ASSOCIATION OF CONSULTING ENGINEERS AUSTRALIA

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SECTION 23AG OF THE INCOME TAX ASSESSMENT ACT (1936)

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An ACEA submission to the Senate Standing Committee on Economics

ACEA SUBMISSION

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The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

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INTRODUCTION

ABOUT THE ACEA

The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

There are over 270 firms, from large multidisciplinary corporations to small niche practices, across a range of engineering fields represented by the ACEA with a total of some 45,000 employees.

The ACEA presents a unified voice for the industry and supports the profession by upholding a professional code of ethics and enhancing the commercial environment in which firms operate through strong representation and influential lobbying activities. The ACEA also supports members in all aspects of their business including risk management, contractual issues, professional indemnity insurance, occupational health and safety, procurement practices, workplace/industrial relations, client relations, marketing, education, sustainability and business development.

SECTION 23AG OF THE INCOME TAX ASSESSMENT ACT (1936)

Section 23AG provides an exemption from Australian income tax for income earned in overseas employment by Australian resident individuals. The exemption applies to foreign earnings derived from service in a foreign country for a continuous period of 91 days or more. Such income would otherwise be subject to Australian tax at the individual's marginal rate, with a credit provided for foreign tax paid.

THE ACEA POSITION

The ACEA believes that the Federal Government's proposed amendments to Section 23AG of the Income Tax Assessment Act (ITAA) (1936) are not in Australia's best interests. The implications of the amendments will be: direct upward pressure on costs for firms, a disincentive to employ Australian residents, a disincentive for skilled workers to remain employed in Australia, delays and complications in obtaining the appropriate tax offset documentation from foreign governments, complexities arising out of differing financial years, and a disincentive for Australian firms to export. Therefore, the ACEA proposes that the legislation be left unchanged, and Australian workers operating overseas continue to be incentivised through an Australian income tax exemption.

However, the ACEA acknowledges that the Australian economy is in the midst of a substantial downturn, and this necessitates substantial fiscal stimulus and a temporary Federal Budget deficit, complemented by a strategy to return to surplus. Therefore, should the Government see no alternative to amending this section of income tax legislation, then including the consulting engineering industry in the exempt criteria of foreign service is an advisable course of action. The ACEA would therefore recommend the following legislative change to Section 23AG of the Income Tax Assessment Act (1936).

RECOMMENDATION:

After subsection 23AG(1)

(1AA) However, those foreign earnings are not exempt from tax under this section unless the continuous period of foreign service is directly attributable to any of the following:

(a) the delivery of Australian official development assistance by the person's employer;

(b) the activities of the person's employer in operating a public fund covered by item 9.1.1 or 9.1.2 of the table in subsection 30-80(1) of the *Income Tax Assessment Act 1997* (international affairs deductible gift recipients);

(c) the activities of the person's employer, if the employer is exempt from income tax because of paragraph 50-50(c) or (d) of the *Income Tax Assessment Act 1997* (prescribed institutions located or pursuing objectives outside Australia);

(d) the person's deployment outside Australia as a member of a disciplined force by:

(i) the Commonwealth, a State or a Territory; or

(ii) an authority of the Commonwealth, a State or a Territory;

(e) an activity of a kind specified in the regulations.

(f) an activity deemed to be a consulting engineering service

THE CONSULTING ENGINEERING INDUSTRY

Consulting engineering is one example of an industry in Australia that will be adversely impacted by the Government's proposed changes to Section 23AG of the ITAA (1936). Critical industries such as this one have developed an international reputation for professional excellence and are consequently successful exporters of their services.

The following information outlines the critical economic contribution made by the consulting engineering industry. The information has been obtained from the ACEA *Outlook for Consulting Engineering May 2009* economic report[1]:

Industry Size

There are an estimated 17,000 firms in the Australian consulting engineering industry, employing approximately 130,900 people.

Revenue

In 2007-08, the consulting engineering industry is estimated to have generated $20.9 billion in revenue, equal to 2 per cent of national GDP ($1,046 billion).

Employment

Approximately 130,900 Australians are employed in the consulting engineering industry, including engineering and technical professions. Employment in the industry has risen 66 per cent since 2001/02.

[1] G. Bills and M. King (2009), Association of Consulting Engineers Australia (ACEA), Outlook for Consulting Engineering

Exports

In 2007/08, exports of the industry's services were to the value of $1334 million. The industry's exports accounted for 2.6 per cent of Australia's total service exports. Over the last five years, the industry has accounted for nearly two thirds of all construction and related services exports.

SECTION 23AG AND ITS VALUE

Section 23AG is highly advantageous to firms in industries, such as consulting engineering, as it:

INCREASES THE COMPETITIVENESS OF AUSTRALIAN FIRMS

Section 23AG is critical to the competitiveness of consulting engineering firms in winning international tenders. The exemption from income tax ensures Australian consultants and contractors are not disadvantaged against foreign competitors. It allows consulting engineering firms to tender more price-competitive bids for contracts, as the cost of labour is substantially reduced. The gross salary that the firm pays an Australian resident working overseas is likely to be less than the gross amount payable for a project in Australia. This is made possible by the low foreign income tax rate. The employee is able to come away from the overseas project with a more generous after-tax income than would have otherwise been applicable in Australia, despite the fact that the gross salary is comparatively low according to Australian industry standards. This arrangement is suitable for the employing firm as the cost of paying the worker is lower; however the employee enjoys the benefit of receiving a more generous salary package.

CAN LEAD TO FOLLOW-ON WORK IN THE OVERSEAS REGION

One successful international contract win can result in flow-on work in the overseas region. As Australian engineers and associated professionals consistently perform strongly for overseas clients, they are frequently sought after for additional work. The additional work can be made up of either, offering supervisory technical expertise on the project, or an entirely separate project(s) that may require similar expertise. Therefore, it must be stated that if Section 23AG can offer a fee-based advantage to an Australian firm that leads to the awarding of a single overseas contract, the benefit will be even greater with the follow-on work that is likely to be awarded based on performance, convenience and experience in the region.

PROVIDES AN OPPORTUNITY FOR FIRMS TO UP-SKILL THEIR WORKERS

Australian service exporters, including consulting engineering firms, look upon overseas projects as an opportunity to develop and expand the skill sets of their professionals. As individual countries pursue their own competitive advantage, professionals, such as consulting engineers, are presented with the opportunity to operate on projects in industries that are not a strong focus within Australia, such as manufacturing. Basic manufacturing makes up a very small proportion of overall GDP in Australia, and therefore engineering professionals employed in the country receive limited exposure to engineering practices associated with the industry. Therefore, if a project associated with the manufacturing industry in an alternative country were to arise, Australian engineering firms would look upon it as an invaluable opportunity to up-skill their workers.

Nations around the world are presently calling for tenders on projects that are typically not feasible in Australia, and they present a tremendous opportunity for Australian firms to up-skill their workers. An example of this type of project can be found below:

EXAMPLE:

North Africa's colossal Autoroute Transmaghrebine road construction project, which will cross the top of the continent east to west, will stretch more than 3200km when complete. Once completed, the motorway is planned to connect the Maghreb states of Morocco, Algeria, Tunisia and Libya. Numerous machines from the Wirtgen Group are being employed for this project, including 36 Vogele pavers, 30 Hamm rollers and Wirtgen slipform pavers for building the concrete crash barriers. The Algerian section of the Autoroute Transmaghrebine motorway is being constructed with three lanes in each direction.[2]

A project of this nature is a rare opportunity for Australian consulting engineers. This single project spans four countries, using skilled workers from all over the world; providing an invaluable opportunity for Australian workers to gain exposure to the skills and expertise of international professionals. Consulting engineering firms look upon a project like this as an opportunity to develop their engineers and associated professionals. If Australian consulting engineering firms were to be excluded from the Section 23AG exemption, these firms would have diminished opportunities to do this.

PROVIDES AN INCENTIVE FOR ENGINEERS EMPLOYED IN AUSTRALIA TO REMAIN IN THE COUNTRY

The ACEA would assert that Section 23AG is an incentive for engineering professionals to remain employed in Australia. Consulting engineers are less enticed by employment in other countries, as they are able to take advantage of the high standard of living in Australia, but enjoy the array of benefits that come from working on occasional overseas projects. They can achieve career development and gain alternative cultural experiences, yet take advantage of Australia's desirable working conditions and one of the highest standards of living in the world.

OBSTACLES ENVISAGED SHOULD SECTION 23AG BE AMENDED AS PROPOSED

Should the Federal Government proceed with its proposed amendments to Section 23AG, the ACEA envisages the following significant problems for Australian firms exporting overseas:

[2] Construction Industry News: Trans-African Highway Underway, 9 January 2009

SIGNIFICANT INCREASE IN COSTS

At present, Australian employees are incentivised to work overseas through generous levels of income taxation in foreign countries. In regions, such as Hong Kong, marginal income tax rates can be as low as 16 per cent. The subsequent benefit for the employing firm is the capacity to tender a very price-competitive bid as the payable salary package may be comparatively low compared to that of an Australian project, however the individual's after-tax outcome is far more generous.

If the current exemption were to become inapplicable, consulting engineering firms would still need to pay a fair remuneration to overseas consultants and contractors, and would therefore be forced to supplement wages in order to achieve the fair remuneration. This will have the effect of substantially eroding into the margins of Australian firms. Australian companies would have no choice but to operate under tighter margins, or enter into international tenders with less price-competitive bids.

EXAMPLE:

A high income-earning professional paying 16 per cent income tax in Hong Kong for 18 months will also have to pay 46.5 per cent in Australian tax. Eventually, the tax payer will be entitled to a credit on the foreign taxation levied. However, the employee has effectively been subjected to nearly a tripling in the level of taxation. The employee is likely to subsequently ask for the employer to supplement their remuneration package in order to achieve the same after-tax income as previously given.

The ACEA believes that the Government's proposed changes to Section 23AG will ensure this type of scenario will arise for many consulting engineering firms, as well as a host of varying Australian firms operating overseas. In many cases, the employee will be looking to renegotiate existing employee contracts and pass this cost back to the employing firm. **One ACEA member firm has advised the Association that they estimate that this legislative amendment could add in excess of $5 million to either the firm's costs, or that of their employees'.**

TAXATION RECORD KEEPING

Taxation levied in foreign countries can be paid in any one of the following ways:

1. Australian firm pays to the government of the host country;
2. Australian firm pays to the government of the host country, but is then refunded for the cost by the overseas client; and
3. The client of the overseas country bares the taxation liability on behalf of the Australian firm

One Australian consulting engineering firm has advised the ACEA that, in their experience, the latter two options are the most common scenarios. Two subsequent problems arise. The first, is the question of who is responsible for obtaining the tax receipt from the government of the foreign country. Secondly, problems will arise with determining who is entitled to the tax credit and the administration of the refund, the individual or the firm.

Given the variation in scenarios, there is an undeniable concern over the means by which the Australian Tax Office (ATO) will be able to ascertain records that clearly indicate what foreign taxation

was levied and paid during the period of work. Ascertaining tax receipts from work carried out in foreign countries will present an enormous challenge for both individuals as well as the ATO. The Department is likely to frequently encounter great difficulty in obtaining tax receipts in an accurate and timely manner.

DIFFERING TAX YEAR ENDS IN OVERSEAS COUNTRIES

Under the proposed changes, income tax will be paid in both Australia and the foreign country and a tax credit for the overseas taxation will be applicable. However, there will be significant administration in gathering the information for different year ends. Delays from the ATO are likely to be unavoidable should the foreign county's financial year be incomplete. The ACEA envisages hypothetical complicated scenarios such as the following:

EXAMPLE:

An Australian consulting engineer works on an overseas project in Hong Kong for a period or 12 months commencing in May 2009. They are required to report their foreign income and taxation levied in their tax return for the financial year 2009/10 in July 2010. They are subsequently taxed by the Australian Government at their marginal rate. The ATO then immediately seeks to credit the tax payer for the income tax levied in the foreign country. However, that foreign country's present financial year does not finish until 31 March, 2011. The ATO or the tax payer is unlikely be in a position to ascertain the tax receipt for the income earned from March 2010 to May 2010 from the Hong Kong Government until April 2011 at the earliest. The tax payer is therefore unlikely to receive their full tax credit until at least April 2011.

The ACEA expects delays and complications such as those described above to be recurrent should the proposed legislative changes proceed.

DIFFERING OVERSEAS TAX RATES & DOCUMENTATION REQUIREMENTS

The ACEA understands that the ATO is currently unsure as to what sort of documentation will be required to determine the rate and the amount of taxation levied in the overseas country. The ACEA would argue that no simple and easy solution to this obstacle is readily available.

The ACEA is of the inclination that there are really only two options available to the ATO in determining the foreign marginal income tax rate that the Australian worker was subjected to. The first option is for the ATO to keep a rigorous watching brief on marginal tax rates on every continent, all around the world. This will undoubtedly be an arduous task, given that overseas governments, like the Australia Government, adjust marginal tax rates frequently according to the extent to which they deem the domestic economy requires stimulation.

The second option is reliance upon supporting documentation in the form of a tax receipt, to either be obtained directly from the issuing government or the tax payer themselves. Some countries that Australian employees operate in will be in a position to offer thorough documentation supporting the taxation levied, however a strong proportion will not. The question of what the ATO will do in the case

of the latter scenario will need to be addressed. If the comprehensive supporting documentation is unavailable, the ATO will not be in a position to properly verify the amount of taxation levied.

FRINGE BENEFITS TAX WILL BE LEVIED BY THE ATO

Under the proposed amendments to Section 23AG, the firm employing the Australian worker will now be liable for fringe benefits tax (FBT) on benefits given to the employee, further increasing costs. The impact on Australian businesses will be adverse. A large number of Australian residents working overseas for extended periods of time are provided with benefits such as accommodation, a motor vehicle, school fees for children, computer-related equipment; etc in the overseas country. The combined value of these benefits distributed to a single tax payer is substantial. The qualification of these benefits for FBT will subsequently impose significant costs on the employing firm in the form of additional tax payable to the Australian Government. Once again, Australian companies will therefore have no choice but to operate under tighter margins, or enter into international tenders with less price-competitive bids.

IT WILL ACT AS A DISINCENTIVE TO EXPORT SERVICES

An exclusion of Australian firms from eligibility for Section 23AG is likely to negatively influence their decisions to export services. The cost of employing workers on overseas projects will have risen significantly, and therefore firms will reconsider exporting their services. According to the Australian Bureau of Statistics (ABS), in 2004/05 services accounted for 22.8 per cent of exports ($35 million). Given this strong contribution from service exports to the broader economy, the economic repercussions would be substantial.

IT WILL ACT AS DISINCENTIVE TO EMPLOY AUSTRALIAN RESIDENTS

The ACEA believes that, in light of the additional cost that this proposed legislative amendment will transfer to Australian firms, employers will less inclined to employ Australian residents to work on overseas projects. Employers will be forced to look seriously at employing non-Australian residents as a means of reducing overall costs.

SKILLED EMPLOYEES WILL CONSIDER RESIDING IN ALTERNATIVE COUNTRIES

Should working Australian residents be excluded from the benefit of low marginal tax rates in foreign countries, such as Hong Kong, they are likely to consider residing and working in overseas countries as opposed to Australia. If skilled workers can reside in an alternative country, and yet still work in various locations around the world with low marginal tax rates; many certainly will. In addition to this, skilled workers residing in overseas countries may not want to come and work in Australia.

It is extremely important that the Government implement incentives to remain employed in Australia, like Section 23AG, as there is a present shortage of consulting engineers in the country. There is a current estimated shortage of 28,000 engineering professionals in Australia. Incentives such as the Section 23AG exemption must be retained and enhanced to prevent any exodus of engineering professionals from Australia.

It is well known that Australia is in the midst of an economic downturn, resulting from a global recession. The Federal Government is responding quickly with an unprecedented investment in nation-

wide infrastructure. Now, more than ever, is the Government in need of stability in the consulting engineering industry. Initiatives, such as Section 23AG, are an incentive for engineers to maintain their employment in Australia, and are necessary to sustain the consulting engineering industry.