tax deductible dividend that may be attached under the parent country's foreign hybrid rules.

4. Dividend Participation Exemption

This section considers whether Subdiv 768-A applies to a distribution made by a TR 2018/5 dual resident to its Australian parent company.

The broad requirements of the "participation exemption" in s 768-5 is to treat a "foreign equity distribution" made to an Australian resident corporate tax entity that holds a participation interest[107] of at least 10% in relation to the foreign company as NANE. A "foreign equity distribution" is a distribution or non-share dividend made by a company that is a "foreign resident" in respect of an equity interest in the company.[108] A foreign resident is a person who is not a resident of Australia for the purposes of the *ITAA36*.[109] Here, the TR 2018/5 dual resident company is an Australian resident as defined in s 6(1) of the *ITAA36*. Accordingly, it does not satisfy the definition of a foreign resident. Therefore, the distributions do not qualify as foreign equity distributions, meaning the participation exemption will not apply.

Subdivision 768-A does not bring in the notion of a "prescribed dual resident" or "Part X Australian resident". Therefore, it would seem that even where a treaty tie-breaker operated to allocate residence to the foreign country, it would not change the result described above. That is, the dividend participation exemption would still not be available in these circumstances. Moreover, the treaty itself does not mean the company is a foreign resident for all purposes of Australia's domestic law. This would mean that, absent a tax consolidated environment, any dividends paid by the subsidiary are taxable as unfranked dividends in the hands of the Australian parent company. The outcome would be different if Australia adapted the position that a company were a foreign resident for treaty purposes and domestic law alike. In that scenario, the distributions would qualify as foreign equity distributions, meaning the participation exemption would apply.

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[102] *Income Tax Assessment Act 1936* (Cth) s 23AH(2).

[103] *Income Tax Assessment Act 1936* (Cth) s 23AH(3).

[104] *Income Tax Assessment Act 1997* (Cth) s 802-30.

[105] *Income Tax Assessment Act 1997* (Cth) s 802-20.

[106] *Income Tax Assessment Act 1997* (Cth) s 802-15.

[107] As defined in *Income Tax Assessment Act 1997* (Cth) s 768-15.

[108] *Income Tax Assessment Act 1997* (Cth) s 768-10.

[109] *Income Tax Assessment Act 1997* (Cth) s 995-1.

5. Interest Deductibility

Consider a TR 2018/5 dual resident that is owned by its Australian parent company that has not elected to form a tax consolidated group or where the TR 2018/5 dual resident is a prescribed dual resident such that it is not eligible to be a subsidiary member of a tax consolidated group.

The parent company should be entitled to claim a deduction under s 8-1 for interest on borrowings that are either on-lent to its subsidiary interest free or invested as equity. Support for this treatment can be found in the Full Federal Court decision of *Commissioner of Taxation (Cth) v Total Holdings (Aust) Pty Ltd*, which involved a taxpayer that borrowed at interest and then on-lent the funds interest free to its subsidiary. In this case, Lockhart J (with whom the others agreed) held that the taxpayer was entitled to deduct the interest expense as its activities were designed to render the subsidiary profitable and promote the generation of assessable income by it and subsequently the derivation of assessable dividends by the taxpayer.[110] Importantly, it is not necessary that the relevant income be produced in the year in which the loss or outgoing is incurred.[111]

C. Interaction with the CFC Regime

This section considers the implications under the CFC regime contained in Pt X of the *ITAA1936* where a TR 2018/5 dual resident company is involved.

Part V(C)(1) sets out an overview of some of the key implications that may arise under the CFC regime where there is a change in residence due to the operation of TR 2018/5. Part V(C)(2) then sets out the rules that determine when a company is a CFC.

Broadly, where such a dual resident company has its residence allocated to a foreign country under a tie-breaker article, it should remain a CFC. However, this does not mean that the company ceases to be an Australian resident for other purposes of Australia's domestic laws.

1. Attribution on Change of Residence to Australia

It is important to consider what other implications arise under the CFC regime where there is a change in residence due to the operation of TR 2018/5. In that regard, a separate attribution calculation is required where a CFC changes residence from an unlisted country to Australia.[112] The attributed taxpayer's assessable income of the year in which the change in residence occurred is calculated by multiplying the "attribution percentage" by the "adjusted distributable profits".

The "attribution percentage" means the attributable taxpayer's attribution percentage, at the residence-change time, in relation to the CFC.[113] In this example, the attribution percentage is 100%. The "adjusted distributable profits" is the CFC's adjusted tainted income (excluding any non-portfolio dividends) derived during the period beginning on the first day of the statutory accounting period in which the residence-change time occurred and ending immediately before the change in residence occurred.[114] The CFC's expenses related to this income are deducted to arrive at a net amount.

For example, consider an Australian company that owns 100% of a CFC that is resident in an unlisted country and that CFC becomes a resident in Australia on 31 December due to the operation of TR 2018/5. The statutory accounting period of the CFC is from 1 July to 30 June. During the period 1 July to 31 December, the CFC had the following amounts of income and expenses, as shown in Table 1.

[110] See *Commissioner of Taxation (Cth) v Total Holdings (Aust) Pty Ltd* (1979) 9 ATR 885, as well as the Commissioner's view in Income Tax Ruling No IT 2606.

[111] *Ronpibon Tin NL v Commissioner of Taxation (Cth)* (1949) 78 CLR 47.

[112] This calculation is also required when the CFC changes residence to a listed country.

[113] *Income Tax Assessment Act 1936* (Cth) s 457(2).

[114] Where a CFC changes residence from an unlisted country to a listed country the CFC is deemed to have disposed of all of its tainted assets for their market value at the time it changed residence. Therefore, the distributable profits include the net profit (if any) arising from this deemed disposal of assets as well as the adjusted tainted income less expenses related to this income.

TABLE 1. Attributable Income Example

Item	Amount ($)
Portfolio dividends*	35,000
Tainted interest income	5,000
Tainted services income	20,000
Expenses related to tainted services income	5,000
Adjusted tainted income	55,000

* The adjusted distributable profits of the CFC do not include non-portfolio dividends, only portfolio dividends.
The amount attributable to the Australian company would be $55,000 (ie 100% × $55,000).[115]

B. When Is a Company a CFC?

Section 340 of the *ITAA36* provides that "a company is a CFC at a particular time if, at that time, the company is a resident of a listed country or of an unlisted country and any of the following paragraphs applies". Each of the key requirements of this definition is considered in turn below.

The first requirement is to determine whether the foreign entity is a company. A company is defined to mean "(a) a body corporate; or (b) any other unincorporated association or body of persons; but does not include a partnership or a non-entity joint venture".[116] A company does not include a company in the capacity of trustee.[117] In this example, the TR 2018/5 dual resident entity is classified as a company for the purposes of the CFC rules.

The second requirement is to establish whether the company is a resident of a *listed country* or of an *unlisted country* at a particular time. The definition of listed country and unlisted country refer to a foreign country.[118] There is no definition of foreign country in either the *ITAA36* or the *Income Tax Assessment Act 1997* (Cth) (*ITAA97*). However, the note to the definition of "foreign law" in s 995-1 refers to the meaning in s 2B of the *Acts Interpretation Act 1901* (Cth), which provides that a "foreign country means any country (whether or not an independent sovereign state) outside Australia and the external Territories".

A company is a resident of a listed country at a particular time where the company is *not* a Part X Australian resident and the company is treated as a resident of the listed country for the purposes of the tax law of the listed country.[119] A listed country is defined in s 320 of the *ITAA36* to mean "a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of this Part".[120] Under s 333(1)(b) of the *ITAA36*, a company is a resident of an unlisted country where the company is not a Part X Australian resident and is not a resident of a listed country.[121]

It follows that in determining whether the foreign entity is a CFC, the concept of a "Part X Australian resident" is critical in that if the foreign entity is considered to be one then it cannot be a CFC. The definition of a Part X Australian resident means a resident within the meaning of s 6(1) of the *ITAA36*, but does not include an entity where:

[115] For the purposes of *Income Tax Assessment Act 1936* (Cth) s 457.

[116] *Income Tax Assessment Act 1997* (Cth) s 995-1.

[117] *Income Tax Assessment Act 1936* (Cth) s 317.

[118] *Income Tax Assessment Act 1936* (Cth) s 320.

[119] *Income Tax Assessment Act 1936* (Cth) s 332.

[120] *Income Tax Regulations 1936* (Cth) reg 152 provides that a foreign country or a part of a foreign country listed in Sch 10 is declared to be a listed country for the purposes of Pt X. These countries are Canada, France, Germany, Japan, New Zealand, United Kingdom and United States.

[121] There is also a detailed list of requirements in *Income Tax Assessment Act 1936* (Cth) s 333(2) setting out other circumstances when a company can be a resident of an unlisted country at a particular time.

(a) there is a double tax agreement in force in respect of a foreign country; and
(b) that agreement contains a provision that is expressed to apply where, apart from the provision, the entity would, for the purposes of the agreement, be both a resident of Australia and a resident of the foreign country; and
(c) that provision has the effect that the entity is, for the purposes of the agreement, a resident solely of the foreign country.

Section 336(c) of the *ITAA36* provides that an Australian entity includes an entity (other than a partnership of trust) that is a Part X Australian resident. For these purposes an entity includes only a company and individual.[122]

In this example, the entity is incorporated in a foreign country but is also an Australian resident under TR 2018/5. Therefore, it satisfies the first requirement of the test for a Part X Australian resident. Importantly, if there is a tax treaty in force and the residence is assigned under the treaty tie-breaker to the foreign country, then the entity will not be a Part X Australian resident and will be considered a CFC. The opposite conclusion is drawn where the entity is an Australian resident under s 6(1) and the treaty tie-breaker allocates residence to Australia. Where there is no treaty in place the company would be a Part X Australian resident and not a CFC.

D. Thin Capitalisation

This section of the article considers some of the possible thin capitalisation implications from the perspective of the Australian parent of a tax consolidated group that is considered an outward investing entity (general). In summary, the main change that could arise is that any interest expense the TR 2018/5 has that is related to a foreign PE should not be deductible.

Prior to the potential application of TR 2018/5, where an Australian company has a foreign subsidiary, any controlled foreign entity debt (ie loans to a foreign subsidiary) is subtracted from the adjusted average debt (AAD) calculation. Further, any controlled foreign entity equity (ie shares in the foreign subsidiary) or controlled foreign entity debt (loans to the foreign subsidiary) is not included under the safe harbour debt amount. The same thin capitalisation result should arise where the company is also considered to be a TR 2018/5 dual resident, but a tie-breaker article applies to allocate residence to a foreign country.

However, in the circumstances where a tie-breaker applies to allocate residence to Australia, the dual resident company should (depending on the facts) be considered to have a foreign PE.[123] For the Australian parent, any amounts lent to that company are subtracted from AAD but only where they lent on an arm's length basis. Also, under the safe harbour debt calculation, the shares in the TR 2018/5 dual resident company and any loans to it are subtracted from the calculation.

The key concept of controlled foreign entity equity is discussed in further detail below.

1. Controlled Foreign Entity Equity

The Australian parent's "controlled foreign entity equity" is the total value of all the equity interests[124] that it holds in entities that are controlled foreign entities of the relevant entity at that time.[125] An Australian controlled foreign entity, in relation to a particular time, includes an entity that is a CFC.[126]

[122] This is so notwithstanding the broad definition in s 317, which defines an entity to mean any of the following: a company; partnership; a person in the capacity of trustee; and any other person.

[123] For the avoidance of doubt, the PE reference in this example envisages the situation where the dual resident subsidiary that is an Australian treaty resident has business activities in the foreign country sufficient to amount to its own PE and, given that it is a subsidiary of a consolidated group, it is therefore a PE of the head entity. It is not suggesting that the subsidiary is a PE of the parent company.

[124] However, not all the value of the equity interest is taken into account. That is, the only value that is taken into account is that which is not attributable to any of the following assets that are held by the controlled entity throughout the relevant period, including assets attributable to the controlled entity's Australian permanent establishments and other assets that are held by the controlled entity for the purposes of producing assessable income of the controlled entity.

[125] *Income Tax Assessment Act 1997* (Cth) s 820-890(1)(a).

[126] *Income Tax Assessment Act 1997* (Cth) s 820-745(1)(a).

Accordingly, prior to the application of TR 2018/5, the investment in the foreign entity would be categorised as controlled foreign entity equity. The result being that the amount is subtracted from the safe harbour debt amount under step 5 in the method statement.[127]

Where a TR 2018/5 dual resident company is deemed to be a resident in Australia under a treaty tie-breaker, it is necessary to consider whether the entity is still considered a CFC and therefore satisfies the definition of controlled foreign entity equity.

As noted in Part V(C)(2) above, the first condition for a company to be a CFC is that it must be a resident of a listed country or of an unlisted country.[128] This hinges on whether the foreign entity is a Part X Australian resident because if it is one then it cannot be considered a CFC. If there is a tax treaty that applies, and the residence is assigned under the treaty tie-breaker to Australia, then the entity will be a Part X Australian resident and therefore will not satisfy the requirements to be considered a CFC. Accordingly, the investment in the foreign entity by the Australian parent no longer satisfies the definition of controlled foreign entity equity.[129]

Where there is no treaty with the foreign country then the same treatment would apply because the company will be a Part X Australian resident. Another consequence is that any debt interests issued by the company to the Australian parent will no longer count as controlled foreign entity debt.[130]

However, it is likely that the Australian company would still have an overseas PE. This will also impact on the entity's maximum allowable debt under the safe harbour debt calculation.[131] The method statement to calculate the safe harbour debt amount expressly states that any amount that is attributable to the entity's overseas PE must be disregarded.[132]

Finally, where residence is assigned under the treaty tie-breaker to the foreign country, then the entity will not be a Part X Australian resident and will still be considered a CFC. The Australian company that wholly owns the CFC would also satisfy the requirements of an Australian controller of a CFC.[133] Accordingly, the CFC will be considered an Australian controlled foreign entity and will satisfy the definition of controlled foreign entity equity. As noted above, this amount is required to be subtracted from the safe harbour debt amount under step 5 in the method statement.

E. Hybrid Mismatch Rules

Consider a foreign incorporated company that becomes part of an Australian tax consolidated group. Any charges from the Australian parent to the foreign incorporated company are ignored in Australia due to the operation of the single entity rule. In this example, it is assumed that the foreign country has adopted its country's version of the foreign hybrid measures that would likely disallow the deduction in its jurisdiction. The issue is to determine how the hybrid mismatch rules in Div 832 apply to this dual resident scenario.[134]

The hybrid mismatch rules are designed to neutralise the effects of hybrid mismatches by modifying the Australian income tax law consequences. In some circumstances the modification of the Australian income tax outcome is subject to whether the effect of the mismatch has been neutralised under the taxation law in a foreign jurisdiction. Where an amount gives rise to a deducting hybrid mismatch, it is necessary to identify a primary response country and a secondary response country in relation to the mismatch.[135]

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[127] *Income Tax Assessment Act 1997* (Cth) s 820-95.

[128] *Income Tax Assessment Act 1936* (Cth) s 340.

[129] *Income Tax Assessment Act 1997* (Cth) s 820-890.

[130] *Income Tax Assessment Act 1997* (Cth) s 820-885.

[131] *Income Tax Assessment Act 1997* (Cth) s 820-890(1)(a).

[132] *Income Tax Assessment Act 1997* (Cth) s 820-95.

[133] *Income Tax Assessment Act 1997* (Cth) s 820-850.

[134] The recently enacted hybrid mismatch rules are a complex and detailed set of rules. This example serves as yet another illustration of the wide-ranging rules that would require consideration, especially in large multinational groups with complex structures.

[135] Explanatory Memorandum, *Treasury Laws Amendment (Tax Integrity and Other Measures No 2) Bill 2018* (Cth) 1.295.

An entity is a deducting hybrid if a payment it makes is deductible for the purposes of the tax law of two countries. However, unless the deducting hybrid is a dual resident, there are rules identifying which country is the primary response country. If Australia is not the primary response country, this subdivision will not neutralise the deducting hybrid mismatch unless:

(a) the primary response country does not have hybrid mismatch rules; and
(b) the relevant parties are in the same control group, or the mismatch arose under a structured arrangement.[136]

It is not necessary to identify a secondary response country for a deducting hybrid mismatch if the only liable entity in respect of the income or profits of the deducting hybrid is the deducting hybrid, and the liable entity satisfies the residence test in s 832-555(9) in both deducting countries. In other words, the liable entity is a dual resident, which in this example is the case. Accordingly, where the deducting hybrid is a dual resident, the mismatch may be neutralised by any country. Here, the foreign country has neutralised the mismatch arrangement by disallowing the deduction in its jurisdiction. This means that Div 832 does not apply.

F. Capital Gains Tax Consequences

This section examines the CGT consequences that arise where a company becomes an Australian resident under TR 2018/5. The CGT implications that arise on disposal and when the company ceases to be an Australian resident are also addressed.

1. Company Becomes an Australian Resident

The general position is that where a company becomes an Australia resident, the first element of the cost base of its CGT assets is the market value at that time. This applies for all assets except an asset that is TAP or assets that are acquired before 20 September 1985.[137] However, this general rule is not universal as it does not apply to a CFC that becomes an Australian resident.

2. CFC Becomes an Australian Resident

The "step up" to market value under s 855-45 does not apply where a CFC stops being a resident of a listed country or an unlisted country and becomes an Australian resident.[138] However, a special rule applies where a CFC becomes a resident of Australia, which modifies the application of the CGT rules.[139] These modifications have the effect they would have, in relation to each "commencing day asset" owned by the CFC at the residence change time, if those modifications were used to work out the taxable income of the CFC rather than its attributable income.

A "commencing day asset" is taken to have been acquired by the company for CGT purposes on its "commencing day".[140] A commencing day asset is defined as a CGT asset, other than one that is TAP, owned by the eligible CFC at the end of its commencing day.[141] The commencing day is the later of: (1) the last day of the most recent period during which there was not an attributable taxpayer with an attribution percentage (greater than nil) in relation to the eligible CFC; or (2) 30 June 1990.[142] The cost base of these assets is the greater of the asset's market value and the asset's cost base on that day (ie *not*

[136] *Income Tax Assessment Act 1997* (Cth) s 832-525.

[137] See *Income Tax Assessment Act 1997* (Cth) ss 112-87, 855-45.

[138] *Income Tax Assessment Act 1997* (Cth) s 855-55.

[139] *Income Tax Assessment Act 1997* (Cth) s 855-55(3) provides that the modifications to *Income Tax Assessment Act 1997* (Cth) Pts 3-1, 3-3 are contained in *Income Tax Assessment Act 1936* (Cth) ss 411–414.

[140] *Income Tax Assessment Act 1936* (Cth) s 411(1).

[141] *Income Tax Assessment Act 1936* (Cth) s 406(2).

[142] *Income Tax Assessment Act 1936* (Cth) s 406(1) provides the following useful example to illustrate its application: "If a taxpayer became an attributable taxpayer with an attribution percentage (greater than nil) in relation to the eligible CFC at 3 pm on 20 October 2004 and there were no other such attributable taxpayers at that time, the commencing day is 20 October 2004."

the residence change time).[143] The impact of this is that it brings non-TAP assets acquired prior to 20 September 1985 into the CGT regime.

There is a further modification that excludes from Australian tax any capital gain on non-taxable Australian assets of the CFC that were held from the commencement date relating to any period before the change of residence, if that gain was subject to foreign tax in a listed country.[144]

3. Disposal of TR 2018/5 Dual Resident Company

The disposal of shares in the TR 2018/5 dual resident will result in CGT event A1 and a capital gain or capital loss may arise, depending on the amount of capital proceeds and cost base of the shares (or reduced cost base).[145]

The Australian parent company that disposed of the shares in the company would not be entitled to reduce any capital gain or capital loss made in relation to the disposal under Subdiv 768-G. This is because one of the key requirements is that the CGT event must occur in relation to a share in a company[146] that is a "foreign resident". As the company satisfies the definition of an Australian resident, then it is not a foreign resident. This is so even where a treaty applies to allocate residence under the tie-breaker to the foreign country. The outcome would be different if Australia adapted the position that a company were a foreign resident for treaty purposes and domestic law alike. In that scenario, the Australian parent company may, subject to satisfying the active foreign business asset percentage (AFBAP) rules in Subdiv 768-G, be entitled to reduce any capital gain or capital loss made in relation to the disposal of the subsidiary.

G. Possible Implications Where TR 2018/5 is Subsequently Determined to Be Incorrect

Various issues would arise if TR 2018/5 is subsequently determined to be incorrect such that it is subsequently withdrawn and ceases to apply to a corporate group that adopted and relied upon the ruling. Where a TR 2018/5 dual resident company was part of a tax consolidated group for a period because of relying on TR 2018/5 ceases to be an Australian resident, then it will no longer satisfy the Australian residence requirements for membership and will automatically cease to be a member of the group. A calculation in accordance with the method statement in Div 711 will be required in order to "set" the amount of the tax cost base of the shares. The amount ascribed under the method statement is used for the purposes of calculating the capital gain or capital loss that arises on exit for the head company (ie Australian parent).[147]

An interesting issue arises as to whether the single entity rule[148] in s 701-1 has any bearing on the application of CGT event I1, if a company that is a subsidiary member of a consolidated group stops being an Australian resident. The view of the Commissioner is that the single entity rule does not affect the application of CGT event I1 in these circumstances "because the CGT event happens after it has

[143] *Income Tax Assessment Act 1936* (Cth) s 412(2).

[144] *Income Tax Assessment Act 1997* (Cth) s 855-55(4).

[145] *Income Tax Assessment Act 1997* (Cth) s 104-10; it is assumed that the shares are post-CGT shares as they were not acquired before 20 September 1985.

[146] Referred to in *Income Tax Assessment Act 1997* (Cth) Subdiv 768-G as the "foreign disposal company".

[147] CGT event L5 could also arise on exit, where in working out the group's allocable cost amount for the entity, the amount remaining after applying step 4 of the table in s 711-20 is negative.

[148] The single entity rule only applies for the core purposes of a head company or subsidiary entity (as defined in *Income Tax Assessment Act 1997* (Cth) s 701-1(2), (3)) during any period that they are members of a consolidated group. The Commissioner has amended its interpretation of the application of the single entity rule contained in TR 2004/11, to include an appendix explaining the Commissioner's view of the decision of the Full Federal Court in *Channel Pastoral Holdings Pty Ltd v Federal Commissioner of Taxation* (2015) 232 FCR 162; [2015] FCAFC 57. The TR addendum 2004/11A1 provides guidance on how the Commissioner will administer the relevant provisions of *Income Tax Assessment Act 1936* (Cth) Pt IVA and *Income Tax Assessment Act 1997* (Cth) Pt 3-90 following this decision.

left the group".[149] That is, the subsidiary company ceases to be a member of the group at the time it stops being an Australian resident[150] and CGT event I1 does not happen unless a company has become a non-resident.

As a non-resident cannot be a member of a consolidated group, CGT event I1 happens at a time after the subsidiary was a member of the group. Accordingly, the single entity rule is not relevant to the application of the event. The Commissioner rejects the alternative view that as a result of the single entity rule, CGT event I1 has no effect when a subsidiary member of a consolidated group ceases to be an Australian resident because, just before the event happened, the subsidiary company did not own any assets because they were assets of the head company.

CGT event I1 happens at the time a company stops being an Australian resident.[151] Broadly, the company makes a capital gain or a capital loss for each post-CGT asset it owned just before the time of the event, except one that is TAP.[152] Unlike the case for an individual, the company is *not* able to choose to disregard CGT event I1 and treat its non-TAP assets like TAP.[153]

H. Effect of Change of Residence – Taxation of Financial Arrangements

Where a foreign company becomes an Australian resident, consideration should also be given to whether there are any possible implications under the Taxation of Financial Arrangements (TOFA).

Where a company changes from being a foreign resident to an Australian resident, special rules apply to determine the relevant amount of gains and losses for that year from the taxpayer's financial arrangements. The general effect of the rules is to calculate any gain or loss from the financial arrangement for the income year by specifically taking into account the change of residence during the income year, and appropriately apportioning the gain or loss to the periods of different residence.[154]

This may be relevant where the company has an intercompany loan with unrealised foreign exchange gains and losses. Relevantly, there may be deemed foreign exchanges adjustments under the TOFA rules. Consequently, it is important to not overlook the possible application of the TOFA rules in this type of scenario.

VI. Conclusion

This article has sought to identify a number of complex issues that require ongoing comprehensive examination as a result of the Commissioner's approach in TR 2018/5. There is no doubt that the breadth and complexity of many of these issues pose real concerns to Australian corporate groups that have significant businesses operating offshore through foreign incorporated subsidiaries. The more sensitive issues arise because the foreign equity distribution exemption in s 768-5 and the AFBAP rules in Subdiv 768-G only apply to foreign residents. Relevantly, the TR 2018/5 dual resident remains an Australian resident even where the treaty tie-breaker article applies to allocate residence to the foreign country. If the Board of Taxation recommendation that a foreign resident for treaty purposes should be treated as a foreign resident for all purposes of the Australian income tax law was adopted, then these issues would not arise. Importantly, this recommendation should be reconsidered especially due to its simplicity.[155]

[149] ATO, *Income Tax: Consolidation: Capital Gains: Does the Single Entity Rule in Section 701-1 of the Income Tax Assessment Act 1997 Affect the Application of CGT Event I1 in Section 104-160 If a Company Which Is a Subsidiary Member of a Consolidated Group Stops Being an Australian Resident?*, TD 2004/42, 6 October 2004, [1].

[150] Column 3 of item 2 in the table in s 703-15(2).

[151] *Income Tax Assessment Act 1997* (Cth) s 104-160.

[152] As covered by item 1 or 3 of the table in s 855-15 or covered by item 4 of that table because it is an option or right to acquire a CGT asset covered by item 1 or 3 of that table.

[153] *Income Tax Assessment Act 1997* (Cth) s 104-165.

[154] *Income Tax Assessment Act 1997* (Cth) s 230-485.

[155] It was noted at the time by the Board of Taxation that "this is a much simpler and comprehensive solution than Australia's current law provides": Board of Taxation, n 4, [109].

This article has highlighted the importance of the relationship between tax treaties and domestic law in that understanding the interaction between the two is critical in evaluating all the possible tax implications. As noted, the prevalence of dual resident companies may increase in light of the renewed focus on corporate residence by the Commissioner. While Australia's tax treaties provide for the alleviation of "residence-residence" conflict through a tie-breaker article, it is not always the case that there is a tie-breaker article, or there may not be a tax treaty in place with the foreign country. The introduction of the MLI that attempts to agree on residence of a company through mutual agreement by competent authorities may only lead to further uncertainty for taxpayers. In the absence of this competent authority agreement on treaty residence, benefits under the treaty will be denied for a dual resident company.

This article also suggests that it could be worthwhile pursuing a practical administrative approach (similar to the practical administrative approach implemented between Australia and New Zealand non-individual dual residents impacted by Art 4(1) of the MLI) for dual resident entities that are impacted by TR 2018/5, such that the residence of the company for treaty purposes can be self-assessed. This would provide much needed certainty for taxpayers given the delays that may be faced while the competent authorities seek to reach agreement.