Chapter 2

Schedule 1: taxation of foreign income

Description of the measure

2.1 Schedule 1 of the bill amends section 23AG of the *Income Tax Assessment Act 1936*. Section 23AG currently provides that where an Australian resident has been engaged in foreign service for a continuous period of not less than 91 days, any foreign earnings from the foreign service are exempt from income tax.[1] The exemption was introduced in 1986 in conjunction with the former foreign tax credit system.[2]

2.2 Proposed subsection 23AG(1AA) removes the general exemption, but maintains it for certain aid or charitable workers or government employees, or for an activity prescribed in the regulations.

2.3 The current exemption applies to persons who are Australian residents for tax purposes. The bill will not change this, and thus will not affect citizens who are not residents for tax purposes.

2.4 The change will apply to foreign earnings derived on or after 1 July 2009 from foreign service performed on or after 1 July 2009. Foreign tax paid will be claimable as a non-refundable foreign income tax offset (FITO).[3]

2.5 If an individual is no longer exempt as a result of proposed subsection 23AG(1AA), the employer will be obliged to comply with the pay-as-you-go (PAYG) withholding rules in Division 12 of the *Income Tax Administration Act 1953*. The employer will also have to comply with *Fringe Benefits Tax Assessment Act 1986* in relation to any fringe benefits provided.[4]

2.6 The Government argued that '[the current] 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 outcome between Australian resident individuals working in different countries with different tax rates, and between individuals working overseas and individuals working

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1 There are some exceptions in s23AG(2).

2 Treasury, *Submission 21*, p.1.

3 Explanatory Memorandum, p.11.

4 Explanatory Memorandum, p.7.

in Australia… The change will remove non-neutral tax outcomes that can currently arise and will minimise opportunities for tax avoidance.'[5]

2.7 Treasury estimates that -

- 15,000 to 20,000 individuals could lose their current exemption;
- Of these, around 3,300 taxpayers earning over $100,000 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;
- After FITOs are claimed for foreign tax paid, the average impact for affected workers will be an increase in tax of $11,000 per year.[6]

2.8 Treasury exposed a draft of this schedule for comment between 12 and 18 May 2009. In response to submissions -

- 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;
- a regulation making power was inserted to allow the continuing exemption to be extended in future as appropriate;
- the application provisions were amended to ensure that income received after 1 July 2009 in respect of services before 1 July 2009 is exempt.[7]

Issues raised in submissions

2.9 Submissions argued against the change for various reasons summarised below.

Effects on competitiveness of Australian firms

2.10 Submissions argued that the change will reduce the competitiveness of Australian firms working offshore, as it will increase their costs. This refers both to the administrative costs of compliance and to the cost of topping up salaries to leave the employee no worse off (assuming they do this).

2.11 For example, the Association of Consulting Engineers Australia claimed:

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5 Treasury, *Submission 21*, p.1.

6 Treasury, *Submission 21*, p.3.

7 Treasury, *Submission 21*, p.4.

> The current exemption from income tax makes Australian consulting engineering firms competitive when bidding for international work. Removing the exemption will substantially increase the cost of working abroad, making it less attractive for engineering businesses to export their services.[8]

2.12 In their submission, they gave the example of a firm with revenue of $99 million and pretax profit of $10 million, which estimates that the measure will increase its costs, or its employees' costs, by $5 million.[9] Pricewaterhouse Coopers gave an example in which the cost of an employee in China was estimated to increase from $332,000 to $565,000.[10]

2.13 Submissions argued that implementing this bill will reduce Australia's income from exporting services; encourage firms to employ foreign nationals in preference to Australian residents; and encourage workers to become non-resident to avoid tax, or to return to Australia. [11] A number of submissions argued that the returning expatriates would add to unemployment in Australia.[12]

2.14 Many submissions from individuals argued that the changes will lead them to either become non-resident or return to Australia.[13]

2.15 Treasury commented generally on these arguments:

- some organisations have been using the exemption as a wage subsidy by paying employees less than they would otherwise receive;
- this results in inequity between employers with Australian resident workers offshore and those who employ Australians to work in Australia. [14]

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8 Mrs Nicola Grayson, Association of Consulting Engineers Australia, *Proof Committee Hansard*, 10 June 2009, p 11.

9 Association of Consulting Engineers Australia, *Submission 18*, p.7 and additional information 15 June 2009, p.6.

10 Pricewaterhouse Coopers, additional information 10 June 2009.

11 Most submissions from the peak organisations and accounting firms made these points - for example, Institute of Chartered Accountants in Australia, *Submission 13*, p.2; Deloitte, *Submission 16*, p.2; Pricewaterhouse Coopers, *Submission 17*, p.1-2; ACEA, *Submission 18*, p.7; Taxation Institute of Australia, *Submission 19, p.5;* KPMG, *Submission 20*, p.5; Minerals Council of Australia, *Submission 24*, pp 2-3.

12 Examples include Mr Mike Durack, *Submission 2*, Mr Peter Lewis, *Submission 3* and Mr George Nims, *Submission 9*.

13 Examples of such submissions are Mr Brett Harms, *Submission 12*, Mr Ray O'Brien, *Submission 27* and Mr Jack Smith, *Submission 111*.

14 Treasury, *Submission 21*, p.6.

Short notice of the change

2.16 Some submitters were concerned by the short notice of the change. For example:

> At any given time a large number of Australian residents will be working offshore…changes to section 23AG from 1 July 2009 will directly impact their remuneration arrangements without any regard for, or recourse to, the terms of the agreement under which they moved offshore.[15]

2.17 The Institute of Chartered Accountants suggested that only new employment agreements made after 1 July 2009 should be caught.[16] Pricewaterhouse Coopers (PWC) noted a problem for companies carrying out long fixed price contracts that do not allow a change in contract price because of tax changes in Australia. PWC suggested that if the government insists on the change, it should at least be deferred for 12 months to allow companies time to adjust. KPMG suggested that projects already in train before the measure was announced should be protected from the change by giving them approved status under section 23AF.[17]

2.18 Treasury argued that inserting a grandfathering provision to protect existing contracts could create inequity and opportunities for tax avoidance. It would create inequity between parties to long term contracts (who would benefit more) and parties to short term contracts.[18]

Issues to do with PAYG withholding

2.19 Employees who are no longer exempt will be subject to PAYG withholding rules. Several concerns were raised about this:

- Employers may have to withhold PAYG tax twice - once for Australia and once for the other country. This could create cashflow problems for employees in the period before the foreign income tax offset could be claimed. If an employer advances salary to cover the employee's cash flow problem this in itself would be a taxable fringe benefit.
- There will be particular cashflow problems where the tax year in the country of work is different from Australia's.
- Seeking a PAYG variation to avoid this problem is impractical for many employers and employees given the difficulty of estimating the likely foreign

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15 Institute of Chartered Accountants in Australia, *Submission 13*, p.3.

16 ICA, *Submission 13*, p.3.

17 Pricewaterhouse Coopers, *Submission 17*, p.2,4. KPMG, *Submission 20*, p.6. Section 23AF gives the same exemption as the current section 23AG to projects approved by the Minister for Trade as being in the national interest.

18 Treasury, *Submission 21*, p.6.

income tax offset. It would be liable to penalty payments if a variation based on estimating the year end liability is mistaken.

- Foreign employers might have to withhold tax for the Australian Tax Office, which would arguably be impractical.[19]
- The administrative difficulties will create a culture of non-compliance (for example, among backpackers working casually or short term), which is undesirable.[20]

2.20 The Taxation Institute elaborated on the 'backpacker problem':

> …I go and stay in a hotel, work, and get paid my £250 each week. However, after three or four months overseas I return to Australia. In that circumstance I will have to disclose my £250 which tax has been withheld. I will also have a problem that my tax year in Australia is different to the tax year in the UK…Since I have paid no tax in Australia on that income, that income will be fully taxed at whatever my marginal rate is. The tax that I have had withheld in the UK is not available as an offset because the offset rules require that tax to actually have been paid…I have to wait through until at least April before the UK tax year ends…I then have a problem because the UK does not require lodgement of tax returns. I have to …pay a UK tax person to lodge my return for £3,000 or £4,000 …which in turn I submit to the government and seek an amendment of my tax return to provide that credit so that reduces the tax that I have already paid. This is just a very simple scenario.[21]

2.21 Pricewaterhouse Coopers and KPMG suggested that these problems could be alleviated by exempting employers from the PAYG rules in respect of their offshore employees - employees would simply pay their tax liability (net of foreign income tax credits) in arrears. PWC suggested that alternatively taxpayers could be allowed to self assess PAYG variations.[22]

2.22 Treasury responded or commented:

- The Commissioner for Taxation may approve a PAYG variation on application. The ATO would use that provision to avoid the scenario of double withholding - Australian PAYG withholding amounts could be varied to match the likely end of year liability net of foreign income tax offsets. In

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19 For example, ICA, *Submission 13*, p.4; Deloitte, *Submission 16*, p.2-3; Pricewaterhouse Coopers, *Submission* 17, p.3; ACEA, *Submission 18*, p.8; Taxation Institute of Australia, *Submission 19*, p.2-3; KPMG, *Submission 20*, p.3.

20 Dr Michael Dirkis, Taxation Institute of Australia, *Proof Committee Hansard* 10 June 2009, p.5.

21 Dr Michael Dirkis, Taxation Institute of Australia, *Proof Committee Hansard*, 10 June 2009, p.2.

22 PWC, *Submission 17*, p.3-4. Mr John Fauvet, PWC, *Proof Committee Hansard* 10 June 2009, p.35. KPMG, *Submission 20, p.3*. Similarly Deloitte, *Submission 16*, p.2

this case there is no penalty if the withheld amounts fall short of the eventual tax liability.[23]

- Employees who have foreign tax withheld regularly will be unaffected by non-aligned financial years, since foreign tax is regarded as paid as soon as it is withheld, and thus may count towards a FITO in the corresponding Australian financial year - there is no need to wait for the foreign end of year tax statement which may come later.[24]
- Where foreign tax is not withheld regularly, claiming a FITO is not possible until the foreign tax has actually been paid. Then the taxpayer could amend their latest Australian tax return to include a FITO matching the part of the foreign tax payment which relates to the latest Australian tax year.[25]
- The scenario that a foreign employer of an offshore Australian resident must withhold PAYG amounts 'does not arise in practice', since the employer would not normally know the employee's residency status.[26] [27]

Possible double taxation of fringe benefits

2.23 Where employees are no longer exempt, their employers will have to comply with the *Fringe Benefits Tax Assessment Act 1986.* Submissions argued:

- There is no facility to claim an offset for foreign fringe benefits tax paid;
- There will be significant compliance costs for employers; and
- It would not be practical for employers to cash out fringe benefits as many employers will want to control the benefits provided such as home leave flights, and many have global policies for medical and travel insurance.[28]

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23 Treasury, *Submission* 21, p.5; additional information 15 June 2007, p.3. Mr Peter Nash, ATO, *Proof Committee Hansard*, 10 June 2009, pp 52-3. The reference in submissions to a penalty may be a reference to the possibility of a penalty for false and misleading information in an application for variation. Alternatively, it may be a reference to PAYG instalments paid by business taxpayers. Business taxpayer may choose to vary their instalment rate, but will be liable to pay interest on any shortfall if the varied rate is less than 85 per cent of the benchmark rate.

24 Treasury, *Submission 21,* p.5. Mr Gregory Wood, Treasury, *Proof Committee Hansard* 10 June 2009, p.51. The comment assumes that employees would have acceptable evidence of tax paid (pay slips, presumably) without waiting for the foreign end of year tax statement.

25 Treasury, *Submission 21*, p.5. It is also possible to apply for extension of time to lodge a tax return.

26 Mr Peter Nash, Australian Taxation Office, *Proof Committee Hansard* 10 June 2009, p.59.

27 The PAYG withholding rules are in the *Taxation Administration Act 1953*. There is no suggestion that this Act can impose a legal duty on a foreign national acting outside Australia. Any imposition on foreign employers for the benefit of the ATO would have to be legislated by the foreign country, presumably after agreement with Australia.

2.24 A particular concern is that fringe benefits may be taxed twice. The Taxation Institute's example was:

> If you are living in Kazakhstan, normally your employer would supply you with a set of Western-style accommodation…Normally in most countries around the world, the benefit is taxable to the employee. An estimation of the non-cash benefit is taken into account in determining what is the value of your package and what that value is in terms of being taxed in that particular country. At the same time, the Australian employer who is providing that benefit is providing a non-cash benefit to an employee who is an Australian resident and therefore is required under the FBT rules to pay fringe benefits tax on behalf of that accommodation,… The problem is that there is a mismatch between the individual rules within the particular country where they are actually working and what the Australian system does.[29]

2.25 Deloitte suggested amending the *Fringe Benefits Tax Assessment Act 1986* so that fringe benefits provided offshore remain exempt. KPMG noted that exempting offshore workers from PAYG provisions, as it suggested already for other reasons, would also solve this problem, since individuals exempt from PAYG withholding by definition are not employees for FBT purposes.[30]

2.26 Treasury responded or commented:

- Bringing offshore employees into the fringe benefits net treats them consistently with Australian-based employees;
- It is acknowledged that double taxation 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; and
- 'Treasury is currently working on that issue to see how it could be resolved with the aim of providing advice to the government.'[31]

Other administrative and compliance issues

2.27 Submissions raised a number of other concerns:

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28 Institute of Chartered Accountants in Australia, *Submission 13*, p.4. Deloitte, *Submission 16,* p.4. Association of Consulting Engineers Australia, *Submission 18,* p.7. Taxation Institute of Australia, *Submission 19,* p.4. KPMG, *Submission 20,* p.4.

29 Dr Michael Dirkis, Taxation Institute of Australia, *Proof Committee Hansard*, 10 June 2009, p.4.

30 Deloitte, *Submission* 16, p.3 KPMG, *Submission 20,* p.4.

31 Treasury, *Submission 21,* p.6. Mr William Potts, Treasury, *Proof Committee Hansard* 10 June 2009, p.50.

- possible difficulty of deciding the employee's residency status, which should not be the employer's responsibility;[32]
- need to have payroll teams in both countries able to understand the laws;[33]
- possible difficulty for employees claiming FITOs in documenting foreign tax paid, particularly in jurisdictions where there is no requirement to lodge a tax return;[34]
- possible inequities at the boundary of those who will still enjoy the exemption (for example, comparing AFP and ADF personnel who will enjoy the continuing 'disciplined force' exemption, with civilian contractors giving them logistical support).[35]

2.28 Some submissions suggested extending the use of the section 23AF exemption to mitigate these problems.[36]

2.29 Treasury commented on concerns about compliance costs:

- Some increase in compliance costs is acknowledged;
- However the calculation of a taxpayer's liability using the FITO system may in some cases be less complex than the calculations required by the current 'exemption with progression' rules, which already require keeping track of a taxpayer's onshore and offshore income separately.[37]

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32 Deloitte, *Submission 16,* p.2. Taxation Institute of Australia, *Submission 19,* p.3.

33 Pricewaterhouse Coopers, *Submission 17*, p. 2.

34 Association of Consulting Engineers Australia, *Submission 18,* p.8. Taxation Institute of Australia, *Submission 19,* p.2.

35 Institute of Chartered Accountants in Australia, *Submission 13,* p.3.

36 Pricewaterhouse Coopers, *Submission 17,* p.3. KPMG, *Submission 20,* p.6. Section 23AF gives the same exemption as the current section 23AG to projects approved by the Minister for Trade as being in the national interest.

37 Treasury, *Submission 21,* p.4. Mr William Potts, Treasury, *Proof Committee Hansard* 10 June 2009, p.54. 'Exemption with progression': a taxpayer's tax rate is calculated on their total income; the non-exempt income is then taxed at that rate (which will be higher than would apply if the rate was calculated considering only the non-exempt income).

Committee comment

2.30 The Committee accepts Treasury's responses on most of the matters mentioned above. On some points the Committee is sympathetic to the concerns raised in submissions and comments as follows.

Administrative burden of PAYG withholding

2.31 The ATO will need to clarify acceptable documentation to prove a foreign tax payment to claim a FITO. It should acknowledge the possible difficulty of obtaining documentation for some taxpayers (eg backpackers in casual work). The government should consider means of reducing the compliance burden where it would be disproportionate to the revenue gain. For example, this could be done by exempting the first $X,000 of offshore income (X set at a level which would aim to distinguish backpackers from salaried employees); or by limiting the measure to large employers; or by exempting offshore salaries from PAYG withholding rules, as some submissions suggested.

Recommendation 1

2.32 The government should consider options for limiting the new measure to reduce the compliance burden where it would be disproportionate to the revenue gain.

Possible double taxation of fringe benefits

2.33 The Committee accepts the concerns about this and notes that the government is considering how to deal with this problem.

Recommendation 2

2.34 The Government should make the necessary consequential changes to ensure there is no double taxation of fringe benefits.