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Our ref 7471663_1

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9 June 2009

Dear Sir

KPMG Submission - Tax Laws Amendment (2009 Budget Measures No.1) Bill 2009

Following the release of the draft legislation to amend the current general income tax exemption for income earned in overseas employment (provided by section 23AG of the *Income Tax Assessment Act 1936* ("ITAA 1936")) we herewith provide our recommendations and discussion.

Submission recommendations

The proposed changes to section 23AG of the *ITAA 1936* create significant employment tax costs and administrative complications for Australian businesses. In light of these adverse implications (which are elaborated upon in the discussion section) our submission recommendations are as follows:

- 1 Section 12-1(1) of Schedule 1 of the *Taxation Administration Act 1953* ("TAA 1953") should be amended to reinstate the position such that wages to employees who would have previously satisfied the conditions of section 23AG of the *ITAA 1936* (prior to the insertion of subsection (1AA)) are exempt from PAYG withholding;

This amendment would ensure that employers continue to have no PAYG withholding obligation on foreign employment income that was previously exempt under section 23AG of the *ITAA 1936* and there is no Australian fringe benefits tax ("FBT") liability for fringe benefits provided in relation to the period of employment.

- 2 The criteria currently being used by Austrade to award "Approved Project" status for the application of section 23AF of the *ITAA 1936*, be extended to projects in foreign countries where tax is levied on employment income, to assist the international competitiveness of Australian companies competing to win international tenders.

- 3 Austrade to also consider granting Approved Project status to projects that have been tendered for and won prior to the 2009/10 Federal Budget announcement, on the basis that projects have been costed based on the current tax exemption under section 23AG being available over the life of the project.

Pay As You Go Withholding (“PAYG”)

Section 12-35 of Schedule 1 of the *TAA 1953* specifies the PAYG withholding for payments to employees; however, section 12-1 of Schedule 1 of the *TAA 1953* provides that where the payment is exempt income for the individual, no PAYG obligation exists.

Where an individual satisfies the conditions contained within section 23AG of the *ITAA 1936* the wages received would be exempt income for Australian tax purposes and as such no PAYG withholding obligation would arise for the payer.

Under the proposed changes to restrict the availability of section 23AG of the *ITAA 1936* there would be no exemption from PAYG withholding from 1 July 2009, for those employees who do not satisfy the amended conditions. Therefore, the employer (payer) will have an Australian PAYG obligation on employment income for these individuals from 1 July 2009.

Most foreign countries require the employer or the payer of salary and wages, to withhold local taxes from the employee working in the foreign country. This withholding obligation along with an Australian PAYG withholding requirement will lead to duplicate withholding obligations, on the same employment income.

The employee would be entitled to a refund of the Australian tax withheld by their employer to the extent they are allowed a foreign tax offset, but only after filing their Australian tax return some 12 months later.

The extent of this issue can be demonstrated by considering the number of countries within the Asia Pacific region that impose a tax withholding obligation on employment income; China, Fiji, India, Indonesia, Japan, Malaysia, New Zealand, Papua New Guinea, The Philippines, South Korea, Sri Lanka, Taiwan, Thailand and Vietnam. The United States of America and the United Kingdom, common destination countries for Australians also impose a tax withholding obligation on employment income;

Where the tax payable in these foreign countries is equivalent to the tax liability in Australia, there would be little or no Australian tax revenue (after the foreign tax credits have been applied). For example an employee earning a salary of A\$150,000 from 1 July 2009 would have an Australian tax and Medicare Levy liability of approximately A\$46,700. This would result in an effective tax rate of approximately 31%.

The same income would result in the approximate effective tax rates in the following countries:

Country	Effective tax rate on A\$150,000
Australia	31%
China	23%
Indonesia	25%
New Zealand	32%
Papua New Guinea	38%
USA (New York state resident)	29%
UK	30%

The additional administrative burden that would be created for the employer having to withhold Australian tax under the PAYG withholding provisions, would not provide a significant amount of Australian tax revenue after foreign tax credits are applied.

While it may be possible to alleviate the issue of dual withholding on the same employment income in Australia by way of a PAYG variation, this is not practical for employers with a large number of affected employees, particularly given the complexity of the form, the risk of penalties if the employee underestimates their personal investment income and the 1 July 2009 implementation date.

PAYG withholding recommendation

It is recommended that Section 12-1(1) of Schedule 1 of the TAA 1953 is amended to reinstate the position such that wages to employees who would have previously satisfied the conditions of section 23AG of the ITAA 1936 (prior to the insertion of subsection (1AA)) are exempt from PAYG withholding.

Fringe Benefits Tax

The definition of an employee contained within section 136 of the FBTAA does not include an individual whose wages are exempt from PAYG withholding.

Where an individual satisfies the conditions contained within section 23AG of the *ITAA 1936*, wages received by these employees would not be subject to PAYG withholding (as outlined above) and therefore, fringe benefits provided to these employees would not be subject to Australian FBT.

Under the proposed changes to restrict the availability of section 23AG of the *ITAA 1936* there would be no exemption from PAYG withholding, from 1 July 2009, for those employees who no longer qualify for the 23AG exemption. As such the wages for these individuals would no longer be exempt from PAYG and as a result be classified as an employee for Australian FBT purposes.

The provision of benefits in the host country such as medical insurance, local transport and home-leave trips would therefore be subject to FBT in Australia from 1 July 2009. The fringe benefits may also be subject to tax in the foreign country.

Where there is no relief under a DTA for the taxation of fringe benefits in Australia and the host country taxes benefits in kind, double taxation would arise, particularly as there is no mechanism within the Australian FBT regime to recognise foreign tax paid on Australian taxable benefits. In addition, where the overseas project is operated through a foreign branch of an Australian company, there would be no corporate income tax deduction for the additional FBT cost.

It would not be practical for employers to pay the employees a cash equivalent amount instead of providing fringe benefits as, for example, many employers will want to control the benefits provided such as home-leave flights and many have global policies for medical and travel insurance.

FBT recommendation

As outlined above, it is recommended that section 12-1(1) of Schedule 1 of the *TAA 1953* is amended to reinstate the position such that wages to employees who would have previously satisfied the conditions of section 23AG of the *ITAA 1936* (prior to the insertion of subsection (1AA)) are exempt from PAYG withholding.

This change would ensure that, as the wages are exempt from PAYG withholding, the individual is not defined as an employee for FBT purposes and any fringe benefits provided, in relation to that period of employment, are not subject to Australian FBT.

Impact on Australian business and employment

The proposed amendment to section 23AG of the *ITAA 1936*, is expected to impact the competitiveness of Australian companies tendering for overseas projects and the attractiveness of Australian employees to international employers.

The proposed amendments are expected to have the following impact on business:

1 *Reduce the international competitiveness of Australian companies tendering for overseas projects and the attractiveness of Australian employees*

Many projects in the Energy and Natural Resources and Building and Construction sectors are in remote, isolated and in some cases dangerous locations. Most of these developing countries do not have tax treaties with Australia. Given the risks and associated difficulties with employees dealing with tax authorities in these developing countries on their own account, it is commonplace for employment contracts to be agreed on a *net* salary basis, i.e. with the employee receiving a net salary and all tax costs being met by the employer.

The proposed changes to reduce the availability of the tax exemption will make Australian employees more expensive to employ and as a result less attractive when compared to employees from other locations with lower tax rates and/or more generous tax exemptions for working abroad, such as the USA, UK, Germany, New Zealand, and many countries located in Asia.

The removal of the tax exemption previously available will increase the overall employment costs for these companies, reducing their competitiveness in tendering for overseas projects. Many Australian employers have been impacted by the downturn in mining activity in Australia over the last 12 months, and have looked to overseas projects to sustain their businesses operations. The tax exemption currently available has assisted these companies be successful in recent tenders.

2 *Increased costs for projects*

Many Australian employers currently have projects currently underway in overseas locations. These projects have been costed based on the current tax exemption available under section 23AG. The changes to the tax exemption will require companies to reassess the viability of these projects due to increased employment costs. There is a risk that Australian companies will not proceed with planned projects or look at alternative international labour, due to the increase in costs from the proposed amendments.

Approved Project Status under section 23AF

Section 23AF of the *ITAA 1936* is designed to assist the international competitiveness of Australian companies competing to win international tenders. This is achieved by granting an exemption from Australian tax for Australian employees working overseas on these projects. For section 23AF to apply, the project must be granted Approved Project status by the Minister of Trade, via Austrade.

It is understood that under the current internal guidelines used by Austrade to award a project with Approved Project status, the contractor must make an application prior to the tendering process being completed and the tender awarded and the project must be undertaken in a country that does not impose income tax on Australian resident employees working in that country.

Recommendation

It is recommended that the criteria for awarding Approved Project status be extended to apply to:

1. those projects that have been tendered for and won prior to the 2009/10 Federal Budget announcement, on the basis that projects have been costed based on the current tax exemption available under section 23AG of the *ITAA 36*; and
2. to projects in foreign countries where income tax is levied on employment income of Australian residents.

This will assist Australian companies:

- maintain their international competitiveness when tendering for projects in foreign locations;
- complete projects which commenced prior to the May 2009 Budget announcement with the 23AG tax exemption priced into existing net salary employment contracts; and
- maintain the cost and attractiveness of Australian employees and discourage employers from seeking alternative international labour, important during a time of economic downturn where unemployment figures are expected to increase.

Should you have any questions in respect of our submission, please contact either Julie Donnellan, James Palmer or me.

Yours sincerely



Rosheen Garnon
Partner