Australian Government

The Treasury

9 June, 2009

Committee Secretary
Senate Standing Committee on Economics
PO BOX 6100
Parliament House
CANBERRA ACT 2600

Dear Sir

SUBMISSION TO THE SENATE ECONOMICS LEGISLATION COMMITTEE'S INQUIRY INTO TAX LAWS AMENDMENT (2009 BUDGET MEASURES NO.1) BILL 2009

Thank you for the opportunity to make a submission to the Senate Economics Legislation Committee's inquiry into Tax Laws Amendment (2009 Budget Measures No.1) Bill 2009.

Treasury's submission is attached.

If you require any further information regarding this submission please contact William Potts (6263 4467) or Greg Wood (6263 3329) regarding Schedule 1 of the Bill, or Nigel Murray (6263 4426) regarding Schedules 2 and 3 of the Bill.

Yours sincerely,

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Treasury submission Senate Economics Legislation Committee's Inquiry into Tax Laws Amendment (2009 Budget Measures No. 1) Bill

INTRODUCTION

Under the order of the Senate on 14 May 2009, the Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009 (the Bill) was referred to the Senate Economics Legislation Committee (the Committee) upon its introduction into the House of Representatives on 27 May 2009. The Committee is to report on:

- Schedule 1 of the Bill that amends section 23AG of the Income Tax Assessment Act 1936 to limit its scope to foreign employment income derived by Australian resident individuals only in specific circumstances.
- Schedule 2 of the Bill will temporarily reduce the matching rate and maximum co-contribution that is payable with effect from 1 July 2009.
- Schedule 3 of the Bill will reduce the concessional superannuation contributions caps.

The purpose of this submission is to provide the Committee with information in relation to the Bill to assist them in its deliberation.

CONTEXT OF PROPOSED MEASURES

These measures were introduced by the Government as part of a package of savings measures in the 2009-10 Budget. The measures are designed to reduce the potential inequities in the tax system, and to build a stronger revenue base.

SCHEDULE 1: LIMITING THE SCOPE OF EXEMPT FOREIGN EMPLOYMENT INCOME

Background

Currently, section 23AG of the *Income Tax Assessment Act 1936* (ITAA 1936) provides a general exemption for Australians working overseas for not less than 91 consecutive days, such that they do not pay any Australian income tax on their foreign employment income.

This exemption was introduced in 1986, in conjunction with the former foreign tax credit system. Section 23AG provides a mechanism to relieve double taxation, but, does not contain a requirement that foreign tax has been paid for the exemption to apply. This can produce non-neutral tax outcomes between Australian resident individuals working in different countries with different tax rates, and between individuals working overseas and individuals working in Australia.

Proposed changes to the exemption

Schedule 1 improves taxpayer equity by removing circumstances whereby Australian resident taxpayers, who have paid little or no foreign tax on their foreign income, can claim an exemption from Australian tax. The change will remove non-neutral tax outcomes that can currently arise and will minimise opportunities for tax avoidance

Under the proposed change foreign employment income earned on or after 1 July 2009 will not be exempt from Australian income tax under section 23AG unless it is income earned:

- as an aid or charitable worker employed by a recognised non-government organisation;

- as a government aid worker;
- as a specified government employee (for example, defence and police force personnel deployed overseas); or
- from an activity prescribed in the regulations.

For those who remain eligible for the exemption, the existing conditions for exemption will continue to apply. In particular, the foreign earnings of individuals engaged in foreign service that are directly attributable to one of the activities referred to above will not be exempt if one of the conditions for non-exemption contained in subsection 23AG(2) applies.

Section 23AG(2) denies an exemption where the foreign earnings are exempt from tax in the foreign country only because of:

- a double tax agreement with Australia or a law giving effect to a double tax agreement;
- the foreign country does not impose income tax on employment or personal services income, or similar income; or
- a law of the foreign country or an international agreement to which Australia is a party, which deals with diplomatic or consular privileges and immunities, or privileges and immunities for people connected with international organisations (such as the United Nations).

However, subsection 23AG(2) does not apply to deny an exemption if the foreign earnings are exempt from tax in the foreign country for a reason other than, or in addition to, those listed above. For example, the income may be exempt in the foreign country because of the application of a double tax agreement and because of an agreement between the government of that country and an international aid organisation.

As a result of this change, non-exempt foreign employment income derived by Australian residents will be included in their assessable income, along with other types of foreign sourced income received by Australian residents. Individuals who derive non-exempt foreign employment income will be able to claim a non-refundable foreign income tax offset (FITO) for foreign income tax paid on that income.

The measure will improve the fairness and integrity of the tax system by ensuring that most Australian resident individuals face the same tax burden in relation to their worldwide income, and workers who earn income overseas do not have an unfair advantage over workers who earn income and pay tax in Australia.

Application

The change introduced by Schedule 1 will apply to foreign earnings derived on or after 1 July 2009 from foreign service performed on or after 1 July 2009.

Foreign earnings derived on or before 30 June 2009 will remain eligible for exemption under the existing rules.

Foreign service performed on or after 1 July 2009 will be included in the calculation of the period of continuous foreign service, even where the foreign earnings derived on or after 1 July 2009 are no longer exempt.

Foreign earnings paid to an individual on or after 1 July 2009 in respect of foreign service performed before 1 July 2009 will remain eligible for exemption under the existing rules.

The current exemption provided by section 23AG only applies to Australian tax residents and the new rules will not change this. It will not affect Australian citizens who are not residents of Australia for tax purposes.

The definition of 'resident of Australia' is contained in section 6(1) of the ITAA 1936 and is applied on the basis of an individual's personal facts and circumstances. The ATO provides guidance on the application of the definition and has issued a number of appropriate rulings and interpretive decisions.

Distributional effects
It is estimated that 15,000 to 20,000 individuals could lose their current exemption.

- Of these, around 3,300 taxpayers earning over $100,000 a year are currently paying very little tax on more than a third of their income on average because of the general exemption.
- A further 8,000 individuals currently pay no or very little tax at all in Australia because of the exemption, despite having average incomes of around $85,000.

It is estimated that after FITOs are claimed for foreign tax paid, the average impact for affected workers will be an increase in tax of $11,000 per annum.

Consultation

The proposed amendments were announced by the Treasurer on 12 May 2009, as part of the 2009-2010 Budget. Public consultation was undertaken but the consultation period was necessarily short so as to facilitate the introduction and passage of this Bill through Parliament 30 June 2009.

Following the Government's announcement and the release of exposure draft legislation, over 100 submissions were received from various organisations and individuals. Treasury also consulted with the Department of Defence, the Attorney-General's Department, the Australian Taxation Office and AusAID.

Changes to the Bill following consultation
As a result of the consultations the following changes were made to Schedule 1 of the exposure draft Bill:

- A new paragraph 26(1AA)(c) was inserted to ensure that employees of recognised organisations that undertake aid or charitable activities, that do not form part of Australian 'official development assistance', are eligible for exemption on their relevant foreign employment income.
  - The change will apply to a prescribed charitable or religious institution that is exempt from Australian income tax pursuant to item 1.1 or 1.2 of section 50-5 of the *Income Tax Assessment Act 1997*. Such organisations are either located outside Australia, or have a physical presence in Australia but incur their expenditure and pursue their objectives principally outside Australia.
- A regulation making power in paragraph 23AG(1AA)(e) was inserted to allow the exemption to apply to other types of employment activities not presently covered. Regulations would be made on the basis of facts and circumstances.

- The application provisions of the Bill (Schedule 1, Item 2 of the Bill) were amended to ensure that any foreign employment income received after 1 July 2009 but which was in respect of services performed prior to that date is eligible for exemption in the 2008-09 financial year.
  - The application provision in the exposure draft had the effect that amounts received on or after 1 July 2009 would be taxable even if they related to foreign employment undertaken before that date. The Bill ensures that such amounts remain exempt, thereby not affecting taxpayers in the 2008-09 financial year.

Other issues raised in consultation

The proposal may add complexity to the law

Some submissions have argued that the proposal will add to the complexity of the income tax law. The proposed changes will result in very small amendments to the lax law.

- The proposed changes add one new subsection to the relevant provisions to describe the types of employment income which will remain subject to the exemption. No other changes are proposed.
- FITOs are already provided for by the existing law (Division 770 of the *Income Tax Assessment Act 1997*) and will relieve double taxation for individuals who have paid foreign income tax on their foreign earnings.
- Where an Australian tax resident earns income from foreign employment that has previously been exempt, the Australian resident may now face additional compliance costs in determining their entitlement to a FITO.
  - However, under the existing law the exempt foreign employment income is taken into account in determining the tax payable on any other income subject to tax. This is referred to as 'exemption with progression' and is designed to prevent the exempt income from reducing the Australian tax payable on other income.

Subjecting the foreign employment income to Australian tax and allowing an offset for foreign tax paid will not necessarily increase the complexity of the law.

- When introduced, section 23AG provided individuals with a lower cost method to alleviate double taxation than the former foreign tax credit (FTC) system, which required taxpayers to complete (among other things) complex calculations.
- To a significant extent, those concerns have diminished given the introduction of the simpler FITO rules which commenced 1 July 2008. The FITO system has reduced the compliance and administrative costs that were associated with the previous FTC system - there are fewer (and simpler) conditions to establish entitlement to the new offset, and fewer (if any) calculations required to establish its magnitude. In many circumstances, the offset will also be slightly more generous.
- The calculation of a taxpayers liability using the FITO system may in some cases be less complex than the current exemption with progression.

Foreign income tax offsets (FITO)

In some cases individuals will have to claim a FITO where Australia's financial year does not align with countries that, for example, adopt the calendar year as their financial year.

- This is a pre-existing feature of the FITO system.

- A FITO for foreign income tax paid (or deemed paid) in respect of foreign income earned by an individual is available only in the year in which the income is included in the individual's Australian assessable income, ie the Australian financial year. Further, the foreign tax must have been paid before a FITO can arise, otherwise double tax has not yet occurred.

- An individual is treated as having paid foreign tax where the foreign tax has been paid by someone else on their behalf, eg where it has been withheld at source by an employer. Thus, employees who have had foreign tax withheld regularly from their salaries will be unaffected by non-aligned financial years. That is, those individuals can apportion the amount of foreign tax paid (and calculate a corresponding FITO) to the Australian financial year in which the relevant foreign income was included in their assessable income.

- Where foreign tax is not withheld throughout the year, and the individual's foreign tax liability is assessed by the foreign country at the end of its financial year, claiming a FITO is not possible until the foreign tax has actually been paid (ie not before double tax arises). Once the foreign tax is paid, the individual could amend their Australian assessment to include the FITO.

Pay as you go (PAYG) obligations
As some individuals will no longer be exempt from 1 July 2009, employers of these individuals will be required to comply with the PAYG withholding rules. That is, those employers, as payers, may be required to withhold amounts from the payments they make to their employees (eg salaries, wages, allowances, bonuses and commissions paid to their foreign-based employees), in accordance with Division 12 of the *Taxation Administration Act 1953*, and remit those amounts to the Commissioner of Taxation.

Where the income is currently exempt this would not occur because no amount is required to be withheld from payments of exempt income.

This outcome is consistent with the treatment of salaries paid to Australian-based employees.

It has also been raised that if PAYG (and the foreign equivalent) is payable both in Australia and in the foreign country in which the Australian resident is working, potentially there will be double withholding. If this was to happen a foreign income tax offset would be available on assessment and in effect the foreign PAYG would be refunded on assessment. However, the income tax law allows taxpayers in particular circumstances to vary amounts required to be withheld by their employer.

Fringe benefit tax (FBT) obligations
As some individuals will no longer be exempt from 1 July 2009, employers of these individuals will be required to comply with the *Fringe Benefits Tax Assessment Act 1986* in relation to any fringe benefits provided to foreign-based Australian employees whose employment income is no longer exempt.

- Unlike taxpayers earning employment income in Australia, Australian resident taxpayers working overseas have been able to receive tax free fringe benefits.

A person is not regarded as an employee for FBT purposes to the extent that their salary and wages are exempt from Australian income tax. Removing the income tax exemption for some employees will effectively bring those employees into the FBT net. Thus, fringe benefits provided to

employees whose foreign employment income is not exempt under section 23AG may be subject to FBT.

This outcome is consistent with the treatment of fringe benefits provided to Australian-based employees.

Some countries tax fringe benefits in the hands of employees. This is not a creditable tax for FITO purposes. Therefore, double taxation of fringe benefits could arise where Australia taxes the employer and the foreign country taxes the employee.

- Some of our tax treaties (United Kingdom and New Zealand) contain rules to resolve this problem.

Increased cost of doing business overseas for some organisations

Some employers have argued that removing the tax exemption for overseas workers will increase their wage costs.

- Although section 23AG applies only to individuals, some organisations have been using the exemption as a wage subsidy (ie lowering the cost of employing Australians overseas), by paying employees less than they would otherwise receive.
- This results in an inequity between employers who employ Australian resident workers offshore and employers who employ Australians to work in Australia.

Grandfathering of existing employment contracts

The proposed changes apply prospectively. The insertion of a grandfathering provision, to quarantine pre-existing employment contracts from the new rules, could create inequity and opportunities for tax avoidance. Submissions have indicated that some employment contracts cover a period of several years. Grandfathering would preserve the exemption in those cases for a considerable period of time, thereby adding complexity to the system. Grandfathering would thereby also create further inequity between parties to long-term employment contracts (who would benefit significantly) and parties to short-term contracts.

Financial impact

This measure is expected to provide an additional $675 million over the forward estimates period.

SCHEDULE 2: TEMPORARY REDUCTION IN THE GOVERNMENT CO-CONTRIBUTION

Background

The co-contribution is a superannuation contribution that the Government makes for eligible persons on low to middle incomes. For every personal undeducted (post-tax) superannuation contribution made by eligible persons, the Government makes a matching contribution. Currently the matching rate is 150%. The maximum co-contribution ($1,500 in 2008-09) is payable for individuals whose income is at or below the lower income threshold ($30,342 in 2008-09). The maximum co-contribution payable reduces by an amount (5 cents in 2008-09) for every dollar of income in excess of the lower income threshold. No co-contribution is payable for persons with incomes at or above the upper income threshold ($60,342 in 2008-09).

Outline of Schedule 2

Schedule 2 of the Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009 will temporarily reduce the matching rate and maximum co-contribution that is payable with effect from 1 July 2009.

The matching rate will reduce to 100 per cent for contributions made in the 2009-10, 2010-11 and 2011-12 income years, with a maximum co-contribution payable of $1,000. The maximum co-contribution will be reduced by 3.333 cents for each dollar by which the person's total income exceeds the lower income threshold ($31,920 in 2009-10). The upper income threshold in 2009-10 will be $61,920.

The matching rate will be 125 per cent for contributions made in the 2012-13 and 2013-14 income years, with a maximum co-contribution payable of $1,250. The maximum co-contribution will be reduced by 4.167 cents for each dollar by which the person's total income exceeds the lower income threshold.

The Government co-contribution scheme will revert back to the current matching rate of 150 per cent and maximum co-contribution of $1,500 in 2014-15. The lower and upper income thresholds will continue to be indexed.

Purpose

The temporary reduction in the co-contribution will generate necessary budget savings in the current economic climate thus supporting Government initiatives such as pension reform, whilst maintaining a significant and generous incentive for eligible persons to contribute to superannuation.

The temporary reduction in the co-contribution matching rate is not expected to have a significant impact on the level of superannuation contributions made by those eligible as the scheme remains very generous – the matching rate will continue to provide a return on contributions of at least 100 per cent.

It is estimated that this will affect around 1.5 million people in 2009-10 who make eligible post tax superannuation contributions.

Financial impact

The measure will deliver savings of $1.395 billion over the forward estimates period.

SCHEDULE 3: EXCESS CONTRIBUTIONS TAX

Background

Since 1 July 2007, concessional and non-concessional superannuation contributions have been subject to annual limits. These limits were introduced as part of the previous Government's 'Better Super' reforms to place a limit on the taxation concessions afforded to superannuation contributions.

Concessional contributions include all employer contributions (including superannuation guarantee), salary sacrifice contributions and tax-deductible personal contributions. Concessional contributions are taxed at 15 per cent in the hands of the superannuation fund as opposed to the individual's marginal tax rate. Investment earnings are also taxed at the generally concessional rate of 15 per cent.

In 2007-08 and 2008-09 the concessional contributions cap was $50,000. A five year transitional cap (that will cease on 30 June 2012) was also introduced on 1 July 2007 which allows individuals aged 50 and over to make concessional contributions up to $100,000.

In 2007-08 and 2008-09 the non-concessional contributions cap was $150,000 as it is calculated as three times the concessional contributions cap. This cap increases when the concessional contributions cap increases with indexation.

Outline of Schedule 3

Schedule 3 of the Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009 will reduce the concessional contributions caps. From 1 July 2009, the concessional contributions cap will be reduced from $50,000 to $25,000 and the transitional cap from $100,000 to $50,000. The non-concessional contributions cap will remain at $150,000 in 2009-10 as it will be calculated as six times the level of the concessional contributions cap from 1 July 2009. The caps will be subject to indexation consistent with current indexation arrangements.

The existing 'grandfathering' arrangements that apply to certain members of defined benefit schemes in relation to the concessional contributions cap will continue. These current arrangements apply to members who had a defined benefit interest on 5 September 2006 (the date the existing contribution caps were first announced by the previous Government). New grandfathering arrangements will apply to members who had a defined benefit interest on 12 May 2009 - these arrangements will be modelled on the existing grandfathering arrangements with the conditions to be prescribed in regulations.

Purpose

The taxation concessions afforded to superannuation are estimated to be in the order of $25 billion in 2009-10. Due to the nature of these concessions, it is important that they are targeted appropriately.

The reduction in the concessional contributions caps will improve equity in the superannuation system as the current caps benefit those who can afford to make large concessional superannuation contributions who are primarily high income earners. A high income earner on the top marginal tax rate effectively receives a tax break of 31.5 cents for every dollar they salary sacrifice into super. The changes are also consistent with the findings of the Australia's Future Tax System report into

retirement incomes which found that tax-assisted voluntary superannuation contributions should be more fairly distributed, and questioned whether the current cap on the concessions was appropriate.

This measure will help ensure Australia's retirement income system remains sustainable into the future and improve equity. It is estimated that the changes will affect around 1.8 per cent of individuals who make concessional contributions in the 2009-10 financial year. The average remuneration of those involved is estimated to be over $220,000 a year.

The reduction in the caps will still allow individuals to make significant contributions in excess of the minimum level of compulsory superannuation guarantee required under the law. For example, an individual earning $100,000 with a $9,000 Superannuation Guarantee contribution could still make additional concessional contributions of $16,000 in compliance with the new concessional contributions cap, or $41,000 under the transitional cap.

Financial impact

It is estimated that this measure will provide revenue savings of $2.810 billion over the forward estimates period.