THE TAX INSTITUTE

14 September 2021

The Hon Josh Frydenberg MP Treasurer
The Hon Michael Sukkar MP Minister for Housing and Assistant Treasurer
House of Representatives
Parliament House
PO Box 6022
CANBERRA ACT 2600

By email: josh.frydenberg.mp@aph.gov.au, michael.sukkar.mp@aph.gov.au,

Cc:

Ms Maryanne Mrakovcic, Deputy Secretary Revenue Group, Treasury
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Mr Paul McCullough, First Assistant Secretary, Individuals and Indirect Taxation, Treasury
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Ms Kathryn Davy, CEO, Board of Taxation Secretariat
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Dear Treasurer and Assistant Treasurer,

Reform of Individual Tax Residency Rules

We welcome the Government's announcement in the Federal Budget 2021–22 to address issues within Australia's individual tax residency rules. We are writing to address the issues and concerns raised by our members with us regarding the recommendations made by the Board of Taxation (**the Board**) in its 2019 report *'Reforming Individual Tax Residency Rules – a model for modernisation'* (**the Report**).

The Tax Institute is supportive of the development of a model to replace Australia's current tax residency rules where the reform brings certainty and simplicity for affected individuals, employers and the Australian Taxation Office (**ATO**) while maintaining the integrity of the system. We recognise a diverse range of views on the merits of reform of the individual tax residency rules throughout our committees and the broader membership of The Tax Institute. However, it is our opinion that the recommendations of the Board, if implemented, will lead to unintended outcomes while unnecessarily increasing the compliance burden for many.

We have had the benefit of reviewing the confidential submission prepared by the Law Council of Australia. We support the issues and concerns raised in that submission and add further comments in **Appendix A**. We similarly ask you treat our submission with the same level of confidentiality as theirs.

Given the consultations to date, we have also enclosed, in **Appendix B**, an overview of what we consider could be a 'middle ground' for the reform of the individual tax residency rules. Our proposal attempts to build on existing law, improve the administrative burden for 'simple' residency cases, and retain provisions to address the variability in circumstances which commonly arise.

It is our opinion that any change in the individual tax residency rules would be well supported by reinstating the former breadth of the foreign employment income exemption in s 23AG of the *Income Tax Assessment Act 1936* (**ITAA 1936**) to address the unnecessary increase in cases reaching our court system and reduce the number of private ruling requests being dealt with by the ATO.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix C** for more about The Tax Institute.

If you would like to discuss any of the above, please contact Scott Treatt, General Manager, Tax Policy and Advocacy, on 02 8223 0008.

Yours faithfully,

Peter Godber

President

APPENDIX A

Overview

The Tax Institute is an advocate of holistic reform of the tax system where causes of legal and administrative concerns and impediments are identified and appropriately addressed. Any reform of the tax system should meet the three accepted fundamental principles of reform, being efficiency, equity and simplicity.

The individual residency rules are fundamental to our tax system. We support any reform to the rules for determining the Australian tax residence of individuals where the reform brings more certainty and simplicity for affected individuals, employers and the ATO while maintaining the integrity of the system. We consider it crucial that the proposed rules are appropriately designed in alignment with existing policy settings and balanced against broader priorities.

We acknowledge the significant work undertaken to date in the production of the Board's Report. The Board's involvement commenced with a self-initiated review in 2016 and, following the Government's response to the Board's initial recommendations[1], the Board undertook public consultation in September 2018. The final report was published in March 2019. The Tax Institute's submission in response to the consultation is available here.

We note that there has been an ongoing process where key issues, concerns and recommendations have been raised by stakeholders by way of submissions and roundtable consultation. Noting that it is not always possible to address all issues and concerns raised during consultation processes, there are several key concerns with the Board's final recommendations. Many of these concerns are well addressed in the Law Council of Australia's submission, with a number also addressed below.

Additionally, the Board has stated that less than 2% of Australians will have uncertainty regarding their residency. To the best of our knowledge, no data or modelling has been released which demonstrates the revenue loss or cost of compliance under the existing individual tax residency rules. Further, there is presently no information publicly available on the potential compliance cost savings or revenue impact of the Board's recommendations.

The Tax Institute is of the opinion that reform of the individual tax residency rules must bring certainty and simplicity for affected individuals, employers and the ATO while maintaining the integrity of the system. Integrity includes maintaining confidence in the system through appropriate and sensible outcomes. We consider that further, targeted consultation with the profession and key stakeholders, and transparency of potential compliance cost savings or revenue impact, is necessary prior to implementation and finalisation of the policy position as stated in the Federal Budget 2021–22.

General observations

Generally, an Australian resident is assessable on their worldwide income derived from all sources, but a non-resident is assessable only on Australian-sourced income. This is overlaid with the operation of Australia's double tax agreements, the temporary resident rules and the working holiday maker rules, among other provisions.

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[1] 'Reforming Individual Tax Residency Rules – A Model for Modernisation' https://taxboard.gov.au/consultation/reforming-individual-tax-residency-rules-a-model-for-modernisation Self-initiated Review of the Income Tax Residency Rules for Individuals https://taxboard.gov.au/consultation/self-initiated-review-of-the-income-tax-residency-rules-for-individuals.

On face value, the definition of a 'resident' appears relatively simple. However, in practice, the application of the definition requires detailed factual analysis and a comprehensive understanding of common law principles that have been established over many decades through case law. The Commissioner has also issued guidance material to assist with interpretation. However, an approach that involves working through a 'checklist' of factors has attracted widespread criticism from both the courts and from the Administrative Appeals Tribunal (**AAT**). Ultimately, where an individual resides is a question of fact and degree and requires consideration and a careful balancing of all the relevant circumstances.

We understand that the proposal on individual residency has been driven, in part, by a significant rise in disputes and, additionally, the increase in private ruling requests to the ATO on the resident/non-resident question. In the 79-year period from 1930 to 2009, there were only 25 court and AAT cases on individual tax residency. However, from 2010 to 2020 there were 56 cases on the residency of individuals and associated issues.

Most of the recent litigation on residency matters has been in relation to individuals working overseas who sought to have their foreign earnings not to be taxed following the 2009 changes which greatly restricted the availability of the exemption for foreign employment earnings under s 23AG of the ITAA 1936. Prior to its amendment, this exemption was a relatively simple way of addressing income earned by Australian tax resident individuals during overseas service or employment. The narrowing seemed to be the catalyst for the change in behaviour that led to several taxpayers attempting to argue that they were non-residents for tax purposes.

Reinstating the former breadth of the foreign employment income exemption, and addressing prior compliance concerns in its redrafting, would:

a) reduce both the number of ruling applications made to the ATO and the number cases going before the AAT and the courts.

b) be completely consistent with the existing approach taken for companies in respect of foreign sourced active income; and

c) encourage the international movement of people and the associated knowledge transfer benefits that generally arise.

The outcome for the revenue in many (if not most) cases is little different to assessing the foreign income and providing a credit but the compliance cost imposed on the individual is significant.

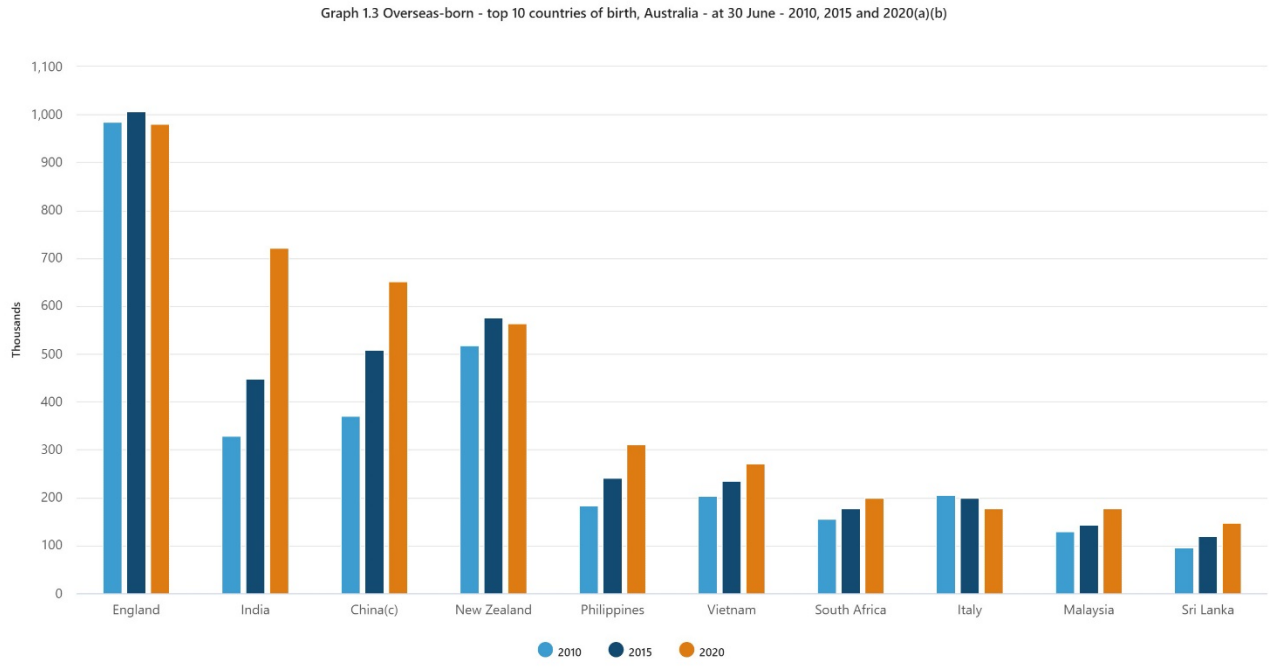
An additional consideration in favour of reducing the administrative and compliance burdens imposed by the individual residency rules includes the creation of greater parity in the tax rates applicable to resident and non-resident individuals. By way of example, in New Zealand, the same tax rates apply to both resident and non-resident individuals. It is our opinion that longer-term benefits would arise from debating more holistic reform options prior to simply amending an area of 'noise' within the system. Such changes could incorporate changes to both the tax and transfer systems to make it more palatable to implement the change.

It is also very important that the individual residency rules and the underlying policy settings are not being used to do the "heavy lifting" that should be done by other parts of the system. For example, if a particular condition associated with a particular class of visa is responsible for generating integrity issues or a counter-intuitive outcome, then the conditions associated with that visa should be examined rather than reliance being placed on the individual tax residency rules to provide a solution.

One example to consider in this regard is the Business Innovations and Investment (provisions) Visa (subclass 188). Where the visa conditions are satisfied, a spouse and children can settle in Australia while the main income earner remains offshore, but for short periods. In our opinion, the Board's recommendations do not adequately address this behaviour, and nor should the individual tax residency rules be drafted in a manner which seeks to address it. We believe that this is a situation where the visa should deem tax residency for a period years after grant of the visa. For completeness, we note this 'deeming' would only affect business migrants from non-treaty, low taxed jurisdictions.

Consideration of Double Tax Agreements

What cannot be forgotten when reviewing the individual tax residency rules is the overlay of Australia's double tax treaties. Australia has double tax agreements with over 40 countries, including all of the top 10 countries from where Australia's migration originates. These countries can be seen in the graph below.



Over the last 40 years, with consistent positive net migration, migration to Australia has remained around double (if not more) of emigration from Australia[2]. As such, Australia's residency issues are predominantly an inbound issue. However, in considering the issues from an outbound perspective, anecdotally it is suggested that similar trends in jurisdictions apply, and Australia would have double tax treaties will all the major destinations to which most Australians emigrate.

To this end, Australia's right to tax is amended by the respective double tax agreements. Residency plays a core role in these agreements and the related tie-breaker provisions dealing with dual residency scenarios are central. These tie breaker provisions consider concepts that the Board's recommendations are trying to simplify. Accordingly, given the immigration data above, for many the complexities will remain, if not be exacerbated, by bringing more individuals into Australia's tax residency net only to be often overridden by a double tax agreement.

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[2] Scanlon Institute, Migration Dashboard https://scanloninstitute.org.au/migrationdashboard.

Accordingly, we would question how far we should depart from our existing individual tax residency rules for the purposes of addressing what should be a limited affected population, given the role of Australia's double tax agreements.

The Board's recommendations

As noted above, we support the comments made by the Law Council of Australia. We add our further comments below.

Primary test — the 183-day test

We support a primary bright-line test based on a 183-day physical presence in Australia. This approach applies principles established within existing laws and Australia's double tax agreements.

The secondary tests

As noted by the Law Council of Australia, the issues and concerns also being raised with us are within the secondary tests. We make specific comments additional to those of the Law Council of Australia as follows:

45-day threshold

It is our opinion that the simple 45-day threshold is too low. We consider a threshold of around, say, 60 days would be more reasonable. The distances travelled to get to Australia, accompanied by the ease by which individuals can work remotely, could easily result in individuals spending more than 45 days in Australia without any genuine or enduring connection to Australia. Given the ease by which the presently proposed factor test can be satisfied, a low threshold would be inappropriate.

Furthermore, it is our opinion that many of the complexities contained within the existing individual residency rules replicate themselves in the factor test. Accordingly, putting aside those who clearly meet the 183-day test, the provisions will impose many of these present complexities on anyone spending more than 45 days in Australia, rather than merely those who should be considered an Australian resident.

By way of example, an individual having two 4-week trips to Australia to visit family could, based upon the tests proposed by the Board, be considered a resident. This would be the case for an individual with a young family being schooled here where the young family otherwise resides in a premises owned by the individual; or alternatively an Australian citizen who lives overseas but returns often to visit elderly family. We do not consider these outcomes as appropriate. If the Government is to continue with the concepts as proposed by the Board, we believe a 60-day period would be more reasonable in these circumstances.

For completeness, we note that practical issues remain with any threshold based on days. Accordingly, a discretion should be built into the law to address unforeseen and extraordinary circumstances, such as COVID-19 where international borders have been closed, to provide limited scope for flexibility on administration in those circumstances.

Number of factors

The Tax Institute acknowledges that the four objective factors were concluded by the Board to demonstrate an individual's connection to Australia. They are intended to be based on key residency considerations from existing rules and international comparisons, but intended to be reduced to simpler, modernised factors that can be objectively determined.

As noted above, we are concerned that the four proposed factors do not resolve the complexities at hand, and we consider the two-factor threshold for achieving residency status to be inappropriate based on the current proposed four factors.

We reiterate the following points raised by the Law Council of Australia:

- A mere 'right to reside in Australia' is not an indicator of where an individual actually lives or is settled — the key consideration for residency. It would be beneficial for this factor to be removed entirely and replaced with a more relevant consideration.
- Where an individual has family in Australia, the individual will usually have access to Australian accommodation. Accordingly, it is too simple for an individual to meet '2 factors' without there being proper consideration of factors relevant for residency.

Balance of factors

In The Tax Institute's 2018 Submission, we suggested the relevant factors should all be easily verifiable and have flexibility and scope to account for the practical circumstances of modern life. It was also considered that there may be some merit in exploring a weighting system as a secondary factor-based test. If the Government is to continue with the concepts as proposed by the Board, we strongly advise a weighting system is adopted, rather than a 'black and white' '2 of 4' factor test.

Other concerns and observations

The Board references 'integrity' as being a key feature for the proposed concepts, in particular noting the issue of 'residents of nowhere'. Similar to the Law Council of Australia, The Tax Institute believes that 'residents of nowhere' is an existing integrity risk predominantly associated with high wealth individuals and results in the avoidance of tax in Australia. As noted above, there has been no data or modelling released, that we are aware of, to demonstrate how big of a risk to revenue this issue is. Accordingly, we would caution over-engineering the relevant tests to address an issue which could be immaterial. If required, a specific integrity rule should be introduced to address the issue rather than it being addressed by the ceasing residency test for all long-term residents as currently proposed.

Options for reform

We restate our opening remarks, any reform should be directed at the cause of the issues and ensure these issues are properly addressed. When considering the impact on increased court cases, reinstating the former breadth of the foreign employment income exemption would be a sensible consideration. We would also suggest a more fulsome consideration of the impact of how thresholds are applied to resident and non-resident individuals and how reform of both the tax and transfer systems could reduce disputation in this regard. These considerations could be considered in addition to amendments to the existing individual tax residency rules.

With regard to the Board's recommendations, we consider further work is required to reduce the risk of inappropriate outcomes. In addition to reshaping the relevant factors, an appropriately structured weighting principle would be no more complex than the current rules and still provide certainty on interpretation.

Separately, we have considered how one may balance the issues and comments raised above, and in the submission put forward by the Law Council of Australia. We have considered how the principles raised by the Board could be addressed, while building upon on existing laws, principles and general practice.

We have enclosed at **Appendix B** a rough outline of how such a revised provision may be structured.

We acknowledge the difficulties and challenges in trying to find the right balance between simplicity and certainty. We believe an approach like that set out in **Appendix B** would address both the key principles raised by the Board in their Report and a number of the concerns raised with us, while ensuring the fundamental principles of tax reform are met.

In our opinion, an approach like this ensures a just and common-sense outcome, and gives rise to the following benefits:

- It acknowledges the significant diversity in the population. Those younger individuals seeking working holidays, skilled labour for industries in need, executives with global assignments and high net worth individuals moving around the world, all of whom have differing family situations.
- Significantly more expatriates than at present will have certainty regarding their residency status. They will be captured by either the 183-day or the 60-day threshold (as proposed by us, or the relevant threshold as determined by Government) combined with the work and accommodation factors.
- Sufficient flexibility is built into the 60-day test to allow a weighting of factors where the work and accommodation factors are not met. This personal and economic ties test is consistent with many of Australia's double tax agreements.
- Certainty is provided regarding the time when residency commences and when it ceases.
- Residents of nowhere are addressed by specific provision rather than increased complexity in a factor test.
- Further integrity of the system can be maintained through the 'resides' test where individuals attempt to manipulate the day thresholds to their advantage.

APPENDIX B

An example of potential reform to Australia's individual tax residency rules, and should be considered in conjunction with the notes below:

(1) **Resident or resident of Australia** means a person, other than a company, who resides in Australia and includes a person:

(a) who spends more than 60 days in Australia in the year of income; and

(i) works in Australia and has long-term accommodation available in Australia; or

(ii) on a weighting of facts, their personal and economic ties are closest with Australia; or

(b) who spends more than 183 days in Australia in the year of income.

(2) **Time of commencing residency**

(a) If you start being a resident in the income year, you are taken to be a resident from the first day you arrive in Australia.

(3) **Time of ceasing residency**

(a) If you cease being a resident under (1), you are taken to be a non-resident:

(i) if you are a temporary resident — from the day following the day you depart Australia;

(ii) if you have *offshore employment within 90 days of when you leave Australia — from the day following the day you depart Australia;

(iii) if you are a *resident of nowhere — from the last day of the income year you cease to satisfy (1) or from when you attain residency in another jurisdiction, whichever is later; or

(iv) in all other cases — from the last day of the second income year following the income year that you last satisfied (1).

(4) **Commissioner discretion in extraordinary circumstances**

(a) Despite (1), (2) and (3) the Commissioner may determine in writing that a person, or a group of persons, is not a resident of Australia for a period.

(b) The Commissioner may only make a determination under (a) where extraordinary circumstances exist, including border closures, outside of the influence or control of the person or persons. Extraordinary circumstances do not include flight cancellations or illness.

(5) **Application of a relevant double taxation agreement**

(a) If you are a resident of another country and not Australia for the purposes of the double taxation agreement between Australia and that other country, then you are not a resident for Australia for all purposes of this Act.

DEFINITIONS

Resident of nowhere means a person, other than a company, who does not satisfy (1) for the income year and is not tax resident in a foreign jurisdiction.

Offshore employment means a contract for employment in a foreign jurisdiction and you have accommodation available to you in that jurisdiction for the employment period.

Notes

- We note that the above is for illustrative purposes only. The design of this option would benefit from further consultation, including testing case studies we may not have considered. For example, further policy consideration would need to be given to an accompanying spouse or family member of an individual who ceased to be a resident and satisfied either (3)(i), (ii), or (iii).
- With regard to (3)(iv) above, while the timing is consistent with that proposed by the Board, it would benefit from further consultation. It is relevant to question whether (iv) is needed if (1) is worded appropriately and residents of nowhere are otherwise sufficiently addressed. We also note the relevant double tax agreements, where in force, would address most outbound scenarios otherwise captured here.
- Regarding the adhesiveness principle, if there are revenue concerns regarding CGT event I1, and the disposal of CGT assets that are not taxable Australian assets, it would be preferable to introduce an integrity rule in that provision rather than overcomplicate the individual tax residency rules. In our opinion, we believe the market value rules should capture most scenarios, and an integrity rule would not be needed. However, if deemed necessary, an integrity rule could potentially 'claw back' gains on those assets sold within, say, 1 year from ceasing residency where Australian tax residency is re-established within a reasonable time thereafter. This would reduce complexity of the individual tax residency rules while maintaining the integrity of the tax system.
- To provide certainty in extraordinary time, for example COVID-19 where borders have been closed, we consider (4) would be beneficial.
- While (5) is not necessary within the definition of resident, we believe further clarity would be achieved by its inclusion in the International Agreements Act.
- The weighting of factors in (1)(a)(ii) could be set by way of regulation to ensure sufficient clarity is provided to taxpayers.
- Irrespective of the final design of the law, we recommend a review of the new rules be set to take place around 5 years after their implementation.

APPENDIX C

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government, and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge, and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships, and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic, and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.