



CR 2004/86 - Income tax: exempt income: employees to the Khanong Development Group working in the Lao People's Democratic Republic (Laos)

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Class Ruling

Income tax: exempt income: employees to the Khanong Development Group working in the Lao People's Democratic Republic (Laos)

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Preamble

*The number, subject heading, **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax laws dealt with in this Ruling are sections 23AF, 23AG and 160AF of the *Income Tax Assessment Act 1936* (ITAA 1936) and section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Class of persons

3. The class of persons to which this Ruling applies are Australian resident individuals employed by Khanong Development Group (KDG) in relation to Phase 2 of a project to provide Engineering, Procurement and Construction Management services (the project) by KDG to Lang Xang Minerals Limited (LXML) in relation to the LXML Copper Processing Plant and Gold Plant Expansion in Laos.

Qualifications

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

5. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is carried out in accordance with the arrangement described in paragraphs 9 to 16.

6. If the arrangement actually carried out is materially different from the arrangement that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies from 1 March 2003. However, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the Gazette;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Arrangement

9. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents which are attached to the file record maintained by the Tax Office for this ruling. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- application for Class Ruling dated 29 September 2003;
- correspondence from the Australian Trade Commission (Austrade) to KDG dated 27 February 2003 confirming approved project status for the project for the purposes of section 23AF of the ITAA 1936 (Approved Project Number 2003/12); and
- further information provided by the applicant.

10. KDG is an unincorporated joint venture between Ausenco International Pty Ltd and Bateman Engineering Pty Ltd formed on 11 December 2002 for the purpose of undertaking Phase 2 of the project involving the development of copper resources and associated infrastructure at the Khanong deposit in Laos being operated by LXML.

11. This project has been granted 'approved project status' for the period March 2003 to March 2005 by the Minister for Trade under subsection 23AF(11) of the ITAA 1936.

12. KDG has employed Australian residents (the employees) to perform personal services on the project in Laos.

13. The employees are not contractors of KDG.

14. The employees are paid salary and wages in respect of services provided to the project.

15. Income derived by the employees from services provided in Laos is taxed in Laos.

16. Employees work in Laos on the project for between 70 and 84 hours per week. Site rotation cycles are six weeks on and two weeks off including travel time. During the two weeks off cycle, employees are not required to return to Australia or to attend the company offices.

Ruling

17. The income referred to at paragraph 14 of this ruling, derived by an employee described at paragraph 3 of this ruling who works in Laos on the project, is exempt from income tax under subsection 23AG(1) of the ITAA 1936 where:

- that employee has been engaged in service in Laos for a continuous period of not less than 91 days; and
- none of the conditions set out in subsection 23AG(2) are satisfied.

18. Where an employee has not been engaged on foreign service in Laos for a continuous period of at least 91 days and they do not met the requirements for exemption from income tax under section 23AF, the gross income derived by the employee from that service is assessable under subsection 6-5(2) of the ITAA 1997. The

employee will be entitled to a foreign tax credit calculated in accordance with subsection 160AF(1) of the ITAA 1936 where:

- the employee has paid foreign tax in respect of that income; and
- the employee was personally liable for that tax.

Explanation

19. A payment or other benefit received by a taxpayer is assessable income if it is:

- income in the ordinary sense of the word (ordinary income); or
- an amount or benefit that through the operation of the provisions of the tax law is included in assessable income (statutory income).

Ordinary income

20. Subsection 6-5(1) of the ITAA 1997 provides that an amount is included as assessable income if it is income according to ordinary concepts (ordinary income).

21. Payments made by KDG to their employees are considered to be ordinary income.

22. Subsection 6-5(2) of the ITAA 1997 further provides that the assessable income of an Australian resident will include the ordinary income derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

23. The determination of a person's residency status depends on their own circumstances and is a determination made in relation to each year of income. For further information, see Taxation Ruling IT 2650. This Class Ruling only applies to the class of persons who remain Australian residents for taxation purposes during the posting period in Laos.

24. Subsection 6-15(2) of the ITAA 1997 provides that if an amount is exempt income, it is not assessable income. Exempt income is that which is made exempt from income tax by a provision of the ITAA 1997 or another Commonwealth law (section 6-20 of the ITAA 1997).

25. Section 11-15 of the ITAA 1997 lists those provisions that make income exempt if it is derived by certain entities. Included in that list is section 23AG of the ITAA 1936.

26. Subsection 23AG(1) states:

Where a resident, being a natural person, has been engaged in foreign service for a continuous period of not less than 91 days, any foreign earnings derived by the person from that foreign service is exempt from tax.

The basic tests for the exemption of foreign employment income are:

- be a 'resident of Australia';
- be engaged in 'foreign service';
- be engaged for a continuous period of not less than 91 days; and
- derive 'foreign earnings' from that 'foreign service'.

However, certain foreign earnings that meet these tests may not be exempt from tax (see below).

27. The payments described at paragraph 14 derived by employees of KDG who are in Laos for more than 91 days is income of the type described in subsection 23AG(1).

Engaged in foreign service

28. 'Foreign service' is defined as '*service in a foreign country as the holder of an office or in the capacity of an employee*' (subsection 23AG(7) of the ITAA 1936).

29. The posting of an employee to Laos constitutes 'foreign service' as those employees are undertaking '*service in a foreign country as a holder of an office or in the capacity of an employee*'.

30. The Class of persons outlined in paragraph 3 of this ruling who are employees of KDG are considered to meet the above definition of an 'employee' for the purposes of section 23AG of the ITAA 1936. Those employees who are deployed to the project work between 70 and 84 hours per week, with site rotation cycles being six weeks on and two weeks off. Paragraph 7 of Taxation Ruling IT 2441 states that where an Australian resident taxpayer is employed in a project in a foreign country, leave taken in circumstances similar to those mentioned in Taxation Ruling IT 2015 would be treated as recreation leave forming part of a period of foreign service under paragraph 23AG(6)(a) of the ITAA 1936.

For a continuous period of not less than 91 days

31. Some employees based in Laos are expected to serve continuously in Laos for a period of at least 91 days. Therefore, these periods of 'foreign service' meet the test that Australian residents working overseas must be engaged '*for a continuous period of not less than 91 days*'. Should an employee of KDG depart Laos prior to the completion of 91 days of continuous service, that employee will normally be ineligible for the exemption.

32. However, in certain instances, an employee who departs Laos prior to serving the necessary number of days, may still qualify for exemption if they return to continue their posting at a later date. Paragraphs 9 to 16 of *Taxation Ruling* TR 96/15 set out the Tax Office view on temporary absences forming part of a period of foreign service.

Derived foreign earnings

33. The definition of 'foreign earnings' is contained in subsection 23AG(7), which provides that:

'foreign earnings' means income consisting of earnings, salary, wages, commission, bonuses or allowances but does not include any payment, consideration or amount that:

- (a) is included in assessable income under Subdivision AA of Division 2; or
- (b) is excluded from the definition of 'eligible termination payment' in subsection 27A(1) because of paragraph (ja), (k), (ka), (m), (ma), (n) or (p) of that definition.

34. The exclusions to the definition of 'foreign earnings' in the above paragraph are not, however, relevant to this arrangement as they relate to pensions, annuities, eligible termination payments and other similar amounts.

35. Wages referred to at paragraph 14 of this ruling are specifically included in the subsection 23AG(7) definition of 'foreign earnings'.

36. Subsection 23AG(1) provides an implicit connection between 'foreign earnings' and 'foreign service', that is, '*any foreign earnings derived by the person from that foreign service is exempt from tax*' (emphasis added). The direct linkage of earnings to service negates the need to consider any potential 'source' issues, even though the source of remuneration under a normal contract of employment is generally regarded as the place where the duties are performed (*FC of T v. French* (1957) 98 CLR 398).

From that foreign service

37. To qualify for the exemption the 'foreign earnings' must be derived from the 'foreign service'. That does not mean that the foreign earnings need to be received at the time of engaging in foreign service. The important test is that the foreign earnings, when received, were derived as a result of the undertaking of that foreign service.

38. In the case of allowances paid after the person returns to Australia that relate to the period of foreign service, such allowances are treated as foreign earnings derived from that foreign service. Also, any advances paid to the taxpayer prior to the undertaking of foreign service against salary arising from the undertaking of that foreign service would be treated as foreign earnings from that foreign service.

Certain foreign earnings not exempt

39. Subsection 23AG(2) provides that no exemption is available under subsection 23AG(1) in circumstances where an amount of foreign earnings derived in a foreign country is exempt from tax in the foreign country solely because of:

- a double tax agreement or a law of a country that gives effect to such an agreement (paragraphs 23AG(2)(a) and (b));
- a law of that foreign country which generally exempts from, or does not provide for, the imposition of income tax on income derived in the capacity of an employee, income from personal services or any other similar income (paragraphs 23AG(2)(c) and (d)); and
- a law or international agreement dealing with privileges and immunities of diplomats or consuls or of persons connected with international organisations (paragraphs 23AG(2)(e), (f) and (g)).

40. Subsection 23AG(2) does not apply as the foreign earnings are not exempt from income tax in Laos.

Period of foreign service less than 91 days

41. The KDG employees are engaged on an approved project for the purposes of section 23AF of the ITAA 1936 (see paragraphs 9 and 11 of this ruling). Section 23AF sets out the requirements for eligible foreign remuneration derived by a person that is attributable to qualifying service on a particular approved project to be exempt from income tax.

42. Income that is exempt under section 23AG is excluded income for the purposes of section 23AF and is not eligible foreign remuneration (paragraph 23AF(17)(a) and the definition of “eligible foreign remuneration” in subsection 23AF(18)). Income referred to in paragraph 14 of this ruling derived by KDG employees which is exempt under section 23AG therefore cannot be exempt under section 23AF.

43. In very limited circumstances, a KDG employee whose income is not exempt under section 23AG may meet the requirements for exemption under section 23AF. For example, KDG employees who do not complete 91 days of foreign service may qualify for exemption under section 23AF for one of the following reasons:

- a KDG employee ceases to be engaged in qualifying service due to unforeseen circumstances prior to completing 91 days of that service (for example the death of a family member) (subsection 23AF(6));
- a KDG employee replaces another KDG employee whose qualifying service was terminated due to unforeseen circumstances (subsection 23AF(7)); and
- a KDG employee is temporarily absent from service on the project and those absences do not form part of the employee's foreign service period for 23AG purposes (for example the absence is not covered by paragraphs 9 to 16 of Taxation Ruling TR 96/15 – see paragraph 32 above) but the absences do not exceed one-sixth of the total period that the employee was engaged on qualifying service on the project (subsection 23AF(8)).

44. KDG employees who do not meet the requirements for income tax exemption under section 23AG but consider that they may meet the requirements for exemption under section 23AF should seek professional advice from their taxation adviser or seek advice from the Australian Taxation Office.

45. Where the period of continuous foreign service completed by an employee is less than 91 days, the income derived from that service is not exempt under section 23AG. Persons that fall into this category and who do not meet the requirements for exemption under section 23AF must include the gross amount of the foreign earnings derived from Laos as assessable income in their Australian tax return.

46. Where foreign tax has been paid in Laos in relation to the assessable foreign earnings, a foreign tax credit will be available.

47. Subsection 160AF(1) of the ITAA 1936 provides that a resident taxpayer, whose assessable income includes foreign income on which the taxpayer has paid foreign tax, for which the taxpayer was personally liable, is entitled to a credit against the Australian tax payable of the lesser of:

- the amount of that foreign tax paid, reduced in accordance with any relief available to the taxpayer under the law relating to that tax; or
- the amount of Australian tax payable in respect of the foreign income.

48. Subsection 6AB(2) of the ITAA 1936 defines 'foreign tax' to include tax imposed on income by a law of a foreign country.

49. Tax imposed by the Laos Government on income derived by employees in relation to the project is a 'foreign tax' for the purposes of subsection 6AB(2) of the ITAA 1936. Accordingly, where an employee is required to include income referred to in paragraph 14 of this ruling in their Australian tax return, a foreign tax credit will be allowable under subsection 160AF(1) of the ITAA 1936 where Laos tax has been paid by the employee in respect of that income.

Exempt 23AG income and other income

50. Foreign earnings of employees that are exempt from Australian tax under section 23AG are nevertheless taken into account in calculating the Australian tax on other assessable income derived by the employee (subsection 23AG(3) of the ITAA 1936).

51. Tax on other assessable income will be calculated by applying to the non-exempt income (for example Australian business or investment income), the notional average rate of tax payable on the sum of exempt income and non-exempt income.

52. Any deductions that relate to the exempt income are allowed as if the exempt income was assessable income. That is, expenses which relate directly to earning income in Laos are deductible from exempt income.

Example

53. In the 2003-2004 income year, an employee derives the following types of income:

- Australian business income of \$45,000;
- exempt foreign employment income of \$15,100; and
- expenses directly related to exempt foreign employment income of \$100.

Assume that the employee has appropriate private patient hospital cover for Medicare levy surcharge purposes.

The total amount of Australian tax payable will be calculated with reference to the following formula:

$$\frac{\text{Notional gross tax}}{\text{Notional gross taxable income}} \times \text{Other taxable income}$$

Step 1

The employee's **notional gross taxable income** is \$60,000 (\$45,000 + \$15,100 – \$100).

Step 2

The **notional gross tax** is \$16,032 (the normal Australian income tax and Medicare levy payable on a taxable income of \$60,000).

Step 3

The **other taxable income** is \$45,000 (Australian business income).

Step 4

The Australian tax payable (including Medicare levy) on the employee's Australian income is:

$$\begin{array}{r} \$16,032 \times \$45,000 \\ \$60,000 \\ = \$12,024.00 \end{array}$$

Detailed contents list

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

CR 2001/1; TR 92/1; TR 96/15;
TR 97/16; IT 2015; IT 2441;
IT 2650

Subject references:

- approved overseas project
- exempt income
- foreign income
- foreign source income
- foreign tax credit
- international tax
- Laos
- overseas countries
- overseas tax laws

Legislative references:

- Copyright Act 1968
- TAA 1953 Pt IVAAA
- ITAA 1936 6AB(2)
- ITAA 1936 23AF
- ITAA 1936 23AF(6)
- ITAA 1936 23AF(7)
- ITAA 1936 23AF(8)
- ITAA 1936 23AF(11)
- ITAA 1936 23AF(17)

- ITAA 1936 23AF(18)
- ITAA 1936 23AG
- ITAA 1936 23AG(1)
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- ITAA 1936 23AG(2)(e)
- ITAA 1936 23AG(2)(f)
- ITAA 1936 23AG(2)(g)
- ITAA 1936 23AG(3)
- ITAA 1936 23AG(6)
- ITAA 1936 23AG(7)
- ITAA 1936 Pt III Div 2 Subdiv AA
- ITAA 1936 27A(1)
- ITAA 1936 160AF
- ITAA 1936 160AF(1)
- ITAA 1997 6-5
- ITAA 1997 6-5(1)
- ITAA 1997 6-5(2)
- ITAA 1997 6-15(2)
- ITAA 1997 6-20
- ITAA 1997 11-15

Case references:

- FC of T v. French (1957) 98 CLR 398

ATO references

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