

International Employment Taxation

September 2009

Removal of the foreign employment income tax exemption

The 2009 federal budget included changes to the taxation of foreign employment earnings to come into effect on 1 July 2009. These changes have now been legislated and as a result, most outbound short-term employees will now be taxable in Australia on their foreign employment income.

This change has far wider implications than just causing employment income to be taxable. Some of the primary implications are discussed below.

The Legislation

Legislation to 30 June 2009

Section 23AG of the *Income Tax Assessment Act 1936* applied if the employee:

- ▶ was a resident of Australia for tax purposes;
- ▶ was employed overseas for a continuous period of at least 91 days;
- ▶ had only restricted absences from the foreign (host) country; and
- ▶ was not exempt from tax in the host country for one of several specific reasons.

If the requirements of section 23AG were satisfied, the employee was exempt from Australian income tax on foreign employment income.

The employer, whether an Australian or foreign entity, was not liable to withhold Pay As You Go (PAYG) from any payments made to the employee. The employer was also not liable to pay Fringe Benefits Tax (FBT) on any benefits provided to the employee in respect of working overseas.

Current legislation from 1 July 2009

All of the above requirements still apply. However, the application of section 23AG is now restricted and applies only to specific employees working for:

- ▶ Australian official development assistance;
- ▶ developing country relief funds or public disaster relief funds;
- ▶ charitable or religious institutions undertaking charitable activities exempt from income tax; or
- ▶ a disciplined force deployed overseas .

All other Australian residents working abroad are no longer exempt from Australian income tax on their employment earnings. In addition, Foreign Employment Termination Payments and payments in respect of foreign duties paid to employees after they arrive in Australia will no longer be exempt from Australian income tax.



Two transitional rules to note:

- ▶ Periods of foreign service after 30 June 2009 can still be used to determine whether the 91 day condition is met for periods up to 30 June 2009.
- ▶ Payments made after 30 June 2009 that relate to foreign service up to 30 June 2009 are still exempt from Australian income tax. This would mean the bonuses paid long after 30 June 2009 in respect of duties prior to that date should still be exempt.

Implications of the change

Foreign Income Tax Offsets

If the employee is liable to income tax in both Australia and the host country, they may claim a Foreign Income Tax Offset (FITO) to alleviate double taxation. This is essentially a credit for foreign tax paid that can be claimed against the Australian income tax due.

The foreign tax paid in many countries will be less than the Australian income tax due, which will result in “top up” income tax to pay in Australia.

In order to claim the FITO, the foreign income tax has to be paid to the foreign tax authority. If the Australian tax return is due before foreign tax is paid, the Australian tax return would need to be amended to include the FITO when it is actually paid.

In addition, the foreign tax must relate to income that is included in the employee’s Australian income tax return. This means that a FITO for foreign tax paid on fringe benefits cannot be claimed as the benefits are not included in the employee’s Australian income tax return.



Pay As You Go

If the foreign earnings are liable to Australian income tax, PAYG withholding including all associated reporting is required by the payer of the earnings.

If host country tax withholding is also required, employers may apply the PAYG withholding class variation issued on 10 July 2009. This allows Australian PAYG to be reduced by the foreign tax to be withheld and paid on the same earnings.

Double Taxation of Fringe Benefits

If PAYG applies, FBT applies. It is the employer who is liable to FBT, even if the fringe benefits are provided by an associated entity. Therefore, usually the Australian entity would need to track benefits provided in the host country.

As most countries charge employees income tax on benefits but Australia charges employers FBT on benefits, double taxation may arise. FITO for foreign income tax paid cannot be claimed against the Australian FBT liability.

There are some possible strategies to alleviate double taxation, including swapping benefits for cash (which is likely to reduce the overall tax payable) and applying the Living Away From Home FBT concessions.

All of the declarations and compliance required for local employees, such as travel diaries, Living Away From Home declarations and Reportable Fringe Benefits Amounts, now apply to resident expatriates working abroad as well.

Technically, FBT (and PAYG) obligations are not restricted to Australian payers and employers. But practically, as the Australian Taxation Office (ATO) recently commented at a Senate Committee hearing, they would not be able to enforce compliance with FBT and PAYG withholding on foreign employers with no presence in Australia.

Residence and Double Taxation Agreements

Foreign employment income is only taxable in Australia for employees who are tax residents of Australia. Foreign residents working abroad are not taxable on their foreign earnings in Australia, so PAYG and FBT do not apply.

Generally, you are a tax resident of Australia if you pass one of the four tests of residence. The most relevant test for outbound Australians is the “domicile” test. This states that you are a tax resident of Australia if you are “domiciled” in Australia, unless the ATO is satisfied that your “permanent place of abode” is outside Australia.

Most outbound Australians will therefore need to set up a “permanent place of abode” outside Australia to become foreign tax residents. In the ATO’s opinion, this requires a review of a range of factors including the intended and actual length of time overseas. The ATO generally considers a period of two years or more to be a substantial period for the purpose of determining tax residence, whilst taking other factors into account.

However, if Australia has a double taxation agreement (DTA) with the host country and the employee becomes a tax resident of the host country while remaining a resident of Australia, the “tie-breaker article” in the DTA can be applied to determine one country of residence for the purposes of the DTA. The tests included in the tie-breaker article vary per DTA but generally require consideration of the employee’s permanent home, habitual abode, centre of vital interests and sometimes nationality.

If the DTA rules that an employee is a resident of the host country only, they are not a tax resident of Australia and their foreign employment income is not taxable in Australia.

If you wish to discuss the impact these changes will have on you and your employees, please contact your PKF International Employment Taxation adviser.

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