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The Income Tax Assessment Act 1936 – S23AG and Double Tax Avoidance Agreements

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Abstract

The paper illustrates that the changes introduced since July 2009 with reference to Income Tax Assessment Act 1936 – S23AG are in direct conflict with both the spirit and purpose of specific Double Tax Avoidance Agreements (DTAA) of which Australia is a signatory. The DTAA with Singapore is taken as an illustrative case. Further, as illustrated in the paper the changes have introduced both social and economic losses to Australia.

[I] Introduction

The Income Tax Assessment Act 1936 – S23 AG (Commonwealth of Australia) sets out the types of foreign employment income that are exempt from Australian taxation[1]. Prior to July 2009, any Australian's foreign employment income (FEI) earned over a period exceeding 91 days was exempt from tax in Australia. Some significant changes were introduced in July 2009 by the then Prime Minister Kevin Rudd and Treasurer Wayne Swan. As of July 2009, only persons belonging to specific professional categories such as aid workers and defence personnel are exempt from such tax. Anyone else earning FEI would be assessable for Australian tax unless he/she is deemed a non-resident for taxation purposes. As a result, several Australians working abroad took precautionary measures to enforce their non-residency status and distanced their connections to Australia to further reinforce their non-residency.

The object of this brief note is to demonstrate that the changes that were introduced since July 2009 with reference to ITAA 1936 – S23AG are in direct conflict with both the spirit and purpose of specific Double Tax Avoidance Agreements (DTAA) of which Australia is a signatory. As the title implies DTAA are designed to avoid the same income being taxed more than once and are guided by tax convention commentaries issued by OECD (2010)[2]. In order to illustrate the nature of the conflict, this paper considers the second DTAA[3] that was signed between Australia and Singapore on September 2009 (and rendered effective on December 2010). Note that the signing of this agreement took place *after* the aforementioned changes were effected to the ITAA 1936 – S23AG in July 2009.

[1] Hereafter this act and section is referred to as ITAA 1936 – S23AG.
[2] OECD, *Model Tax Convention on Income and on Capital*, 8th Edition, Paris 2010
[3] *International Tax Agreements Amendment Bill (No.2) 2010* (Commonwealth of Australia); Also see http://www.iras.gov.sg/irasHome/uploadedFiles/Quick_Links/Singapore-Australia%20DTA(Ratified)(22Nov2010).pdf

The paper is structured as follows. The next section provides a summary of the changes that were introduced in July 2009 with reference to FEI in ITAA 1936 – S23AG. This is followed by an examination of how these changes are in direct conflict with the DTAA that was signed September 2009. In the end it is possible to demonstrate that Australia has been the net loser in both social and economic terms because of the changes to ITAA 1936 – S23AG.

[II] The Changes to ITAA 1936 – S23AG from July 2009

As indicated above, prior to July 2009, any FEI earned in excess of 91 days was exempt from Australian tax. The changes that were ushered in by the Rudd-Swan Government in July 2009 represented an explicit effort to broaden Australia's tax base and concur that Australia could tax the world wide income of her residents.

It is noteworthy that the narrative provided by the Australian Tax Office (ATO) on taxation categories of FEI is not consistently clear and explicit. In some instances the narrative tenuously worded and couched within the double-negative. Consider first the exposition that is clear with reference to FEI. The ATO (2013) describes this as follows[4]:

> "Australian residents for tax purposes are taxed on their worldwide income, so if you have foreign employment income, including salary, wages, commission, bonuses allowances or you receive non-cash benefits, you may need to include it in your tax return.
>
> If you have paid tax in another country, you may be entitled to claim a foreign income tax offset (FITO) in your Australian tax return, which provides relief from double taxation.
>
> Foreign earnings derived on or after 1 July 2009, from foreign service performed on or after 1 July 2009 may be exempt from tax in Australia, but the exemption for foreign employment income is limited to certain types of employment".

The conditions and the certain types of employment that are exempt from taxation for an Australian resident are clearly stipulated as follows[5]:

[4] http://www.ato.gov.au/Individuals/Income-and-deductions/In-detail/Foreign-income/Foreign-employment-income-and-section-23AG---employees/

[5] http://www.ato.gov.au/General/International-tax/In-detail/Foreign-employment-income-of-Australian-residents/Exempt-foreign-employment-income/

"Your foreign employment income is exempt from tax if **all** of the following applies:

- you are an Australian resident
- you are engaged in continuous foreign service as an employee for 91 days or more
- your foreign service is directly attributable to any of the following
  - delivery of Australian official development assistance by your employer
  - activities of your employer in operating a public fund declared by the Treasurer to be a developing country relief fund
  - activities of your employer in operating a public fund established and maintained to provide monetary relief to people in a developing foreign country who are distressed as a result of a disaster (a public disaster relief fund)
  - activities of your employer as a prescribed charitable or religious institution exempt from Australian income tax because it is located outside Australia or the institution is pursuing objectives outside Australia
  - deployment outside Australia by an Australian government (or an authority thereof) as a member of a disciplined force
- you are not excluded from exemption by the non-exemption conditions."

Tax treaties are included in the so called "non-exemption conditions" identified in the last bullet point above. ATO's language on the exemption afforded by the treaty is tenuous and is couched in the double negative[6]:

"Your foreign employment income is not exempt from Australian tax if you did not have to pay tax in the country where you earned that income because of any of the following:

- a tax treaty with Australia or a law giving effect to a treaty agreement …."

This could be interpreted as:

"Your FEI is exempt from Australian tax if you paid tax in the country where you earned the income because of any of the following:

- a tax treaty with Australia or a law giving effect to a treaty agreement …."

[6] http://www.ato.gov.au/General/International-tax/In-detail/Foreign-employment-income-of-Australian-residents/Exempt-foreign-employment-income/?anchor=Non_exemption_conditions#Non_exemption_conditions
(Please see screen snapshot of these websites content in Appendix)

Although ATO (2013) has required concurrent compliance with all conditions listed above, a reading of ITAA 1936 – S23AG does not appear to dictate concurrent compliance of its Subsections (especially Subsections 1 and 2)[7]. Nevertheless, the changes introduced by the Rudd-Swan administration and their implementation by the ATO were to remove Australian residents from the specific treaty provisions in order to render them liable for taxation in Australia.

But there is a clear conflict between the changes introduced in July 2009 with reference to ITAA 1936 – S23AG and the DTAA (with Singapore) that was signed in September 2009. As indicated below the DTAA does not make reference to the professional categories that the ATO stipulates, notwithstanding the possibility that ATO is likely to have breached ITAA 1936 – S23AG by deeming the concurrent compliance of Subsections 1 and 2 of the Act. Instead the DTAA makes the distinction in terms of the *source* and *situ* of the FEI. The source of the income of professional categories identified in the changes made to ITAA 1936 – S23AG is exclusively Australian. The source and situ for those covered within the DTAA can be either Australia or the contracting state, namely Singapore in our illustrative case. This is considered next.

[III] The DTAA between Singapore and Australia

The first DTAA between Singapore and Australia was signed in 1968. As indicated the amendment to this agreement was signed in September 2009 – after the ITAA 1936 – S23AG changes were introduced in July 2009. The amendment was solely on Article 19 of the first agreement and sought primarily to enhance the exchange of information between the two sovereign states. All other Articles were left intact.

Articles 11 and 12 of this treaty quite explicitly stipulate a different and distinct set of conditions for tax exemptions. This then begs the question as to why the Australian signatory did not repeal these articles - especially given that the changes to ITAA 1936 – S23AG were introduced two months earlier. In other words Articles 11 and 12 of the Singapore – Australia DTAA existed both *before* and *after* the changes to ITAA 1936 – S23AG took effect. The distinct exemption conditions are found on Paragraph-1 of each of these Articles and are as follows:

[7] For example see a display of the Act at: http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s23ag.html

ARTICLE 11

Paragraph-1: Subject to this Article and to Articles 12, 13 and 14, remuneration or other income derived by an individual who is a resident of one of the Contracting States in respect of personal (including professional) services shall be subject to tax **only** in that Contracting State **unless** the services are performed or exercised in the other Contracting State. If the services are so performed or exercised such remuneration or other income as is derived therefrom shall be deemed to have a source in, and may be taxed in, that other Contracting State.

(Bold font – Author's emphasis)

ARTICLE 12

Paragraph-1: Remuneration or other income derived by an individual who is a resident of one of the Contracting States in respect of personal (including professional) services performed or exercised in the other Contracting State shall be exempt from tax in the other Contracting State if -

(a) the recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days in the year of income or in the basis period for the year of assessment as the case may be of that other Contracting State;

(b) the services are performed or exercised for or on behalf of a person who is a resident of the first-mentioned Contracting State; and

(c) the remuneration or other income is not deductible in determining the profits for tax purposes in the other Contracting State of a permanent establishment in that other Contracting State of that person.

In terms of these articles, an Australian resident would be exempt from Australian tax if:

1. He/she performed the services to earn FEI in the contracting state – Singapore;
2. The FEI was earned over period exceeding a presence of 183 days in Singapore; and
3. The employer who provided the FEI is a resident of Singapore and not Australia.

The paragraphs of Articles 11 and 12 cited above are drawn explicitly from Article 15 in the OECD Model Convention on Income and Capital[8]. This begs the question of as to why the signatories did not amend Articles 11 and 12 of the DTAA.

[8] OECD (2010), above n 2

The next question to be resolved is whether or not the DTAA is a binding agreement. In common parlance a document bearing signatories is regarded as binding. In that case including the DTAA as a condition within ITAA 1936 – S23AG violates the binding nature of the DTAA. For example, one who satisfies the exemption conditions in terms of the DTAA would not always meet the criteria set out in the changes to the ITAA 1936 – S23AG, notwithstanding the fact that ITAA 1936 – S23AG (1936) as such does not dictate concurrent compliance as the ATO does.

Nevertheless, the consensus appears to be that anyone who is in breach of ITAA 1936 – S23AG would be taxed on the basis of worldwide income regardless of the DTAA. In this instance, both the ATO and tax agents operate on the basis of determining foreign income tax offsets. If the DTAA is a binding document, (as it should be, because it is bound by signatories), then the application of foreign income tax offsets is also a breach of the DTAA. This is because the DTAA is designed *to avoid the same income being taxed more than once*. The net effect of the confusion has been that almost all Australians earning FEI have sought to claim non-residency status in the contexts where foreign tax rates are lower than those of Australia. For its part, the ATO has introduced stringent residency criteria – beyond those readily discernible from the public domain – in order to capture a broader tax base. As argued below, the net effect is more than likely a welfare loss to Australia instead of a gain.

[IV] The Losses to Australia

The drive by Australians on FEI to nominate themselves as "non-residents for taxation purposes" has meant that they have had to distance themselves from Australia as much as possible. In most instances, the mere compliance with the four statutory tests – namely the *resides test, domicile test, the 183 day rule and superannuation rule* – could prove insufficient. Consider for example, the definition for a permanent abode offered by OECD (2010) in Paragraph 13 of the Commentary on Article 4 of the Model Convention[9]:

As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not

[9] OECD (2010), above n 2

occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.)

Even if one were able to demonstrate permanence of residence abroad by recourse the content of Paragraph 13 displayed above alongside compliance with the other statutory tests, the tax authority could introduce other criteria to claim Australian residence. These include*: family connections, economic ties, frequency of visits* and above all *an intention to return to Australia* on the completion of foreign employment[10]. The net effect is that many Australians have distanced themselves from Australia as much as they could. The measures adopted have included reduced visitations and diminution of family connections. In such a context, the tax authorities could be seen as agents of estrangement and contraction of social capital.

The changes to ITAA 1936 – S23AG have caused clear economic losses to Australia. A study of primary income credits in Australia's balance of payments demonstrates these credits which increased steeply until 2009 showed a marked decline soon after the changes were introduced 2009. The trend analysis of the data, spanning time periods (1970 – 2012) and (2002 – 2012), displays a clear downward trend after 2009; Figure-1. Between 2008 and 2010, the loss in primary income credits amounted to about $10.5 billion.

(Figure-1 About here)

Apart from the loss in primary income credits the reduction in visitation by those working abroad does bear adverse impacts. This is because when those on FEI visit Australia, they spend their FEI in Australia and thereby contribute to both Australia's GDP and fiscal revenue by recourse to GST. For example consider the case of Australian expatriates in Singapore. In 2012 there were some 20,000 Australians residing in Singapore; (Asia Society 2012)[11]. For purely illustrative purposes suppose that these Australians made 6 visits back to Australia annually and each spent a cumulative total of 80 days in Australia. Further suppose that on each visit they each person spent some $300 (AUD) per day. The contribution of these Australians to Australia's expenditure estimates of GDP would be $480 Million with a

[10] Australia is not alone in the adoption of such criteria which are often not visible on the public domain. Canada, the United Kingdom and the United States also adopt such criteria.
[11] http://asiasociety.org/australia/lee-hsien-loong-singapore-ever-more-connected-world

potential GST contribution of $48 Million. The numbers are of course arbitrary and intended to illustrate the potential impact on the Australian economy. Australia has tax treaties with 44 counties. If one were to extend the hypothetical illustration assuming similarity in numbers, then the potential loss to Australia by recourse to reduced visitation could easily be around $2-3 Billion per year.

[V] Conclusion

As argued above, the changes to ITAA 1936 – S23AG have more than likely failed to deliver the revenue effects the then government of the day had anticipated. In fact the outcome has been the reverse context because many Australians on FEI had sought to demonstrate their non-residency status by minimizing their contacts with Australia. Apart from the pecuniary effects, the social effects of proving non-residency could border on prompting estrangement, emigration and disenfranchisement. One of the hidden criteria for non-residency is removal from the electoral roll. But, here again inconsistency pervades. The Australian Electoral Commission dictates that every Australian citizen must vote and that one could be enrolled in an electorate if he/she had resided at an address of that electorate for at least one month – a period significantly shorter than 183 days. But, the biggest inconsistency is to make binding document, namely the DTAA non-binding.

It would be prudent for the Australian government revise the changes that the Rudd-Swan government hurriedly formulated in 2009. If not for many Australians the Peter Allen ballad of *still calling Australia home* may be just a sour note.

Figure-1A: Primary Income Credits in Australia's Balance of Payments (1970-2012)

(Source Australian Bureau of Statistics)

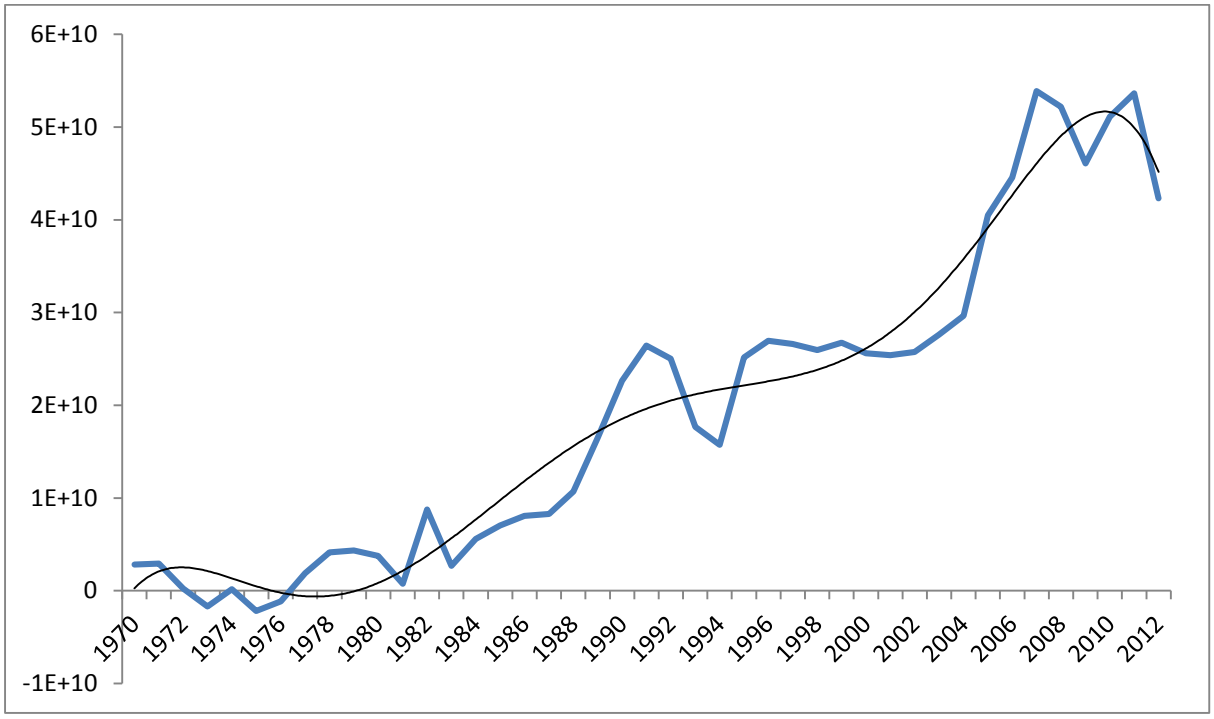
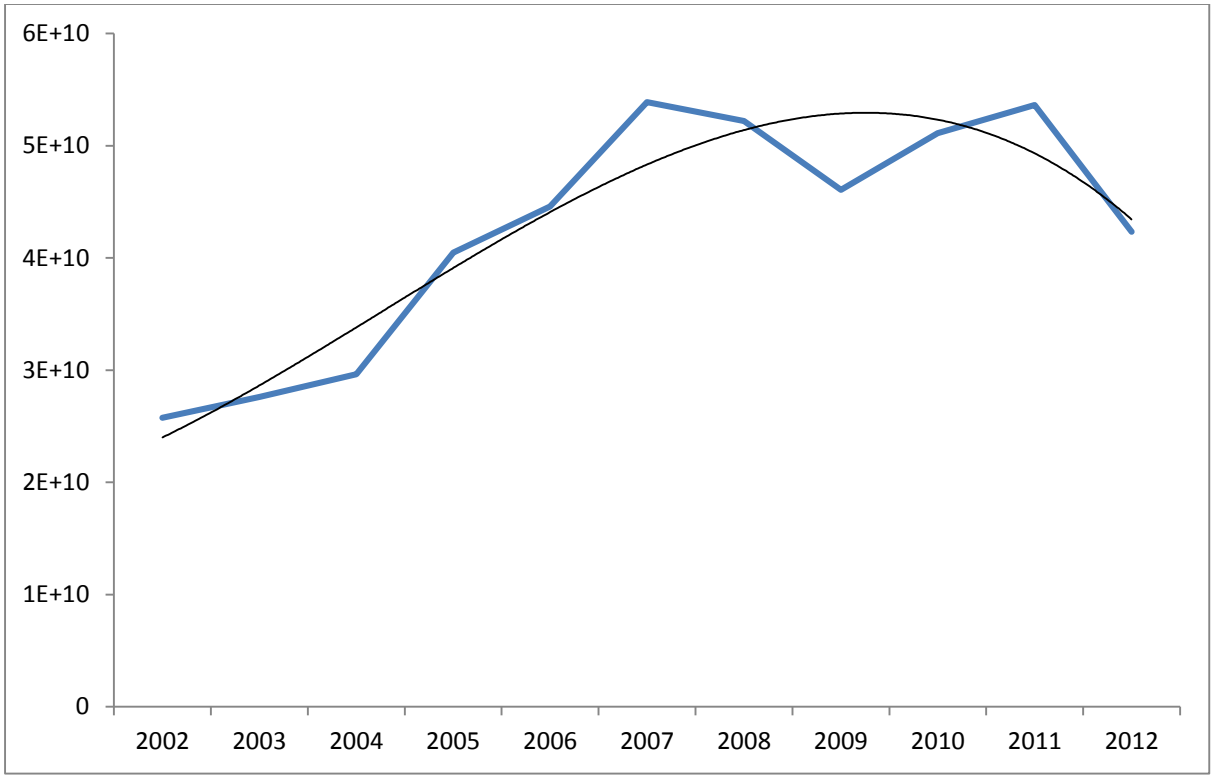


Figure-1B: Primary Income Credits in Australia's Balance of Payments (2002-2012)

(Source Australian Bureau of Statistics)



APPENDIX

SNAP-SHOTS OF:

http://www.ato.gov.au/General/International-tax/In-detail/Foreign-employment-income-of-Australian-residents/Exempt-foreign-employment-income/ and http://www.ato.gov.au/General/International-tax/In-detail/Foreign-employment-income-of-Australian-residents/Exempt-foreign-employment-income/?anchor=Non_exemption_conditions#Non_exemption_conditions