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Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Email**:** economics.sen@aph.gov.au

Dear Sir

**Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009**

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to provide comments in relation to the *Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009* (**Bill**). This submission relates solely to the proposed changes to s 23AG of the *Income Tax Assessment Act 1936* (**ITAA 1936**) (i.e. the income tax exemption for Australians working overseas) as outlined in the Bill.

The Taxation Institute has concerns regarding the proposal to limit the scope of s 23AG solely to aid, charitable and certain government workers. Specifically, the Taxation Institute is concerned about the impact of the proposed amendment on:

- ***Individual taxpayers*** – it will add complexity to tax law and administration which will impact unfairly on ordinary Australians working overseas and limit opportunities for Australian workers to work overseas; and
- ***Australian businesses*** - it will impose additional costs on Australian companies employing Australian residents overseas and therefore reduces their competitiveness and opportunities to expand their businesses internationally.

With over one million Australians working overseas, the compliance costs associated with this measure will be immense. Given this multi million dollar compliance cost imposition, the Taxation Institute is concerned that there has been no attempt by the Government to mitigate the impact of the new compliance obligations which will arise as a result of this amendment nor deal with the harsh financial effects arising from the interaction between the proposed s 23AG, the Foreign Tax Offset **(FTO)**, Pay-as you-go **(PAYG)**, Fringe Benefits Tax **(FBT**) provisions and Australia's tax treaties.

As some taxpayers will be affected from 1 July 2009 (refer discussion below), the Taxation Institute recommends delaying the introduction of the proposed alteration of s 23AG until consequential amendments can be enacted simultaneously. Such consequential amendments are vital to deal with the impact of the amendments on Australians working offshore.

The Taxation Institute's concerns are outlined in detail below.

## 1. Individual taxpayers

In relation to individual taxpayers, the Taxation Institute's main concerns relate to the following issues:

- the application of the foreign tax offsets;
- the application of the PAYG provisions; and
- the determination of the residency status of individual taxpayers.

Each of these concerns is discussed in detail below.

### *Foreign tax offset provisions*

The Taxation Institute's concerns in relation to the FTO provisions can be summarised as follows:

- The FTO rules were not designed with the intention that they would generally apply (subject to relief being available under a DTA) to all Australians working offshore;
- The application of the FTO provisions will place a large compliance burden on individual taxpayers due to the complexity of these provisions; and
- There will be timing mismatches as a FTO will only be available where foreign tax is "paid".

Section 23AG of ITAA 1936 was introduced as part of the former foreign tax credit system for the purpose of ensuring the administrative integrity of that system by removing many small taxpayers from its operation (see *Explanatory Memorandum, Taxation Laws Amendment (Foreign Tax Credits) Bill 1986 (Cth)*, 22). Australia's double taxation agreements (**DTAs**) also operate to remove many Australians working offshore from the Australian tax net. Generally, the taxing right in respect of salary income is allocated to the country of source under Australia's DTAs (provided that the 183 day rule is satisfied).

Both the original foreign tax credit rules in the ITAA1936 and the revised foreign tax offset (**FTO**) rules in Division 770 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) were designed, and have operated, only to deal with FTOs of sophisticated taxpayers and on the rare occasions with the small amounts of foreign income not excluded by s 23AG (as illustrated by the $1,000 limit under s 770-75(2) of the ITAA 1997). They were not designed with the intention that they would generally apply to all Australians working offshore (subject to relief being available under a DTA).

The application of the FTO provisions will impose a large compliance burden on unsophisticated taxpayers. The compliance cost concerns arise primarily from the fact that, as noted above, the FTO rules in Division 770 of the ITAA 1997 are ill equipped to deal equitably with the large number of affected ordinary working Australians as it was designed within the policy setting of only a small number of individual taxpayers being within its scope (via s 23AG of the ITAA 1936).

The Taxation Institute considers that the need to apply the FTO provisions will force individual taxpayers working offshore who are not currently using tax agents to use a tax agent to prepare their income tax return. For example, taxpayers will need to understand and prove that they have satisfied the "tax paid" requirement. This will be difficult in jurisdictions where there is no requirement to lodge an income tax return (e.g. United Kingdom and New Zealand). In the Taxation Institute's view, individual taxpayers will need tax agents to provide advice on such issues. Further, tax agents will need to be fully skilled up to provide advice on these areas.

The "tax paid" requirement will also result in timing mismatches between when a taxpayer is considered to have "paid" foreign tax for the purposes of the FTO provisions and when they are liable for Australian tax. This could occur whenever a taxpayer is working in a country which has a different year end for tax purposes than Australia (eg the US and the UK both have different year ends to Australia). These timing differences will adversely affect the cash flows of these salaried taxpayers, as taxpayers will have to meet a tax liability levied without regard to potential FTO for some months before the FTO can be claimed.

Further, individual taxpayers will incur additional compliance costs arising from the need to file amended assessments on an annual basis to claim FTOs which are "paid" in respect of prior year income. Additional complexity will also arise as individual taxpayers will have to determine what income period the FTO is referable to.

***PAYG provisions***

The PAYG withholding rules do not apply in relation to income which is exempt under s 23AG. However, as a result of the proposed changes to limit the scope of s 23AG, many employees who were previously exempt from the PAYG withholding provisions will now be subject to these provisions. This will be the case regardless of whether they are working for Australian or foreign employers.

Double PAYG withholding could arise, for example, where an individual taxpayer is working in a non-DTA country (eg Greece) and being paid by a non-resident employer. Assuming that the relevant non-DTA country imposes PAYG withholding on the individual, the individual could be subject to double PAYG withholding (i.e. PAYG withholding overseas and PAYG in Australia).

The possibility of double PAYG withholding will occur on a year by year basis because the PAYG instalment rate will be set without regard to any FTOs which may be available. Accordingly, individual taxpayers will need to fund their PAYG instalments on a monthly or quarterly basis in addition to funding any PAYG instalments offshore.

***Residency***

It is well-known that a large number of Australians, of all ages and from all walks of life (including executives of multinational companies, professionals, backpackers and students) travel and work overseas for extended periods.

Under the current s 23AG, the issue of residency was largely ignored as Australians working overseas were either:

- residents and therefore their foreign income was exempt under 23AG; or
- non-residents and therefore not assessable on their foreign source income.

Individual taxpayers working overseas will now have to seek advice on whether they are still "residents" for Australian tax purposes. Although some large Australian companies mistakenly use a two year rule of thumb in relation to their employees who are posted overseas, there is no legal basis for doing so. The specific facts and circumstances of each individual taxpayer working overseas will have to be considered to determine whether they are, in fact, residents of Australia for tax purposes.

It will become necessary, on a case-by-case basis, to determine whether an individual who has gone overseas has:

- ceased to be a "resident of Australia" - on the basis that their "permanent place of abode is outside Australia" (refer s 6(1) of the ITAA 1936). In which case, they will not have to report foreign employment income in Australia. However, there may be other tax implications (eg deemed disposals under the CGT provisions); or
- remained a resident of Australia - in which case (and most likely completely unknown to them) they will be required to continue lodging Australian income tax returns, even though they may well have no other Australian source income.

Given the lack of clarity in the legislation and case law surrounding the residency status of individuals, the Taxation Institute considers that this would place an onerous burden on individual taxpayers. Once again, the Taxation Institute considers that this would force individual taxpayers working offshore who are not currently using tax agents to use a tax agent to prepare their income tax return.

At a time when the Board of Taxation is attempting to make the Australian taxation system less complex, and the Treasury is attempting to simplify Australia's Foreign Tax System, the proposed s 23AG amendments will make the tax affairs of hundreds of thousands of working Australians even more complicated, and require them each to undertake, on a continuing basis, a complicated legal review of their residential status.

## 2. Employers

In relation to employers, the Taxation Institute's main concerns relate to the application of the:

- PAYG provisions; and
- FBT provisions.

Each of these concerns is discussed in detail below.

### *FBT provisions*

Employers are exempt from FBT in relation to fringe benefits provided to Australian resident employees working overseas if the income paid to the employees is exempt under s 23AG. However, as a result of the proposed changes to limit the scope of s 23AG, some employers who were previously exempt from the FBT provisions in respect of fringe benefits provided to employees working overseas will now be subject to those provisions.

Double FBT liabilities could arise, for example, where fringe benefits are provided to an individual taxpayer working overseas who is personally subject to FBT in the overseas jurisdiction and whose Australian employer is also subject to FBT under Australian tax law.

Given that the ATO has accepted that fringe benefits provided to an employee who is within the present s 23AG are not caught by the FBT legislation and do not give rise to an FBT liability, there will also be a significant change in the complexity of reporting and paying tax in respect of those fringe benefits plus the compliance costs. The effect of this is also going to make Australian companies seeking to use Australian employees in their foreign activities less competitive.

For employers, FBT liabilities may arise as a result of the proposed amendments to s 23AG from 1 July 2009.

### *PAYG provisions*

As noted above, the PAYG withholding rules do not apply in relation to income which is exempt under s 23AG. However, as a result of the proposed changes to limit the scope of s 23AG, many employees who were previously exempt from the PAYG withholding provisions will now be subject to these provisions. A corresponding number of employers will have Australian PAYG withholding obligations based on the gross foreign salary of the employee. Satisfying these obligations will not be straight forward.

There will be compliance costs associated with employers determining whether each employee in a foreign job is, in fact, a resident of Australia before seeking to deduct PAYG tax in respect of the gross foreign sourced salary of that employee. It is likely this will result in a structural change to the manner in which foreign postings are arranged in the future, with a shift in the identity of the employer to a foreign entity. It will also favour foreign multi-nationals as against Australian employers.

By way of example, the Taxation Institute understands from its members that it has been common practice to rely on s 23AG to apply to "cyclical workers" (i.e. workers who might work "six weeks on, two weeks off"). In the experience of the Taxation Institute's members, the Commissioner has accepted that s 23AG workers can apply to these workers in a number of cases. The broad idea is that the relevant worker will be taxed in the country where they work.

In the case of drilling contractors and other mining contractors, the head contractor often pays the "in country taxes", including the employee taxes. The tax rates in the country concerned are often lower than in Australia. The effect of the removal of s 23AG will be that the worker will ultimately be subject to Australian tax rates on this income rather than the previously lower foreign tax rates. As a consequence, employee costs will substantially increase since employees are likely to seek extra compensation so that they receive at least the same after tax income as before. The additional wage pressure this places on employers will lead to an increase in unemployment in certain sectors as employers conclude that working in already difficult overseas areas has become uneconomic or they decide to hire non-Australian workers.

For employers, PAYG withholding obligations may arise as a result of the proposed amendments to s 23AG from 1 July 2009.

The Taxation Institute would be happy to appear before the Senate Committee to discuss these issues further. If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours sincerely

Joan Roberts
President