Objectives:

To understand the core principles of international tax:

- Residence
- Foreign income of residents
- Taxation of non-residents
- Source

1. Introduction

The international tax rules are generally the laws concerning two jurisdictions. This topic mainly focuses on the basics of Australia’s jurisdiction for income taxation and, in particular, the basic concepts of residence and source of income. Generally, a resident is taxed on worldwide income (ordinary and statutory income), while a foreign resident is taxed only on Australian-sourced income (ordinary and statutory income). These general rules, though, are subject to voluminous and complex international tax provisions that apply to residents earning foreign income and to foreign residents receiving Australian income.

**Online activity 1:** Read Div 6 ITAA 1997

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**2. Foreign Income of Residents**

Australian residents are taxed on worldwide income, Div 6 ITAA 1997. This means they must generally include all foreign income as assessable income (unless an exemption applies).

**Foreign employment income**

Foreign employment income is income derived by an Australian resident working overseas as an employee. This includes foreign salary, wages, commissions, bonuses and allowances.

The net foreign employment income is any foreign employment income that does not qualify as exempt income, less any expenses incurred in earning that income that are deductible.

The net foreign employment income is taxed in Australia at normal marginal tax rates, plus the Medicare levy and Medicare levy surcharge if applicable.
For foreign tax paid on your net foreign employment income the foreign tax is added back to your net foreign employment income to work out the assessable income amount.

A foreign income tax offset may be claimed for the tax paid.

Include the grossed up income in the tax return as 'Assessable foreign income' and also include the net foreign employment income.

Example:

Andreas was employed in a foreign country from 11 October 2008 until 3 April 2010. During the period of his foreign employment, he earned A$11,250 after he paid A$3,750 in foreign tax and incurred work related expenses for which he could claim a deduction of A$500 in relation to his foreign employment. After adding back the foreign taxes, he would have assessable foreign income of A$15,000. After claiming a deduction for his expenses, he would have net foreign employment income of A$14,500.

Foreign employment income is exempt from Australian tax only in limited circumstances if you are engaged in certain tasks in continuous foreign service as an employee for 91 days or more, subject to certain disqualifying conditions: ITAA 1936 s 23AG.

**Foreign business income**

For income from international transactions, the source of the income must be worked out. This depends on whether the other country has a tax treaty with Australia. (more than 40 countries do).

For **treaty countries**, then it will generally have an Australian source income. If the business though is carried on through a permanent establishment in the treaty country, this may change.

For **non-treaty country**, involving the exports of goods, patents, information or know-how, the source is generally the place of contract. If the exports of services is involved, the source is generally the place where the services are performed. This could be the place of contract.

**A subsidiary incorporated overseas** is a foreign resident under Australian tax law. A foreign-resident subsidiary is usually not considered to be a permanent establishment of its Australian parent company.

Foreign income that is exempt from Australian tax may need to be reported since it may take it into account to work out the amount of tax payable on both the Australian and foreign assessable income.

Note rules apply for converting foreign income to Australian dollars.

If you operate an Australian resident company, certain types of foreign business income your company receives are exempt from Australian tax.
For thinly capitalised or highly geared entities (where the assets are funded by a high level of
debt and relatively little equity), special rules may apply that limit debt deductions if you
operate in Australian with overseas investments or operate a foreign entity with investments
in Australia.

Capital gains and Goods and Services Tax (GST) implications for international transactions
are discussed in later topics.

**Foreign Investment Income**

Assessable income from overseas must be declared in the Australian income tax return. For
foreign tax paid in another country, an Australian foreign income tax offset may apply to
provide relief from double taxation.

To be entitled to a foreign income tax offset:

- you must have actually paid an amount of foreign income tax
- the income or gain on which you paid foreign income tax must be included in your
  assessable income for Australian income tax purposes.

The offset though maybe subject to a limit.

The foreign income tax offset applies to foreign income tax imposed on all forms of income,
profits and gains, (including gains of a capital nature) and to all taxpayers, whether
individuals or other entity types.

**3. Taxation of Foreign Residents**

Foreign residents are taxed in Australia on their Australian sourced income, Div 6 ITAA
1997.

**Employment Income**

Foreigners are working in Australia need to work out whether they are an Australian resident
for tax purposes. Non-residents pay tax differently from residents.

For Australian residents see above. (They need to report in your income tax return all
Australian income (except Australian sourced interest, dividends and royalties derived before
they became an Australian resident from which non-resident withholding tax has been
withheld) and foreign source income derived from the date they became an Australian
resident.

For foreign residents, they must lodge an income tax return and report all your:

Australian income, except any income from which non-resident withholding tax has been
withheld - that is, interest, unfranked dividends or royalties, franked dividends.

The tax rate will be different to that applying to Australian residents and interest payments
from their Australian bank account will have tax withheld.
Business income

Foreign resident entities that receive income sourced in Australia, must lodge an Australian tax return for the entity and pay tax on that income.

Investment Income

Foreign resident entities receiving interest, unfranked dividends or royalties from Australia: If tax has been withheld at the correct rate they don't need to lodge an Australian tax return unless they have other Australian source income.

Foreign resident entities receiving rental income from an Australian property: May be liable to pay tax in Australia and need to declare the income in an Australian tax return.

Foreign resident entities receiving a capital gain or loss from the disposal of an Australian asset: May be liable to pay tax in Australia and need to declare the gain or loss in an Australian tax return.

Interest, unfranked dividends and royalties

Tax is generally withheld in Australia from interest, unfranked dividends and royalties paid to foreign/non-residents. Foreign resident entities don't need to lodge an Australian income tax return if the only Australian-source income you receive is interest, dividends or royalties on which non-resident withholding tax has been correctly withheld.

4. Residence of Individuals

Residence is important in determining the Australian income tax liability for residents (all income sources) and foreign residents (Australian income sources) of ordinary and statutory income: see ITAA 1997 ss 6-5(2), 6-10(4).

Australian residents assessable includes ordinary income derived directly or indirectly from worldwide sources during the income year. Whilst for foreign residents, assessable includes ordinary income derived directly or indirectly from Australian sources during the income year (or ordinary income included in their assessable income on some other basis than having an Australian source).

Australian residents assessable also includes statutory income from worldwide sources during the income year. Whilst for foreign residents, assessable includes statutory income from Australian sources during the income year (or statutory income included in their assessable income on some other basis than having an Australian source).

ITAA 1936 s 6(1) provides four alternative tests for establishing the residence status of an individual (that is, if any one of these tests is satisfied, then residence will be achieved) as follows: resides test; domicile test; 183-day rule and superannuation test.

The courts have formulated relevant factors for three of these tests that need to be weighed up in determining residence. You need to weigh up these factors; where they mostly point one
way, this will generally determine whether the test is satisfied, although this can still be quite
difficult as some factors are more important than others, and sometimes the factors point both
ways. As you may imagine, this definition of residence will lead to many grey areas, thus it is
little wonder that the ATO and the accounting and tax professions are often at loggerheads as
to where the residence line should be drawn. The four tests and relevant factors are detailed
below.

**Online Activity 2:** Read ITAA 1936 s 6(1) “resident”

(i) **The Resides Test**

The first test provides that a resident resides in Australia, however, resides is not defined in
the Act. The courts have tended to follow the ordinary meaning of resides in formulating a
list of relevant factors to determine whether a person resides in Australia and they are:

- physical presence;
- family, employment or business ties;
- maintenance of a place of abode and other assets;
- frequency, regularity and duration of visits;
- habits and mode of life. The weight to be given to each factor will vary with the individual circumstances and no single factor is necessarily decisive.

**Physical presence**

Physical presence is generally the most important factor as the absence of physical presence
points to the taxpayer not being a resident: see *FCT v Applegate* 79 ATC 4307 and *FCT v
Pechey* 75 ATC 4083; *FCT v Miller* (1946) 73 CLR 93.

Whilst presence in a country is important in considering whether a person resides in a country
during that year, it does not necessarily mean that some presence is sufficient to make him or
her a resident in that country. A person who is absent for the entire year but did not have a
place of abode elsewhere may be a resident: see *Rogers v IRC* (1879) 1 TC 225; *Slater v CT
(NZ)* (1949) 9 ATD 1.

**Family, employment or business ties**

This factor assumes more importance, particularly family ties. For example, in *Levene*, the
taxpayer had strong family ties in the United Kingdom. See *Levene v IRC* [1928] AC 217.

**Maintenance of a place of abode and other assets**

This is important, especially if previously a resident. However, it is not necessary to have a
place of abode in Australia: see *Levene* above. If a person is absent from a particular country
but keeps a place of abode in that country which is available for his or her use, this is an
important factor in determining whether or not the person has ceased to be resident in that
country. Also important is whether motor vehicles and household items are maintained in
the particular country. This may indicate where a person resides.
Frequency, regularity and duration of visits

The importance of this factor depends on the history of residence. For example, a person who was previously a resident need not have a great frequency and duration of visits to be a resident. However, if not previously a resident, a taxpayer who visits for a short and temporary time is unlikely to be a resident (for example, a tourist visiting Australia, temporary worker): see *FCT v Pechey*.

Habits and mode of life

Habits are important to determine if a taxpayer has ceased to be a resident. A change or break in his or her mode of life could mean that he or she has ceased to reside in a country. Did the taxpayer join local sports clubs or local community clubs or the taxpayer’s children attend local schools? For example, in *Levene* the taxpayer did not maintain a permanent place of abode outside the United Kingdom. The itinerant nature of his lifestyle was important. There was no significant change in his lifestyle.

Nationality

Nationality is unlikely to be important, except in borderline cases.

**Online Activity 3:** Read *FCT v Applegate* 79 ATC 4307; *FCT v Pechey* 75 ATC 4083; *FCT v Miller* (1946) 73 CLR 93

(ii) Domicile test

This test generally applies to situations where a resident leaves Australia to work overseas for a lengthy period of time. There are two parts to this test to be a resident: a person’s domicile must be Australian; and the Commissioner is satisfied that his/her permanent place of abode is not overseas.

Domicile test

This test refers to the legal relationship between a person and a state by which the person invokes the state’s legal system as his or her personal law. By law, every person has to have a domicile but he or she can only have one domicile at any time. There are three types of domicile:

Domicile of origin: the domicile of the father at the date of birth. A person’s domicile of origin is retained until suspended by the acquisition of a domicile of choice: *Bell v Kennedy* (1868) LR 1 Sc & Div 307 (HL).

Domicile of choice: a person must intend and act so as to select the new jurisdiction as the person’s permanent home. The intention that a person must have in order to acquire a domicile of choice in a country is the intention to make his or her home indefinitely in that country (*Domicile Act 1982* s 10).
Domicile of dependency: minors and insane people will have their domicile determined by the parent or carer domicile.

Whether permanent place of abode is overseas?

The courts have developed relevant factors as follows:

- intention as to length of stay
- actual length of stay
- abandonment of place of abode in Australia
- acquisition of place of abode outside Australia
- intention to make place of abode home
- nature and quality of use made of place of abode
- duration and continuity of presence in place
- durability of association (ties) with place do you own it, lease it or are you just staying there and ties family, kids at school, employment, bank accounts etc.

The leading case in this area is Applegate. Having regard to FCT v Applegate 79 ATC 4307, it appears that when a person leaves Australia for a defined period they will not have a permanent place of abode overseas. Where, however, the absence is for an indefinite period they will have a permanent place of abode overseas.

Taxation Ruling IT 2650 generally lists the above factors to be taken into account in determining whether a person has a permanent place of abode overseas. The general rule in IT 2650 is that if a taxpayer leaves Australia and intends to return within two years, then they will not have a permanent place of abode overseas. If greater than a two-year absence then they will have a permanent place of abode overseas.

Online Activity 4: Read FCT v Applegate 79 ATC 4307

(iii) The 183-day test

There are three requirements for this test:

1. A person must be physically present in Australia for more than one-half of a year of income; and the Commissioner must be satisfied that both;

2. A person’s usual place of abode is not outside of Australia; and

3. A person does intend to take up residence in Australia.

Must be physically present in Australia for more than one half a year of income

3.23 A person’s presence in Australia need not be continuous for 183 days. Wilkie v IRC (1952) 1 All ER 92 illustrates that the courts will adopt a fairly strict approach to the 183-day rule.
The usual place of abode is not outside Australia

A person’s usual place of abode is their habitual place of residence when physically present in a country. This can be contrasted with short-term accommodation such as hotels. Since this test looks to the nature of the accommodation and physical presence, it works in a very similar way to the resides test.

Intention to take up residence in Australia

The intention of the taxpayer can be discerned by having regard to the taxpayer’s subjective intent and the surrounding objective circumstances.

(iv) Superannuation test

A person is a resident if he or she is a member of the superannuation scheme for Commonwealth public servants. This also includes his or her spouse and children. Former public servants are no longer included by this test.

Part-year residents

If a person resides in Australia for less than six months then he or she will be resident for the time present in Australia under the resides test. If a person is present for more than six months and a resident for the 183-day test the position is not clear. Early cases considered that a person would be a resident for the entire year; a later case found that a person could not be deemed to be a resident for an entire year: see Case S19 85 ATC 225.

Temporary residents, Div 768 ITAA 1997

Individuals who have temporary visas and qualify as temporary residents from 1 July 2006 are not assessable on most of their foreign-source income (even though they may be residents under s 6(1) ITAA 1936). Temporary residents are exempt for all ordinary and statutory income from a foreign source and net capital gains from assets that do not have the necessary connection to Australia. Also, interest withholding tax obligations associated with amounts owing to foreign lenders do not apply. Further, Div 768 exempts temporary residents from attribution under the controlled foreign company rules and transferor trust rules.

SOURCE

As a general rule Australian residents are taxed on their ordinary and statutory income from all sources and foreign residents are subject to Australian tax only on their Australian-sourced ordinary and statutory income: see ITAA 1997 ss 6-5 and 6-10.

Source is not defined in the ITAA, and given the lack of source rules the courts have had to determine relevant principles. Courts have determined source rules for particular types of income as follows:
• income from personal services
• business income
• real property
• interest income
• dividend income
• royalties.

Additionally, there exist a number of specific source rules for certain types of income. These are:

**Income from personal services**

The relevant factors for determining the source of personal service income are (see *French* and *Mitchum*):

- where the services are rendered
- where the contract is negotiated and made
- where payment is made.

Ordinarily, source is where the services are performed per *FCT v French* (1957) 98 CLR 398. However, there are certain exceptions to this general principle, such as the case of an artisan, a person having special skills and creative talents. In such case the other factors will be more important: *FCT v Mitchum* (1965) 113 CLR 401.

**Online Activity 5:** Read *FCT v Mitchum* (1965) 113 CLR 401

**Business income**

Generally, the source of business income is where the trading activities take place (the most important factor): see *C of T v Meeks* (1915) 19 CLR 568. The relevant factors for the source of the sale of trading stock are:

- where the trading activities are undertaken
- where the contract is negotiated and made
- where payment is made.

Thus, if a business sells trading stock by way of a contract made in Australia, under common law its source would be in Australia. Where activities are conducted across a number of countries, apportionment may be required.

**Business income - Statutory source rules**

To reduce the ability of businesses to manipulate the above source rules for the sale of goods, a number of statutory source rules have evolved. See ITAA 1936 s 6CA. Australia’s double tax agreements also provide source rules for business income.
Real property

The source of income from rental or the sale of real property would appear to be its location given that it is immovable. For movable personal property (that is, ships) the hiring agreement constitutes the essence of the arrangement. Thus, source will generally be the place of executing the agreement.

Interest income

The relevant factors are:

- where the loan contract is negotiated and made is crucial: see Commissioner for Inland Revenue v Lever Bros and Unilever Limited (1946) SAPC 1; FCT v Spotless Services Ltd 93 ATC 4397
- where the loan funds are advanced is important: see Spotless below
- where repayments are made
- where the debt is secured.

Dividend income

The general rule is that the source of dividend income is located where the company paying dividends made its profits. However, for an investment company, source is located at the place where the company is centrally managed and controlled, and where the decisions were made: see Esquire Nominees v FCT 72 ATC 4076

Royalties

The source of royalties will be where the knowhow is located: see FCT v United Aircraft (1943) 68 CLR 525.

Income derived by a non-resident consisting of a royalty paid to the non-resident by a resident is deemed as having a source in Australia: ITAA 1936 s 6C.

Apportionment where more than one source

Income can be sourced in more than one place; in this case the relevant factors to apportion are: the nature of the transaction or business; the mode in which the business or transaction is carried out business judgment and experience.

Online Activity 6: Australian Tax Chapter 3 Practice Problem 6