Law Council
OF AUSTRALIA

Business Law Section

9 November 2018

Board of Taxation Secretariat
Level 5, 100 Market Street
SYDNEY NSW 2000

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of the Income Tax Residency Rules for Individuals – Consultation Paper

The Taxation Committee of Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity of commenting on the Consultation Paper of September 2018 prepared by the Board of Taxation entitled *Review of the Income Tax Rules for Individuals*. The Committee acknowledges the magnitude and importance of the task facing the Board given that "Australian residence" is one of the two pillars upon which Australia's taxation jurisdictional claim rests, individual residence being a major part of the first pillar of this jurisdictional claim.

1. Summary

Rather than comment on each of the thirty-eight specific questions raised in the Consultation Paper, this submission seeks to outline the key principles that the Committee thinks will achieve the primary goal of the Board's review – certainty, simplicity and integrity. We hope that a clear statement as to what we think any revised test for individual residency should be will have the most impact.

As an opening comment, the Committee believes that some of the integrity and fairness concerns that have been raised during the consultation process are not issues that should be dealt with by the residency test, but rather are broader policy issues that should be addressed by the review and, if necessary, reform of these other areas.

For example, one concern raised was that there is a subset of permanent visa holders that obtain visas for themselves and their families, yet never spend a significant amount of time in Australia, continue to conduct business predominantly overseas and leave their families in Australia to draw upon the education and healthcare benefits that Australia offers. If this is the case, then it would be an example of an issue that would be best dealt with by reviewing the relevant visa conditions rather than trying to solve the issue through the definition of a resident for tax purposes.

The concern is that trying to solve for every potential integrity concern, especially when those concerns have not to our knowledge been measured or modelled in terms of their impact on tax revenues, will make any attempt to improve the certainty and simplicity of the rules hopelessly conflicted.

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2. Preferred test.

Whilst it is fair to say that amongst our members there are a number of different views on what a revised test of individual residency should look like, we have set out below what we believe represents on balance a fair reflection of those views and the principles they embody.

(a) A simplified bright line test.

The test needs to be simple and certain and ensure that the vast majority of individuals, predominantly those with uncomplicated affairs, can apply the test and obtain the correct outcome.

The bright line test should only focus on days present in Australia. It should clearly define the period over which the days are being counted and what constitutes a "day" for the purposes of the test.

For the reasons identified in the Consultation Paper, we agree that it is sensible to have a different bright line test for inbound and outbound individuals, and to distinguish between individuals who have never been a resident of Australia from those who have.

(b) A secondary test.

If applying the bright line test and an individual is regarded as a resident of Australia, then the individual may choose to apply the secondary test. The secondary test would hopefully address a large number of the remaining individuals who apply the first bright line test and get what they believe is an inappropriate result.

Following the adhesiveness concept, this test should focus on factors associated with the individual's connections with Australia (and not overseas) and should be both as objective as possible and easily verifiable. Such an approach should allow employers to make an accurate determination without an exhaustive fact gathering process requiring information they may not readily have access to.

Rather than the "Factor Test" outlined in the Consultation Paper, we think a "points test" is the best way to give certainty to taxpayers as it would allow for a more flexible and appropriate allocation of weight to the relevant considerations. Clearly the identification of those factors and the weight to be allocated to each is a further discussion that should be had. We have provided an example of how such a set of factors and points could look below.

This approach ensures that the multitude of problems arising from the current tests revolving around the concepts of intention, domicile, permanent or usual place of abode, and requiring something to the Commissioner's satisfaction are all avoided.

(c) Commissioners discretion

Where after applying both the primary and secondary test an individual is still considered to be a resident of Australia, and believes they should not be, then that individual should be able to ask the Commissioner to exercise his discretion to treat him or herself as a non-resident. The criteria for the exercise of the Commissioner's discretion, and examples of when it might be applied, should be set out in guidance issued by the Australian Taxation Office.

Consistent with any bright line test, the Committee believes that it is sensible to have either different factors, or preferably only different weighting of those factors, for inbound and outbound individuals.

3. Specified Integrity Measure.

If the certainty and simplicity that the above primary and secondary tests provide is considered to result in an unacceptable level of risk to the Australian tax system, for example it allows some high net worth individuals to plan to become non-resident for the purpose of extracting funds from Australia without paying further Australian tax (by taking a large franked dividend once they are non-resident, or a large capital gain from an offshore trust) and then resuming residence, then those issues are best dealt with by targeted integrity measures, rather than overcomplicating the basis issue of tax residence of individuals as it applies for super majority of taxpayers.

Our further comments are set out below.

4. Bright Line Tests

Consider the following simple bright line test:

(a) Inbound

Never previously a resident:

- Resident if physically present for 183 days or more in Australia in any 12-month period, starting on the first of those 183 days.

If a resident at any time in the preceding three years:

- Resident if physically present for 61 days or more in Australia in any 12-month period.

Residency would commence on the day of arrival and a split or part year treatment would apply (as set out in design principle 7 in the Consultation Paper).

There are a number of views regarding the appropriate period across which to apply any day counting test. To the extent that the use of an Australian income year gives rise to potential manipulation, a day-count test that spans two or more years (such as the calendar day test in the US) could be used. The preferred measure is to test across any 12-month period and allow for part-year residence (discussed further below).

The general view is that a "day" in Australia for the purpose of the tests will include any day where the individual is physically present in Australia at any time during that day. Such a definition provides clarity and is simple to apply.

An additional bright line test involving the arrival of an individual in Australia holding an immigration visa could be considered further, although we note our opening remarks that the policy concerns of non-resident visa holders might best be addressed through changes to the relevant visa categories. This can also be worked into the secondary test as one of the factors to consider.

Some members have suggested having specific alterations to the bright line tests that would be designed to avoid inappropriate results for certain classes of individuals in particular circumstances. For example, if an individual would otherwise be resident under the bright line test but was in Australia for less than 273 days in a year of income, the taxpayer may elect to be tested under the Secondary Tests, but only for the first year, and only if the taxpayer is at least 30 years of age at the end of the Australian year of income. This might be particularly relevant for example to visiting academics, but to prevent abuse by others, such a test would need to be confined to a single year – "serial academics" and others shouldn't continue to get non-resident status.

(b) Outbound

If always previously a resident:

- Resident if physically present in Australia at any time in any 12-month period, or physically present for more than 30 days in any 24-month period.

If not always previously a resident, but resident in the previous year of income:

- Resident if physically present in Australia for 61 days or more in any 12-month period or 122 days or more in any 24-month period.

The framework for the simplified tests should err on the side of "overreach", that is, catching more people than it potentially should. The reason for this is that under this model such individuals should be able to then rely on the secondary test to reach the correct result. Such an approach should assuage some of the integrity concerns

Having a third and separate test of individuals who "work" overseas, whilst appealing, adds a degree of complexity back into the test. Such a test would potentially discriminate against those who are self-employed or contractors, and would be open to manipulation, for example, through the use of personal services companies. The Committee's preference is, on balance, therefore not to create a separate class of residence for individuals working overseas. The issue could be better addressed through reintroducing a standalone provision along the lines of the old section 23AG prior to its amendment.

Alternate test

An alternate test could be to have an upper and lower threshold that apply to determine an individual as either resident or non-resident, and then the secondary test would be applied only if you fall between those two. We think this adds an additional layer of

complexity and so is not the preferred model for that reason. For example, such a test could look as follows:

(a) Inbound

Never previously resident:

- Not a resident if present for less than 60 days in Australia in a year of income.
- Resident if present for 183 days or more in Australia in a year of income, starting on the first of those 183 days. If resident under this test, but in Australia for less than 273 days in a year of income, the taxpayer may elect to be tested under the Secondary Test, but only for the first year, and only if taxpayer at least 30 years of age at the end of the Australian year of income.
- Resident on arriving in Australia on an immigration visa.

If a resident at any time in the preceding 4 years:

- Not a resident if present for less than 30 days in Australia in a year of income.
- Resident if present for 91 days or more in Australia in a year of income, starting on the first of those 91 days.

(b) Outbound

If always previously a resident:

- Not a resident, if not present in Australia in any period of 365 days.
- Resident if present in Australia for 183 days or more.

If not always previously a resident, but resident in the previous year of income:

- Not a resident if not present in Australia for more than 14 days in a year of income.
- Resident if present in Australia for 183 days or more.

5. Secondary "points" test

If a person is a resident under the bright line tests, then they can elect to apply the secondary test. Individuals applying the test will only be a non-resident if in the relevant testing period they have less than 100 points made up of points taken from a list of factors. This approach has been recently used in other areas of tax legislation, such as the Early Stage Investment Company rules[1], and in practice the predominant view is that the clarity and simplicity of such an approach outweighs the odd circumstance in which a points test (if properly drafted) can give an unfair result.

[1] Division 360 of the *Income Tax Assessment Act* 1997

As noted above, adopting the adhesiveness concept, the secondary test should focus on factors associated with the individual's connections with Australia (and not overseas) and should be both as objective as possible and easily verifiable. Focusing on Australian connections also avoids much of the unfairness and difficulties that can arise when trying to assess, for example, whether or not someone has a permanent home in another jurisdiction or has financial interests in another country.

The factors also need to be sufficiently clear in order to avoid disputes over the meaning of any terms used in them. For this reason, the use of concepts such as "domicile" or "permanent place of abode" should be avoided.

A model for the secondary test is set out below:

Citizenship	**30 Points**
Holder of permanent resident visa	**15 Points**
Ownership of a residential dwelling in Australia by the taxpayer or an associate of the taxpayer, that is available to be occupied by the taxpayer	**50 Points**
Having a lease of at least one year, over a residential dwelling in Australia by the taxpayer or an associate of the taxpayer, that is available to be occupied by the taxpayer	**30 Points**
Spouse (from whom taxpayer is not legally separated), or de facto a resident of Australia under bright line tests	**20 Points**
Any dependent children who are residents of Australia under the bright line tests	**30 Points** *(regardless of how many)*
Director of an Australian company or self-managed super fund	**15 Points**
Each 30 days (or part thereof) physically present in Australia during the testing period	**8 Points**
On any electoral roll (Commonwealth or State)	**15 Points**

The key question to be addressed is clearly the weighting to each of the factors noted above. The outcomes need to be road tested and some basic scenarios worked through to ensure the correct outcome is reached. For example, should someone who accepts a job overseas but leaves their spouse and teenage children behind in Australia (and happens to visit for more than 30 days over say a three-year period) be regarded as a resident? Based on the above model, the bright line test would be failed, and the secondary test would also be failed. Is that the right outcome?

The points awarded for each factor could vary depending on whether it is an inbound or outbound analysis. However, the preference is to have one set of factors with the same points and to work through the various scenarios and to try and arrive at a weighting that gets the "correct" result in the vast majority of the cases. As noted above, there will clearly be differences of opinion as to what the correct result is on occasion.

Other factors that could be taken into account in the secondary test are too nebulous or are able to be manipulated. For example, how passenger cards are filled out, membership of clubs, driver's licences, holding of bank accounts and health insurance. One suggestion has been to include a factor capturing individuals under a certain age who have Australian resident parents (based on the notion that they will have a place available to stay when they return to Australia). The risk with such specific factors is that they can create arbitrary outcomes – for example if the relevant age is 30, then the day you turn 31 you could cease to be resident where there has been no objective change in your circumstances.

6. Examples

It helps to "road test" any model against simple scenarios in order to assess the outcomes. There are likely to be different views on what the outcomes should be under each scenario, so the ones explored below (using the simpler bright line test set out above) are really designed to tease out the underlying issues for discussion purposes. It is difficult to envisage any model where every set of circumstances will have what is broadly accepted as the right result. The importance is to ensure the model remains simple and clear, and deals with the vast majority of people. Australia's treaty network and the availability of the Commissioner's discretion are tools that can be used to address any extreme examples where clearly the wrong result is obtained under the two tests.

(a) Backpacker or Student

Inbound

- If they have never previously been a resident of Australia and are present in Australia for 183 days or more, then they will be resident under the bright line test. Many students or backpackers will come to Australia under a one-year temporary visa.
- If they are in Australia for 300 days in a 12-month period, and are single with no minor children, no Australian house ownership or lease, they will have 80 points (10 periods of 30 days presence) and may elect to be a non-resident.

- Allowing individuals to elect into the secondary test means that if individuals pass the bright line test and are regarded as residents they can simply stop there and are not forced to apply the secondary test. Such flexibility would potentially solve the problem of the shortage of seasonal workers currently being caused by the imposition of the 32.5% minimum tax on non-residents (reduced to 15% in some circumstances). The loss to the revenue of giving all or part of the $18,200 tax free threshold to seasonal workers who stay 183 days or more is justified economically to help agriculture.

Outbound

- Consider an Australian who has always been an Australian tax resident and citizen, is single with no minor children, has no Australian home ownership or lease and goes overseas to backpack or study for 183 days or more.

- If the person does not return to Australia at all in the first two years they will be a non-resident under the bright line tests.

- If they come back to Australia for 7 days to attend a wedding after being away only 10 months they will be a resident under the bright line test. They can elect to apply the secondary test and have only 38 points (30 for citizenship and 8 for physical presence), therefore remaining non-resident.

- If in year three they come back to Australia for 4 months over the Christmas break and stay with their parents, then they will be a resident under the inbound bright line test. Applying the secondary test, they will have 62 points (30 for citizenship and 32 for physical presence). They could in theory return for up to 8 months in any 12-month period before breaching 100 points and therefore reaffirming Australian residence). Is this the correct result after a sustained period of non-residence and no other ties to Australia? Compare this to the circumstances of a visiting professional outlined below.

(b) Professional or trades person

Inbound

- A non-citizen without a permanent residence visa and who has never previously been a resident of Australia comes to Australia for 180 days accompanied by their spouse. They have no dependent children and no Australian house or long-term lease.

- They will be non-resident under the bright line test. And the secondary test is not required.

- If they are in Australia for 300 days, then they will be resident under the bright line test and resident applying the secondary test – 100 points (spouse 20 points and physical presence present 80 points). If they come by themselves then can stay longer and not breach 100 points (360 days) or can only stay a maximum of 270 days with their spouse before reaching 100 points.

Outbound

- An Australian tax resident and citizen leaves Australia with their spouse to work overseas for 300 days before returning. They have no dependent children but own an Australian home which remains vacant and available for their use.

- Under the bright line test for outbound individuals the person would be a resident. Applying the secondary test, they would have 104 points (citizenship 30 points, home 50 points and 3 periods of physical presence 24 points).

- If they were to rent their home out such that it was not available for their use and were absent from Australia for 18 months before returning, then they would still be resident under the bright line test for outbound individuals. Applying the secondary test, they would still have 128 points (citizenship 30 points, home 50 points and 6 periods of physical presence 48 points). The test period under the model would be the 24-month period that applies for outbound residents. Even though they lease their home out for 18 months, the fact they move back in for six months means they will be treated as having a home. Citizenship and physical presence would not alone amount to 100 points.

- The overall outcome is that where the bright line test is failed, an Australian citizen who has always been an Australian resident cannot be regarded as a non-resident where they have a spouse and/or dependent children who remain in Australia and retain a residence that remains available to them for their personal use, regardless of whatever other factors are present.

- It also accepts that someone who leaves a home and family behind in Australia and does not return for more than 30 days in any 24-month period is not a resident. The testing periods can be adjusted to alter the outcomes if they are deemed inappropriate

7. Superannuation test

The superannuation test was never intended to cover all government employees, nor even cover all Commonwealth public servants. It was believed in 1930 that they were covered by the domicile test. That claim first emerges in an Explanatory Memorandum in 1992.[2]

However, as doubt exists then the adoption of a specific government service residency test makes sense. It is an international norm to include such test. For example, Canada deems members of Canadian Forces,[3] ambassador, high commissioner, minister, and gent-general or other Canadian or provincial government officials,[4] to be residents. Similarly, New Zealand approach is to deem all government employees (civil servants) acting in any capacity for the government (exercising their duties) to be residents.[5] A test could be adopted to overcome any uncertainty.

2 Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1992 (Cth) 181.
3 *Income Tax Act* RSC C 1985 (Can), s 250(1)(b).
4 Ibid s 250(1)(c).
5 *Income Tax Act 1994* (NZ) s OE1(5).

8. Other Issues

There are clearly other parts of the Australian tax landscape that need to be considered in light of any changes to the individual resident test. In particular the residency rules need to work alongside the "temporary resident" regime. The gateway to the temporary residence regime is qualifying as a resident of Australia. The interaction and the outcomes need to be carefully thought through. To the extent that inappropriate outcomes are identified, then careful consideration of whether those outcomes are a result of the residence rules or of the temporary residence rules is necessary.

As Australia has an "exit" tax regime for individuals ceasing to be tax residents of Australia, the general consensus is that there is no need to have a temporary absence regime, such as the UK, where any gains made while temporarily absent from the Australia are subject to tax. As noted above, a specific integrity rule could be used to address any deliberate manipulation of the residency rules.

The concept of part year tax residence can be dealt with by changing the question on page one of an Australian tax return form, "are you a resident of Australia", to "were you a resident of Australia at any time in the year of income" and requiring the foreign source income earned during the period of non-residence to be disclosed as exempt, which will allow some statistical record of the cost of the exemption, and potential early warning of what is at stake for the revenue in accepting that return at face value.

Transitional rules

There is a possibility for some disputation, where an individual needs to use the current residency rules to determine their prior residence in circumstances where the proposed rules apply differently to an individual if they were previously a resident or not.

Calls for a specific transitional rule needs to consider what the actual potential for disputes is and balance that with the added complexity and potential planning opportunities. The Committee suggests that if there a minimum of at least a 9-month gap (preferably 12 months) between enacting the new rules and the commencement date of the new rules employers would have adequate time to adjust systems and processes, as would taxpayers to determine their new status.

Thank you again for the opportunity, and the additional time afforded to us, to prepare this submission. Should you wish to discuss further any aspects of the submission please do not hesitate to contact Clint Harding, Chair of the Committee (charding@abl.com.au or 02 9226 7236).

Yours Sincerely,

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