Law Council
OF AUSTRALIA

Business Law Section

27 September 2023

Mr Bede Fraser
Assistant Secretary
Personal and Small Business Tax Branch
Personal and Indirect Tax and Charities Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: individualtaxresidency@treasury.gov.au

Dear Mr Fraser,

Modernising Individual Tax Residency—Consultation Paper

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to respond to the Consultation Paper of July 2023 prepared by the Treasury and entitled *Modernising Individual Tax Residency* (**Consultation Paper**).

The Committee would like to emphasise the importance and value of this policy initiative. A taxpayer's residence is one of the two central pillars upon which Australia's taxation jurisdictional claim rests, and it is therefore crucial that the definition of residence in domestic legislation is fit for purpose.

The Committee strongly believes that a world-leading framework can be developed that provides appropriate outcomes for individuals in all circumstances and satisfies the requirements for certainty, simplicity and integrity—something that the current framework, which dates back to circa 1930, clearly no longer achieves.

Annexures 2 and 3 to this submission are two previous submissions made by the Committee:

(a) a submission of 9 November 2018 to the Board of Taxation in response to the September 2018 consultation paper entitled *Review of the Income Tax Residency Rules for Individuals* (the **2018 BLS Submission**); and

(b) a letter of 5 July 2021 to the former Assistant Treasurer regarding the reform of the individual residency rules and the Government's announcement in the 2021–22 Federal Budget that it will replace the existing individual tax residency rules with a new, modernised framework (the **2021 BLS Submission**).

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Summary

This submission focuses on four key issues raised by the Consultation Paper about the principles that should underpin an enduring framework for individual tax residency:

- adhesiveness;
- the 45-day limit;
- the overseas employment rule; and
- treaty issues.

The Committee's views on each of these central issues necessarily encompass most of the questions raised in the Consultation Paper but do not answer each question directly. These views can be summarised as follows:

Adhesiveness

The concept of adhesive residency, developed by the Board of Taxation and set out in its paper entitled *Reforming Individual Tax Residency Rules* released in March 2019, is:

(a) inconsistent with the most recent case law and the overall residency policy setting in Australian legislation to date;

(b) inconsistent with the OECD principles and Australia's network of double taxation agreements (**DTA**); and

(c) disproportionate, in terms of the increase that the proposed rules will have to the tax base, to the phenomenon of a '*resident of nowhere*', which the rules are attempting to address.

The distinction drawn between short-term and long-term residents when ceasing residency, and the proposed two-year testing period after a taxpayer has left the country, flow directly from the adoption of this "adhesiveness" concept. The Committee believes that these distinctions create unfairness and lead to unnecessary complexity for taxpayers.

The Committee considers the better way to deal with cessation of residency is to adopt a new rule, similar to the Commissioner's current formulation for the domicile and permanent place of abode test in *TR 2023/1*, and applying the decisions in recent case law. That is, a taxpayer would continue to be an Australian tax resident unless they have:

(a) definitely abandoned their residency in Australia; and

(b) commenced living permanently in another country.

Alternatively, there could be a single test based on a modified version of the ceasing short-term residency test with an individual ceasing to be an Australian tax resident where:

(a) they spend less than 90 days in Australia in the current income year; or

(b) they satisfy less than [two factors]/[X points] and spend less than 183 days in Australia.

45-day *t*est

The Committee agrees that a simplified bright line primary test for residence is required and that 183 days is appropriate.

As set out in the 2018 BLS Submission, and explained in more detail below, the Committee is of the view that the 45-day period in the secondary test is too short a period and will give rise to many inconsistent or unfair outcomes.

The Committee recommends that a 90-day period would be a more appropriate limit allowing for unforeseen circumstances beyond the individual's control.

Factor Test

An objective fact-based test that is simple and easy to apply, and provides an appropriate outcome in most circumstances, should form part of an effective framework for determining individual residency.

Satisfying two of only four factors does not give a correct reflex of when an individual commences residing in Australia (Commencing Residency Test) and when a short-term resident ceases residing in Australia (Ceasing Short-term residency test). The practical effect of the proposed four-factor test is to determine an individual's residence by reference to his or her family unit, which is not an appropriate outcome. The Committee also believes that under the proposed test non-resident Australian citizens with historical connections to Australia can too easily become tax residents of Australia.

We believe these concerns can be addressed in a simple manner by either:

(d) using a balanced 'points test' that allows for a more nuanced consideration of objective facts, that are aligned with tax treaty concepts, and that will provide more appropriate and consistent outcomes without creating any integrity concerns;

or

(e) changing the factors to address some of the more obvious issues and to narrow some of the clearly non-objective elements of the factors. For example, removing the 'right to reside' factor and narrowing the 'economic interests' factor.

A points test is used in other areas of tax law, such in the ESIC regime, and a points test is also used for certain visa application processes, so it is not an uncommon approach.

Overseas employment rule

Having a third and separate test for individuals who "work" overseas, whilst appealing, creates unnecessary complexity and uncertainty, and is likely to generate inconsistent outcomes.

The Committee would support the reintroduction of a standalone provision similar to the old section 23AG of the *Income Tax Assessment Act 1936* prior to its amendment. Such an exemption is a relatively simple way of addressing income earned by Australian tax resident individuals during periods of overseas service or employment.

Treaty issues

The proposed changes to simplify the individual residency test will have little impact in practice where a taxpayer is a dual resident of both Australia and a country with which Australia has a DTA. Capturing a greater number of individuals under a more adhesive domestic definition of residency will result in a greater number of taxpayers needing to rely (and obtain advice on) the relevant position under any applicable DTA.

The factors (or alternatively the criteria under any points system) should be clearly aligned with, and reflect, the factors examined when applying the tie-break tests for individual residency under Australian DTAs. Contrary to the statement in paragraph 62 of the Consultation Paper, the Committee believes such an alignment would provide more certainty and reduce the need for taxpayers to consider, and obtain advice on, two different sets of rules.

Aside from the issue of aligning the domestic framework with the outcomes under DTAs, it is critical that the framework recognises that the outcome under a DTA tie-breaker test overrides any different outcome as a result of the Australian domestic provisions, for all purposes of the Tax Acts. This allows individuals greater levels of certainty and the knowledge that double tax treaties work to avoid double taxation.

Further detail supporting the views expressed above can be found in Annexure 1.

Transitional rules will be critically important, particularly for people already residing outside of Australia. The Committee submits that the framework should phase in over time. For people already residing outside Australia, the ceasing Australian residence tests should not apply to them unless those provisions would apply in their favour. The new rules should only apply to income years following Royal Assent.

Conclusion and further contact

Thank you for the opportunity to make this submission on these very important issues. We would be happy to meet with you at your convenience to discuss any aspects of this submission (or earlier submissions), or to workshop potential solutions with you.

Please contact the chair of the Committee, Justin Byrne at justin.byrne@qldbar.asn.au or phone 0409 754 833, if you would like to do so.

Yours faithfully



Philip Argy
Chairman
Business Law Section

ANNEXURE 1

DETAILED SUBMISSIONS

Part One: Adhesiveness

What is adhesive residency?

1. The Board has designed the proposed individual residency rules with 'adhesive residency' as a guiding principle. This principle has been developed by the Board to mean that it should be harder to cease residency than it is to establish it. However, the Board's concept of adhesive residency is not an established concept in the current residency framework in Australia.

2. The rationale behind this principle is said to be that the longer an individual is considered a resident for tax purposes, the more connections that taxpayer has to Australia and the harder it should be to break their Australian residency status. In other words, adhesiveness or the difficulty to cease residency should increase with the length of a taxpayer's residency.

3. The use of adhesive residency as a guiding principle has resulted in the Board making a distinction between the treatment of short-term and long-term residents in terms of the tests to cease residency.

    (a) For long-term residents, they must have spent less than 45 days in Australia in the current income year, and each of the two previous income years, to be a non-resident.

    (b) For short-term residents, they must have spent less than 45 days in Australia and must not satisfy two or more of the factors in the Factor Test.

4. The Board's introduction of the concept of adhesive residency causes the proposed residency rules:

    (a) to be inconsistent with the case law and the residency policy setting in the Australian legislation to date;

    (b) to be inconsistent with the OECD principles and Australia's double taxation agreements (**DTA**); and

    (c) to be disproportionate to tackling the phenomenon of a 'resident of nowhere' given the increase that the proposed rules will have to the tax base.

Adhesive residency and Australian case law

5. The concept of adhesiveness was developed by the Board in its *Reforming Individual Tax Residency Rules* that was released in March 2019. The proposal was developed without the benefit of *Harding v Commissioner of Taxation* [2019] FCAFC 29 (***Harding***) which is a key case for Australia's residency rules.

6. In *Harding*, the Full Federal Court concluded that the taxpayer was not an Australian resident for tax purposes and made clear that after a taxpayer ceases residency, any remaining ties that the individual has to Australia are nothing more than 'the remnants of his prior residency' and are not indicators of a continued residency in Australia (at [63]).

7. The decision in *Harding* also noted that factors such as economic interests in Australia have little bearing on where a person resides. The Full Federal Court commented that globalisation has increased the ability of people to make investments in other countries despite having abandoned residency in that country (at [64]). This means that 'Australian economic interests' under the Factor Test in the proposed rules should be considered in this context.

8. *Harding* is also consistent with *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241 where the High Court said (at 241):

> The place of residence of individuals is determined, **not by the situation of some business or property which he is carrying on or owns, but by reference to where he eats and sleeps and has his settled or usual abode**. If he maintains a home or homes he resides in the locality or localities where it or they are situate, but he may also reside where he habitually lives, even if this is in hotels or on a yacht or some such other place of abode— see Halsbury's Laws of England (2nd ed), Vol XVII., pp 376–377

9. The primary test of actual residence was set out in the decisions of *Levene v Inland Revenue Commissioner* [1928] AC 217 (***Levene***) and *Lysaght v Commissioners of Inland Revenue* [1927] 2 KB 55 (***Lysaght***). In *Levene*, the House of Lords said that:

> ... the word "reside" is a familiar English word and is defined in the Oxford English Dictionary as meaning "to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place." No doubt this definition must for present purposes be taken subject to any modification which may result from the terms of the *Income Tax Act* and Schedules but, subject to that observation, it may be accepted as an accurate indication of the meaning of the word "reside." **In most cases there is no difficulty in determining where a man has his settled or usual abode**, and if that is ascertained he is not the less resident there because from time to time he leaves it for the purpose of business or pleasure.

10. *Levene* and *Lysaght* were adopted by the High Court of Australia in *Federal Commissioner of Taxation v Miller* (1946) 73 CLR 93 where Latham CJ stated that:

> I should have thought that **there was no doubt that a man resided where he lived**, and I do not think that there is any interpretation of the word "reside" by the courts which makes it impossible to apply the ordinary meaning of the word "reside" in the present case.

11. The proposed rules significantly depart from the current case law. They mistakenly conflate the concept of adhesiveness that was developed by the Board with part of the concept of residence. Residence has the dual factors of physical presence in a particular place and the intention to treat that place as home (at least for the time

being): *Hafza v Director-General of Social Security* (1985) 60 ALR 674. A person may be physically absent, but continue to reside in a particular place if they intend to return to that place and treat it as home. This is entirely different from the adhesiveness imported in the Board's proposed rules, where an individual who does not intend to treat a place in Australia as home can still be an Australian tax resident.

12. A good example of the distinction between the concepts can be found in a line of residency cases involving Scottish mariners. In these cases, the courts considered that the location of dependent family was an indicator of where the taxpayer resides. This led to the conclusion in *Pickles v Fulsham* (1923) 9 TC 261 that 'a sailor resides at the port where his wife and children live' (at 275). The courts reached this conclusion because the permanent location of dependent family supported the conclusion that the sailor intended to return and reside in that location. It was not because any concept of adhesiveness continued to apply to the taxpayer after he left his family in that tax jurisdiction.

13. The current legislation already contains specific provisions that have an 'adhesive effect'. There is no need to introduce new rules that further expand the base by introducing an 'adhesive' concept into the definition of resident. As an example of those provisions, abandoning residence in Australia results in a CGT event I1, or if this is disregarded, the legislation continues to include that taxpayer's CGT assets in the Australian capital gains tax net.

14. It is also necessary to keep in mind the disadvantages of ceasing Australian residence, including:

    (a) the taxpayer no longer has the benefit of the general CGT discount;

    (b) the loss of the main residence exemption (subject to a narrow set of exceptions); and

    (c) issues for taxpayers who are trustees of self-managed superannuation funds.

15. Not only is the Board's concept of adhesive residency unnecessary, but the concept of adhesive residency stands in stark contrast to the current policy settings established by Australian case law. This is because adhesive residency adopts those remnants of a taxpayer's prior residency such as investments, business or property as an indication of continued residency in Australia.

16. The Committee questions the merit of such an elaborate approach where a combination of the overseas employment rule and the tie-break provisions in Australia's tax treaties would mean that relatively few individuals would be impacted. As a matter of good law design, the provisions should not be drafted in an unnecessarily complex manner just to solve for a few isolated instances.

17. There is also nothing in the current domicile and permanent place of abode test that supports the Board's perspective and definition of adhesiveness.

18. In *Harding*, the Full Federal Court reflected on the "Explanatory Notes" to the 1930 Amending Act. Those Explanatory Notes demonstrate that the purpose of the domicile and permanent place of abode test:

> was the taxation, for the first time, of the Australian High Commissioner in London, together with the Agents-General of the states, and their respective staff. Until the 1930 Amending Act, these individuals were not liable to pay income tax under the 1922 Act, nor British income tax.

19. Relevantly, the Explanatory Notes stated:

> The primary test is actual residence in Australia. If a person is in fact residing in Australia then, irrespective of his nationality, citizenship or domicile, he is to be treated as a resident for the purposes of the Act.
>
> …
>
> The application of the test of domicile will cause the High Commissioners for Australia and Agents-General for the Australian States, together with the members of their staffs, to be treated as residents of Australia liable to income tax assessment on Australian and extra-Australian income as proposed for other residents.

20. The proposed rules disconnect the question of residency from the long-standing principle that residency tests where a person lives; where they eat and sleep and have their settled or usual abode. The benefit of the case law in *Harding* shows that the concept of adhesiveness does not conform with the current policy setting and conceptual residency framework in Australia.

21. Further, if the test is going to be framed in terms of days spent in Australia rather than the personal attributes and circumstances of the taxpayer, the test should be framed similarly to international jurisdictions like New Zealand. The New Zealand test under section YD of the *Income Tax Act 2007* (NZ) is a fair example of residency rules premised on days spent. The test applies such that the taxpayer is deemed to have lost their residency if they are physically absent from New Zealand for more than 325 days in total in a 12-month period (section YD(5)). Under this test, non-residency occurs from the first of the 325 days until the taxpayer is treated again as a resident under section YD (section YD(6)). Notably, the New Zealand test is premised on days absent without any concept of adhesiveness attached. Adopting a test along these lines would be more consistent with Australia's current residency framework and consistent with other jurisdictions.

Adhesive residency and OECD principles

22. The Board has asserted that the proposed rules, including the adhesiveness principle, are consistent with international practice and existing rules adopted in other countries.

23. However, the primary consideration should be whether the proposed residency rules are inconsistent with the OECD's Model Tax Convention and Australia's DTAs. Inconsistency between the domestic law and Australia's DTAs will only create complexity and undermine the key reason for devising new residency rules.

24. In the first instance, the proposed rules will likely increase the number of individuals who will be subject to Australian income tax. The Board has stated that the intention is only to protect Australia's existing tax base by reducing opportunities for

manipulation, for example, by single year absences that break an individual's residency status.

25. However, a natural consequence of the proposed rules is an increase in the tax base as it is more difficult for an individual to cease being an Australian resident for tax purposes. This is clear from the more onerous test posed for long-term residence and the low 45-day threshold contemplated by the test.

26. The Committee has analysed a number of cases where tribunals and courts have found that the Commissioner's income tax assessments have been excessive due to an incorrect assessment of the taxpayer's residency status. In all cases, the proposed residency rules would reverse or modify the decisions made in these cases. There is plainly an increase in the base under the proposed new rules. The Committee would be happy to provide you with this further analysis upon request.

27. The Committee comments further on some of the treaty issues below.

Adhesive residency versus a residency of nowhere

28. A key consideration by the Board in the development of the proposed residency rules was the phenomenon of a 'resident of nowhere'. The Board was concerned with the risk that a taxpayer could manipulate the rules to avoid their potential tax liability in Australia.

29. The Board acknowledges that, whilst the population of individuals capable of achieving the status of a 'resident of nowhere' is small, the consequences could be substantial. Under the Board's proposed rules, the adhesion of residency is proposed to eliminate the concern raised by this phenomenon—at least for three income years.

30. As noted above, from a law design perspective, the problem is that the proposed measures taken to prevent 'nowhere residency' are not proportionate to the risk and unnecessarily affect individuals who have no intention to be a 'resident of nowhere'. First, the risk of becoming a resident of nowhere, as acknowledged by the Board, is small. Secondly, the overseas employment rule is problematic—as discussed below. It is not only those 'residents of nowhere' who are being caught but taxpayers who fall into the expanded concept of the proposed rules.

31. Given that the Board acknowledges the minimal risk and does not intend to expand but to protect the tax base, the proportionality of the proposed residency rules through adhesive residency should be considered against the risk of nowhere residency.

32. The Committee suggests that the better way to deal with this risk is to adopt a new rule, similar to the Commissioner's current formulation for the domicile and permanent place of abode test in TR 2023/1, applying *Harding*. That is, a taxpayer would continue to be an Australian tax resident unless they have:

    (a) definitely abandoned their residency in Australia; and

    (b) commenced living permanently in a country overseas.

33. The ‘domicile’ requirement could be changed to Australian citizen or permanent resident if this was considered a simpler test.

34. This would introduce a simple rule, consistent with the current rule and the current tax base.

35. Alternatively, there could be a single test based on a modified version of the ceasing short-term residency test, with an individual to ceasing to be an Australian tax resident where:

    (a) they spend less than 90 days in Australia in the current income year; **or**

    (b) they satisfy less than [two factors]/[X points] and spend less than 183 days in Australia.

36. There is a significant degree of overlap between the factors such that for individuals who are Australian citizens, permanent residents, or certain temporary visa holders, they will almost certainly not be able to cease residency under the test as they will satisfy at least two factors (right to reside and family and/or accommodation). For this reason, the Committee suggests that the test should be ‘*or*’ rather than ‘*and*’.

Part Two: The 45-day limit

37. The Committee believes that a 45-day limit for the secondary test is not an appropriate limit that would give a true reflection of an individual’s connection to Australia, and one that would give rise to unfair and inconsistent outcomes.

38. There are a number of reasons beyond an individual’s control that may mean they unintentionally breach a 45-day limit. These could include circumstances where a person is unable to travel or to leave Australia due to:

    (a) border closures (as have recently been seen with the global COVID 19 pandemic),

    (b) personal health complications;

    (c) attending to legal and other commitments such as acting as an executor, discharging obligations and functions as a director of Australian companies, and

    (d) personal family commitments which require physical attendance such as caring for an incapacitated family member.

39. The Committee suggests that a 90-day test would be fairer and make allowance for complications to travel plans, without giving rise to undue integrity concerns.

40. At the very least, the Committee believes that certain days should be excluded from the day counting exercise, such as days where:

    (a) travel restrictions apply in Australia or destination countries;

    (b) personal illness or injury prevents travel;

(c) attending to obligations as a legal personal representative, company director, and other functions requiring personal attention to matters in Australia; and

(d) attending to the needs of others as a result of life events or similar which require physical attendance upon that person.

41. The residence tests have long involved non-objective criteria, and the proposed Factor Tests still do. It is submitted that compliance with the exclusions listed above should rest with the individual in the same way that the day counting obligation also rests with them. The position adopted by a taxpayer would be subject to review by the ATO in the normal manner and consistent with all other aspects of a self-assessment tax system. The taxpayer would bear the onus of proving any basis for concluding such days are excluded.

Part Three: Ceasing residency other than under the overseas employment rule

Long-term v Short-term Distinction

42. One manifestation of the "adhesiveness" concept is the Factor Test, which applies differently, depending upon whether an individual is a "long-term resident" or a "short-term resident". The Factor Test is intended to simplify the operation of the law significantly, but having separate tests for individuals who are long-term residents as distinct from short-term residents adds complexity and will generate inconsistent outcomes. For example:

    (i) An individual retiring overseas would remain a resident for at least three income years under the proposed ceasing long-term residency test but a person moving overseas for employment, who satisfies the overseas proposed employment test (below), could cease being a resident in the year of departure.

    (ii) Under the current rules, an individual with an Australian domicile can cease being a resident if they have a permanent place of abode outside Australia; under the proposed ceasing long-term residency test, the same individual will remain a resident for at least three years.

    (iii) Under the proposed short-term residency test, Australian citizens, permanent residents, and New Zealand citizens on special category visas who are not temporary residents, will almost certainly not be able to cease residency under the short-term test as they will satisfy at least two factors (right to reside and family and/or accommodation) and so will need to look to satisfying the long-term residency test.

43. The Board of Taxation's Report, in justifying the use of a three-year period of residence, relies on the Republic of Ireland's "ordinarily resides" test (footnote 19, page 48). Apart from this justification, the use of the three-year period is arbitrary and would represent a significant expansion of Australia's taxing rights and will capture significantly more people than under the current tests.

44. The nature of the proposed rules means that "long-term" residents—who may have been in Australia for barely three years—would remain residents for two years after the year of departure.

45. There appears no policy justification for this beyond revenue raising and it would be a disincentive for people to move to Australia, thus impairing Australia's ability to attract skilled workers. The position will discriminate against self-funded emigrants. The change also discriminates against countries that do not have a tax treaty with Australia which might otherwise provide relief through the application of the tie break mechanism.

46. For these reasons, there should not be a separate test for ceasing long-term residency. Rather there should be a single test based on a modified version of the ceasing short-term residency test. Some possible solutions have been set out above.

47. The Committee believes 45 days is too short. An individual having two 4-week trips to Australia, whether for work or personal reasons, will easily satisfy this requirement. We consider a higher threshold is appropriate and that there should be a single test for individuals to cease being an Australian tax resident with the test being as follows:

    (i) they spend less than **90 day**s in Australia in the current income year; **or**

    (ii) they satisfy less than [two factors]/[X points] and spend less than 183 days in Australia.

48. Under this reformulated test, individuals who spend less than 90 days in an income year will cease to be residents. Someone who spends more than 90 days in Australia, but less than 183 days, will cease to be a resident if they satisfy less than two factors.

49. The first limb of the test will mainly be applicable for individuals with strong connections with Australia while the second limb will mainly be applicable to individuals without those strong connections.

Part Four: The Factor Test

50. For the reasons set out in the 2018 BLS Submission and the 2021 BLS Submission, the Committee believes satisfying two of the proposed four factors does not correctly reflect when an individual commences residing in Australia (Commencing Residency Test) and when a short-term resident ceases residing in Australia (Ceasing Short-term residency test).

51. As noted above, the proposed factor rules import excessive adhesiveness into the framework, ultimately resulting in an individual who does not intend to treat a place in Australia as home still being an Australian tax resident and paying Australian income tax on their worldwide income.

52. One example is the "Australian family" factor which seeks 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 - these two factors 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. 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 the Committee's view is that the family unit should not be used in isolation as a proxy for individual residence.

53. It is not unusual in the modern globalised economy 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.

54. The Committee considers that the factor test should allow for more flexibility, so that family presence and available accommodation should not alone be sufficient to trigger residency.

55. The practical effect of the two-factor test is also that non-resident Australian citizens with historical connections to Australia can too easily become tax residents of Australia. The effect of the two-factor test is that such a person will likely become an Australian tax resident if he or she spends 45 days in Australia in an income year, notwithstanding that the person may have taken no steps to break their overseas residency or establish residence in Australia.

Suggestion 1: Points system

56. The use of a 'points test' rather than a four-factor test was first raised in the 2018 BLS Submission. The Committee continues to believe that the suggested points test better achieves the objects of the proposed reforms without introducing unnecessary complexity, subjectivity, or the need to carry out extensive investigations.

57. The criteria for a points system can be developed having regard also to the relevant factors in the tie-break tests for dual resident individuals in Australia's network of tax treaties.

58. A framework of a possible points test was provided in the 2018 BLS Submission. That framework is now five years old and obviously requires further consideration in light of the Committee's comments above. We would be happy to work with you to further develop a points test and what the appropriate factors and weighting might be, having regard to the other issues raised in this submission.

59. If the implementation of a points system is not favoured, then the proposed factor test needs to be reconsidered. Some suggested changes are set out below.

Suggestion 2: Omit the "right to reasonably reside" factor

60. The reasons for removing this factor were set out in the 2021 BLS Submission.

61. 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.

62. 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
- an Australian passport + welcoming immediate or extended family = resident

63. 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.

64. In addition to the reasons outlined in the earlier BLS Submissions, it should be noted that the use of a jurisdictional criterion based upon the existence of a right to reside permanently (i.e., citizenship, nationality, or permanent residence via visa) lacks any strong and/or accepted theoretical basis. Such a criterion is based upon the discredited exchange theory of taxation which arises from the philosophical social contract that arguably exists between government and the individual. The exchange theory fell out of favour due to theoretical and equity concerns. As early as the late 1800s it had been suggested that the concept:

> "in the modern age of the international migration of persons as well as of capital, political allegiance no longer forms an adequate test of individual fiscal obligation. It is fast breaking down in practice, and it is clearly insufficient in theory. (Seligman, Essays, 109. His views are adopted word for word in the League of Nations, Report on Double Taxation, 1923, 19)."

65. The use of such a jurisdictional criterion is generally inconsistent with international practice in this area. Only the United States uses citizenship as its primary nexus for worldwide taxation of citizens regardless of where the individual resides.[1] It is used in only three other countries in limited circumstances (i.e., Eritrea, to impose tax on citizens living abroad in respect of certain income types, and in Myanmar and Hungary in limited situations where the citizen resides in a non-tax treaty country.) It is also used as a linkage in respect of exit taxes in some jurisdictions.

66. Even in treaty policy a right to reside permanently (nationality) is not the first-tier criterion of the individual resident tiebreaker tests in article 4 of the OECD Model Tax Convention on Income and Capital (2017 OECD Model) and the United Nations Model Double Taxation Convention between Developed and Developing Countries (2017) (UN Model).

67. Finally, the importance of the nationality criterion under the common law has always been minor at best. Justice J A Logan RFD, P E Hack SC DP, and R G Kenny SM in ***Re Dempsey and FCT*** [2014] AATA 335 noted at [102]:

> "[W]e consider that the adoption of [the nationality] criterion as one indication of whether a person "resides" in Australia is apt to mislead. ... Nationality doubtless confers a right of residence but whether or not that

[1] Internal Revenue Code, 26 U.S.C. § 1. A citizen is a person born or naturalised in the USA—C.F.R. § 1.1–1(c).

right is exercised in circumstances that admit of the conclusion that a person is a "resident", as opposed to a lawful visitor, is quite another thing. Further, it has been observed that a person may become a resident "completely against his will" [referring to Inland Revenue Commissioners v Lysaght [1928] AC 234 at 248 per Lord Buckmaster].:

Suggestion 3: Tighten the definition of "Australian economic interests" factor and exclude residential accommodation and financial interests connected with property investment

68. The "Australian economic interests" factors described in the Consultation Paper are unduly broad, and lack the objective approach intended by the proposed changes. Passive investment in Australian assets is very common, whether property, shares, or other investment interests. It is not clear how 'substantial' an Australian bank account balance must be to satisfy the factor. The taxation provisions already bring to tax Australian sourced income on such investments held by non-residents. The Committee submits that passive investment interests should not then be taken into account as a factor in the proposed framework.

69. One particular proposed economic connection is a potential interest in an Australian discretionary trust. Individuals can be potential beneficiaries of trusts and never receive any benefit, and indeed never even know about the potential interests or the fact they are a potential beneficiary. Compliance with this factor will be very difficult. The Australian tax rules already deal comprehensively with Australian trust distributions to non-residents.

70. It is also not clear how an interest is to be defined. Any definition will need to take into account equitable interests, non-controlling interests in corporate structures, interests received by operation of law, inheritances, and discretionary trust holdings in which a person has no economic interest. The Committee suggests that this factor be removed, or at the very least a person should control a family or discretionary trust before their interest in it is considered a relevant factor.

71. An interest in Australian real property (other than property leased to a tenant) potentially satisfies both the Australian accommodation and Australian economic interests factors. That particular circumstance should not be "counted twice".

72. A person who owns a rental property in Australian will most likely have an Australian bank account into which the rent is deposited, and from which payments of outgoings for maintenance, land tax, utilities etc can be made. The maintenance of an Australian bank account in these circumstances should also be excluded from consideration of the Australian economic interests test.

73. One solution could be to narrow the concept of economic interest to focus on the actively carrying on of a business in Australia, or the control of an active Australian business.

Suggestion 4: Exclude the residence of other family members from "Australian accommodation" factor

74. Where an individual has family in Australia, the individual will generally have access to accommodation. Accordingly, the fact that a person has family members residing in Australia should not be "double counted".

75. In addition, or in the alternative, 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).

76. Further, the Consultation Paper refers to the 'nature' of arrangements with family members potentially giving rise to Australian accommodation of those family members counting as accommodation to the test individual. This introduces another very subjective test. The Committee submits that Australian accommodation not exclusively available to the particular individual should be excluded from the factors completely.

Part Five: The Overseas Employment Rule

77. Having a third and separate test for individuals who "work" overseas, whilst appealing, adds a degree of complexity back into the test that has potential to generate odd outcomes. For example, mismatches in residency status will result between:

    (a) Spouses moving at the same time—where one moves with overseas employment secured and the other follows without employment but is subject to the general ceasing long term residency tests.

    (b) Those who move overseas with employment already secured in advance compared to those who secure employment only after moving—the proposed wording of the test indicating the rule only applies if employment is secured in advance.

    (c) Those who secure long term or permanent employment compared to those working on shorter term contracts or moving between different overseas jurisdictions—noting that is becoming a more common employment pattern with increased use of short-term engagement models.

    (d) Self-employed individuals and contractors and other employees - and in this respect would be open to manipulation, for example, through the use of personal services companies.

78. On balance the preference is not to create a separate class of residence for individuals working overseas. The Committee believes the issue could be better addressed through reintroducing a standalone provision along the lines of the old section 23AG of the *Income Tax Assessment Act 1936* prior to its amendment.

79. The old section 23AG exemption was a relatively simple way of addressing income earned by Australian tax resident individuals during overseas service or employment. The narrowing of the exemption was the catalyst for a change in behaviour, and an onslaught of cases and private ruling requests, with some

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, should:

(a) reduce both the number of ruling applications made to the ATO and the number of cases going before the Administrative Appeals Tribunal 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.

80. If the overseas employment test is to be implemented, the Committee recommends adjusting the test to prevent arbitrary distinctions arising based on differing rules overseas around maximum durations for which work permits and visas can be obtained—that period being shorter than 2 years in some jurisdictions. The adjustment could be to require the employment be for the shorter of either "*two years from when the employment commences or the longest duration permitted by the overseas jurisdiction*".

81. The Committee also recommends removing any distinction between employment secured prior to, and employment secured after, a taxpayer moves overseas. The rule could simply apply if full-time employment secured overseas is for a total period of 2 years with any number of employers in any 3 year period.

82. How a breach of the 45-day rule would play out also requires careful consideration. The current framing of the test provides that spending longer than 45 days in Australia in any income year could result in residency status for all years of overseas employment being impacted. This is problematic in circumstances where reasons for greater duration of presence in Australia can be outside of the individual's control—such as ill health, or a broader Asia-Pacific job role requiring more presence in Australia due to the decisions of the employer.

Part Six: Treaty Issues

83. Contrary to the announced policy, the proposed changes to simplify the individual residency test may unfortunately have little impact in practice where a taxpayer is a dual resident of both Australia and a country with which Australia has a double taxation agreement (DTA). Any such taxpayer will still be required to consider the 'facts and circumstances' tie-breaker tests in the relevant DTA. In most DTA's the tie-breaker test looks at the economic and personal relations of the taxpayer in both countries to determine their DTA residency status. In addition, the DTA and OECD Model Convention each still reference the 'permanent home' being available to the individual.

84. In the leading text*, Klaus Vogel on Double Taxation Conventions*[2], the discussion on tests for personal and economic relations makes it clear that the OECD Convention

[2] Ibid [62] K, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions,* 1997

and the DTAs for countries such as Australia rely upon facts and circumstances such as:

> (1) Personal and Economic Relations… many factors from the taxpayer's private and economic sphere are relevant to determine his personal and economic relations…
>
> In practice, the courts have… based their decisions on an evaluation of facts surrounding the following non-exhaustive list of facts…
>
> house; family home; furnishings; rented apartment; owned apartment; passport; sharing a room, no rent, no lease; place where the taxpayer was born and raised; children; country of birth of children; spouse; country of divorce; where spouse seeks employment; family visits; other family members such as parents; partner; friends; acquaintances; memberships; language skills; work; employer; adoption of professional qualifications such as nursing license; temporal dislocation; no relations apart from day-to-day living expenses (renting on yearly basis, bank account only for needs abroad, no car), relocation support, normally granted when an employee has temporarily moved to work in another country than that in which he had his residence; bank accounts; brokerage account; credit card; money transfer; health insurance; driver's licence; personal belongings, such as a car, purchase new home; registration of car; future retirement places; retirement accounts.

85. Another consideration for the application of changed Australian individual residency tests may be the impact of the non-discrimination article in the OECD Model Convention (included in many DTAs such as those with UK and USA). The operation of such a clause was challenged in the series of backpacker cases culminating in the 2021 *Addy* decision in the High Court[3]. In that case, Article 25(1) of the UK-Australia DTA was interpreted to prevent discrimination on the grounds of nationality by providing that nationals of one country may not be less favourably treated than nationals of the other country in the same circumstances. In other words, if a potentially dual resident taxpayer may be affected adversely by Australian tax laws, then such a non-discrimination article may be applied by the courts to protect their interests.

[3] Addy v Commissioner of Taxation **[2021] HCA 34** https://eresources.hcourt.gov.au/showCase/2021/HCA/34