SUB029

The Institute of Chartered Accountants in Australia

9 June 2009

Mr John Hawkins
Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear John,

**Proposed changes to section 23AG**
**Inquiry into Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009**

The Institute of Chartered Accountants in Australia welcomes the opportunity to put forward this submission to the Senate Standing Committee on Economics inquiry into the Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009 (the Bill). This submission deals specifically with the amendments proposed in Schedule 1 of the proposed Bill; Schedule 1 deals with amendments to section 23AG of the *Income Tax Assessment Act 1936*.

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 140 countries around the world.

## Background

As the Senate Economics Committee (the Committee) will be aware, section 23AG was introduced in 1986 with the objective of ensuring that income earned overseas by Australian resident taxpayers was not subject to double tax, being tax in the destination country as well as in Australia. This policy objective is clearly articulated by Treasury in written correspondence and submissions lodged with a previous Parliamentary Joint Standing Committee Inquiry undertaken in July 2003.[1]

[1] Letter dated 11 July 2003 from Acting Secretary to the Treasury, Mr Martin Parkinson, to the Inquiry into Australia's Maritime Strategy conducted by the Joint Standing Committee on Foreign Affairs, Defence and Trade.

GPO Box 9985
in your capital city

**Customer Service Centre**
1300 137 322

**NSW**
33 Erskine Street
Sydney NSW 2000
**Phone** 61 2 9290 1344
**Fax** 61 2 9262 1512

**ACT**
L10, 60 Marcus Clarke Street
Canberra ACT 2601
**Phone** 61 2 6122 6100
**Fax** 61 2 6122 6122

**Qld**
L32, 345 Queen Street
Brisbane Qld 4000
**Phone** 61 7 3233 6500
**Fax** 61 7 3233 6555

**SA / NT**
L11, 1 King William Street
Adelaide SA 5000
**Phone** 61 8 8113 5500
**Fax** 61 8 8231 1982

**Vic / Tas**
L3, 600 Bourke Street
Melbourne Vic 3000
**Phone** 61 3 9641 7400
**Fax** 61 3 9670 3143

**WA**
Ground, 28 The Esplanade
Perth WA 6000
**Phone** 61 8 9420 0400
**Fax** 61 8 9321 5141

The introduction of section 23AG corresponded with the adoption by Australia of the foreign tax credit system. Although section 23AG provides exemption from Australian tax for eligible taxpayers, the model adopted does involve an 'exemption with progression' approach, whereby taxpayers with assessable income are required to take account of the quantum of section 23AG exempt income derived during an income year in ascertaining their marginal tax rate.

**Comments on proposed changes**

The Institute has set out below our key comments on the proposed amendments to section 23AG. The Institute has not previously made a submission to Treasury before introduction of the proposed Bill into Parliament due to the short timeframes within which those submissions had to be lodged following announcement of the proposed changes as part of the 2009-10 Federal Budget [the due date for lodgement of submissions with Treasury was 18 May 2009].

**1. Competitiveness of Australian businesses operating abroad will be impacted**

Given the increased globalisation of business activities over recent years, many successful Australian companies operate in overseas locations, where they can deliver significant infrastructure and development projects that draw upon their expertise, skill and experience. Undertaking such projects in overseas locations also adds value to Australia by repatriating that experience into Australia from overseas, thereby boosting the intellectual capital of our country. Tenders for significant projects are often subject to rigorous guidelines and assessment criteria and price sensitivity is quite often a material factor in the awarding of contracts.

By world standards, Australian companies face comparatively higher labour costs, which in the context of high value-add and high specialisation projects, can make it difficult for Australian companies to successfully compete with companies from other [low labour cost] countries. The ability to optimally manage labour costs is therefore an important element in business decision-making in relation to competing for offshore contracts. Significant and unexpected additional labour costs can sometimes convert a profitable offshore project into a loss-making venture.

The changes proposed in this Bill will have a dramatic effect on the competitiveness of Australian companies operating in offshore locations. Also, the implications of this on Australia's desire to be a regional financial centre and its capacity to attract and retain the 'best and brightest' people will also be jeopardised. In light of this, we believe the Government should re-consider its policy decision to move away from the section 23AG exemption model before enacting the proposed changes.

The move away from the 'exemption model' that is currently adopted in relation to foreign income derived by Australian residents, is, in many cases, expected to result in the additional tax being borne by the Australian resident's employer. This is particularly the case where tax equalisation arrangements[2] are adopted by residents working abroad for Australian-based businesses. At a time when many businesses are finding it difficult to survive in the current challenging economic climate, this additional tax impost will have a significant impact on profitability.

It is worth pointing out that this proposed change is expected to generate additional tax revenues of $675 million over the four-year forward estimate period of the 2009-10 Federal Budget, in-line

[2] The concept of 'tax equalisation' refers to arrangements whereby employers undertake to maintain an employee's stay-at-home net position so that the employee is not better-off or worse-off as a result of deciding to move abroad for a period of time for their employer. A global survey of companies conducted by PricewaterhouseCoopers in 2004 found that around 84 percent of those companies surveyed adopted a tax equalisation policy in respect of staff sent abroad on assignment.

with the arguments set out above, it is likely that most of this additional revenue will be collected from Australian businesses.

**2. No transitional arrangements have been proposed**

The changes proposed in the 2009-10 Federal Budget are proposed to have effect for income derived by Australian resident taxpayers from 1 July 2009. Imposing an immediate start date for a dramatic change such as this will cause significant concerns, and potentially financial hardship, for many taxpayers.

At any given time, a large number of Australian residents will be working offshore and therefore be potentially impacted by this change. All of those workers will have left Australia under the auspices of particular financial and tax arrangements, and made decisions about whether or not to accept offers to move offshore on the basis of those arrangements. For those workers, 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.

Given the potential for significant financial impact for certain taxpayers, in our view it would be more appropriate for the Government to implement the proposed changes via a transitional arrangement whereby only new employment agreements entered into from 1 July 2009 would be subject to the new rules which limit access to the section 23AG exemption. Adopting this approach would allow those workers who are currently offshore on specific agreements to retain the features of those agreements until their natural expiry. Typically, many pre-existing agreements would only continue for a set period of perhaps up to two years.

It would seem reasonable and appropriate, given the circumstances, for the Government to adopt a transitional arrangement in this case so as to not unfairly jeopardise existing agreements that were entered into based on Australian taxation law as it stood at the time of agreement. The principle of allowing a 'grandfathering' type approach to transitioning to new tax laws is well established in Australia and has been used extensively for implementation of significant new tax policies such as this.

**3. Limited access to section 23AG will create distortions**

The proposed changes seek to limit eligibility to the section 23AG exemption to Australian residents who are considered to be performing duties that are 'in the national interest'. Imposing a restriction on eligibility to access the section 23AG exemption on the basis of 'national interest' seems at least equally as arbitrary and distortionary as having the exemption in the first place. By way of example, members of the Australian Federal Police (AFP) and the Australian Defence Force (ADF) would appear likely to continue to be eligible for the section 23AG exemption if the proposed changes are ultimately brought into law with effect from 1 July 2009.

As the Committee would be aware, over recent years there has been a move towards the outsourcing of certain logistical and support services work carried out by organisations such as the AFP and ADF in offshore locations where Australia has a peace-keeping role, or some other development assistance commitment. It would therefore appear to be the case that employees of the AFP and ADF may have on-going access to the section 23AG exemption for carrying-out work deemed to be 'in the national interest', whilst employees of a commercial business that has been contracted to carry-out logistics and other support services alongside the AFP or ADF would not enjoy access to the same exemption. This outcome gives rise to a clear and direct distortion as between employees of government organisations and employees of commercial organisations, who in certain cases will be carrying-out substantially similar duties and functions 'in the national interest'.

This being the case, it is difficult to reconcile how the proposed changes will remove distortions that are said to currently exist as a result of the section 23AG exemption, given that employees of the AFP or ADF will be eligible to access the exemption and others will not.

**4. Certain consequential amendments are required**

The proposed amendments to section 23AG do not foreshadow the need for a number of consequential amendments that would appear to be required as a result of the move away from the exemption model.

Firstly, the *Tax Administration Act 1953* (TAA) requires that an employer withhold tax from an amount of salary, wages and other similar remuneration payments paid to an employee in respect of employment services. Under the current provisions of the TAA, PAYG withholding is not required where the payments to which the employment services relate are exempt under section 23AG. Moving away from exemption of income under section 23AG will therefore give rise to a need for PAYG withholding from salary and wages payments. Such withholding would be triggered over and above, and in addition to, any foreign tax withholding that may take place in the destination country in which the employee is carrying-out their duties. Withholding of tax on salary and wages derived in the destination country is likely to take precedence over Australian PAYG withholding on the basis that double tax agreements typically assign primary taxing rights to the destination country in which the employee is performing their duties.

This situation could effectively result in two amounts of tax being withheld in respect of the same income derived by the offshore employee.

Consequential amendments are therefore required in order to ensure that excessive withholding of salary and wages does not take place so as to significantly erode the net cash financial position of offshore employees.

Secondly, a potentially unforeseen consequence of the proposed changes to section 23AG is that foreign companies would appear to be required to register for Australian PAYG withholding purposes as a result of the fact that an Australian resident working offshore will be providing services which give rise to Australian PAYG withholding obligations. This will give rise to a need for the foreign company to register not only for Australian PAYG withholding purposes, but also for Australian Business Number purposes thereby creating additional compliance obligations for both the foreign company but also the Australian Taxation Office.

Thirdly, the operation of Australia's fringe benefits tax regime (FBT) will result in an outcome whereby benefits provided to employees working offshore will be subject to an Australian FBT liability. Unlike income tax, no facility exists whereby a FBT credit can be claimed on the value of tax that may have already applied to the value of the benefit provided to the employee working in the offshore location [given that the benefit in the offshore location is likely to have already been subject to local income tax in the hands of the employee].

**Summary of recommendations**

In summary, the Institute believes that the Committee should recommend the following to the Parliament:

1. The Government should re-consider the merits of the proposed changes and confirm whether or not the policy position accords with broader Government strategies which seek to make Australia a more attractive regional financial centre and attract and retain the 'best and brightest' people in this country.

2. If the proposed changes are enacted, appropriate transitional arrangements should be implemented which exempt current agreements that have been entered into on the basis of the Australian tax law as it stands before implementation of the proposed changes. Adoption of an appropriate transitional arrangement will go some way to addressing the immediate competitiveness concerns that many Australian business will face where they are delivering contracts offshore utilising Australian resident labour.

3. A number of consequential amendments that arise as a result of implementing the proposed changes should be considered and legislated at the same time as the primary changes to section 23AG [given the proposed start date of 1 July 2009] so as to provide businesses with some certainty about other related matters.

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The Institute would be pleased to provide the Committee with further information on any of the issues raised in this submission as part of the Inquiry into this Bill. If we can be of any assistance, please do not hesitate to contact me direct on 02 9290 5623.

Yours sincerely,

**Yasser El-Ansary**
Tax Counsel
The Institute of Chartered Accountants in Australia