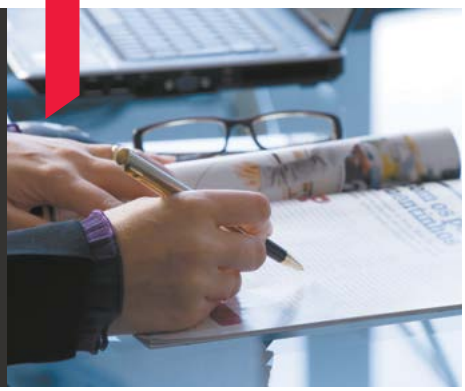
NOVEMBER 2018

TECHNICAL UPDATE



REFORM OF THE INCOME TAX RESIDENCY RULES FOR INDIVIDUALS

THE BOARD OF TAXATION HAS PROPOSED NEW RESIDENCY RULES AIMED AT IMPROVING CERTAINTY, REDUCING COMPLIANCE COSTS AND REMOVING A POTENTIAL BARRIER TO AUSTRALIA'S ATTRACTIVENESS AS AN INVESTMENT LOCATION. THERE HAS BEEN NO FUNDAMENTAL CHANGE TO THE POLICY INTENT OF THE RESIDENCY RULES FOR INDIVIDUALS, HOWEVER OVERALL RESIDENCY WILL BE HARDER TO GET RID OF THAN TO ACQUIRE.

OVERVIEW

The Board of Taxation (the BoT) completed a self-initiated review of Australia's individual income tax residency rules that was provided to the Government in August 2017 and made available publically on 9 July 2018 to signal reform of the rules. On 25 September 2018 the Government released a consultation guide to canvass views on options for:

- a two-step model for individual tax residency
- the integrity risk posed by 'residents of nowhere' and related schemes to circumvent the tax residency rules
- updating the superannuation test.

In the 'self-initiated review' the BoT also recommended that the temporary resident tax concessions should not be available where an individual has been in Australia for more than four years and temporary residents should be subject to non-resident income tax rates, however these recommendations were not included in the 'consultation guide'.

Australia's individual income tax residency rules are inherently uncertain to apply, lead to inconsistent outcomes and have not been updated in more than 80 years. Reform that simplifies the rules, reduces the compliance burden on taxpayers and reflects an increasingly global mobile labour force is welcome.

CURRENT RULES

The legislation currently provides four tests to determine whether an individual is an Australian tax resident that depend not solely on time spent in Australia, but the nature and substance of the individual's connections to Australia.

1. **The resides test** - this a rather subjective test that takes into account a holistic review of the individual's circumstances and gives weight to various factors such as intention and purpose of their presence in Australia; family and economic ties; location and maintenance of assets; and social and living arrangements.
2. **The domicile test** – according to this test if the individual does not 'reside' in Australia according to the first test, but are nonetheless domiciled in Australia e.g. domicile of origin at birth (usually the place the person's father had a permanent home) or their domicile of choice, they are still considered a resident of Australia for tax purposes unless their 'permanent place of abode' is outside of Australia.

3. **The 183-day test** – in this text an individual is assumed to be a tax resident if they are physically present in Australia for 183 days or more and their 'usual place of abode' is not outside of Australia.
4. **The superannuation test** – according to this test an individual is an Australian resident if they are a member of certain Government public service superannuation funds.

CONFUSION

The Australian residency rules were enacted over 80 years ago and have remained unchanged since 1936. The ATO has several rulings including IT 2650 and TR 98/17 however contradictory judgements providing inconsistent guidance as to what factors should be given more weight than others has led to led to numerous disputes and rulings about the receipt of individual income and the susceptibility of that income to Australian tax as well as high-profile tax evasion cases and investigations relating to the diversion of income via offshore entities and structures. In *Harding v Commissioner of Taxation [2018] FCA 837 (Harding)* on 8 June 2018, the Federal Court held that an Australian citizen who had lived outside of Australia for some years, and who had established a home overseas, remained a tax resident of Australia because his fully furnished apartment maintained overseas was not permanent enough. This decision highlighted for Australian expatriates, when it comes to tax residency and when establishing a home overseas, that the type of property and importantly how the property is used, does matter. The decision placed significant emphasis on the concept of 'permanent place of abode' and cast doubt on situations that most would previously have considered fairly straight forward. There are currently 30 cases in front of the AAT on residency according to the ATO.

The situation has also been made more complex with the restriction of the foreign services exemption in section 23 AG from 1 July 2009, which had a general exemption for foreign service income where the foreign service period exceeded 91 days. Prior to 2009 the question of tax residency was not so important where the individual's foreign income was mainly from the foreign services. Tax residency has also become further complicated since the increase in global mobility in the modern working environment. The current rules no longer reflect global work practices in an increasingly global mobile labour force and impose an inappropriate compliance burden on many taxpayers. Indeed, the rules are inherently uncertain to apply and rely on a weighting system that leads to inconsistent outcomes, particularly for outbound individuals.

NEW RULES

The BoT proposes to replace the current rules with a new residency model comprising a policy statement, primary 'bright-line' days test, and secondary 'factors' test to determine the connection between the individual and Australia. Where an individual does not satisfy the bright-line test (i.e. is not automatically considered a resident or a non-resident), a secondary test, called the 'factor test,' would apply to determine the connection between the individual and Australia. The policy statement suggests these will not be legislative tests; rather, they will summarise the principles underpinning the Australian residency rules and the Government's policy intention. The BoT consultation paper contains 38 questions that address the following eight design features the BoT consulted on:

1. A guiding adhesive residency principle that means that it should be harder to cease residency than it is to establish it.
2. A statement of individual residency policy with an objects clause or theme statement in the ITAA 1997 that encapsulates the principles underpinning the residency rules and the Government's policy intention.
3. A bright-line test for inbound and outbound individuals that will act as a primary test to help those clearly resident and non-resident to identify the basis on which they may claim such status to manage their tax affairs accordingly [see below for detail].
4. A secondary 'factors' test to determine the connection between the individual and Australia that determines the level of connection to Australia and acts as a secondary test for individuals who do not satisfy the bright-line tests [see below for detail].
5. An integrity measure where an individual has been an Australian resident and would otherwise satisfy the conditions to become a non-resident, the change in status will only be effective if the individual demonstrates that they have established residency in another country to precent individuals being 'residents of nowhere'.
6. Updates to the superannuation residency test to align with common international practice and reflect the original intention of these rules.
7. Alignment of the part-year rules for the tax-free threshold with the residency rules in general, if this can be done with relative simplicity.
8. Operation of the rules prospectively from a commencement date.

Primary 'bright-line days' test

The primary test is a days test, under which an individual is automatically considered to be an Australian tax resident when he or she spends a specific number of days in Australia in any 12-month period, or automatically is considered an Australian tax non-resident when he or she spends less than a specific number of days in Australia during a particular period (i.e., there will be separate standards for inbound and outbound individuals). These tests are similar to bright-line tests in the UK, but have been adapted and simplified for Australia. This test will automatically determine the residency status of the majority of individuals. The test is designed to provide a bright-line for individuals to be able to conclusively determine their residency status, based on time spent in Australia. Acknowledging the potential revenue impact and integrity risks of a pure 183-day non-resident test, the proposed model is adhesive with differentiated bright-lines. The Board is interested in feedback as to whether the bright-line strikes the right balance. The BoT's preferred model is as follows:

SCENARIO	DESCRIPTION
Previously a resident of Australia	An individual that was previously a resident of Australia is a non-resident if they spend less than X number of days in Australia in any 12-month period.
Previously not a resident of Australia	An individual that has never been a resident of Australia is a non-resident if they spend less than Y number of days in Australia in any 12-month period (where Y is greater than the X number of days required for those previously a resident, in line with the adhesive residency principle*).
Working overseas	An individual that works full-time overseas is a non-resident if they spend less than a certain number of days working, or a larger number of days in total, in Australia in any 12-month period.

*According to the BoT's adhesive residency principle once sufficient time is spent in Australia, and an individual's connections are sufficiently embedded, then it is appropriate that this level of engagement with and benefit from Australian society must be scaled back to a large extent before residency ceases. This is a feature maintained from the existing rules, and reflects international practice.

Secondary 'factors' test

This test will be used for more complex situations and will take into account the individual circumstances. It may also apply differently to inbound and outbound individuals. The proposed test will have a clearer weighting system for the relevant factors to ensure greater certainty in determining residency than under the current rules. The BoT has proposed that if the individual was previously a resident of Australia, X number of factors must be satisfied; or if the individual was not previously a resident of Australia, a higher number of Y number of factors must be satisfied. The BoT considers the following factors crucial to determining residency:

FACTOR	DESCRIPTION
Time spent in Australia	This factor is satisfied if a certain amount of time is spent in Australia, as per the primary test.
Immigration status	The factor is satisfied if the individual is an Australian or permanent resident.
Personal relationships	This factor is satisfied if the individual's family is largely located in Australia.
Accommodation	This factor is satisfied if the individual has readily accessible accommodation (rented or owned) that they use regularly.
Economic ties	This factor is satisfied if the individual has substantial economic ties to Australia, such as employment, business interests, assets etc.

OTHER CHANGES

The BoT have also recommended that the temporary resident tax concessions should not available where an individual has been in Australia for more than four years and temporary residents should be subject to non-resident income tax rates. Interestingly, the BoT has not included these points in the items for which it is seeking consultation. The BoT also considers that the 'superannuation test' no longer achieves its policy objective. The test was designed to ensure that Australian government employees working on behalf of the Australian Government abroad (e.g., foreign affairs and trade officials, civilian defence officials), their spouses and children under 16 years of age, are treated as Australian residents. The Government imposes tax on the worldwide income of these individuals.

BDO note that the BoT consultation guide does not currently contain any transitional relief in relation to individuals that will have their residency status change as a result of the implementation of the proposed changes. BDO are concerned about how a transition might look in terms of amnesty, grandfathering, and an opportunity for the ATO to go fishing into prior years for non-resident people who have taken more aggressive positions and now get picked up as resident under the new rules (for example).

INBOUND V OUTBOUND INDIVIDUALS

There are currently no separate residency rules for 'inbound' versus 'outbound' individuals.

In its self-initiated review, for outbound individuals, the BoT recommended individuals be considered non-resident if they work overseas and spend less than 31 days working, or 61 days total, in Australia. Former residents would become non-resident if they spent less than 16 days in Australia; and someone who has never been resident of Australia would remain a non-resident if they spent less than 46 days in Australia. The BoT consultation guide however does not include this recommendation. Instead the inbound individual test determines whether an individual has automatically established residency.

The common standard is 183 days (being one day more than half a regular year). This is considered a reasonable proxy for determining whether an individual spends the majority of their time in Australia. In order to guard against manipulation (e.g., by staying in Australia for less than half of two separate income years in one 12-month period), the 183-day standard may be met by an individual if present in Australia for 183 days or more in any 12-month period. An individual may then be a resident for that part of the first income year in which they were physically present, while the second year would be determined under the outbound individual bright line test, secondary test or perhaps via a split year treatment. The BoT has proposed mechanisms designed to gauge an individual's level of connection to Australia where an individual could require a certain number of points to be regarded as either a resident or a non-resident; or in a similar manner to the UK's statutory residency test, an individual could require a number of 'ties', being a set number of significant factors that lead to a conclusion of either resident or non-resident.

BDO COMMENT

BDO is pleased that the BoT acknowledges that the current rules no longer reflect global work practices in an increasingly global mobile labour force and impose an inappropriate compliance burden on many taxpayers. The current rules are also inherently uncertain to apply and rely on a weighting system that leads to inconsistent outcomes, particularly for outbound individuals. BDO is of the view that reforming the residency rules so they are more simple and produce revenue neutral outcomes is the right approach rather than just updating ATO guidance or relying on the judicial system. If the proposed residency rules are legislated along with a structured process to determine the more complex cases, this may result in a decreased need to apply for private rulings. BDO also observe that the BoT consultation does not contain any great changes to current positons i.e. there are no proposed changes to 23AG or visa categories and hope to see alignment of the tax residency rules and Australia's immigration visa regime and these issues addressed in further consultation or draft law.

BDO Partners attended a BoT consultation roundtable session on 22 October 2018 and provided feedback to the BoT on the questions in the consultation guide. The Government will now consider the BoT's recommendations. The BoT will then provide its final report to Government in November 2018. BDO anticipate it will be made publically available next year. The Government has not announced a timeline regarding any legislative change, and it is likely that the reform of the residency rules will take some time. The impact of that change will be dependent on the eventual model adopted by Government so contact BDO to stay updated.

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BNE 0963/1118