KPMG submission

Board of Taxation

Review of the Income Tax Residency Rules for Individuals

Consultation Guide

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Executive Summary

KPMG welcomes the opportunity to comment on Board of Taxation's (the Board's) *Review of the Income Tax Residency Rules for Individuals Consultation Guide.*

KPMG supports simplifying the individual tax residency rules, while at the same time seeking to accommodate a reasonable level of equity and integrity.

We recommend that the residency tests being considered by the Board should operate as follows:

Primary test:

183 days or more of presence in Australia in a year of income, applicable to both "inbound" and "outbound" individuals, and regardless of whether the individual has been a resident in the previous income year.

Secondary test:

Where the primary test is not satisfied, the following four factors should be considered in the test for residency, namely:

1. The test individual has 'citizenship ties' to Australia,
2. The test individual has 'family ties' to Australia. Consideration should be limited to where the taxpayer's spouse (or spouse equivalent) and dependent children reside.
3. The test individual has 'economic ties' to Australia. Most weight should be given to the location of the individual's principal place of employment, or fixed base for other business activity. Least weight should be given to the location of relatively fungible financial assets such as bank accounts and listed investments.
4. The test individual has 'accommodation ties' to Australia. This should be limited to consideration of accommodation that is immediately and continuously available to the test individual.

Split year:

The taxpayer should have the ability to split the income year between resident and non-resident periods, and not be treated as a resident until the first day of presence in Australia (or later in

some cases) where he or she was not a resident in the previous income year. A taxpayer who leaves Australia and ceases to satisfy the secondary test during the year of income should generally not be a resident after that point in time.

Detailed comments

1. General

1.1 KPMG welcomes the opportunity to comment on Board of Taxation's (the Board's) *Review of the Income Tax Residency Rules for Individuals Consultation Guide.*

1.2 KPMG believes that simplifying the income tax residency rules for individuals is rightfully a high priority for the Board of Taxation.

1.3 As a general matter, KPMG submits that an uncomplicated bright-line test, supplemented by a 'streamlined' secondary test based on a limited number of existing principles can achieve the aspired-for objective. Our additional, specific comments and recommendations are outlined below.

2. Consultation questions

Q1: Does the Board's proposed wording [of the objects clause] appropriately encapsulate the policy objective of ensuring that individuals with substantial ties should be residents?

No additional comments.

Q2: The Board's report suggested that the statement should identify how the residency rules address the tax policy objectives of simplicity, equity, efficiency and integrity (in particular, the prevention of tax avoidance) to help taxpayers and the ATO understand whether taxation (or its absence) in any given context is a intended outcome or the result of tax avoidance.

Do you consider that this statement achieves this standard? If not, how may it more accurately do so?

2.1 The proposed wording strikes a reasonable balance between achieving the standard, and achieving an appropriate level of impact.

Q3: To what extent does a bright-line test provide balance between certainty, simplicity and integrity? Are other measures needed to provide integrity – for example, those discussed under design principle 5?

2.2 KPMG regards the bright line test as striking the right balance, provided it is supported by the secondary qualitative test based on ties to Australia.

Q4: Are there any other bright-line tests that you think should be included (whether as alternatives to a day count test, or in some form of combination)? For example, should you be a resident if:

a. Your only home is located in Australia; or

b. You work full-time in Australia.

2.3 The addition of these further bright-line tests creates problems as it is difficult to define those terms. Further, the additions would make the overall conclusion more complex to arrive at, which would undermine the purpose of any eventual reform. KPMG submits that the addition of further bright-line tests creates too great a risk to the simplicity objective of the Board of Taxation in seeking to reform the residency rules.

Q5: Should an individual spending 183 days or more in any 12-month period in Australia spanning two income years be considered a tax resident in both periods?

2.4 We recommend that the 183 day test should be applied separately in each year of income, and NOT by reference to a rolling 12-month period. It would be too complex for taxpayers to assess whether they had hit the threshold over a rolling 12-month period.

2.5 In addition, taxpayers would need an extended period of time in which to lodge their annual tax return, as days of presence occurring more than four months after the end of the financial year could be relevant in determining the taxpayer's residence status. There is also the risk of taxpayers lodging a return on a non-resident basis because they do not expect further days of presence in Australia, and then having to amend because they have an unexpected visit here which retrospectively impacts the prior return.

2.6 We do not see the 183-day rule as open to significantly more manipulation where it is applied to each income year in isolation, given that it will be backed-up by the secondary test for residence.

2.7 Regardless of whether the bright-line test applies separately in each year of income or on a rolling 12-month basis, there is a need for an opportunity for "split-year" treatment in order that taxpayers are not required to resort to double taxation agreements to resolve their situation when, for example, they relocate to or from Australia during a year.

2.8 One way of achieving this would be for a taxpayer who was a non-resident throughout the previous income year, but who also satisfies the secondary test of residence for part of the current year, to only be a resident from the date on which they first satisfied the secondary test. This could be subject to the proviso that the number of days in Australia before that time is within a reasonable de minimis limit (say 28 days).

2.9 Further, a taxpayer who was a non-resident throughout the previous income year, and does not satisfy the secondary test at any time during the current year, could only be considered a resident from the date of first entry to Australia during the current year.

Q6: What consequences (if any) will arise for the temporary residency and working holiday maker rules if these changes were adopted? How should these issues be addressed?

2.10 The law should be clarified to show that the "temporary resident" classification is a subset of the resident classification.

Q7: Are there any other bright-line tests [in addition to the day count model for outbounds] that you think should be included? For example, should you be a non-resident if your only home is located outside of Australia?

2.11 No other bright-line tests are required to achieve the relevant objectives that the Board of Taxation has established. An 'outbound day count test' for someone who has never been a resident of Australia is a redundant concept and should be removed from consideration.

Q8: Do the proposed day-count tests appropriately balance simplicity and integrity? Is it too complex? Alternatively, are other measures needed to provide integrity – for example, those discussed under design principle 5?

2.12 We support the use of a day-count test, supplemented by a secondary qualitative test based on limited criteria of ties to Australia. This strikes an appropriate balance between simplicity and integrity.

2.13 Our preference is that the day-count test should be applied separately for each year of income. When coupled with the secondary test, we do not see this approach as giving rise to increased risk of abuse.

2.14 We do not support the proposition that a taxpayer who has previously been a resident should have to satisfy the Commissioner that he/she has established residence somewhere else, in order to become a non-resident of Australia. The residence outcome should be a result solely of the bright-line days test and the secondary test based on ties to Australia. The secondary test should require analysis of the ties to Australia on an absolute basis, and not by comparison to the ties with any other country. The latter approach would not achieve any simplification when compared to the current law.

Q9: Should the outbound individual test apply over a 12-month period, per income year or on some other basis? Why?

2.15 The outbound individual test should also ideally apply separately to each year of income. Again, this is more straightforward for taxpayers, and does not present any greater risk of abuse when supported by the secondary test.

2.16 We disagree with the proposition that residence, once attained, should be relatively adhesive. Therefore the day-count test should be the same for taxpayers who have previously been resident as it is for those who have never been resident.

Q10: How does this test interact with the limited foreign employment income tax exemption (section 23AG of the Income Tax Assessment Act 1936)?

2.17 The removal of eligibility for this exemption in respect of most employees has caused great complexity for those resident taxpayers who are employed and paid overseas by a foreign employer. In these circumstances, the employer is not subject to fringe benefits tax ("FBT") and so the employee has to determine the value of these benefits under section 15-2 ITAA 97 to include in his or her personal tax return.

2.18 Section 15-2 ITAA 97 does not include the same scope of exemptions that is present in the FBT legislation. Therefore employees whose employer is not subject to FBT are not only in a more complex position than those employed by an Australian employer, but also subject to a higher personal income tax burden.

2.19 We recommend that the Board of Taxation investigates solutions to this issue further with Treasury.

Q11: Are the factors proposed for the secondary test [ie qualitative: number of days, citizenship, family, accommodation, economic (ie business / employment)] the most appropriate factors?

2.20 A day-count test should not feature in both the "bright line" test and the secondary test. It would be confusing for taxpayers, and also unnecessary if the bright line days test is set appropriately. The factors are reasonable, and we agree with the proposition of limiting the number of factors that should be considered under the secondary test.

Q12: Are there any key matters that should be adopted in preference to, or addition to, the listed factors? For example:

(a) the length of a taxpayer's stay in a single overseas country;

(b) the answers on immigration forms upon arriving or departing Australia;

(c) whether a taxpayer established a home (in the sense of dwelling, house or other shelter that is the fixed residence of a person, a family, or a household), outside Australia;

(d) the duration and continuity of a taxpayer's presence in the overseas country outside of a single income year;

(e) whether a taxpayer informs government departments such as the Department of Social Security of leaving permanently and stopping social security payments (ie, family allowance payments);

(f) whether accommodation in Australia has been effectively abandoned (ie, the extent to which accommodation is actually available).

2.21 **Factors (a), (c), (d):** Including these factors would make the proposals too close to the analysis required under current law for any real simplification to be achieved. KPMG submits that these factors should be disregarded.

2.22 **Factor (b):** The addition of factor (b) would add too little information of value to justify the additional complexity that would result. In particular, we submit that these forms are often completed hurriedly and without the degree of care and attention that should be informing determinations on tax residency.

2.23 **Factor (e):** The current rules for eligibility for social security payments have been set with particular policy intentions in mind. If an individual who is non-resident for tax purposes (under either current or future rules) remains eligible to receive those payments based on their circumstances, then he or she should not be required to give up those payments.

2.24 **Factor (f):** This factor should be a component of the proposed accommodation test.

Q13: What level of 'economic ties' should be necessary for the factor to be conclusively determined? For example:

2.25 The dominant factor in assessing the taxpayer's economic ties should be related to their employment or other income-producing activity (for example as a sole trader or professional). Where the taxpayer has a principal place of employment or fixed base of business, and this is in Australia, then the "economic ties" test should be satisfied. By contrast, if the taxpayer's principal place of employment or fixed place of business is outside Australia, then the "economic ties" test would not be satisfied, regardless of the existence of other financial connections with Australia.

Q14: maintaining bank accounts in Australia;

2.26 Maintaining a bank account in a country has ceased in the 21st century to be indicative of any significant tie to that country. This should be disregarded.

Q15: maintaining an ABN in Australia;

2.27 This should not be a factor in circumstances where a taxpayer has simply forgotten to cancel their ABN following the cessation of an active business. Where an individual is, in fact, carrying on an active business through a fixed base in Australia (and therefore entitled to maintain an ABN), this would be a relevant economic tie.

Q16: directorship of an Australian company (or other entities such as a self-managed super fund);

2.28 This should not be taken into account as an economic tie in circumstances where an employee is required to take on a directorship of an Australian subsidiary company of his or her employer in the ordinary course of the person's employment. In other circumstances it would be a reasonable factor to consider in the assessment of economic ties.

Q17: the level of investment in Australia (both passive and active);

2.29 It would be counter-intuitive for this not to feature in the assessment of economic ties. However there is difficulty in taking this factor into account and at the same time maintaining the focus on simplification. We consider that listed investments should not be taken into account, as these can be readily acquired and disposed of without having any other ties to Australia.

2.30 Due to the complexity involved in obtaining an overview of the allocation of a taxpayer's investments between Australia and other countries, and the cost and complexity of valuing certain assets, consideration of this aspect should be limited to whether the taxpayer has unlisted assets in Australia or not, and should be given a relatively low weighting in the assessment of economic ties.

Q18: compliance with any other residency requirements for the purposes of making or maintaining investments (i.e., whether a foreign investment application is required by the taxpayers). No additional comments.

Q19: What level of connection to accommodation should be required to satisfy the Australian accommodation factor?

2.31 To satisfy this factor, the accommodation should be available for the taxpayer, their spouse (or spouse equivalent), and their dependent children's exclusive and immediate use without the need to notify any other parties.

Q20: To what extent should a person's personal and social ties be located in Australia to satisfy the Family factor?

2.32 This factor should be restricted to consideration of the taxpayer's spouse (or spouse equivalent) and dependent children only.

Q21: At what level should the resident and non-resident 'time spent' factor be set (ie, how should they interact with the primary bright-line test for outbound individuals)? Should they be spread over a medium term (i.e., 2 to 3 years)?

2.33 There should be no secondary 'time spent' factor, other than a de minimis threshold below which a taxpayer could not be a resident even if they satisfied sufficient elements of the secondary test to otherwise be a resident. We suggest that this threshold could be set at 28 days in a year of income.

Q22: What should be necessary to satisfy any of the other factors? No additional comments.

Q23: Are the outcomes fair and equitable? If no, please elaborate.

2.34 KPMG expects that the application of the day-count test and the secondary test would together be capable of producing generally fair and equitable results for taxpayers. Key to achieving this will be the way in which the secondary tests are applied.

2.35 Fair and equitable results would generally arise where an individual was regarded as resident if they met at least three of the four proposed (namely citizenship, family, economic, accommodation) secondary factors (noting that we believe a further day-count test should be deleted from the list of secondary factors).

2.36 As regards satisfaction of the economic ties factor, the dominant consideration should be the location of the taxpayer's principal place of employment or of engagement in an active business. Where the individual is neither an employee nor engaged in an active business, the economic ties factor should only be satisfied if the taxpayer has more than 50% of their income-producing real property portfolio in Australia. If the taxpayer has no income-producing real property, the economic ties test should be regarded as inconclusive.

Q24: An individual working overseas may automatically be a non-resident, but under the secondary test would likely have otherwise been a resident. Does this interaction provide appropriate results? No additional comments.

Q25: In the UK a stepped approach to 'ties' is adopted – the Board considers this adds additional complexity. Does the Board's approach balance simplicity with integrity in the absence of this tiered approach?

2.37 The Board's approach strikes a reasonable balance in the Australian context, where international neighbours are much further away than in the case of the UK. A stepped approach is not necessary for Australia.

Q26: Would a 'points' style approach be more easily accessible and understood? Does the different approach make a material difference?

2.38 If the relevant factors that determine residency are defined clearly and in a way that will be clear to most people (which is the objective of this consultation) a points system would not add anything to the definition and as such would only add another potential layer of complication to residency determinations.

Q27: Should the new residency rules include a provision to align domestic and treaty residency for dual residents, eliminating potentially inconsistent outcomes?

2.39 This is not necessary. 'Inconsistent' outcomes are likely to only arise in a very small number of cases. Endeavouring to match domestic law with international treaties is likely to greatly increase complexity for taxpayers. The double tax agreements are drafted in the expectation of differences occurring between domestic law and how the two countries have agreed to allocate taxing rights.

Q28: Other than the resident of nowhere phenomenon, what other arrangements should be taken into account when designing an integrity rule for residency?

2.40 We are not convinced of the need for an integrity rule vis-à-vis the "resident of nowhere" phenomenon. We do not see a legitimate integrity concern in a case where an individual has satisfied the requirements to cease Australian tax residency under both the proposed primary and secondary tests, but has not established a connection with another jurisdiction of a type that would satisfy the Australian concept of residence.

2.41 One of the most complex aspects of the current law is the focus on the taxpayer's level of connectivity with a foreign jurisdiction, and the often inappropriate projection of Australian norms onto the taxpayer's domestic situation in the other country. For example, we do not believe that it is fair and equitable for two taxpayers whose ties to Australia are very similar to have different Australian tax residence outcomes based on the type of accommodation that could practically be available to them in the country in which each of them actually resides.

2.42 A taxpayer may have a closer connection with another country than to Australia, but be unable to demonstrate that he or she has become a resident there for the purpose of that country's tax law. Obtaining evidence of tax residence, as certified by the taxation authority, may be costly and time consuming, or practically impossible. Some countries do not have a concept of tax residence, preferring to only tax income that has its source within the jurisdiction.

Q29: Which of the options described best guard against short-term gaming that may allow otherwise taxable income, profits or gains to become exempt from Australian tax under either the current or proposed rules?

2.43 We do not see significant opportunities for "short-term gaming". Taxable Australian property ("TAP") remains subject to Australia's capital gains taxation regime after the taxpayer ceases residence, and TAP includes all assets in respect of which the taxpayer has not recognised a "deemed disposal" on ceasing residence. Similarly all Australian-sourced income will remain taxable in Australia after ceasing residence, including employment income attributable to any prior period spent working in Australia.

Q30: Are you aware of any arrangements which primarily seek to take advantage of resident-only [i.e. "artificially" establishing residence in AU] tax outcomes? If so, please explain.

2.44 KPMG is not aware of any arrangements of this type.

Q31: Do you think that a strict citizen-based residence test or a remittance based regime would improve the income tax system and/or complement new residency rules?

2.45 KPMG does not support either of these measures.

Q32: Do the proposed design considerations capture the appropriate Government officials and functions? If not, what else should be considered? No additional comments.

Q33: Do any of the international comparisons provide a clear guide for reforming the superannuation test? No additional comments.

Q34: Should the residency rules continue to deem spouses and dependants of Government officials to be Australian residents? No additional comments.

Q35: Should the new residency rules include part-year residency provisions? Should there be different part-year provisions for inbound and outbound individuals?

2.46 Yes. Taxpayers should not have to resort to treaties to resolve their position when they move from one country to another. Please see our comments at paragraphs 2.8 and 2.9 in response to Question 5.

Q36: Do the above design features [ie first day of presence as a resident / last day of presence if previously resident] provide a reasonable mechanism to determine split year income periods?

2.47 There is a need to ensure that the taxpayer is not regarded as a resident from the date of their first entry during the income year, where this entry does not coincide with the taxpayer's commencement of satisfying the secondary test. We suggest that periods of presence of up to 28 days in aggregate should not cause a taxpayer who at a later date in the income year starts to satisfy the secondary test to be treated as a resident any earlier than the date he or she first satisfies the secondary test.

2.48 Equally, periods spent during an income year in Australia of in aggregate 28 days or less following cessation of satisfying the secondary test should not extend the taxpayer's period of residence beyond the last day of satisfying the secondary test.

2.49 Taxpayers who are resident for a year of income based on the primary test (which we believe should be 183 or more days of presence in the income year), and who never satisfy the secondary test during that year or the previous year should only be considered resident from the first date of presence in Australia during the income year.

Q37: How might part-year rules interact with Australia's double tax treaties?

2.50 Where the Board adopts KPMG's recommendations on how the primary and secondary tests should be structured, we believe they will interact with Australia's double tax treaties in a way that does not unnecessarily complicate the taxpayer's experience.

2.51 In this respect, we do not have great concern about the fact that certain double tax treaties measure eligibility for the dependent personal services exemption on the basis of periods spent in the country over a 12-month period falling wholly or partly within the income year. In many countries it is the case that the test for tax residence is different to this eligibility test for the treaty exemption.

Q38: Should there be any transitional relief for any affected individuals? If so, please identify the affected type of individuals and relevant relief.

2.52 Any new residence rules should not take effect until 1 July following Royal Assent, unless there are fewer than 6 months between Royal Assent and the next 1 July in which case the effective date should be 1 July in the subsequent year.

2.53 In addition, a taxpayer who has been a non-resident for the complete year of income which precedes the new rules taking effect should be able to elect to have their residence status assessed under the current rules for a further two years.