05 July 2021

Law Council
OF AUSTRALIA

Business Law Section

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Assistant Treasurer
House of Representatives
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Dear Assistant Treasurer,

Reform of Individual Residency Rules

We refer to the Government's announcement in the 2021-22 Federal Budget that it will replace the individual tax residency rules with a new, modernised framework.

The Taxation Law Committee (**the Committee**) of the Business Law Section of the Law Council of Australia is one of the fourteen specialist committees established within the Business Law Section to offer technical advice on different areas of law affecting business. Each of these Committees approaches issues of law reform and practice from a different perspective, which reflects their respective primary focus.

The Committee agrees that Australia's current tax residency rules are difficult to apply in practice, create uncertainty and result in high compliance costs for individuals and their employers.

The Budget Papers noted that the new framework will be based on recommendations made by the Board of Taxation (**the Board**) in its 2019 report to Government, "*Reforming individual tax residency rules — a model for modernisation*", will be easier to understand and apply in practice, deliver greater certainty, and lower compliance costs for globally mobile individuals and their employers (**the Report**).

We write to you to bring to your attention several important issues arising out of the recommendations made by the Board that we believe need to be considered further as part of the implementation of any new framework for individual tax residency.

The Committee participated in the consultation conducted by the Board and made a detailed submission in response to the Board's consultation guide entitled "Review of the Income Tax

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Residency Rules for Individuals: Consultation Guide" released in September 2018 (**2018 LCA Submission**). A copy of that submission is attached at Annexure A to this letter.

Key Issues requiring further consideration

We wish to draw your attention to the following key issues arising from the recommendations made by the Board that we believe should be revisited and carefully considered:

1. The two factor test

The Board has recommended the application of a factor test to determine if an individual has commenced residency in Australia in circumstances where the individual has not been in Australia for more than 183, or less than 45, days in an income year. The factor test will also be relevant to resident individuals ceasing 'short-term' residency.

Under the Board's proposal, an individual will commence being a resident of Australia on the date of arrival where two of the four specified factors are applicable. Those four factors are:

a. The right to reside permanently in Australia;
b. Australian accommodation;
c. Australian family; and
d. Australian economic interests.

For the reasons set out in the 2018 LCA Submission, the Committee believes satisfying two of the above four factors does not give a correct reflex of when an individual should be considered to have commenced residing in Australia.

The practical effect of the factor approach favoured by the Board is to determine an individual's residence by reference to his or her family unit. If an individual has family in Australia he or she will, at a practical level, almost always have access to Australian accommodation and so factors (b) and (c) above will be determinative in such circumstances. The approach to determining residency in Australia has never focused exclusively on the location of an individual's family, even if that factor has been important and persuasive in the overall balancing exercise that is currently carried out as part of any enquiry[1]. The nuances involved with family arrangements make reliance upon such a factor fraught with uncertainty. Australia does not tax a family as a unit, and so our view is that the family unit should not be used in isolation as a proxy for individual residence.

It is not unusual in the modern globalised economy (COVID conditions aside) for individuals to live and work for long periods of time in a different country to where their immediate family is located. Australia has a health and education system envied by many countries in the world and so it is often the case that where circumstances allow, Australia is the preferred country in which to raise a family.

[1] Commissioner of Taxation v Pike [2020] FCAFC 158 at para 16.

Consider the circumstances where a foreign citizen met and married an Australian overseas and they lived for many years in that foreign country (assume no treaty) where all of the economic, social and financial ties were located. Once they had children the spouse and children wanted to return to Australia but family business and financial reasons meant that for the foreseeable future the individual is obliged to remain in the foreign country. A permanent residence is maintained in that foreign country where the individual spends all of his or her time when not in Australia visiting his or her spouse and children. When the individual visits Australia he or she naturally stays in the family home owned by the spouse. The fact that the individual has family and, therefore, accommodation available would then be determinative (assuming a stay of more than 45 days). The Committee believes the factor test should allow for more flexibility, so that family presence and available accommodation should not alone be sufficient to trigger residency.

The practical effect of the two factor test is also that Australian citizens with historical connections to Australia residing overseas, can too easily become tax residents of Australia. Consider the circumstances of a married Australian expatriate couple who have lived and worked in Hong Kong for 10 years and who have children attending school in Hong Kong. They may have a family beach house available to them in Australia or they may have an investment property in Australia. The effect of the two factor test is that, once they spend 45 days in Australia in an income year, they become Australian tax residents – despite not taking any steps to break their residency with Hong Kong, or steps actually to establish residence in Australia.

2. Ceasing residency

The Committee believes that the recommendations of the Board for determining when an individual has ceased to be an Australian resident represent a significant expansion of Australia's taxing rights and will capture significantly more people than under the current tests.

Of real concern to the Committee is the extent to which the concept of "adhesiveness" would be applicable under the recommendations. For so-called 'long-term' residents, the outcomes can be particularly harsh.

The Board commented in its recommendations that -

> *… long-term residents should retain residency regardless of their physical presence in Australia for a set number of income years, and has designed this rule to reflect this view.*

This will be a significant expansion of Australia's taxing rights over individuals who may have no physical presence in Australia and no social, economic or ongoing connection whatsoever. It will also have the very clear and immediate impact of discriminating against countries that do not have a tax treaty with Australia which might otherwise provide relief through the application of the tie break mechanism.

The 'sticky' nature of the proposed rules would mean that global talent present in Australia as temporary residents for more than three years would potentially be unable

to lose that status for two years following their departure. Such an outcome would counter the Government's policy aims of attracting talent to Australia.

It is not clear to the Committee why a 'long-term' resident must be required to retain residency for a period of two years following their departure. There does not seem to be a logical principle behind this recommendation, other than the opportunistic collection of revenue.

For example, an individual who has been a tax resident in Australia for 5 years severs absolutely every connection with Australia, relocates to Hong Kong, rents long term accommodation, and seeks employment. Where he or she cannot satisfy the overseas employment rule (for example, on one of the technical bases outlined below), such an individual would be subject to Australian taxation on his or her worldwide income for a period of at least two years, perhaps longer. Such a position can only be described as an "exit tax" and is overly pecunious. If the same individual, in exactly the same circumstances, moved to Singapore then he or she would not be subject to the 'exit charge" as the tie break test in the Singapore tax treaty would most likely determine that individual to be a resident of Singapore and not Australia.

There should be no basis to discriminate against individuals based on the country to which they choose to move.

Solutions

1. ***Modification 1 – the "factor test" should not include a right to reside permanently in Australia as a factor and expansion of factors***

   Removing the right to reside permanently in Australia as one of the relevant factors will, together with our other suggestions, allow the factor test to operate in a manner that more accurately reflects whether a person is a resident of Australia. In the 2018 LCA Submission we suggested a more flexible points test.

   Residency is based on where an individual lives; where the individual keeps a usual or settled abode. The right to reside in Australia does not reflect meaningful, real connections with Australia. Unlike the other three factors proposed in the factor test, it only reflects a legal possibility.

   As noted above, a consequence of the currently proposed rules is that, assuming an individual spends 45 days or more in Australia:

   - an Australian passport + investment property = resident
   - an Australian passport + beach house available = resident

   This would result in Australian tax residency in any income year in which the taxpayer is present in Australia for 45 days or more. They would then need to test, in the subsequent income year, whether they satisfied a 'ceasing residency test' – despite never having abandoned their residence in the foreign country.

Removing the right to reside permanently results in more appropriate outcomes. For example, assuming Australian citizens spent 45 days in Australia in an income year:

- investment property only = non-resident
- beach house available only = non-resident
- Australian family + Australian accommodation = resident
- Australian family + Australian economic interest = resident

The 'beach house available' scenario potentially meets two factors: Australian accommodation and an Australian economic interest. The factor test should be modified to prevent double counting: one asset should not be permitted to count towards two tests.

Similarly, and as noted above, where an individual has family in Australia, the individual will generally have access to accommodation. Accordingly, these two factors should be collapsed to avoid double counting.[2]

The 'availability of accommodation' test extends far beyond the ownership of real property, so that access to a parent's or an adult child's home would potentially be sufficient. Although the Board was not in favour of a de minimis period[3], one solution would be some form of threshold test where an individual should only fail to satisfy this factor where the majority of their time in Australia is actually spent in residential Australian accommodation. This would exclude hotels and other short-term lodging arrangements, consistent with the Board's recommendations[4].

The meaning of "Australian family" should be restricted to a spouse or any children under the age of 18 (excluding parents or remote family members)[5].

2. Modification 2 - the ceasing short-term residency test and ceasing long-term residency test should be the same

Whilst the concept of "adhesiveness" is attractive in theory and allows for a more nuanced approach to the cessation of residency, the problem with the distinction between short-term and long-term residency is that the gateway question relies on an assumption that a taxpayer's residency status for the past three income years is certain.

This is particularly problematic in the current COVID-era, where individuals' tax residency is less certain, often as a result of (1) individuals becoming 'stuck' in Australia; and (2) individuals being able to 'work from home' for their foreign employer in Australia.

[2] The Board noted in its report that the ability to access accommodation should not rely upon an identifiable legal right, but rather whether, from a factual inquiry, an individual has an arrangement to access accommodation in Australia.

[3] Paragraph 7.29 of the Report.
[4] Paragraph 7.30(a) of the Report.
[5] Paragraph 7.32 of the Report.

There have been many cases where long-term non-residents have returned to Australia during COVID, but intend to return to their foreign country as soon as it is safe or practical to do so. Their current residency status can be difficult to determine, both under the current domestic law and the tie-breaker tests in a relevant treaty. The ATO has been responsive by including further information for such individuals on their website, but such material is not law and represents only administrative practice.

The proposed new rules will remove the uncertainty in the ordinary meaning of the word 'resides' test and 'permanent place of abode' test, but will do nothing to remove the uncertainty in the application of the treaty tie-breaker tests – particularly the 'habitual abode' and 'personal and economic relations' tests.

The scope of relief offered by the Board's Recommendation 5 (that where an Australian is treated as a resident of another country under one of Australia's comprehensive tax treaty arrangements the individual should also be treated as a 'non-resident' for domestic tax law purposes) is uncertain as it is dependent upon the tie-breaker tests, which are factually based and result in continued complexity. It also does not assist with individuals dealing with non-treaty jurisdictions.

Notwithstanding the Committee explored the differentiated approach as part of its 2018 LCA Submission, further thought should be given as to whether taxpayers should be able to self-assess their residency status for a current income year, without having to consider their residency status for the prior three income years.

The 'residents of nowhere' problem should be dealt with separately (see below) and not form part of the policy reasons for distinguishing between long-term and short-term residents.

One solution we think worth investigating would be to have only one "ceasing residency" test, based on the current short-term residency test, incorporating the modification above (about removing the right to reside as a factor) and below (about the overseas employment rule). This will simplify the law and remove the uncertainty of which test should apply depending on a taxpayer's residency status in the past three income years. Alternatively, a period shorter than three years should be considered.

3. Modification 3 - there should be a special anti-avoidance rule to deal with 'residents of nowhere'.

The integrity concern over 'residents of nowhere' should not be addressed by the 'ceasing long-term residency test'. It is difficult to imagine that the added complexity and potential for unfair outcomes arising from an expanded and complicated cessation of residency test outweigh the potential loss to revenue arising from residents of nowhere.

'Residents of nowhere' is an avoidance problem and should be dealt with under a specific anti-avoidance rule.

One possible solution could be that an individual, who has been a tax resident of Australia, will continue to be an Australian tax resident unless the individual can

demonstrate he or she has become a tax resident of a foreign country. Whether the individual is liable to pay tax in that foreign country should not be a condition: it creates unnecessary complexity and is irrelevant from an Australian perspective. Some jurisdictions do not impose tax and so further thought will need to be given as to how such individuals would satisfy such a requirement. Such circumstances could warrant a simplified approach based on physical presence and an assumption of residence or some form of deemed "tie break" test in circumstances where there is no treaty.

4. ***Modification 4 – the overseas employment rule should (a) not test the 3 prior income years; and (b) be robust enough to deal with foreign employment practices***

There is no reason why, for an individual permanently departing Australia to start living and working in a foreign country, their residency status upon departure should have any connection to whether the individual previously resided in Australia for one, three, five, ten income years, or all of their life to that point. That factor should be removed.

If a "rule of thumb" is used to justify the "overseas employment rule" then the Committee believes a rule of thumb (for example "two years out of country") should also apply to relieve the largest group of Australian expats to be caught by the new adhesive rule.

The outcomes under the adhesive concept are particularly harsh on young and mobile Australians who have traditionally, and some would say as a rite of passage, travelled to number of foreign countries to take up job offers (teachers, nurses, labourers, etc) or simply arrive and obtain employment once they are "on the ground". The tax compliance costs for these individuals are high, and currency differences mean the potential Australian tax liability is not appropriate as the cost of living in those countries will generally be higher. As this group has little attachment to Australia other than family, citizenship, overseas travel insurance/Medicare and enrolment on voting registers, they were traditional "residents where they resided".

The Committee believes the concept of overseas work should expand to capture these individuals as well, not merely the employees of large business clients or those fortunate enough to secure long term permanent employment before they depart Australia.

Possible solutions could include:

- Extending the exemption to total full-time employment secured overseas for a total period of 2 years with any number of employers in any 3 year period;
- Excluding people under 35 years of age who earn less than a de minimis amount; or
- Re-introduce the former section 23AG on a more limited basis to cover only individuals under a certain age.

It is very common for foreign employment agreements, for what are ostensibly permanent positions, to be legally framed on the basis of renewable 12 month contracts. The legal form of the contract should not trump the substance of the relationship. Twelve month renewable contracts, for a position on a project that is expected to last 10 years,

should not be treated differently to permanent contracts where both parties can terminate on 6 weeks' notice.

The Committee favours the position that the overseas employment rule should test this 'permanent' factor by having regard to:

- the specified term of the engagement in the individual's employment agreement; or
- whether it is reasonable to conclude (objective test) that the individual's employment agreement would be 2 years or longer; or
- an expanded test along the lines suggested above.

This modification would allow an individual to be able to prove, based on evidence other than the employment agreement, that its expected move to the foreign country is sufficiently permanent.

There should also be some flexibility as to the timing of entry into the employment agreement. There does not seem to be any strong policy reason not to allow entry into the agreement after an individual has left Australia, for example, within 3 months of departing.

Further, there are a number of other problems with the overseas employment test, for example, it does not relieve the spouse or children who accompany the taxpayer overseas from residency as they do not have the relevant employment contract; and there is uncertainty in circumstances where the 45 day condition is breached by the taxpayer (for example, returning home to see a sick parent) – is it only in the year of breach residency is reactivated or does it apply to earlier years?

Conclusion and further contact

The Committee would be pleased to discuss any aspect of this submission.

Please contact the chair of the Committee, Angela Lee, at angela.lee@vicbar.com.au, if you would like to do so.

Yours faithfully

Greg Rodgers
Chair, Business Law Section