THE TAX INSTITUTE

20 November 2018

Ms Karen Payne
CEO, Board of Taxation
The Treasury – Sydney Office
Level 5, 1999 Market Street
SYDNEY NSW 2000

By email: taxboard@treasury.gov.au

Dear Ms Payne,

Review of the Income Tax Residency Rules for Individuals

The Tax Institute welcomes the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the *Review of the Income Tax Residency Rules for Individuals* Consultation Guide (**Consultation Guide**). As Australian residence is one of the two foundation stones upon which Australia's taxation jurisdictional claim rests, the importance and potential impact of this review of individual residence cannot be underestimated.

Summary

Our submission below addresses each of the design principles in the Consultation Guide rather than focussing on each individual question. There are two overarching concerns, being:

- That the proposed changes ensure that the goals of certainty and simplicity are met and not frustrated by an integrity regime that seeks to deal with rare occurrences that arise not necessarily due to residence abuse but often due to the operation of other provisions of the Income Tax Assessment Acts; and
- That the reform proposals mooted in the Consultation Guide will expand the scope of persons caught by the rules. This is so notwithstanding the assertion that the stated intention (on page 26 of the Consultation Guide), is that the revenue impact of the measure will be 'immaterial or negligible'.

  Our view is based on the proposals which would include the development of a more adhesive residence rule, the creation of two clear bright-line tests (which may include the measurement of presence over any 12-month period) and a factor test coupled with revision of the superannuation test. Therefore, in light of these potential

impacts the Taxation Institute urges the Board to undertake the modelling and associated costings appropriate in the context of this major reform of Australia's jurisdictional change.

Discussion

1. Guiding Principles

The Tax Institute believes that a clear policy intention is essential in designing the reforms to the individual residence rules. This was evident in respect of the existing rules introduced in 1930 and 1939. They were:

- if a person is in fact residing in Australia then, irrespective of his nationality, citizenship or domicile, he is to be treated as a resident for the purposes of the Act (resides test); [1]
- to place public officials located abroad in the same position as foreign public officials representing their governments in Australia (domicile test); [2]
- to obviate the difficulties in establishing if a person is a resident in any country (more than half year test), [3] but to ensure that there was '... no danger of treating as resident persons who are purely visitors'; [4] and
- to bring within the Australian taxable field the salaries paid to locally engaged High Commission staff, who had recently been extended the benefits of the Commonwealth superannuation scheme (the superannuation test).[5]

The Tax Institute notes that although the Consultation Guide adopts a similar approach in the guiding principles (on page 7) and policy statement (on page 8) recognising the changes in mobility and the nature of work over the past 90 years, the lack of detail in the actual proposed design of the tests (e.g., number of days) makes it difficult to gage the impact of the proposed rules.

In terms of the guiding principles (which seem to express equity as an outcome of the operation of those principles rather than an objective), the Tax Institute would urge the Board to ensure that the goals of certainty and simplicity, in particular, are met and not frustrated by a complex integrity regime that seeks to deal with, what appears to be, rare

1 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 9.

2 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10. The Government had identified that the High Commissioner for Australia in London did not pay tax in Australia as services were rendered outside Australia; they were exempt from British income tax and received the general exemption available to residents on their Australian source income. A J Baldwin and J A L Gunn, *The Income Tax Laws of Australia* (1937), 61, note that "... since 1930 High Commissioners for Australia and Agents-General for the Australian States, together with members of their staffs and other public officials who are located abroad, have been treated as residents of Australia."

3 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 11.

4 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 11.

5 Commonwealth, *Parliamentary Debates*, House of Representatives, 21 September 1939, 964 (Sir Percy Spender, Assistant Treasurer).

occurrences of dual non-residence, or arise due to the operation of other provisions of the Income Tax Assessment Acts, rather than residence rule abuse.

For example, (subject to the new yet to commence anti-hybrid rules), a taxpayer who becomes a US resident will get the fully franked dividends tax free under both the US and Australian rules even where the profits giving rise to those dividends accrued in a Proprietary Limited Company whilst the taxpayer was an Australian resident shareholder. The tax-free nature arises from the franking/withholding rules, not the residence status of the taxpayer.

The revised rules should deliver simplicity and certainty for the vast majority of individuals. It must also be recognised that there exists in Australia's domestic law, Foreign Income Tax Offset rules and an extensive treaty network containing rules that will overlay these newly developed rules, which together will ameliorate double taxation issues in most cases.

2. Bright-line test

The Tax Institute notes that the recommended changes remain consistent with international norms in respect of individual residence, which is generally based upon an individual's facts and circumstances and combined with a 183-day test. The major change under the Board's model is to give primacy for inbound individuals to a day count test, with specified facts and circumstances underlying the secondary test.

The Tax Institute supports the adoption of a 183-day test for inbound individuals. It also supports the adoption of rules to minimise avoidance by persons leaving the country before the specified time period is satisfied and returning once the period restarts by adopting a test that seeks to take into account presence in prior years. This is the international norm and is adopted in jurisdictions such as Norway,[6] the United States and Ireland.

Such a test would treat both temporary residents and working holiday makers as residents, but the existence of specific rules that vary the scope of income caught and the rate of tax applicable (respectively) should not be affected. The fact that the working holiday maker rules potentially breach the non-discrimination article adopted in most post-2003 Australian treaties is likely to have a greater impact.

In a departure from Recommendation 4 of the Board of Taxation, *Review of the income tax residency rules for individuals (*2017), which recommended a single outbound test the proposal is now for three different bright-line outbound tests for individuals. This departure seems to complicate rather than simplify matters. The previous resident test

6 A taxpayer who has stayed in Norway for at least 183 days in a 12 month period is a resident. If spread over two years, then residency occurs in the year in which the 183 days requirement is satisfied. Residency is deemed to occur where the individual's total presence in the country is 270 days in a three year period (i.e. an average of 90 days per year). Loss of residency only occurs if residency is established in another state and the person does not have a permanent home and has spent less than 61 days in Norway.

seems sufficient to establish an outbound bright line test, that is, if any individual spends less than x days in Australia over any 12-month period (i.e., not tied to a financial year) they are a non-resident. This test could also be applied to take into account presence in prior years, thereby minimising avoidance by persons leaving the country before the specified time period is satisfied and returning once the period restarts.

The need for the 'previously not a resident' test seems unnecessary and from a policy viewpoint seems to undermine the inbound bright-line test. It seems to provide that if a person enters Australia for the first time and exceeds 183 days, then under this test the residence determination is reversed and treats them as a non-resident if they are here for more days than a person who was formerly a resident. This is because they are resident for the first time. This different treatment cannot be justified on the adhesive principle. In fact, it undermines that principle by saying it is only adhesive if you are a serial resident. For consistency and certainty, the Factor test should be the instrument used to exclude them.

The third test seems to reinstitute the former scope of section 23AG and extend its scope further by treating persons working full-time in non-taxing jurisdictions as non-residents. The only difference between this and other departing Australians is a continuing employment relationship with an Australian employer and that the employment must be full-time.

This leads to definitional issues on what amounts to full time work and whether the employment must be with the Australian employer or with an affiliated entity. For example, if fulltime work is defined in terms of hours, then this this can be problematic as some European countries' labour laws mean that full time can range from 28 hours to 38 hours. In these countries if you work longer weeks you get longer holidays. In the gig environment fulltime work as traditionally defined may not exist, with a person renumerated per task or on a piecemeal basis. Verification can be difficult for people who are employed by companies they control. If someone is posted overseas for two or three years, then they will either fall outside the bright-line outbound test or succeed under the factor test. Therefore, this test will increase complexity and is inconsistent with the guiding principles listed on page 7 of the guide and Recommendation 4.

Finally, Recommendation 7 of the Board of Taxation, *Review of the income tax residency rules for individuals (*2017), recommended 'that the new residency test for outbound individuals ensures that all residents remain resident unless and until tax residency is established in another jurisdiction.' The Tax Institute notes that it appears that this recommendation is not picked up in the proposed out-bound tests. Given that it is easy to acquire 'tax residence' in a number of countries around the world (e.g., Portugal) whilst in other countries it may be difficult to establish tax residence where the country does not have an income tax system (e.g. Lebanon), such a rule would result in inequitable outcomes in some cases and encourage avoidance in other cases. As such, the Tax Institute believes that recommendation 7 should not be adopted.

3. Factor test

The relevant factors to be used under the secondary test should all be easily verifiable. They also need to be highly relevant in determining residence under the secondary test. Some factors that currently get taken into account under the existing residency tests (and suggested in questions 11 to 17) are of little relevance (e.g., immigration passenger cards, membership of clubs, driver's licences, holding of bank accounts, and health insurance), or able to be manipulated, or do not take into account the practical circumstances of modern life (e.g. the inclusion of family members as a linking factor regardless of dependence, age and estrangement).

The other issue is weighting. Any weighting system would no doubt add some complexity. However, we consider there may be merit in exploring a weighting system as a secondary factor-based test as the Consultation Guide suggests, provided it is based on a short list of objective factors and it is clear what 'weighting' is allocated to each one.

4. Integrity

It is not considered that any new rules will significantly change the residency status of the majority of Australian taxpaying residents. With this in mind, any measures to preserve the integrity of the rules should be targeted so that they do not involve a compliance burden on a large number of taxpayers.

During the consultation process there was strong support for a bright-line test based solely upon a number of days, supplemented by the 'easy' application of Part IVA and from other participants support for a citizen test (similar to the United States). The Tax Institute does not support either proposal. Part IVA is not an appropriate integrity rule in this context. It would lead to more uncertainty and complexity. Similarly, the Tax Institute recognises the uncertainty that would result from a citizen test (which includes a permanent residence test) given the numerous visa categories that exist in Australia. In addition, such tests impose continuing compliance issues on non-resident citizens/permanent residents long after they, for all practical purposes, no longer reside in Australia.

5. Superannuation test

As discussed above, the superannuation test was never intended to cover all government employees, nor even cover all Commonwealth public servants. It was believed in 1930 that Government officials were covered by the domicile test. As far as we are aware, the first public claim that the test was a government service residence rule only first emerged in an Explanatory Memorandum in 1992 in respect of an amendment to insert a reference to a superannuation scheme established under the Superannuation Act 1990.[7]

7 Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1992 (Cth) 181.

As the use of government service tests is an international norm, it makes sense to adopt such a test to overcome any uncertainty. Similar to the Canadian and New Zealand tests it could cover both Federal, State and Territory public servants, diplomats and members of the defence forces.[8] The New Zealand approach is to deem all government employees (civil servants) acting in any capacity for the government (exercising their duties) to be residents.[9] The 'acting in any capacity for the government' gloss is important as it would exclude persons who are government officials but are not carrying on official duties (e.g. a government official on leave without pay engaged in foreign aid work). The test could also include local government employees on the basis that Article 19 of Australia's tax treaties gives Australia the sole right to tax local government employees.

The inclusion of the spouse and dependants of the taxpayer less than 16 years in the superannuation test in s 6(1)(a)(iii) was to entitle the High Commission officials to dependency deductions (concessionary rebate/tax offsets). To capture persons within a new Government services test, who would not otherwise be residents, merely because they enjoy a familial relationship with a public servant is inequitable. Such a rule also appears to amount to discrimination based upon marital status. This is inconsistent with the intent of the United Nations *Convention on the Elimination of All Forms of Discrimination against Women*[10] and the *Sex Discrimination Act 1984* (Cth).[11] However, it would appear that such discrimination is not strictly illegal under the Income Tax Assessment Act 1936 as that Act is exempt under section 40(2)(c) of the Sex Discrimination Act 1984. A similar exemption does not exist for the Income Tax Assessment Act 1997.

6. Part-year residency

Under the current 'resides' and 'domicile' tests part year residence is possible as it is a factual determination on when residence begins[12] and ends, when domicile ends, and when a permanent place of abode is established. However, it is not certain that residency commences from the date of arrival in Australia under the 183-day test. The older precedents indicate that a finding of residency under the 183 day test deems the person to have been resident for the whole year,[13] while a more recent Board of Review case indicates that apportionment is possible.[14] Although the pro-rating of the tax-free threshold may solve some problems, the potential inclusion of otherwise exempt offshore income derived prior to arrival in Australia remains an equity issue.

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8 *Income Tax Act* RSC C 1985 (Can), s 250(1)(b) & (c).

9 *Income Tax Act 1994* (NZ) s OE1(5).

10 GA Res 34/180, UN GAOR, 34th sess, 107th plen mtg, 193, UN Doc A/Res/34/180 (1979). Article 9.1.

11 The United Nations *Convention on the Elimination of All Forms of Discrimination against Women* is incorporated into Australian law via the *Sex Discrimination Act 1984* (Cth).

12 *Case 29* (1985) 28 CTBR (NS); *Case S19* 85 ATC 225.

13 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774; 4 ATD 397; 1 AITR 201.

14 However, the case cited in support of part year residence may have limited precedence value as *Case 29* (1985) 28 CTBR (NS); *Case S19* 85 ATC 225 was concerned with departure from Australia. The Board found the purpose of the 183 day test is to aid in determining residency and it plays no part in determining when someone departs Australia - see especially PM Roach at 248 and 232 respectively.

As the bright-line test is similar to the current 183-day test it does make sense to clarify when residence commences and ceases if this can be achieved simply. And there would seem to be no better proxies than the day of arrival or departure. Part-year residence should not be an issue under the factor test for the reasons discussed above in respect of the current fact-based tests (the resides and domicile tests).

Treaty issues

There may be treaty override issues for many of Australia's pre-2009 comprehensive tax treaties. Prior to 2009, Australia consistently departed from the OECD Model Convention in respect of Article 4(1) by not using the 'liable to tax' criteria in the first sentence of Article 4(1) in defining 'persons' as resident for the purposes of its treaties. Australia preferred to define an Australian resident under those tax treaties in terms of Australia's domestic law (i.e., 'a person who is a resident of Australia for the purposes of Australian tax'). The reason for this departure has not been revealed but the reasoning could be due to concerns that the liability to tax would not capture persons who were caught under the superannuation test but were not liable to tax. A similar problem arises with Australia's nine Additional Benefit Agreements[15] which adopt the same approach.

The problem with this approach is that the treaty partners had agreed to a treaty which links directly to the existing domestic rules. If these rules change then the new rules are not those to which they agreed in those pre-2009 tax treaties. This change could be perceived by these treaty partners to be a unilateral alteration to terms of their existing tax treaty. This did occur when the Australian Taxation Office (ATO) sought to argue that the CGT rules introduced in 1985 applied in the context of Australia's pre-1985 treaties.

In eight of the pre-2009 treaties, Australia's treaty partners opted for the OECD wording in defining residence under the treaty rather than the domestic law approach that was adopted by Australia.

This may not be such a problem post-2009 as Australia moved away from reliance on the domestic law by adopting the OECD Model Convention's 'liable to tax' terminology.

7. Transition rules

As the proposed outbound rules intend to treat taxpayers differently where they were previously a resident, there is a possibility for some disputation as an individual will need to use the current residency rules to determine their prior residence. However, given the ATO's compliance focus on individual residence over the last 10-year period (which principally arose from the narrowing of section 23AG) and the perceived uncertainty in those residence rules, the level of litigation was minimal (36 cases over 10 years) given that there are over 14 million individual taxpayers. Thus, the likelihood of large scale disputation should be low. Therefore, a specific transitional rule to deal with such a potentially minuscule disputation rate would only add complexity and could potentially

[15] These are additional negotiated agreements less comprehensive than Double Tax Agreements, e.g., with places like the Cook Islands, Mauritius and the Isle of Man.

give rise to planning opportunities. If the outbound tests were combined into a single test with the same adhesiveness, then there would be no disputation.

However, compliance costs for employers, advisors and the community could be reduced by the adoption of a deferred date of effect in respect of the new rules. One approach may be for there to be a minimum of at least a nine-month gap (preferably 12 months) between enacting the new rules and the commencement date of the new rules. This would give time for employers to adjust systems and processes and would give taxpayers adequate time to determine their new status.

8. Other Matters

We note there are some matters that have not been considered in the Consultation Guide that should be considered by the Board when reviewing the individual residency test.

i) Interaction between tax residency and Fringe Benefits Tax – where an Australian tax resident works overseas for six months and receives fringe benefits that would be exempt if they were in Australia, the benefits are taxed in their hands. This is an incongruous outcome.

ii) Residency requirements and self-managed superannuation funds (SMSF) – there is a requirement in the definition of 'Australian superannuation fund' that the controllers and members of an SMSF must be Australian tax residents. Complexity arises if a member or controller changes their residency status. The ATO has no discretion to prevent a change in residency of a member or controller from causing the SMSF to breach the rules. This is an unnecessary complexity in the law.

iii) Foreign resident CGT withholding regime – the individual residency test has a flow-on effect on the foreign resident CGT withholding regime. If the individual residency test is kept simple, this will assist in keeping determinations required under the foreign resident CGT withholding regime to be made more simply.

If you would like to discuss any of the above, please contact either myself or Senior Adviser, Bruce Quigley on 02 8223 0011.

Yours faithfully,

Tracey Rens
President