TR 2004/D1 - Income tax: the assessability of salary and wages derived under teacher exchange programs between Australia and the United States

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Draft Taxation Ruling

Income tax: the assessability of salary and wages derived under teacher exchange programs between Australia and the United States

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Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This draft Ruling deals with the assessability of salary and wages derived under teacher exchange programs between Australia and the United States (US). The Ruling looks at the application of section 23AG of the *Income Tax Assessment Act 1936* (ITAA 1936) and its interaction with the Double Taxation Convention between Australia and the United States (the Convention).

Class of person/arrangement

2. This Ruling deals with the assessability of salary and wages derived by Australian and US resident teachers participating in teacher exchange programs where those teachers continue to be paid by their employer in their country of residence and where those employers are not operating through a permanent establishment in the host country or otherwise carrying on a business there.

3. The Ruling does not apply to Australian resident teachers paid by a US employer, or to US resident teachers paid by an Australian employer. The Ruling also does not consider the fringe benefits tax implications of any remuneration packages involving the exchange teachers.

4. In this Ruling, a reference to an Australian or US resident teacher is a reference to someone who is a resident of that country for the purposes of the Convention.

5. The views expressed in this Ruling relating to the application of Articles 15 and 19 of the Convention relate solely to that Convention.

Ruling

6. Article 15 (Dependent Personal Services) of the Convention applies to teachers (whether government or private sector employees) participating in teacher exchange programs between Australia and the US. Article 19 (Governmental Remuneration) does not apply.

Australian resident teachers on a teaching exchange program to the US

7. Where an Australian resident exchange teacher is present in the US for 183 days or less of a US taxable year as an employee teacher, Article 15 of the Convention provides that the salary and wages paid will be taxable only in Australia. In these circumstances, the salary and wages are assessable income under section 6-5 or 6-10 of the *Income Tax Assessment Act 1997* (ITAA 1997), and no exemption is available under section 23AG of the ITAA 1936.

8. Where the period that the Australian resident exchange teacher is present in the US exceeds 183 days of a US taxable year, the salary and wages may be taxed in the US under Article 15 of the Convention (whether or not the US actually exercises that taxing right depends on US domestic tax law). In this situation, the salary and wages will be exempt from Australian tax under section 23AG of the ITAA 1936, provided the exchange teacher is engaged in continuous foreign service for a period of 91 days or more.

US resident teachers on a teaching exchange program to Australia

9. Where a US resident exchange teacher is present in Australia for 183 days or less of an Australian year of income as an employee teacher, Article 15 of the Convention provides that their salary and wages will be taxable in the US only.

10. Where the period that the US resident exchange teacher is present in Australia exceeds 183 days of the Australian year of income, their salary and wages may be taxed in Australia under Article 15 of the Convention. In this case, the salary and wages are assessable income under section 6-5 or 6-10 of the ITAA 1997.

Date of effect

11. When the final Ruling is issued, it is proposed that it apply to income years commencing both before and after its date of issue. However, the Ruling will 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).

Previous Rulings

12. This Ruling replaces Taxation Ruling No. IT 2574.

Explanation

Background

13. For Australian residents who go to the US under a teaching exchange program and derive salary and wages, the starting point is that they are assessable on income from all sources, including sources outside Australia (see sections 6-5 and 6-10 of the ITAA 1997).

14. US residents who come to Australia under a teaching exchange program are assessable only on their Australian source income (see sections 6-5 and 6-10 of the ITAA 1997).

15. The salary and wages of Australian residents in the US may be exempt from Australian tax if specifically made so by a provision of the ITAA 1997 or any other Commonwealth law (see section 6-15 and 6-20 of the ITAA 1997). For instance, the salary and wages derived by Australian resident teachers who go to the US on a teacher exchange program may be exempt under section 23AG of the ITAA 1936.

16. The domestic tax law may be modified by the Convention. The Convention allocates taxing rights between Australia and the US which, in the case of Australia, may modify the operation of its domestic taxation law. Sections 6 and 6AA of the *International Tax Agreements Act 1953* (Agreements Act) gives the Convention the force of law in Australia. Moreover, subsections 4(1) and 4(2) of the Agreements Act provide that the ITAA 1936 and ITAA 1997 should be read as one with the Agreements Act and that, generally, the Agreements Act prevails in the case of any inconsistencies that may arise. Therefore, subject to certain limited exceptions, where an Article of the Convention prescribes the extent of Australia's taxing rights, it has effect for the purposes of the ITAA 1936 and ITAA 1997.

Australia/US Double Tax Convention and Protocol

17. The US Convention does not contain an Article that deals specifically with visiting professors and teachers. It does contain both a Dependent Personal Services Article and a Governmental Remuneration Article. Where the teacher participating in the teacher exchange program is employed (and paid) by the government, a question has arisen as to whether the Dependent Personal Services Article or the Governmental Remuneration Article determines the respective countries' taxing rights under the Convention.

Application of Article 19 to government-employed teachers

18. Article 19 of the Convention applies where, among other things, wages and salaries are paid from government funds to an individual that is an employee of that government for labour or services performed 'in the discharge of governmental functions'. In this Ruling a reference to a government employee is a reference to an individual employed by:

(i) the government of Australia or the US;

(ii) a state or political subdivision of (i); or

(iii) or an agency or authority of (i) or (ii).

19. For a teacher on an exchange program to come within this Article, they must be discharging 'governmental functions' when teaching in the other country.

20. The term 'in discharge of governmental functions' is not defined in the Convention. Article 3(2) provides that where a term is not defined in the Convention it takes on the meaning it has under the domestic law of the country applying the Convention unless the context otherwise requires. Australian domestic tax law does not statutorily define what governmental functions are. Nor is there unequivocal case law that provides a definitive, domestic law meaning. There are indications in the case law that a governmental function could be defined broadly to encompass any function that a government chooses to undertake.[1] However, there is also judicial support for a distinction between the traditional, core activities of government and other activities undertaken by government.[2] The cases supporting both views were all decided in contexts very different to a tax treaty context. Also, none turned on an interpretation of the specific phrase 'governmental functions'.

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[1] See for example *SGH Ltd v FC of T* (2002) 210 CLR 51, at 87 per Kirby J; *Committee of Direction of Fruit Marketing v Australian Postal Commission* (1980) 144 CLR 577, at 594; *Ex Parte Professional Engineer's Association* (1959) 107 CLR 208 at 275; *South Australia v The Commonwealth* (1942) 65 CLR 373 at 423 per Latham CJ.

[2] See, for example, *Ex Parte Professional Engineers' Association* (1959) 107 CLR 208 at 246 per McTiernan J and 274 per Windeyer J; *Federated Amalgamated Government Railway and Tramway Service Association v The New South Wales Railway Traffic Employees Association* (1906) 4 CLR 488 at 539.

21. The ATO's practice in relation to treaty interpretation principles is set out in Taxation Ruling 2001/13. As outlined at paragraphs 95 – 97 of that Ruling, the Vienna Convention permits reference to the following material to establish the meaning of the words used in the treaty:

- any subsequent agreement between the parties as to the interpretation of the treaty;
- any subsequent practice regarding the application of the treaty that establishes such an agreement; and
- supplementary material.

22. While we recognise that the words of Article 19 are open to interpretation, the various documents and practices that we consider form the extrinsic materials referred to in the previous paragraph definitely indicate that:

- the US does not consider education, and hence the function of teaching, to be a 'governmental function';[3] and
- Australia has accepted this position for the purposes of this Convention.[4]

23. The Convention is a bilateral, consensual agreement reached by negotiation between Australia and the US.[5] Accordingly, the phrase 'in discharge of governmental functions' should be interpreted with this and the matters raised in paragraph 22 in mind.

24. The subsequent agreement between Australia and the US in relation to the interpretation of the Convention and the subsequent practices of both countries exclude teaching services provided by a government-employed teacher from being a governmental function for the purposes of Article 19 of the Convention. Therefore, Article 19 of the Convention does not apply to government-employed teachers. It is also noted that the absence of the standard business and trade exception[6] in Article 19 of the Convention is consistent with the view that the Article was intended to be applied in the context of the bilateral agreement referred to in paragraph 22.

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[3] The Inland Revenue Service has advised that, as a general rule, the US would not view teaching as an activity which constitutes the discharge of governmental functions within the meaning of Article 19, in addition see US Treasury Department Technical Explanation to the 1996 US Model Income Tax Convention.
[4] The Commissioner has most recently expressed this view in Income Tax Ruling IT 2574.
[5] See TR 2001/13, at paragraph 46.
[6] See the exception contained in Article 19(3) of the OECD Model Tax Convention on Income and Capital 2003.

Application of Article 15

25. Article 15 of the Convention, which deals with Dependent Personal Services, applies in cases of paid employment. It allocates taxing rights between Australia and the US in relation to Australian and US teachers, whether they are employed by the government or the private sector.

26. Article 15(1) of the Convention contains a general rule that salary and wages derived by an employee who is a resident of one country will be taxable only in that country, unless the employment is exercised in the other country.

27. This general rule is subject to Article 15(2) which provides that the salary and wages is taxable only in the country of residence, where:

- the exchange teacher is present in the other country for a period or periods not exceeding 183 days in the year of income of that country (note that Australia's year of income runs from 1 July to 30 June whereas the US taxable year runs from 1 January to 31 December);
- the salary and wages is paid by, or on behalf of, an employer who is not a resident of the other country; and
- the salary and wages is not deductible in determining taxable profits of a permanent establishment or business which the employer has in the other country.

28. The Protocol contained in Schedule 2A of the Agreements Act which amends the Convention does not make any changes to Articles 15 and 19.

Exemption for foreign employment income

29. Subsection 23AG(1) of the ITAA 1936 exempts from Australian tax the foreign earnings of an Australian resident teacher where they are engaged in continuous foreign service for a period of 91 days or more.

30. However, subsection 23AG(2) of the ITAA 1936 provides that there is no exemption in circumstances where an amount of foreign earnings derived in a foreign country is exempt from tax in the foreign country only 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)); or
- a law or an 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)).

31. Therefore, where any of the circumstances set out in subsection 23AG(2) are present, and this is the only reason why the foreign earnings are exempt from tax in the foreign country, then the foreign earnings are not exempt from Australian tax.

32. *Taxation Ruling* TR 96/15 explains what is meant by continuous foreign service for section 23AG purposes.

Australian resident teachers on a teaching exchange program to the US

33. As noted at paragraph 27, Article 15(2) of the Convention gives Australia sole taxing rights where the employment activity is exercised in the US for a period of 183 days or less during the US taxable year. Where an Australian resident teacher is on an exchange teaching assignment to the US for a period of 91 days or more but less than 184 days of the US taxable year Australia has sole taxing rights over the foreign earnings. In this case, no exemption is available under section 23AG because the Australian resident teacher on the exchange program is exempt from Federal income tax in the US on their foreign earnings solely because of the Convention.

34. Where an Australian resident teacher is teaching in the US on an exchange program and the period of foreign service is continuous and is greater than 183 days during the US taxable year, both the US and Australia have a taxing right under Article 15 of the Convention in respect of the foreign earnings derived from employment exercised in that country. In this case, none of the circumstances set out in subsection 23AG(2) apply to prevent the exemption from being available under that section. Consequently, the foreign earnings from that foreign service are exempt from Australian tax under section 23AG.

35. Where an Australian resident teacher is teaching in the US on an exchange program for a period of 90 days or less, irrespective of whether that period straddles the US taxable year, the foreign earnings from that foreign service will be taxable in Australia under section 6-5 or 6-10 of the ITAA 1997. In this case, section 23AG does not apply because the teacher has not been engaged in foreign service for a continuous period of 91 days or more.

US resident teachers on a teaching exchange program to Australia

36. Where a US resident teacher comes to Australia on a teacher exchange program, Article 15 of the Convention allocates taxing rights in respect of the earnings derived from the exercise of employment in Australia. If the period of employment in Australia is for 183 days or less of an Australian year of income, the US has sole taxing rights over that employment income (see paragraph 27).

37. Where the period of employment in Australia under a teaching exchange program is for periods greater than 183 days during the Australian year of income, Australia may tax the salary and wages of the US resident teacher in accordance with Article 15 of the Convention. The teacher's salary and wages are included in assessable income under section 6-5 or 6-10 of the ITAA 1997.

Examples

Example 1 – Australian resident teacher present in US for 183 days or less of a US taxable year

38. An Australian resident teacher is employed by an Australian employer and participates in a teacher exchange program to the US from 1 August 1998 to 31 May 1999. With the US taxable year running from 1 January to 31 December, this represents a stay of 153 days in the 1998 US taxable year and 151 days in the 1999 US taxable year. As the taxpayer is not present in the US for more than 183 days of either the 1998 or 1999 US taxable year, the foreign earnings are taxable only in Australia under Article 15 of the Convention. No exemption is available under section 23AG, even though the taxpayer has been engaged in foreign service for a continuous period exceeding 90 days. That is because the foreign earnings derived by the Australian teacher from service in the US are exempt from US Federal income tax solely because of the operation of the Convention.

Example 2 – Australian resident teacher present in US for more than 183 days of a US taxable year

39. An Australian resident teacher is employed by an Australian employer and participates in a teacher exchange program in the US from 1 January 2000 to 30 November 2000. As this represents a stay of more than 183 days during the US taxable year, the US may tax the foreign earnings from the teacher exchange program in the US.

40. The foreign earnings are exempt from tax in Australia under section 23AG because the taxpayer has been engaged in continuous foreign service for a period of more than 90 days and the income is subject to tax in the US.

Example 3 – US resident teacher present in Australia for more than 183 days of the Australian year of income

41. A US resident teacher is employed by a US employer and participates in a teacher exchange program to Australia from 1 July 2001 to 31 May 2002. As this represents a stay in Australia for more than 183 days of the Australian year of income, the earnings from the teacher exchange program may be taxed in Australia under Article 15 of the Convention and will be included in the taxpayer's assessable income under section 6-5 or 6-10 of the ITAA 1997.

Your comments

42. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date:	**14 July 2004**
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Detailed contents list

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Commissioner of Taxation
2 June 2004

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2574; TR 92/20; TR 96/15; TR 2001/13

Subject references:

- double tax convention
- foreign employment
- foreign exempt income
- foreign source income
- overseas employment
- teachers

Legislative references:

- ITAA 1936 23AG
- ITAA 1936 23AG(1)
- ITAA 1936 23AG(2)
- ITAA 1936 23AG(2)(a)
- ITAA 1936 23AG(2)(b)
- ITAA 1936 23AG(2)(c)
- ITAA 1936 23AG(2)(d)
- ITAA 1936 23AG(2)(e)
- ITAA 1936 23AG(2)(f)
- ITAA 1936 23AG(2)(g)
- ITAA 1997 6-5
- ITAA 1997 6-10
- ITAA 1997 6-15
- ITAA 1997 6-20
- TAA 1953 Pt IVAAA
- International Tax Agreements Act 1953 4(1)
- International Tax Agreements Act 1953 4(2)
- International Tax Agreements Act 1953 6A
- International Tax Agreements Act 1953 6AA
- International Tax Agreements Act 1953 Sch 2 Article 3(2)
- International Tax Agreements Act 1953 Sch 2 Article 15
- International Tax Agreements Act 1953 Sch 2 Article 15(1)
- International Tax Agreements Act 1953 Sch 2 Article 15(2)
- International Tax Agreements Act 1953 Sch 2 Article 19
- International Tax Agreements Act 1953 Sch 2 Article 19(3)
- International Tax Agreements Act 1953 Sch 2A

Case references:

- Committee of Direction of Fruit Marketing v Australian Postal Commission (1980) 144 CLR 577
- Ex Parte Professional Engineer's Association (1959) 107 CLR 208
- Federated Amalgamated Government Railway and Tramway Service Association v The New South Wales Railway Traffic Employees Association (1906) 4 CLR 488
- SGH Ltd v FC of T (2002) 210 CLR 51
- South Australia v The Commonwealth (1942) 65 CLR 373

ATO references:

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