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Central management and control test of residency: ATO provides risk assessment framework guidance

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The Australian Taxation Office (ATO), on 28 June 2023, released updated guidance Draft Practical Compliance Guideline PCG 2018/9DC1 *Central management and control test of residency: identifying where a company's central management and control is located* which updates PCG 2018/9.

Significantly, the updated draft PCG includes a new risk assessment framework to assist foreign-incorporated companies to further understand when their circumstances may be low risk, or when the ATO might apply compliance resources to review their corporate residency status under the central management and control (CMC) test of residency.

Given recent ATO practice when introducing risk assessment frameworks into PCGs, the inclusion of the proposed framework may be a signpost to a future disclosure in the Reportable Tax Position (RTP) Schedule.

This updated guidance must be read in conjunction with Taxation Ruling TR 2018/5 *Income tax: central management and control test of residency*, which sets out the Commissioner's views on how to apply the CMC test of residency.

PCG 2018/9DC1 comes as the transitional approach under the original PCG 2018/9 ended on 30 June 2023 which applied to a foreign incorporated company that had previously relied on TR 2004/15 to establish that it was not a resident of Australia (but would have become a resident under the CMC test of residency per the Commissioner's revised view in TR 2018/5).

In addition, the timely release of PCG 2018/9DC1 closely follows the introduction of Schedule 1 of *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (the Bill) on 22 June 2023 which requires that for financial years commencing on or after 1 July 2023, Australian public companies (listed and

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unlisted) must disclose information about subsidiaries in their annual financial reports including the tax residency of each of those entities during the financial year.

It is also noted that the previous government (announced in the Federal Budget 2020-21) proposed amendments to the existing legislation to clarify the position so that a foreign incorporated company will only be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. It remains unclear whether this proposal will proceed and the expiry of the ATO's transitional period emphasises the need for this legislative clarification as soon as possible.

Overview of corporate residency

A company is treated as an Australian resident for tax purposes where the company is:

- incorporated in Australia; or
- it carries on business in Australia and has either:
  - Its CMC in Australia; or
  - Its voting power is controlled by shareholders who are residents in Australia.

Broadly, as outlined in TR 2018/5 and the PCG, CMC refers to the control and direction of a company's operations. The key element to this control and direction of the company's operations is the making of high-level decisions which determine the company's general policies, the direction on its operations and types of transactions that the company will enter into.

As set out in TR 2018/5, corporate residency under the statutory definition is interpreted such that if a company has CMC in Australia, then the ATO generally considers that the company also conducts a business in Australia. It is not necessary for the substantive trading or investment activities of the business that generate its profits to take place in Australia.

Consequences of becoming an Australian corporate tax resident

It is critical to determine a company's tax residency with certainty given the various implications of a foreign company becoming an Australian resident. For example:

- An Australian tax resident is taxed in Australia on its worldwide income whereas a foreign tax resident should only be assessed on their Australian-sourced income.
- A wholly-owned foreign subsidiary of an Australian income tax consolidated group will automatically join the consolidated group at the time the company becomes an Australian tax resident.
- Other implications include tax treaty considerations where a company is considered a dual resident; the CGT participation exemption does not apply in relation to disposal of shares in a foreign company; or significant global entity penalties as a result of late lodgement of prescribed forms (e.g. income tax returns, activity statements, etc) by an Australian resident company.

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PCG 2021/DC1 – Risk Assessment Framework

PCG 2018/9DC1 includes a draft risk assessment framework outlining the ATO's compliance approach according to three risk zones. These risk zones are as follows:

Risk zone	ATO resource allocation	Key highlights/observations of the criteria
Low	No, unlikely	Includes a company that self-assesses as non-resident and is a resident of a foreign jurisdiction (that is not a tax haven), where one or more of the following apply. 1 The company ordinarily has their CMC in that foreign jurisdiction, but has one-off or temporary changes to their established governance practices that result in either meetings being held in Australia or directors attending meetings from Australia via modern communications technology. 2 The company is a subsidiary incorporated in that foreign jurisdiction and is subject to an Australian parent company's policies, proposals or approval processes and there is evidence demonstrating independent consideration and judgement by directors in making high-level decisions in that foreign jurisdiction. 3 The company has a wholly offshore operating business in that foreign jurisdiction, the company's tax position in Australia is substantially similar to what it would be if the company was an Australian resident, and a substantial majority of the company's CMC is exercised in that jurisdiction through: - board meetings that are held outside Australia, or - board meetings (including meetings via the use of modern communications technologies including teleconferencing) where the majority of directors are not present in Australia when such meetings take place, or - decisions by the board undertaken by circular resolution where the majority of directors are not present in Australia when such decisions are made.

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		4 The company intended to change its governance arrangements so that CMC was exercised outside Australia under the transitional compliance approach; however, did not meet all the criteria in paragraphs 102 to 104B of PCG 2018/9DC1, solely because it was unable to change its governance arrangements by the end of the transitional period (30 June 2023). This criterion only applies for the transitional period. **From 1 July 2023, these companies should reconsider their governance arrangements in line with TR 2018/5 and the draft PCG.**
Medium	Yes, more likely	Includes a company that self-assesses as non-resident, is a resident of a foreign jurisdiction and one or more of the following: 1. The company has a repeated or sustained lapses in directorial standards or corporate governance including in circumstances where there are only one or few people who make decisions in a closely-held private group, and it is difficult to ascertain in what capacity a person is making decisions in Australia (creating uncertainty regarding where CMC is exercised). This also includes circumstances where a company does not always keep contemporaneous board minutes and records that accurately reflect the company's high-level decision making. 2. The majority of directors of the company spend most of their time in Australia but are stated to make all high-level decisions in a foreign jurisdiction. However, the company's business or directors' circumstances and roles indicate that high-level decisions appear to be made more regularly or outside of board meetings in Australia. 3. There are circumstances relating to the exercise of CMC of the company that appear to lack a clear commercial basis. For example, the foreign jurisdiction where high-level decisions are ordinarily made may not appear to be compatible with the company's economic presence and operations and there may not be obvious commercial or other non-taxation reasons or connections to the jurisdiction. Alternatively, the directors do not appear to

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		ordinarily make high-level decisions in the jurisdiction in which the company is incorporated or there appears to be no clear commercial rationale for incorporation in the relevant foreign jurisdiction, such as where no or minimal staff are employed in the foreign jurisdiction and the company is highly reliant on its Australian parent or associates to enable its operations. 4. There are unusual circumstances such as the director's role or roles appearing to be undertaken by outsiders (such as ultimate shareholders or beneficial owners in closely-held private groups) in Australia who appear to make high-level decisions, or where one or more of the company’s directors are employed by its Australian parent and it is unclear to what extent the company’s high-level decision making is being dictated by the Australian parent. There may be a question of whether a person is merely influential or the real decision maker. 5. There appears to be some mismatch between legal form arrangements relating to residency outcomes and high-level decision making in substance, including some mismatch between where CMC is exercised as documented in available records and the substance of high-level decision making. 6. The company’s residency position relates to a broader set of taxation issues being reviewed by the Commissioner. 7. The company purports to have satisfied the criteria of the transitional compliance approach within the transitional period up until 30 June 2023, however, is unable to adequately demonstrate satisfaction of all the requisite criteria.
High	Yes, will likely be subject to compliance activity. May lead to audit.	Includes a company that self-assesses as non-resident and one or more of the following apply: 1. The company appears to not be a resident of any foreign jurisdiction. 2. There are facts suggesting that CMC is not exercised in any foreign jurisdiction.

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		3. Tax and profit outcomes in Australia do not appear to be commensurate with Australian operations – for example, where significant functions, assets and risks appear to be located in Australia including some high-level decision making, and no or minimal staff are employed in the relevant foreign jurisdiction; however, the company does not have an Australian permanent establishment or branch with attributable profits or income in relevant years. 4. There is an artificial or contrived arrangement affecting the location of CMC, including previous or subsequent 'migration' of residency. This does not include where there are genuine, commercial purposes for the migration. For these purposes, if board meetings are undertaken in a country where a company has a substantive commercial presence, the mere fact that a company may fly Australian directors overseas to attend those board meetings would not by itself be regarded as artificial or contrived. 5. A tax avoidance scheme exists whose outcome depends, in whole or part, on the location of a company's residence, including any arrangement identified in a Taxpayer Alert. 6. There are arrangements to conceal ultimate beneficial or economic ownership. 7. There are arrangements involving abuse of board processes such as backdating of documents or the board not truly executing its functions. This also includes where the details of board minutes are shown to be false or misleading. 8. Evidence indicates that there is no substantive high-level decision making in the jurisdiction in which the company is a resident (or in the foreign jurisdiction where it is asserted that CMC is exercised), including evidence of mere implementation, or rubberstamping, of decisions made by others or by directors without the exercise of independent consideration or judgment. The Commissioner does not anticipate that companies that maintain effective corporate governance (as described in Appendix 1 of PCG 2018/9DC1) would fall within this criterion.

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What should taxpayers consider now?

While the new risk assessment framework contains welcome recognition that one-off or temporary events outside of establish CMC governance practices do occur (and are low-risk), it reinforces the need to review the tax residency position and supporting documentation for companies, particularly subsidiaries of Australian groups.

With the transitional compliance approach in PCG 2018/9 ending on 30 June 2023, foreign-incorporated companies who relied on that approach and are uncertain about their residency status should read TR 2018/5 and the draft updated guidance in PCG 2018/9 to assess:

- how the ATO's view on CMC applies to them;
- the risk zone applicable to their residency position based on the CMC test;
- likely compliance treatment they can expect from the ATO; and
- any actions they should take to bolster or better evidence their CMC position in anticipation of ATO review.

The ongoing compliance approach for public groups, as outlined in PCG 2018/9, continues to apply where the requirements are met.

In addition, the new disclosure requirement in financial reports introduced in the Bill with effect from 1 July 2023 means tax residency of subsidiaries will need to be considered as part of their annual reporting and corporate governance processes. Coupled with the seeming likelihood of future RTP Schedule disclosure (under the self-assessed risk framework), this heightened focus on CMC requires careful attention to CMC policies, procedures and documentary support.

The ATO is seeking feedback on the PCG 2018/9DC1 by 28 July 2023. Please contact your KPMG Tax Advisor if you have any comments or would like to discuss the above.

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