20 May 2011

Mr Mark O'Connor
Assistant Commissioner
Australian Taxation Office
Canberra ACT 2600

By email: Mark.O'Connor@ato.gov.au

Dear Mark

Alleviating the double tax burden for Australians working overseas
Submission on ATO interpretation of the Medicare Levy and the Foreign Income Tax Offset provisions

We refer to the discussions on 21 April 2011 between representatives of the Australian Taxation Office (ATO), Treasury, Corporate Tax Association, the Institute of Chartered Accountants and The Taxation Institute. Following those discussions, we provide this submission outlining the double taxation faced by certain Australians working overseas due to the interpretation by the ATO of the Foreign Income Tax Offset (FITO) and Medicare levy provisions.

Executive Summary

The ATO is currently assessing the income tax returns of Australians who are working overseas temporarily, and paying foreign taxes, on the basis that a FITO cannot be applied to reduce the Medicare levy obligation of an individual taxpayer. This means that where an Australian is, say, working in PNG on a resources project, and incurs foreign tax which is greater than the individual's Australian tax, the individual receives a FITO for (in this case) the PNG tax but cannot apply the FITO for the PNG tax against their Australian Medicare levy.

We consider that the ATO interpretation is inconsistent with the domestic law, Australia's obligations under double tax agreements and legislative policy. The restrictions on the application of section 23AG of the *Income Tax Assessment Act 1936* (ITAA 1936) which took effect on 1 July 2009 mean that this approach significantly disadvantages many lower and middle income individuals working in higher tax jurisdictions. (Legislative references are to the ITAA 1936 and *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise stated.)

Technical analysis

The table in section 63-10(1) of the ITAA 1997 which outlines the order in which tax offsets are to be applied refers to tax offsets being applied against 'your basic tax liability.' 'Basic tax liability' is not defined in section 995-1(1) of the ITAA 1997, however it is referred to in section 4-10 of the ITAA 1997. Step 2 of the method statement in section 4-10(3) of the ITAA 1997 states that you 'work out your basic income tax liability on your taxable income using the income tax rate or rates that apply to you for the income year'.

We understand that the ATO has interpreted 'income tax rate or rates' as only including the general rate of tax as opposed to the general rate of tax and the Medicare levy.

We disagree with this interpretation for the following reasons:

- Schedule 1 of the *Tax Administration Act 1953* (TAA) was specifically amended in 2010 by inserting section 90-1 to ensure that the Medicare levy and the Medicare levy surcharge were treated in the same way as normal income tax. Thus section 90-1 of the TAA has the effect of allowing a FITO to be applied against Medicare levy in the same way as income tax.

  Section 90-1 of the TAA states

  *"except so far as a contrary intention appears, this Schedule [which deals with Medicare levy and Medicare levy surcharge] and the Income Tax Assessment Act 1997 apply, and are taken always to have applied, in relation to the following in the same way as they apply in relation to income tax and *tax:*

  (a) Medicare levy (as defined in section 251R of the Income Tax Assessment Act 1936); and
  *(b) *Medicare levy surcharge."*

  This provision is consistent with subsection 251R(7) of the ITAA 1936, which previously had the same effect. Section 251R(7) stated that "*in this Act unless the contrary intention appears, income tax or tax includes levy payable in accordance with this Part and surcharge*."

- The position that foreign tax can be applied to reduce Medicare levy was explicitly recognised when the Medicare levy was introduced. The Explanatory Memorandum to the *Income Tax Laws Amendment (Medicare Levy) Bill 1983* stated that foreign tax would be creditable against the Medicare levy.

- This interpretation was also reflected in the *International Tax Agreements Act 1953* (ITAA 1953), in particular subsection 3(10), which states that the Medicare levy is deemed to be income tax and references to income tax or tax shall be construed accordingly. In accordance with the ITAA 1953 and the provisions for relief from double tax in most double tax agreements, Australia is required to provide relief from double tax which extends to relief from the application of the Medicare Levy.

- Although the foreign tax credit provisions of the ITAA 1936 were replaced by the foreign tax offset provisions with effect from 1 July 2008, the operative provision of subsection 4-10(3) has not altered since its enactment in 1997, and thus should operate in the same way.

- Prior to the introduction of Division 770, "foreign tax" was included in the list of tax offsets in section 13-1 of the ITAA 1997, with former section 160AF of the ITAA 1936 listed as the relevant provision. Accordingly, in the context of the application of subsection 4-10(3), the logic under which recognition was provided for foreign tax when the foreign tax credit provisions applied has not changed. Both before and after 1 July 2008, to give effect to the policy of allowing foreign tax to reduce the Medicare levy, the calculation of basic income tax liability included Medicare levy.

As explained in the Appendix, in our view this analysis applies only to the offset of FITO and Medicare levy. We are not seeking the offset of other non-refundable tax offsets against Medicare levy.

In the Appendix, we have also set out how the ATO's interpretation operates to adversely impact Australian workers with lower to middle incomes who do not derive other investment income. Thus, the ATO interpretative view adversely impacts middle-income Australians working overseas, yet does not adversely impact high-income taxpayers.

Proposed resolution

This issue is, in our view, capable of being resolved by:

a) the ATO reviewing its current interpretation; or
b) by exercise of the ATO's administrative powers.

We do not believe it is necessary for the government to be required to amend the legislation to address this matter, at a time of great pressure on parliamentary timelines and processes to deal with many other changes, as it is clear to us that the law as it currently stands is capable of being applied by the Commissioner to achieve the correct outcome.

Should the Commissioner reach a position that is consistent with the views put forward in this submission, we request the following:

1. objection decisions already issued be reconsidered;
2. alternatively, if objections that were disallowed and then out of time for an appeal will be corrected, for example by a request for amended assessment; and
3. to the extent that affected taxpayers are now required to appeal to a Tribunal or Court, that the Commissioner would favourably agree to Test Case funding.

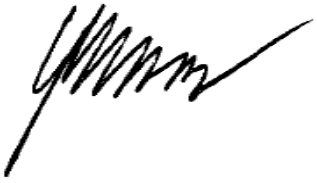
Interim approach

While these issues are being considered by the ATO, we recommend the following approach to affected taxpayers:

1. the ATO should refrain from enforcing collection of Medicare levy that is assessed contrary to this submission, or alternatively set an extension of time to pay, without interest or penalty; and
2. the ATO should defer decisions on new objections against imposition of the Medicare levy (with a deferral of collection as above);

Should you wish to discuss any aspect of this paper, please contact Frank Drenth of Corporate Tax Association on 03 96004411, Yasser El-Ansary of the Institute on 02 9290 5623, Peter Murray of The Tax Institute on 02 8223 0011.

Yours sincerely



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cc.
Mr Bruce Quigley, Commissioner of Taxation
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Appendix 1

Alleviating the double tax burden for Australians working overseas - submission on ATO interpretation of Medicare Levy and Foreign Income Tax Offset provisions

A. Background

Following the significant narrowing of the section 23AG foreign earnings exemption from 1 July 2009, Australian resident taxpayers working overseas and paying taxes overseas must rely on the FITO provisions to reduce the double tax burden that may otherwise be payable on their overseas employment income. The FITO provisions allow for a non-refundable tax offset for foreign income tax paid on income that is also taxable in Australia.

Because Australian income tax rates for lower to middle incomes have a significant taper, the tax rates in foreign countries can exceed the Australian tax rates including Medicare levy. This creates a situation where the FITO offset exceeds the Australian liability due. Where the FITO is sufficient to offset wholly the Australian income tax and Medicare liabilities, Australian income tax returns have been lodged with a FITO claim that reduces the Australian liability to nil.

The ATO in turn has issued Notices of Assessment that allowed the FITO to offset the Australian income tax liability, but not the Medicare liability i.e. the taxpayer must still pay the Medicare levy (and Surcharge, if applicable), despite the fact that his/her FITO offset limit is more than enough to cover both the income tax and Medicare liabilities.

For example, if we assume an individual has:

1. Australian income tax liability of $63,550;
2. Medicare levy liability of $3,000; and
3. Pays foreign tax $70,000

then adopting the ATO's current interpretation of the legislation, the taxpayer would be entitled to reduce his/her income tax liability to nil but would not be able to use the remaining FITO to offset the Medicare Levy liability of $3,000.

In effect, this would result in the Australian working taxpayer being subject to double taxation on the income on which the Medicare levy has been imposed.

We understand that the interpretative approach of the ATO is that the Medicare levy is not an income tax for purposes of the method statement in section 4-10(3), and the FITO cannot be offset against it. This position is elaborated in an ATO objection notice attached as Appendix B.

In our view this interpretation is not consistent with the policy and operation of the legislation.

B. Analysing the legislation

In our view, exposing an Australian working taxpayer to double taxation on the income on which the Medicare Levy has been imposed would appear to be an unintended outcome of the legislation and is inconsistent with the broad object of the FITO provisions to relieve double taxation.

Paragraph 1.18 of the Explanatory Memorandum to the *Tax Laws Amendment (2007 Measure No 4) Act 2007* which introduced the FITO provisions states that

> "*The potential Australian tax will be reduced by the amount of the foreign income tax already paid on those double tax amounts or* ***reduced to zero where the foreign income tax exceeds the potential Australian tax payable***" (emphasis added).

This would appear to suggest the policy intent of the FITO provisions contemplates the possibility of a taxpayer's Australian tax liability being reduced to zero.

Furthermore, the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* specifically amended the legislation to clarify that the income tax provisions apply to Medicare levy and Medicare levy surcharge in the same way they apply to income tax.

Pursuant to Table 6.18 of the Explanatory Memorandum to the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*:

> *"The amendment to Schedule 1 to the TAA 1953 ensures that the Schedule and the ITAA 1997 do apply to the Medicare levy (as defined in section 251R of the ITAA 1936) and the Medicare levy surcharge in the same way as they apply to normal income tax".*

To allow a FITO to apply to basic income tax but not to the Medicare levy would appear to be in direct conflict with this statement. If the ATO's current interpretation is to be maintained, we suggest an amendment to section 4-10 of the ITAA 1997 to include the Medicare levy in the definition of "basic income tax liability".

Legislation

Pursuant to subsection 770-5 of the ITAA 1997, the object of the FITO provisions is to relieve double taxation where:

- The taxpayer has paid foreign income tax on amounts included in their Australian assessable income; and
- The taxpayer is prima facie liable to pay Australian income tax on the same amounts.

To achieve this object, Division 770 provides the taxpayer with a tax offset to reduce or eliminate Australian income tax otherwise payable on those amounts.

Subsection 770-10(1) provides that where the assessable income of a resident contains foreign income and foreign income tax has been paid on that income, a FITO will be allowed. The tax offset has the effect of reducing the Australian tax that would otherwise be payable on the double tax amount.

There is a limit on the amount of the tax offset for an income year, being the greater of (subsection 770-75):

1. $1,000 and
2. the amount of income tax payable for the income year less the amount of income tax that would be payable for the income year if the following amounts were excluded from assessable income:
    a. amounts on which foreign income tax has been paid that counts towards the tax offset and
    b. any other amounts of ordinary or statutory income from a source other than Australia.

Tax Laws Amendment (2010 Measures No. 1) Act 2010 (amending Act) amended Schedule 1 of the TAA to clarify that the income tax provisions apply to Medicare Levy and Medicare Levy Surcharge in the same way they apply to income tax, i.e. the Medicare Levy and Medicare Levy Surcharge can be included in calculating the FITO limit. The Act applies retrospectively from 1 July 2008 aligning with when the FITO rules became effective. The Explanatory Memorandum to the Bill specifically states the intention that the amendment ensures Medicare Levy is taken into account in determining a taxpayer's FITO.

This approach is also consistent with the ATO's *Guide to foreign income tax offset rules* NAT 72923 publication.

In our view, the amendment to schedule 1 of the TAA also has the effect of enabling the FITO to be offset against the Medicare Levy in the calculation of income tax payable.

Section 90-1 of the TAA (inserted by Tax Laws Amendment (2010 Measures No. 1) Act 2010) states that the TAA and the ITAA 1997 apply in relation to the Medicare Levy and Medicare Levy Surcharge as they apply to income tax.

Under section 4-10 of the ITAA 1997, a tax offset, including a FITO is able to be offset against income tax in determining the amount of tax payable. As the FITO is able to be offset against income tax, section 90-1 of the TAA has the effect of allowing the FITO to also be applied against the Medicare Levy as the ITAA 1997 applies to the Medicare Levy in the same way as it applies to income tax. Therefore where the FITO limit exceeds the income tax payable, it should be applied to offset the Medicare Levy payable.

If the above interpretation is not applied, the amendment effected by the amending Act would have no application. That is, increasing the offset limit for Medicare has no purpose if the offset cannot be applied to reduce Medicare.

Policy behind 2009 changes to section 23AG

In the Federal Budget on 12 May 2009, the Treasurer Mr Wayne Swan stated[1] that the changes to section 23AG[2] were intended:

> '*… to ensure that workers who earn income overseas do not have an unfair advantage over workers who earn income and pay tax in Australia.'*

In the second reading speech to the amending Bill[3] the Treasurer expressed the policy behind the 23AG changes as follows:

> '[The amendment to section 23AG] … *will enhance the fairness and integrity of the tax system by ensuring that Australian resident taxpayers who work in low-tax jurisdictions pay the same rate of Australian tax as individuals who work in Australia.*'

If continued unchanged the ATO's current interpretation of the FITO rules would ensure that some Australian resident taxpayers who work overseas are unfairly disadvantaged over comparable workers in Australia.

Indeed Australian resident taxpayers who work in high-tax jurisdictions and who already pay higher levels of tax will pay even higher amounts of tax under the ATO view compared with individuals who work in Australia.

[1] Media release No. 66, 12th May 2009.
[2] The *Income Tax Assessment Act 1936* (Cth) as amended. ('ITAA 1936'.)
[3] *Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009*.

Policy objective of FITO provisions remain unchanged from the former foreign income tax provisions

The Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Tax Credits) Bill 1986* states that the foreign tax system is intended to provide Australian resident individuals with a credit for analogous foreign taxes, up to the amount of the Australian income tax referable to the relevant double taxed foreign income, against the Australian tax payable.

In calculating the taxpayer's final Australian tax liability, clause 4 of the Explanatory Memorandum to the *Income Tax Laws Amendment (Medicare Levy) Bill 1983* states:

> *"New sub-section 3(10) deems the Medicare levy to be income tax for the purposes of Australia's double taxation agreements with other countries. Under the income tax law, Australians who receive income from overseas that is included in their taxable income are entitled to a credit for foreign tax on that income.* ***This amendment will ensure that these arrangements for relief of double taxation apply to both income tax and Medicare levy".***

This was further supported by section 251R(7) of the ITAA 1936 which ensures Medicare levy is included as "income tax or tax". Under the FITO provisions, this section has been replicated by the introduction of section 90-1 of the TAA.

The calculation of "basic income tax liability" in step 2 of the method statement in section 4-10(3) of the ITAA 1997 refers to the "income tax rate or rates that apply to you", explicitly acknowledging that more than one rate may have been applied to taxable income.

Prior to the introduction of Division 770, 'foreign tax' was included in the list of tax offsets in section 13-1 of the ITAA 1997, with former section 160AF of the ITAA 1936 listed as the relevant provision. Accordingly, in the context of the application of subsection 4-10(3), the logic under which recognition was provided for foreign tax when the foreign tax credit provisions applied has not changed.

Accordingly, both before and after 1 July 2008, to give effect to the policy of allowing foreign tax to reduce the Medicare Levy, the calculation of basic income tax liability included Medicare Levy.

Treaty obligations

In the event that a taxpayer is working in a country which Australia has entered into a Double Tax Agreement ("DTA"), it is necessary to consider the provisions of that DTA.

Australia is a party to a large number of bilateral double tax agreements with treaty partners, which are ratified via the domestic law[4]. In dealing with the domestic tax law and its international treaty agreements the ITAA 1953 provides that:

> '*The provisions of* [the ITAA 1953] *have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than Part IVA of that Act) or in an Act imposing Australian tax.*'[5]

This provision makes it certain that any inconsistency in the Assessment Act[6] or in an Act imposing ***Australian tax*** shall not override the provisions of the ITAA 1953. In other words, the provisions of the Assessment Act are to be interpreted with reference to the ITAA 1953 and the later prevails in the event of an inconsistency.

For this purpose ***Australian tax*** is defined as income tax imposed as such by an Act.[7] In other words it does not define a particular type of tax, it encompasses a tax on income imposed by an Act. It is therefore not restricted, for example, solely to the *Income Tax Act 1986* (Cth) and includes, for example, the *Medicare Levy Act 1986* (Cth). This issue is dealt with expressly by the ITAA 1953 which states explicitly:

[4] *International Tax Agreements Act 1953*, as amended (Cth). Hereinafter 'the ITAA 1953'.
[5] Subsection 4(2) ITAA 1953.
[6] Subsection 3(1) ITAA 1953 "the Assessment Act" means the *Income Tax Assessment Act 1936* or the *Income Tax Assessment Act 1997*.
[7] Subsection 3(1) of the ITAA 1953.

> '*For the purposes of this Act, Medicare levy shall be deemed to be income tax and to be imposed as such and, unless the contrary intention appears, references to income tax or tax shall be construed accordingly*.'[8]

As such the Medicare levy is deemed to be '***income tax***' and thus '***Australian tax***' for all purposes of the ITAA 1953 and, notwithstanding any inconsistency, as ***income tax*** for the purposes of the Assessment Act including the *Income Tax Assessment Act 1997* (Cth).

The Agreement with Papua New Guinea

Papua New Guinea is an example of a country where many individuals will be subject to higher taxes than the Australian tax that would otherwise apply. It is therefore relevant to consider the specific example of the Agreement with PNG.

Section 11T of the ITAA 1953 provides for the double tax agreement with the Independent State of Papua New Guinea, and states:

> '*Subject to this Act, on and after the date of entry into force of the Papua New Guinea agreement, the provisions of the agreement, so far as those provisions affect* ***Australian tax****, have the force of law according to their tenor.*' (Emphasis added.)

The consequence of this section being that the provisions of the PNG Agreement shall have the force of law so far as they affect ***Australian tax***. As indicated already this includes the Medicare levy. The PNG Agreement is contained in Schedule 29 of the ITAA 1953, and Article 23[9] of that Agreement provides both the mechanism for and the general principle for the relief of double taxation. With respect to relief of Australian tax, which includes Medicare levy, the agreement expressly provides:

> '*… Papua New Guinea tax paid under the law of Papua New Guinea and in accordance with this Agreement, whether directly or by deduction, in respect of income derived by a person who is a resident of Australia from sources in Papua New Guinea shall be allowed as a credit against* ***Australian tax*** *payable in respect of that income.*'[10]

Notably the relief is in respect of *Australian tax* and by the definition of that term in sub section 3(10) expressly incorporates income tax and the Medicare levy. Accordingly, Article 23(1) shall be applied such that tax paid under the law of PNG in respect of income derived by a resident of Australia shall be allowed as a credit [offset in the current vernacular] against Australian income tax and the Medicare levy payable in respect of that income.

While Article 23(1) provides that credit [offset] against Australian tax is subject to '*… the provisions of the law of Australia from time to time in force which relate to the allowance of a credit against Australian tax of tax paid in a country outside Australia'* the broad principle thereof is required to be maintained by the words appearing in parentheses '***which shall not affect the general principle hereof"***. Or to put it more directly, the provisions of the domestic law relating to allowance of a credit [offset] for PNG tax paid against income tax and the Medicare levy shall not affect the general principle expressed in Article 23.

Thus to the extent that an interpretation of section 4-10 of the ITAA 1997 would result in an outcome that affects or alters the general principle of Article 23 of the PNG Agreement, Australia would be in breach of its treaty obligations.

Further, by virtue of subsection 4(2) of the ITAA 1953 the provisions of the ITAA 1953 and Article 23 of the PNG Agreement shall apply notwithstanding anything inconsistent with the provisions of section 4-10 of the ITAA 1997.

[8] Subsection 3(10) ITAA 1953.
[9] For purposes of clarity and the avoidance of doubt Australia's DTAs with numerous other countries each contain similar relief of double tax Articles to the PNG Agreement.
[10] Paragraph 1 of Article 23.

For the purposes of clarity and avoidance of doubt when the Medicare levy was first introduced the then Treasurer, The Hon. Paul J Keating, in the Explanatory Memorandum accompanying the Bill[11] explicitly stated:

> '*New sub-section 3(10)* [of the International Tax Agreements Act 1953] *deems the Medicare levy to be income tax for the purposes of Australia's double taxation agreements with other countries. Under the income tax law, Australians who receive income from overseas that is included in their taxable income are entitled to a credit for foreign tax on that income. This amendment will ensure that these arrangements for relief of double taxation apply to both income tax and Medicare levy.*'

It is clear from the EM that section 3(10) ensures that the arrangements in Australia's double tax treaties for relief of double taxation apply to both income tax **and** Medicare levy. Section 3(10) has neither been amended nor repealed since that time and the principle set out above remains Australia's policy position notwithstanding the change to tax offsets from tax credits.

Conclusion - DTAs

The provisions of the DTA should be applied in a manner to enable the foreign tax to offset Australian income tax and Medicare levy as:

1. Medicare levy is expressly included in the definition of income tax by section 3(10) of the *International Tax Agreements Act;*
2. The DTA applies to "income tax" which is defined to include Medicare levy; and
3. There is an express clause with the object of "elimination of double taxation" that covers the tax to which the DTA applies (which includes Medicare levy) and is intended to ensure Australia provides a credit for foreign taxes paid against any Australian income tax or Medicare levy.

Accordingly, tax paid in PNG in respect of income derived by a resident of Australia shall be allowed as a credit (including by offset) against income tax including the Medicare levy payable in respect of that income. Further, the provisions of the law of Australia shall not affect this general principle.

Accordingly, section 4-10 of the ITAA 1997, including the method statement in subsection 4-10(3) allowing a tax offset in particular shall be applied appropriately.

Tax offsets – in context of ITAA 1953

It has been suggested that *income tax* has a different meaning for the purposes of 'tax offset' in subsection 4-10(3) of the ITAA 1997 than required by the provisions of Australia's international treaty obligations.

In our view, it does not have a different meaning.

Section 995-1(1) of the ITAA 1997 states that 'tax offset' has the meaning given by section 4-10, and step 3 in the method statement in subsection 4-10(3) expressly provides that

> '*A tax offset reduces the amount of income tax you have to pay.*'

As indicated above, *income tax* is explicitly defined to include Medicare levy[12] and as such a tax offset, which in the current matter is foreign income tax, reduces income tax including the Medicare levy. The thought that 'income tax' has a different meaning insub section4-10 is dispelled by the ITAA 1953 which states:

> '*… the Assessment Act is incorporated and shall be read as one with this Act.*'[13]

That is, there is no difference in interpretation between the two Acts. Even if there were (which is not conceded) any such inconsistency is resolved by subsection 4(2) of the ITAA 1953 as set out above.

[11] *Income Tax Laws Amendment (Medicare Levy) Bill 1983*, enacted as Act No. 51 of 1983.
[12] Subsection 3(10) ITAA 1953
[13] Subsection 4(1) ITAA 1953.

It has been suggested by the ATO that the collective words 'basic income tax liability' are a self-contained phrase that has a meaning inconsistent with or different to '*income tax'*.

Firstly, it should be noted that 'basic income tax liability' does not appear in the dictionary provisions of section 995-1, nor does it have definition elsewhere in the Act. The on-line version of the ITAA 1997 links to the definition of '*income tax'* only.

Secondly, it is submitted the 'basic income tax liability' is simply a mechanism to help make the method statement work effectively but it does not create a new meaning. The method statement is designed for one purpose, as stated in step 4 in method statement – to identify '.. **how much income tax you owe for the financial year'**. As a mathematical equation it makes sense to use a phrase other than 'income tax' to avoid confusion since income tax is the result. However, 'basic income tax liability' does not create a different variable or factor because of the statement in step 3, which is 'A tax offset reduces the amount of income tax you have to pay.'

As such step 2 of the method statement is merely a mechanism to work out the starting point – that is the amount of income tax payable on your taxable income, in order to apply the subtraction required by step 4.

Notwithstanding the foregoing, to the extent that step 2 was capable of defining a unique term 'basic income tax liability' the amount of that term is equal to the amount income tax on your taxable income using the 'income tax rate or rates that apply to you for the income year' (and any special provisions). As concluded above, the Medicare levy (and if applicable, the Medicare levy surcharge) is income tax and since it is worked out by applying a rate to a taxpayer's taxable income it does in fact meet all of the requirements to be included in the term 'basic income tax liability' for the purposes of step 2 and then step 4 of the method statement.

Nothing within the method statement requires a different result. The signpost at step 2 is not a part of the Act, and in any event is not considered an exclusive set of rules to work out the income tax rate or rates that apply to you for the particular income year.

Conclusion – tax offsets

Subsection 4(1) ITAA 1953 has the effect that the method statement in subsection 4-10(3) is incorporated with and read as one with the ITAA 1953 and by virtue of subsection 4(2) of the ITAA 1953 the provisions of the ITAA 1953 shall apply notwithstanding any inconsistencies in the ITAA 1997.

Accordingly, incorporating the meaning of 'income tax' provided by subsection 3(10) of the ITAA 1953 with the method statement in subsection 4-10(3) of the ITAA 1997, Medicare levy is an amount of income tax (using a tax rate applied to taxable income) at step 2 and thus is included in the 'basic income tax liability'.

Step 3 of the method statement clarifies that foreign income tax paid reduces the '*amount of **income tax** you have to pay*' and then step 4 requires the subtraction of your tax offsets, which in this case is the foreign tax paid set out in Article 23(1) of the PNG Agreement, from your basic income tax liability inclusive of the Medicare levy. The result being the amount of ***income tax*** you have to pay.

Inclusion of the Medicare levy as income tax and as basic income tax liability in the method statement is consistent with the construction of the provisions and with the general principle of Australia's international treaty obligations such as those expressed in Article 23 of the PNG Agreement.

C. Impact of foreign and Australian Tax rates

Medicare Levy and Foreign Income Tax Offset – changes to section 23AG

In the Federal Budget on 12 May 2009, the Treasurer Mr Wayne Swan stated[14] that the changes to section 23AG[15] were intended:

> "*… to ensure that workers who earn income overseas do not have an unfair advantage over workers who earn income and pay tax in Australia.*"

In the second reading speech to the amending Bill[16] the Treasurer expressed the policy behind the 23AG changes as follows:

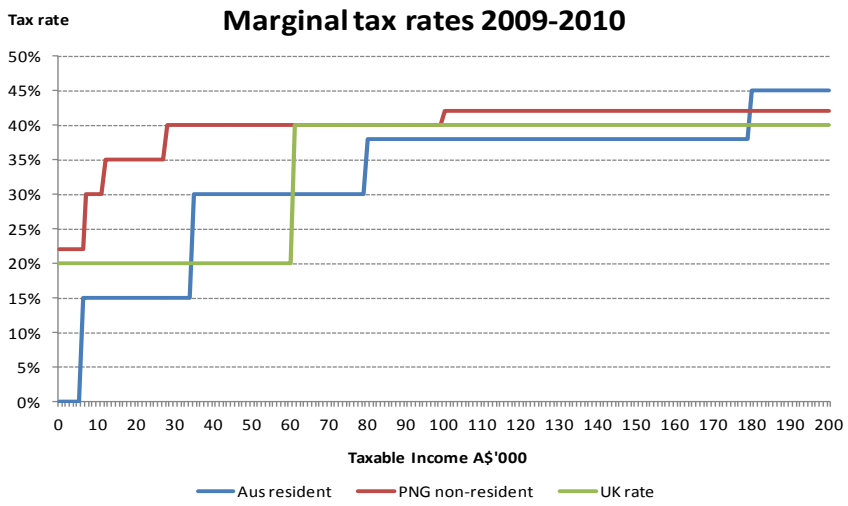
> '[The amendment tosection23AG] … *will enhance the fairness and integrity of the tax system by ensuring that Australian resident taxpayers who work in low-tax jurisdictions pay the same rate of Australian tax as individuals who work in Australia.*'

If continued the ATO's current interpretation of the FITO rules would ensure that some Australian resident taxpayers who work overseas are unfairly disadvantaged over workers in Australia. Indeed, under the ATO view an Australian resident taxpayer working in a high-tax jurisdiction and who currently pays more foreign tax would pay even greater tax than an individual working in Australia.

1. Marginal tax rates

Generally speaking, Australia's personal tax rates are comparatively modest at lower income levels; roughly in line with other countries at 'middle' income levels; and generally higher at taxable incomes above A$180,000 – as depicted in Chart 1.

Chart 1



[14] Media release No. 66, 12th May 2009.
[15] The *Income Tax Assessment Act 1936* (Cth), as amended. 'ITAA 1936'.
[16] *Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009*.

2. Average tax rates

Chart 2

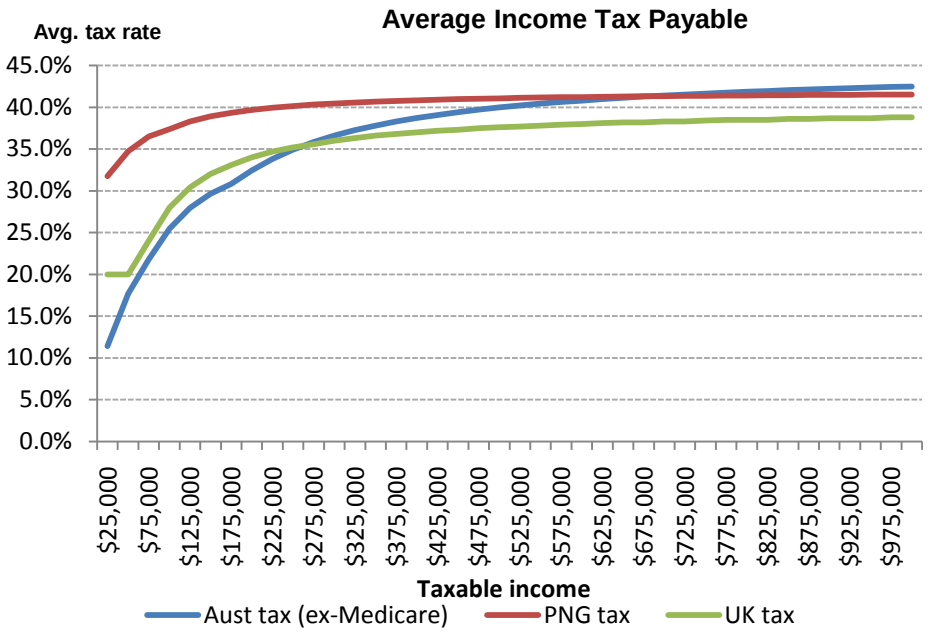
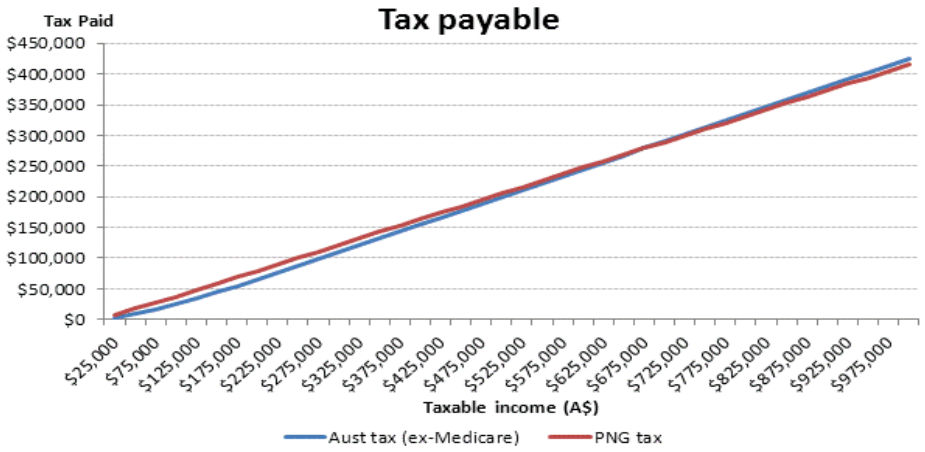


Chart 2 indicates that as a proportion on taxable income the average rate of tax in Australia exceeds UK tax payable at taxable income around $250,000, and exceeds PNG tax payable at taxable income around $675,000.

3. Tax paid

Comparing Australia with Papua New Guinea, tax paid in Australia is usually lower than tax paid in PNG up to a taxable income of A$675,000 – as depicted in Chart 3.

Chart 3



Analysis

From the charts above it can be seen that, in broad terms:

a) taxpayers with comparatively higher foreign taxable incomes should not be affected by the ATO's current interpretation that Medicare levy is not income tax[17] for the purposes of the method statement in section 4-10(3)[18]. This result arises because the Australian tax (exclusive of the Medicare levy) exceeds the foreign tax paid and the taxpayer should not have an excess foreign income tax offset position. Or to put it another way, the foreign tax paid should be fully offset against the Australian tax payable excluding Medicare levy.
b) Australian taxpayers with lower foreign taxable incomes and tax paid will generally be worse off under the ATO's current interpretation since they will have an excess FITO position and, if the ATO is correct, a liability for the Medicare levy as well. The total tax burden for those ordinary Australian working families will comprise the sum of: the Australian tax payable; the excess foreign tax paid; and the Medicare levy amount, resulting in an average tax rate significantly greater than the comparable Australian average tax rate.

This was neither the intent nor the stated policy of the amendments to the former section 23AG exemption. In the second reading to the amending Bill[19] the Treasurer expressed the policy as follows:

> '[Thesection23AG amendments] … *will enhance the fairness and integrity of the tax system by ensuring that Australian resident taxpayers who work in low-tax jurisdictions pay the same rate of Australian tax as individuals who work in Australia.*'

However, under the ATO's current interpretation an Australian resident taxpayer working in high-tax jurisdiction and who already pays a higher rate of tax will pay an even greater tax burden compared with individuals who work in Australia.

Hypothetical tax arrangements

Many Australian-based foreign employment arrangements operate a hypothetical tax (hypo-tax)(also known as tax equalisation) mechanism. The objective of hypo-tax is to place the Australian resident employee in no worse a situation because of higher tax rates in the foreign employment location than had the employee derived that employment income in Australia. Additional costs due to income taxes are equalised through payment of additional gross salary to the employee, so to leave the employee with the same net income on a hypo-taxed basis.

As such the additional costs fall to the employer as increased gross salary.

Hypothetical tax example

The hypo-tax for an Australian resident individual on a base salary of A$100,000 per annum is A$26,950[20] (tax $25,450 and Medicare levy $1,500) and the net take-home pay after hypo-tax is A$73,050. Where the foreign employment location is Papua New Guinea the gross salary cost to the employer would be A$117,955 to place the employee on no-worse a position. That would be an additional cost of A$17,955 to the employer.

[17] Basic income tax liability.
[18] *Income Tax Assessment Act 1997* (Cth). 'ITAA 1997'.
[19] *Tax Laws Amendment (2009 Budget Measures No. 1) Bill 2009*.
[20] 2009-10 resident individual tax rates applied.

Even though in this example foreign tax paid of A$44,905 exceeds the total Australian tax of A$34,042 (the excess FITO of A$10,863 would be forfeited), under the current ATO interpretation the employee would have a residual Medicare levy liability of A$1,769[21] on assessment. If the ATO view were correct the employer would need to increase the employee's gross salary by a further A$3,131[22] to leave the employee no-worse off than the hypo-taxed position. In other words, the ATO view would result in a tax-on-tax as demonstrated in the following table.

Table 1

	Hypo-tax A$	External view of Australian tax A$	ATO view of Australian tax A$	Total tax-adjusted gross A$
Base salary (TFR)	**100,000**	**117,955**	**117,955**	**121,086**
Australian tax	25,450	32,273	32,273	33,463
+ Medicare levy 1.5%	1,500	1,769	1,769	1,816
Total income tax	26,950	34,042	34,042	35,279
- FITO	-	-34,042	-32,273	-33,463
Tax payable on assessment	26,950	0	1,769	1,816
Foreign tax paid	-	44,905	44,905	46,220
- FITO		-34,042	-32,273	-33,463
Excess FITO forfeited		10,863	12,632	12,757
Total tax burden:				
Australian tax	25,450	32,273	32,273	33,463
Medicare levy	1,500	1,769	1,769	1,816
Excess FITO		10,863	12,632	12,757
Total	26,950	44,905	46,674	48,036
Net take-home after tax	**73,050**	**73,050**	**71,281**	**73,050**
Average tax rate	26.9%	38.1%	39.6%	39.7%

Comment

As indicated in the introduction the purpose of thesection23AG amendments was to ensure an individual who works in a low-tax jurisdiction did not have an unfair advantage over an ordinary Australian individual who works and pays tax in Australia. The policy was not intended to increase further the tax burden on an ordinary Australian working and paying tax in a high-tax jurisdiction.

The example in Table 1 demonstrates that:

- the average tax rate[23] of an ordinary working Australian family with Australian-sourced income of A$100,000 pa is just 26.9%; and
- to generate an equivalent after-tax position an ordinary working Australian family would need to earn A$117,955 of foreign-service income; paying an average rate of tax of 38.1%; but
- under the ATO current view, the average tax rate of an ordinary Australian working family earning A$117,955 of foreign-service income would increase to 39.6%; and
- under the current ATO view, to generate an after-tax income of A$73,050 and ordinary working Australian family will need to earn A$121,086 of foreign-service income; paying an average tax rate of 39.7%.

[21] A$117,955 x 1.5% = A$1,769.
[22] A$1,769 / (foreign marginal tax rate + 1.5%) = $1,769/56.5% = A$3,131.
[23] 2009-10 resident individual tax rates applied.

In the fourth column in table 1 the foreign government would collect additional tax of A$1,315 while the Australian government would collect additional tax of A$1,816. Thus, the additional cost of A$3,131 to the employer would be consumed entirely by additional taxes compared with the current position, and the total tax burden of A$48,036 would be 78% greater than the comparable Australian position.

D. Who is affected by the current ATO view?

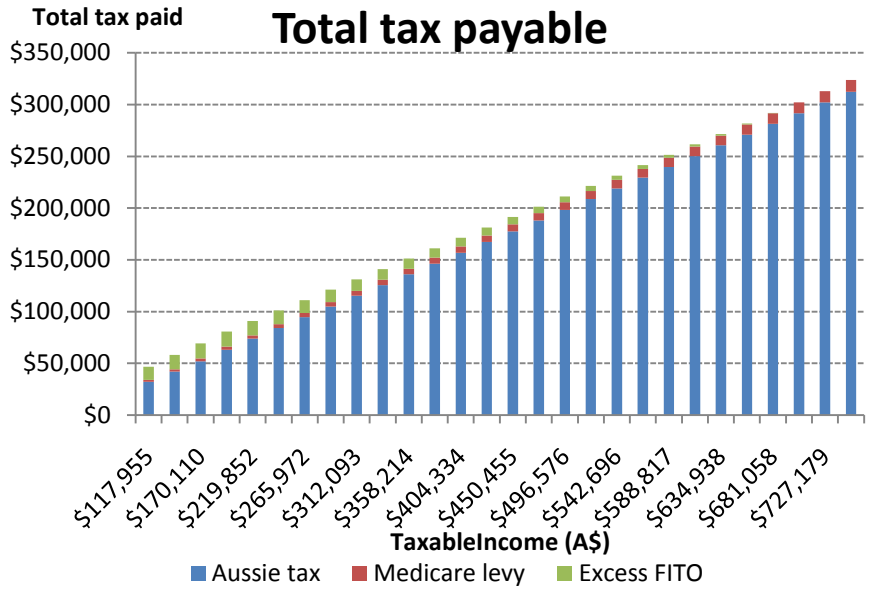
As indicated earlier, if not altered the current ATO view will affect resident individuals working in high-tax jurisdictions.

Furthermore, the ATO view may result in inequitable outcomes for Australian resident individuals working in comparable high tax jurisdictions, depending on whether the individual has investment income in addition to their foreign employment earnings. That is, individuals with investment income would be able to fully utilise the FITO against both their foreign employment income and investment income, whereas individuals without investment income would lose the excess FITO after offsetting it against employment income.

So the real impact is on the lower-income Australians working overseas. In our view this is inconsistent with the comments by the Federal Treasurer that '[thesection23AG amendments] … *will enhance the fairness and integrity of the tax system by ensuring that Australian resident taxpayers who work in low-tax jurisdictions pay the same rate of Australian tax as individuals who work in Australia.*'

The potential effects of the current ATO view are shown in Chart 4, for a wide range of taxable incomes which is designed to give the ATO the full range of circumstances.

Chart 4



The impact of Australians' income from other investments in Australia

Furthermore, the probable number of affected taxpayers should be substantially fewer than the pool of Australian residents with foreign services incomes because:

a) the tax paid in the foreign jurisdiction has to be significantly greater than the Australian tax payable on that income and

b) Another factor will be whether a taxpayer has any Australian tax payable on income from other sources, for example investment income.

Table 2 compares the net outcome under each of the current ATO view and the alternate (or external) view for a taxpayer with foreign-sourced income only and a taxpayer with foreign-sourced income and A$10,000 of Australian investment income.

Under the ATO view the additional FITO amount of A$3,800 shelters the income tax liability on the investment income. The net change in after tax income is equal to the investment income less an additional A$150 of Medicare levy. Although the Medicare levy would still be payable under this view the taxpayer's net position would be ahead by A$2,031[24] compared with original A$73,050 position due to the additional FITO.

Table 2

	ATO Current View		External (treaty) view	
	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$
Foreign employment income	117,955	117,955	117,955	117,955
Australian-sourced income	-	10,000	-	10,000
Taxable income	117,955	127,955	117,955	127,955
Foreign tax paid on salary	44,905	44,905	44,905	44,905
FITO Limit Amount:				
Tax & Medicare on total income	34,042	37,992	34,042	37,992
Tax & Medicare on other income	n/a	0	n/a	0
Tax on foreign income - FITO limit	34,042	37,992	34,042	37,992
Current ATO view:				
Basic income tax liability	32,273	36,073	34,042	37,992
- FITO	-32,273	-36,073	-34,042	-37,992
Tax payable	0	0	0	0
+ Medicare levy	1,769	1,919	0	0
Net payable on assessment	1,769	1,919	0	0
Total tax burden:				
Australian tax	32,273	36,073	34,042	37,992
Medicare levy	1,769	1,919	-	-
Excess FITO	12,632	8,832	10,863	6,913
Total	46,674	46,824	44,905	44,905
Net income after tax	71,281	81,131	73,050	83,050
Average tax rate	39.6%	36.6%	38.1%	35.1%

Under the external view the taxpayer would enjoy nil additional tax on the investment income because of the additional FITO amount. Under this view the taxpayer would be ahead by A$3,950.

Similar 'savings' are achieved where the taxpayer has A$25,000 of Australian-sourced investment income. Under the ATO view the net tax paid on the investment income would be A$375 only; being the increased Medicare levy. Compared with the original after-tax position, the taxpayer would be ahead by A$7,731 due the additional FITO amount.

Compared with the ATO view, the taxpayer's after tax income would be $269 only greater under the external (treaty) view, as demonstrated in Table 3.

[24] A$81,131 – (73,050 + (A$10,000 – A$3,950)) = A$2,031.

Table 3

	ATO Current View		External (treaty) view	
	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$	Hypo-tax adjusted PNG income A$
Foreign employment income	117,955	117,955	117,955	117,955
Australian-sourced income	-	25,000	-	25,000
Taxable income	117,955	142,955	117,955	142,955
Foreign tax paid on salary	44,905	44,905	44,905	44,905
FITO Limit Amount:				
Tax & Medicare on total income	34,042	43,917	34,042	43,917
Tax & Medicare on other income	n/a	1,875	n/a	1,875
Tax on foreign income - FITO limit	34,042	42,042	34,042	42,042
Current ATO view:				
Basic income tax liability	32,273	41,773	34,042	43,917
- FITO	-32,273	-41,773	-34,042	-42,042
Tax payable	0	0	0	1,875
+ Medicare levy	1,769	2,144	0	0
Net payable on assessment	1,769	2,144	0	1,875
Total tax burden:				
Australian tax	32,273	41,773	34,042	42,042
Medicare levy	1,769	2,144	-	1,875
Excess FITO	12,632	3,132	10,863	2,863
Total	46,674	47,049	44,905	46,780
Net income after tax	71,281	95,906	73,050	96,175
Average tax rate	39.6%	32.9%	38.1%	32.7%

The example in Table 3 shows that despite the imposition of the Medicare levy of A$2,144 under the ATO view, the FITO allowed under step 3 of the method statement insection4-10(3) is increased by $7,731 compared with the original position.

Conclusion

Subject to each individual's particular circumstances it can be expected that the quantum of the difference of views will be substantially reduced where a taxpayer has tax payable on Australian-sourced income.

Furthermore the absolute number of affected taxpayers should also be fewer than perhaps would otherwise be the case.

Appendix 2

ATO's interpretation

We understand that the interpretative approach of the ATO is that the Medicare levy is not an income tax for purposes of the method statement in section 4-10(3) of the ITAA 1997, and the FITO cannot be offset against it.

We refer to the attached ATO objection notice.