HUNT STRATEGIC Advisors

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TEMPORARY RESIDENTS

TAX ISSUES SURROUNDING THIS NEW CLASS OF TAXPAYER

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1. Background

The basis of taxation in Australia has always been the residency status of the individual. All tax practitioners would be familiar with the concepts of being either a resident or a non-resident of Australia for tax purposes. Generally, a resident of Australia is taxed on worldwide income while a non-resident is taxed on Australian sourced income only.

In undertaking its review of Australia's international tax regime in 1999, The Review of Business Taxation (RBT) identified the taxation treatment of foreign expatriates as an area in need of reform. In response to RBT recommendation 22.18 the Government introduced new rules for the taxation of "temporary residents". As we will see these taxation rules rely heavily on immigration law.

This paper considers the new temporary resident rules introduced with effect from 1 July 2006. As the topic is broad, I have limited the scope of this paper to individual tax issues. Understandably the issues become considerably more complex when an individual has interest in closely held entities such as private companies, partnerships and family trusts when they arrive in Australia. These entities would have their own unique tax issues, including determining residency status and the taxation treatment of the foreign and Australian sourced income derived, and would therefore warrant special attention.

2. What do the new rules broadly seek to achieve?

Subdivision 768-R of ITAA' 97 provides that temporary residents will:

- Be exempt from Australian tax on foreign sourced income (other than employment or alienated personal services income earned while a temporary resident).
- Disregard capital gains and capital losses from assets which do not have a necessary connection with Australia (unless these are in relation to an employee share or option where the relevant employment was in Australia).
- Be exempt from the capital gains tax (CGT) deemed disposal rules that apply when the individual ceases to be an Australian tax resident.
- Not be considered an attributable taxpayer for the purposes of the controlled foreign companies, foreign investment funds and foreign trust rules, and be relieved of some record-keeping obligations in relation to these entities.
- No longer be subject to interest withholding tax obligations.

These exemptions will be covered in further detail later in the paper.

Individuals will still need to determine whether they are a resident of Australia for tax purposes as this will determine the applicable tax rates as well as their liability to Medicare Levy (and Surcharge) and eligibility for various off sets. They will also need to determine whether they are a resident of Australia in order to determine whether they are taxed on their worldwide income. For example, a temporary resident who is also a tax resident will be assessable on foreign salary, subject to a s23AG exemption, whereas a temporary resident who is non resident will not be assessed on such income.

3. Why have the new rules been introduced?

There are several reasons for the new rules:

1. A desire of the Federal Government to continue to attract internationally mobile skilled labour to Australia. The former Government believed that the previous rules, which generally treated expatriates as tax residents of Australia, discouraged skilled foreign workers from relocating to Australia.
2. A desire to reduce the costs to Australian business of bringing skilled expatriates on-shore. Expatriates that do relocate usually negotiate "normalisation" payments as part of their Australian package (so that they are no worse off in terms of tax that if they were not an Australian tax resident). This was an added cost to Australian which generally makes it more expensive to recruit and retain foreign talent.
3. Several of Australia's trading partners and competitors have adopted a more graduated approach to individuals entering and leaving their jurisdiction (including UK, Singapore, Japan and Thailand).
4. Equity and fairness considerations. The Government believes that expatriates do not derive the same long term benefits from tax funded public spending as permanent residents. Concessional treatment of temporary residents is seen as one means of redressing this inequity.

4. Who are most affected by the new rules?

The new rules impact individuals holding temporary visas granted under the Migration Act 1958 that are in receipt of income from foreign sources or hold foreign assets and who do not have access to benefits similar to those available to the holders of permanent visas (whether directly or indirectly via their spouses). This will include individuals who enter Australia under the economic, international, social/cultural and student visa streams. Additionally, businesses that employ or are run by individuals who qualify for the exemption may benefi t indirectly from the new rules.

5. What is a temporary resident?

"Temporary resident" is defined in ss 995-1 (1) of the 1997 Act as a person who:

a) holds a temporary visa granted under the Migration Act 1958; and
b) is not an Australian resident within the meaning of the Social Security Act 1991; and
c) whose spouse is not an Australian resident within the meaning of the Social Security Act 1991.

6. A temporary visa granted under the Migration Act 1958

A temporary residence visa is any visa other than those allowing the holder to remain in Australia indefinitely. Examples of temporary residence visas include Business Long Stay (457), Business Short Stay (456), Electronic Travel Authority, Bridging, Student, Occupational Trainee and Tourist.

7. Long Stay Temporary Business (subclass 457) visa

The subclass 457 visa is designed specifically for expatriates to work temporarily in Australia for a period between three months and four years at a time. At this time, there is no limit on the number of subclass 457 visas an individual may hold in a lifetime. There are three separate and distinct applications involved in obtaining a subclass 457 visa, namely Business Sponsorship; Nomination; and personal subclass 457 visa application.

1. The Business Sponsorship application may be made by an Australian company or by an off shore company wishing to set up in Australia or send staff to Australia to fulfil obligations for a contract, or other business activity in Australia.

2. The Nomination application is an assessment of the position to be filled and the salary to be paid to the nominated assignee.

   The position must be included on a list prescribed by the Department of Immigration and Citizenship (DIAC) and must meet a set minimum salary threshold level.

3. The personal subclass 457 visa application includes the individual assignee to be employed in Australia and any accompanying dependent family members. The individual assignee must evidence that he/she has the required qualifications, skills and experience to be employed in the nominated position. There are also health and character requirements that all visa applicants must satisfy.

8. Business Electronic Travel Authority (subclass 456) visa

The Business Electronic Travel Authority (ETA) is a short validity visa which is intended for persons entering Australia for short business visits to explore business opportunities, participate in business negotiation, attend meetings, training, conventions and conferences,. The ETA is a multiple entry visa, generally granted for a period of 12 months, permitting the holder to remain in Australia for three months from each date of entry. The ETA arrangements are available to nationals/passport holders from a gazetted list of countries and locations, subject to their meeting all other requirements for an ETA.

Both the Business ETA and subclass 456 visa are granted with a condition that states that the holder of the visa must not engage in work in Australia that might otherwise be carried out by an Australian citizen or an Australian permanent resident (condition 8112).

Therefore, holders of a subclass 456 visa or Business ETA should generally not be paid in employment in Australia. There is limited scope for individuals to work on a subclass 456 visa or Business ETA where employment does not breach the above condition 8112 and is highly specialised and not ongoing, or is emergency in nature and not on going, or is in Australia's interests. Not ongoing generally means a period of no more than 21 days but can extend up to three months. This would need to be assessed on a case by case basis.

9. An Australian resident defined under the Social Security Act 1991

For the purposes of the Social Security Act 1991, an Australian resident is defi ned as a person who resides in Australia and is:

- an Australian citizen;
- the holder of a permanent visa; or
- a SCV holder who is a "protected SCV holder". (s 7(2) Social Security Act 1991.)

Although the term "resides" is not defined in the Social Security Act, ss 7(3) of the Social Security Act 1991, outlines a number of factors that must be considered in determining whether a person resides in Australia. These are:

- the nature of accommodation used by the person in Australia;
- the nature and extent of family relationships in Australia;
- the nature and extent of employment, business and financial ties in Australia;
- the nature and extent of a person's assets located in Australia;
- the frequency and duration of travel; and
- other matters relevant to determining whether there is an intention to remain permanently in Australia.

Australian citizen *:* For the purposes of the Australian Citizenship Act 1948, an Australian citizen is broadly speaking a person who was born in Australia, adopted by an Australian citizen while present in Australia as a permanent resident, was born outside Australia but has been granted Australian citizenship, or has a natural parent who was an Australian citizen at the time they were born.

Permanent Visa Holder *:* A temporary resident who has applied for a permanent visa will only cease being a temporary resident from the date the permanent visa is granted, not from the date of application.

Protected SCV Holder *:* A protected SCV holder is defi ned in ss 7(2) to 7(2G) of the Social Security Act 1991 and applies to SCV holders (ie New Zealand citizens) who were residing in Australia on or before 26 February 2001.

Protected SCV Holders are individuals who:

- Were in Australia on 26 February 2001; or
- Had been in Australia for a period of, or for periods totalling 23 months during the two years before 26 February 2001 and returned to Australia after that date; or
- Were residing in Australia on 26 February 2001 but were temporarily absent; or
- Commenced or recommenced residing in Australia by 26 May 2001.

The rules in this regard are complex and accordingly New Zealanders must be given special attention when determining their eligibility for the temporary resident exemptions. Generally however, New Zealanders arriving in Australia after 26 February 2001 may be able to be considered a temporary resident.

Residency of Spouses

Where a taxpayer has a spouse who is an Australian resident under the Social Security Act 1991, both the taxpayer and the spouse will not be considered to be temporary residents. A spouse is defined under Australian tax law to include "another person who, although not legally married to the person, lives with the person on a bona fi de domestic basis as the husband or wife of the person". In this regard, the definition of a spouse includes de-facto partners, but does not include same-sex partners.

10. Temporary Resident: Points to Note

There are several points worth highlighting in the defi nition of a temporary resident:

- Only a natural person can be a temporary resident. Companies, trusts and other foreign entities cannot qualify.
- There is no time limit imposed on how long an individual can be temporarily resident. However, if an individual resides in Australia long enough, their visa status may change which may in turn alter their tax status.
- There is no prohibition on a person who has been a temporary resident previously qualifying as a temporary resident a second time (eg on a subsequent work assignment in Australia).
- The tax residence of a spouse is not directly relevant to the status of the potential temporary resident. It is the spouse's status under the Social Security Act 1991 that is determinative.
- Some permanent resident visas are for a specified period, for example five years; holders of these visas are not considered temporary residents despite the finite term of the visa.

11. New Temporary Residence Exemption rules

Section 768-910(1) of the Income Tax Assessment Act 1997 provides that the following is non-assessable non-exempt (NANE) income:
a) the ordinary income you derive directly or indirectly from a source other than an Australian source if you are a temporary resident when you derive it;
b) your statutory income (other than a net capital gain) from a source other than an Australian source if you are a temporary resident when you derive it Importantly, as NANE income does not constitute "exempt income", it will not affect the calculation of an individual's tax losses.

12. Provisions relating to capital gains

Section 768-915 provides that a capital gain or capital loss made from a CGT event is disregarded if:

a) [the person] is a temporary resident when, or immediately before, the CGT event happens; and
b) [the person] would not make a capital gain or loss from the CGT event, or the capital gain or loss from the CGT event would have been disregarded under Division 855, if you were a foreign resident when, or immediately before, the CGT even happens.

Essentially, this means that a temporary resident will make a capital gain or loss from a CGT asset only where it is taxable Australian property, as it is only in these circumstances that a foreign resident would make a capital gain or loss (pursuant to s855-10).

Section 855-15 lists assets which are taxable Australian property to include:

- interests in real property in Australia; and
- non-portfolio interests in interposed entities where the assets of those entities are wholly or principally in Australian real estate.
- assets used in carrying on a business through a PE
- options or rights to acquire the above
- assets which have been chosen to be taxable Australian property on ceasing to be a non resident

Deemed acquisition rules

Section 768-950 provides that s855-45 (the "deemed acquisition" rule) does not apply upon an individual becoming an Australian tax resident (within the meaning of subsection 6(1) of the 1936 Act), if the individual was a temporary resident immediately prior to this.

13. Other Exempting Provisions

Section 768-960: A temporary resident is not taken to be an attributable taxpayer in relation to a Controlled Foreign Company (CFC) or Controlled Foreign Trust (CFT) for the purposes of Part X of the 1936 Act.

Section 768-965: A person who is a temporary resident at the end of an income year is not subject to s 529 (which provides that a taxpayer's assessable income includes foreign investment income) or Div 22 (which sets out the record-keeping requirements in respect of FIFs and FLPs).

Section 768-970: A person who is a temporary resident is not a resident for the purposes of s 102AAZD of 1936 Act (which deals with transferor trusts)

Section 768-975: A person who is a temporary resident is not a resident for the purposes of ss 96C(6) of the 1936 Act (which calculates a beneficiary's net income from a non-resident trust).

Section 768-980: Interest paid by a temporary resident is not subject to s 128B of the 1936 Act (where such interest was paid to a non-resident of Australia, s 128B would subject the payer to interest withholding tax of 10 percent). Additionally, the interest received from the temporary resident will be considered NANE income in the hands of the non-resident payee, unless the payee carries on business in Australia through a permanent establishment in Australia (section 768-980).

Amendments to paragraph 136(1)(i)(ii)(B) of the Fringe Benefi ts Tax Assessment Act 1986 (FBTAA 1986)

Paragraph 136(1)(j)(ii)(B) of the FBTAA 1986 which provides that the following will not constitute a fringe benefit, was amended to read:

the making of money to a non-resident superannuation fund….where the employee is a temporary resident (within the meaning of the Income Tax Assessment Act 1997) when the payment is made.

This means that companies which are making contributions to non-resident superannuation funds on behalf of employees who are temporary residents will not be liable to fringe benefits tax while soever the employee remains a temporary resident, which may be indefinitely. There is no change to the rule that such contributions are non-deductible.

14. Exceptions

There are certain exceptions to subsection (1), which are contained in ss 768-910(3) which states that the following are not NANE income:

a) ordinary income [which the taxpayer derives] directly or indirectly from a source other than an Australian source to the extent that is remuneration for employment undertaken, or services provided, while [the taxpayer] is a temporary resident;
b) statutory income (other than a net capital gain) from a source other than an Australian source to the extent that it relates to employment undertaken, or services provided, while [the taxpayer] is a temporary resident;
c) an amount included in [the taxpayer's] assessable income under Div 86 [personal services income];
d) an amount that, but for ss (1), would be included in your assessable income under Division 13A of the Income Tax Assessment Act 1936.

15. Ceasing to be a temporary resident

Section 768-955 provides that the cost base of an asset owned by a temporary resident who ceases to be a temporary resident, but remains an Australian resident, will be the market value of the asset as of the date they cease to be a temporary resident.

Section 768-955 also provides that the capital gains tax rules apply as if the asset was acquired as of this date. Effectively, this means for the purposes of applying the CGT 50% discount, the individual would need to hold the asset for more than 12 months after they ceased being a temporary resident.

16. Employee Share/Option Schemes

There are new rules that will specifically apply to shares and options acquired under an employee share/option scheme which will impact the applicable CGT treatment. The new CGT rules are designed to ensure that temporary residents do not avoid Australian tax on the part of any gain realised that properly relates to employment services in Australia.

The tax treatment of the income from employee share option grants is initially governed by Division 13A of the Income Tax Assessment Act 1936. Under the current rules, the timing of the tax liability is firstly dependent upon whether or not the stock options are considered "qualifying" or "non-qualifying" in Australia.

Income from "non-qualifying" grants is subject to income tax at the later of:

- the grant date; or
- the date of arrival in Australia, if the share option has not yet vested prior to arrival.

The same treatment can apply to the income on "qualifying" grants where the employee makes an election to be subject to income tax at the later of the grant date or the date of arrival in Australia, if the grant has not yet vested prior to arrival.

Any further gain is then taxed under the CGT regime. Alternatively, the employee can defer the income tax payable on any income from "qualifying" share option income to a later "cessation" time.

Cessation is the earliest of:

- the time of disposal of the option/restricted shares (other than by exercising it)'
- the time the employee's employment with the company ceases;
- the time of exercise of the option (if no restrictions applies to the shares acquired);
- the time when restrictions on sale of shares are lifted for restricted shares or
- 10 years from the date of award of restricted shares and share options.

The rules apply where an individual has been subject to tax on the grant value of a share or option (either by choice or because the grant is non-qualifying). Any subsequent capital gain or loss made by the employee as a temporary resident will be recognised to the extent that the gain/loss relates to employment in Australia, regardless of the residence status of the individual at the time the gain/loss arises. The rules are designed to ensure that the part of the capital gain that can effectively be attributed to service in Australia up to cessation time will be taxable in Australia. Without these rules, all of the capital gain would be exempt in the hands of a temporary resident.

Fully vested shares or share options held at date of arrival in Australia would not be subject to tax on arrival so therefore, any subsequent capital gain by a temporary resident would also be exempt from Australian tax.

17. Impact of permanent residence application

With the advent of the new temporary resident exemptions, it is less attractive for individuals from a tax perspective to obtain a permanent residence application. In summary, some of the implications of such an application are:

- the temporary resident exemptions no longer apply from the time of grant (tax on foreign income, FIF taxation etc)
- any Medicare levy exemptions will not apply from the time of application
- foreign superannuation taxable on transfer or withdrawal by an employer
- foreign superannuation contributions would be subject to FBT

Australian superannuation is subject to normal preservation rules, however, a permanent residence (PR) application may allow the individual to:

- not be restricted from acquiring assets under the FIRB (Foreign Investment Review Board) rules
- access Australian social security payments, (FTB, etc)
- obtain a Medicare card and have access to Australia's free health system
- be less restricted in relation to working and retiring in Australia
- dispose of foreign investments (ie CGT assets without the necessary connection with Australia) either free of tax before PR is granted or after PR with the cost base set at market value of the asset as at date of grant of PR.

18. Summary Comments

More so than ever before the visa status of foreigners intending to take up employment in Australia is relevant in determining the Australian income tax implications. In certain cases (eg where the applicant already has an Australian resident spouse) the class of visa may be irrelevant. However, in others, it may be critical. In so far as the measures are consistent with other initiatives designed to encourage the establishment of foreign businesses in Australia, they make good sense. However, only time will tell whether the objectives set out earlier will be achieved.

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About David Hunt

David Hunt is a Chartered Accountant and Fellow of the Taxation Institute of Australia. He has a Bachelor of Business degree majoring in accounting and a Master of Taxation degree from Sydney University where he obtained a distinction average.

David commenced his career at Industrial Equity Limited (IEL) in the 1980s and worked in the accounting division of Chase Manhattan Securities in London before completing his undergraduate degree and commencing with Peter H Hunt & Associates (renamed Hunt Professional Group) in December 1992. He became a partner of the firm on 1 July 2000 and acquired majority share of the firm by 2007. David has since gone on to form Hunt Strategic Advisors.

David's significant experience and expertise are in the following areas:

- Tax effective business structures
- Capital gains tax
- Employee share schemes
- International taxation
- Family business advising
- Self-managed super fund gearing
- Superannuation and retirement planning
- Estate planning

Often sought after for press commentary on current taxation matters, David has spoken on numerous occasions as the key note speaker to audiences as private bankers, lawyer associations and member based organisations.

David is advisor and confidante to some of the most senior executives in Australia and is highly regarded by many institutions and small to medium enterprises and associations.

David is happily married with three children. His interests include all sport, particularly rugby, rugby league, golf and tennis.