IT 2563 - Income tax : foreign tax credit system : issues relating to the practical application of section 23AG

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TAXATION RULING NO. IT 2563

INCOME TAX : FOREIGN TAX CREDIT SYSTEM : ISSUES RELATING TO THE PRACTICAL APPLICATION OF SECTION 23AG.

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OTHER RULINGS ON TOPIC: IT 2441, IT 2508

PREAMBLE Taxation Ruling No. IT 2441 deals with certain matters relating to the practical application of section 23AG of the Income Tax Assessment Act. That section, which applies in respect of income of the 1987/88 and subsequent income years, provides a full or partial exemption from Australian tax for foreign earnings derived by a resident individual taxpayer during a continuous period of foreign service exceeding 90 days where those earnings are not exempt from tax in the country in which the services are performed.

2. The purpose of this Ruling is to clarify other aspects of the practical application of section 23AG (as amended by section 13 of the Taxation Laws Amendment Act (No.2) 1988.) Specific aspects are dealt with in this Ruling under the following headings -

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RULING Change in residential status

3. The question has been raised whether section 23AG is capable of application where the residential status for Australian tax purposes of an individual taxpayer changes during a year of income from non-resident to resident and on or after that date the taxpayer receives foreign earnings in respect of a continuous period of foreign service performed whilst a non-resident. That question has been raised against the background of the well established principle that salary and wages income, whether for current or past services, is generally derived when received.

4. The taxpayer could not, in the circumstances described, normally claim that the foreign earnings qualify for exemption from Australian tax pursuant to paragraph 23(r) of the Assessment Act. Although the income is ex-Australian income, it is not derived by a non-resident. Nevertheless, while it is a requirement for the operation of section 23AG that the foreign earnings be derived whilst the individual is a resident for Australian taxation purposes, it is not also a requirement that the relevant foreign service be performed whilst the individual is a resident for those purposes. Accordingly, where in those circumstances the foreign earnings are subject to tax in the country in which the services were performed, exemption from Australian tax as provided under section 23AG may apply.

5. Where foreign earnings are derived (received) while the taxpayer is a non-resident, section 23AG is, of course, inapplicable, and the earnings would qualify for exemption from Australian tax under paragraph 23(r).

Exempted foreign earnings not to be aggregated with other foreign income for foreign tax credit purposes.

6. Taxation Ruling No. IT 2508, which deals with the aggregation of the various classes of income for foreign tax credit purposes, specifies that the worldwide basis for determining foreign tax credits requires that all foreign income of the same class, whether or not subject to foreign tax, be taken into account for those purposes. It is clear, however, from the terms of subsection 160AF(1), that the foreign income to be taken into account is only that which is included in the taxpayer's assessable income for Australian tax purposes. Taxation Ruling No. IT 2508 should be read as adjusted accordingly.

7. It follows that foreign earnings derived by a taxpayer in a year of income which is exempted from Australian tax under section 23AG, and the foreign tax paid in respect of those foreign earnings, are not to be taken into account in determining any foreign tax credit entitlements of the taxpayer with respect to a class of other foreign income derived by the taxpayer in the same year of income.

Continuous Period of Foreign Service

8. One of the key tests to be satisfied before foreign earnings may qualify for a full or partial exemption from Australian tax under section 23AG is that those earnings be derived during a continuous period of foreign service. Taxation Ruling No. IT 2441 deals with certain aspects of the practical application of that test. This Ruling deals principally with other circumstances, and distinguishes between certain breaks in foreign service that may be treated as forming part of that service and others that do not qualify for that treatment.

. Temporary absences forming part of a period of foreign service

9. Subsection 23AG(6) identifies certain temporary absences from a period of foreign service that are related to the foreign service, basically recreation leave wholly attributable to the period of foreign service (other than long service leave and leave without pay) and sick leave, that will not be taken to constitute a break in a period of foreign service. As this provision does not cover the gamut of temporary absences, representations have been received seeking clarification of when section 23AG will be treated as applicable in circumstances where there is a temporary break within a person's commenced foreign service engagement as a consequence of visiting Australia (or another country):

(a) in the course of carrying out duties under a continuing foreign service engagement (i.e. business trips);

(b) on weekends, public holidays, rostered days off, or other approved paid time off; or

(c) compassionate leave.

10. In each case such visits fall to be treated as temporary absences related to a period of foreign service and are to be dealt with as follows:

(a) Business Trips to Australia

Where an employee/office holder engaged in foreign service makes a short business trip to Australia or to another foreign country during a period of foreign service for reasons directly related to that person's continuing foreign service engagement, and made bona fide for that purpose, for example, to attend conferences, training sessions or briefing sessions, it is accepted that those trips should be treated

as part of the person's continuous period of foreign service provided they are not excessive by comparison with the scheduled period of foreign service;

(b) Weekends, public holidays etc.

A period of foreign service is taken to include weekends, public holidays, rostered days off and flexidays, and days off in lieu of such, provided such breaks are authorised by the terms and conditions of the foreign service employment or engagement. Any such breaks utilised to visit Australia or another foreign country do not break the continuity of service provided that there are no restrictions in the terms and conditions of employment or engagement prohibiting the employee or officer from leaving the country of foreign service on those occasions.

(c) Compassionate leave

Given that the absence of a person from foreign service due to an accident or illness is specifically treated as part of foreign service by reason of paragraph 23AG(6)(b), it is accepted that similar treatment would be appropriate in the case of compassionate leave granted for reason of an accident or illness of a person other than the taxpayer, or because of the death of another person. Accordingly, a short visit to Australia or another country for such a reason as permitted by the employer should be treated as forming part of the taxpayer's period of continuous foreign service. However, where compassionate leave is granted for other reasons it is considered that a break will have occurred in the continuous foreign service.

11. Similarly, where the foreign service employment or engagement is part time in nature, it will be accepted that visits to Australia or another foreign country would not constitute a break in continuous foreign service provided the visits etc., do not occur in times that attendance at work is required and there are no other restrictions in the foreign service engagement preventing such visits.

12. Each day of a visit to Australia or another country which, in accordance with subparagraphs (a), (b), or (c) of paragraph 10, or paragraph 11, is treated as forming part of a person's continuous period of foreign service would qualify to be taken into account in determining the person's "absentee credits" in relation to that period of foreign service pursuant to subsection 23AG(6B). Conversely, each day of a visit which is treated as constituting a break in a person's continuous period of foreign service would give rise to an "absentee debit" in accordance with subsection 23AG(6C). See further below concerning the operation of subsections 23AG(6B) and (6C).

. Temporary absences not forming part of a period of foreign service

13. Broadly speaking, subsections 23AG(6A) to (6E) allow in

certain circumstances for successive periods of foreign service which are broken by a period where the person is not engaged in foreign service - for example, when the person is between jobs in a foreign country or breaks a period of foreign service by, for example, taking long service leave or leave without pay or returns to Australia for reasons not directly related to his or her foreign service engagement - to be added together to constitute a single continuous period of foreign service. As indicated in subparagraph 10(c) above, periods of compassionate leave granted for reasons other than the death of, or serious accident or illness of a person other than the taxpayer, or other forms of special leave granted for miscellaneous brief absences, such as moving house, should be treated as subject to those provisions.

14. Those subsections were introduced by section 13 of the Taxation Laws Amendment Bill (No. 2) 1988. In broad terms, the subsections operate on the basis that provided a person is not absent from foreign service for such reasons for a period in excess of an "absentee credit balance" of days accrued during a continuous period of foreign service, the periods of foreign service either side of the period of absence will together constitute a continuous period of foreign service.

15. In other words, provided a person has an absentee credit balance, the continuity of the person's foreign service will not be broken even when there is an intervening period between engagement on a foreign job or jobs. Conversely, when a person ceases to have an absentee credit balance, continuity will be interrupted by such an intervening period and it will be necessary to consider whether part of the foreign earnings qualify for exemption pursuant to subsection 23AG(2). The purpose of the subsections is further explained in the Explanatory Memorandum to the enabling bill. This Ruling does not incorporate that explanation but sets out examples to illustrate the practical application of the subsections.

16. With respect to subsections 23AG(6A) to (6D), assume a resident taxpayer is engaged in foreign service for three successive continuous periods of foreign service as shown below:

FOREIGN SERVICE PERIOD	BREAK	SERVICE (DAYS)	BREAK (DAYS)
1		400	
	A		40
2		200	
	B		16
3		100	
	C		Indefinite

. Period 1

Subsection 23AG(6B) operates to accrue an absentee credit of 31/334 x 24 hours for each of the first 334 days. As there are no breaks in period 1, the absentee credit balance

(subsection 23AG(6A)) in whole days at the end of the 334th day will be 31 days. As the balance would exceed 31 if there were further credits, no credits will arise in respect of days 335 to 400. Thus, the balance at the end of the 400th day will be 31 days.

. Break A

Subsection 23AG(6C) operates to reduce the absentee credit balance of 31 days at the end of each whole day of the break by 1 day. Thus, after a break of 30 days (i.e., at the beginning of the 31st day) the balance will be 1 day. A further absentee debit of 24 hours will arise at the end of the 31st day resulting in an absentee credit balance of nil. As the balance is nil at the start of the 32nd day, paragraph 23AG(6C)(d) will operate to prevent an absentee debit of 24 hours arising for break days 32 to 40.

. Periods 2 and 3

At the commencement of period 2, paragraph 23AG(6D)(c) will operate to prevent periods 1 and 2 constituting a single continuous period of foreign service. Continuity is not achieved as the "absentee credit balance" at the beginning of break day 40, i.e., the day before the commencement of period 2, did not exceed nil. (Note that if break A was less than 32 days duration, continuity would have followed.)

. It should also be noted that once the absentee credit balance is reduced to nil, which is the position at the commencement of period 2, it is not necessary to have regard to all prior absentee credits and debits in calculating future balances. They are, in effect, reflected in the nil balance. The following results in respect of periods 2 and 3 are achieved:

		BALANCE (whole days)	CREDITS-DEBITS (hours)
(a)	Absentee credit at end of period 2	18	$\frac{(200 \times 31 \times 24)}{334}$
(b)	Absentee credit balance at the beginning of the day before commencement of period 3	3	$\frac{(200 \times 31 \times 24 - 15 \times 24)}{334}$
(c)	Absentee credit balance at the commencement of period 3	2	$\frac{(200 \times 31 \times 24 - 16 \times 24)}{334}$
(d)	Absentee credit balance at the end	11	$\frac{(300 \times 31 \times 24 - 16 \times 24)}{334}$

of period 3

(e) As (b) exceeds nil, periods 2 and 3 would constitute a single continuous period of foreign service.

17. The following further example illustrates the interaction of subsections 23AG(6D) and (6E). Assume that a resident taxpayer is engaged in foreign service for a period of 30 whole days and takes 27 hours leave without pay (LWOP) from 9 am on the 31st day to midday on the 32nd day. LWOP of 7 hours is subsequently taken from 9 am on the 95th day.

FOREIGN SERVICE PERIOD	BREAK	SERVICE DAYS	BREAK (HOURS)
1		30-3/8	
	A		27
2		62-7/8	
	B		7
3		Indefinite	

. Break A is not less than 24 hours and subsection 23AG(6E) will not apply. As Break A consists of two part days (as distinct from a "whole day" as defined in subsection 23AG(6J), subsections 23AG(6B) and (6C) will not operate and there will be no absentee credits or absentee debits arising in respect of either the 31st or 32nd days. The absentee credit balance at the commencement and conclusion of Break A will therefore remain at 2 days (30 x 31/334). The application of subsection 23AG(6D) will result in foreign service periods 1 and 2 constituting a continuous period during which the taxpayer was engaged in foreign service.

. At the end of period 2 (i.e., at 9 am on 95th day), the continuous period of foreign service will be 93 days and the absentee credit balance will be 8 whole days [92(i.e., 30 + 62) x 31/334]. As with the 31st and 32nd days, no absentee credits or debits will arise in respect of the 95th day, the day on which Break B of 7 hours occurs.

. As Break B is less than 24 hours, subsection 23AG(6E) will operate to make the first period (periods 1 and 2 by a previous application of subsection 23AG(6D)) and the second period (period 3) constitute one continuous period. The absentee credit balance at the commencement and conclusion of Break B will remain at 8 days and the next credit will accrue at the end of the 96th day at which time the foreign service period will be 94 7/12 days (93 1/4 + 1 1/3).

Meaning of "foreign earnings" and "foreign service"

18. An exemption afforded by subsections 23AG(l) or 23AG(2) applies only in respect of foreign earnings derived from a continuous period of foreign service. The term "foreign earnings" is defined in subsection 23AG(7) to mean income

consisting of earnings, salary, wages, commission, bonuses or allowances and "foreign service" to mean service in a foreign country as the holder of an office or in the capacity of an employee. The exemption is, of course, only applicable, by reason of subsection 23AG(3), in respect of such earnings that are not exempt from tax in the country of foreign service. Earnings from services performed in a country with which Australia has concluded a comprehensive taxation agreement that qualify for exemption from tax in the treaty partner country under the dependent personal services article of the relevant treaty, or earnings which are otherwise exempt from tax in the country in which the services were performed, do not therefore qualify for consideration under section 23AG.

19. Representations have been received seeking guidance on whether certain types of payments fall within the ambit of the definitions of "foreign earnings" and "foreign service". The position of these payments is discussed in the following paragraphs.

. Fees for independent personal services

20. While the term "foreign earnings" as defined may, on its own, be capable of being construed as sufficiently broad to include earnings derived from the provision of independent personal services by professional persons such as doctors, lawyers, architects and the like, such earnings fail to qualify for exemption under section 23AG because they are not rendered during the course of a period of "foreign service", i.e., as the holder of an office or in the capacity of an employee (see Case R45, 84ATC 369 and FC of T v White; FC of T v Griffin, 85ATC 4743). Accordingly, foreign earnings from the provision of independent personal services remain subject to the provisions of the general foreign tax credit system.

. Directors' fees

21. Directors may be classified as either executive directors or non-executive directors. The former are generally salaried employees as well as directors and may receive no separate fee for their activities as directors although their salary package may recognise such a role. In such a case there would be no doubt that the income in this situation would be "earnings, salary, wages," etc., derived as the holder of an office or in the capacity of an employee. Similarly, while fees paid to non-executive directors might not come within the ordinary meaning of salary or wages, such remuneration would nevertheless fall within the concept of "earnings" derived as the holder of an office.

22. However, in order for such earnings to qualify for exemption under section 23AG the requirement of derivation during a continuous period of "foreign service" must also be satisfied. This means that the director must perform his or her duties in a foreign country for at least 3 continuous months, with full exemption only applying after a continuous period of at least 12 months.

. Lump sum and other termination payments accrued solely in respect of foreign service

23. Lump sum termination payments, including any lump sum redundancy payments made because of early termination of an employment contract, and superannuation payments (provided the superannuation payment is paid by a foreign based superannuation fund, which would include a foreign branch of an Australian based fund), accrued solely from foreign service and subject to foreign tax, is treated as foreign earnings within the meaning of that expression in section 23AG. In this regard, the reference at page 24 of the Explanatory Memorandum to the Taxation Laws (Foreign Tax Credits) Bill 1986 to "pensions, annuities or superannuation payments" not qualifying as "foreign earnings" should be taken to encompass recurring or pension-type superannuation payments but not lump sum payments.

24. As with other "foreign earnings" which are exempted under section 23AG, such a termination payment paid to a person who is a resident of Australia for Australian tax purposes, or to a person who has become a resident of Australia for those purposes, will be subject to the "exemption with progression" provisions of subsection 23AG(4). Accordingly, the exempt income would be taken into account in determining the rate of tax on other income earned by the resident during the year of income in which the termination payment was made. This situation would apply in relation to such termination payments made while the person was a resident of Australia and irrespective of whether the termination payment was made in or outside Australia.

Supplements paid under the Australian Staffing Assistance Scheme - (ASAS) or similar arrangements.

25. Where the remuneration package of an Australian resident in respect of foreign service performed in a foreign country under the ASAS or a similar arrangement consists of a base salary paid and taxed in the foreign country, as well as a supplement paid in Australia and not subject to tax in the foreign country, the supplement (in common with the base salary) is considered to be derived from sources in the country where the service is performed (see FC of T v French (1957) 98 CLR 398). However, by reason of subsection 23AG(3), no part of the supplement is eligible for exemption from Australian tax under subsection 23AG(1) or 23AG(2) because it is an "amount" of foreign earnings that is not subject to tax in the country in which the services are performed.

26. In this regard, the view is taken that, for the purposes of section 23AG, the supplement is severable from the rest of the employee's remuneration package and only the base salary component of the package which is subject to foreign tax is to be taken into account in calculating the employee's exemption entitlement under section 23AG. It is considered that the circumstances and nature of these payments render them distinguishable from those composite payments that have been found in other cases to be non-severable.

Exemption with Progression

27. Some taxpayers who derive foreign earnings or other foreign income which is exempt from income tax under provisions other than section 23AG have asked whether this exempt income is to be treated as subject to "exemption with progression", and therefore taken into account in calculating the Australian tax on other income of the taxpayer.

28. This is true only with respect to remuneration derived by persons working overseas on approved projects, which qualifies in certain circumstances for exemption from Australian tax pursuant to section 23AF of the Assessment Act.

29. Subsection 23AF(17A), which contains such "exemption with progression" provisions, specifically applies only in respect of income which is exempt from tax under section 23AF. Likewise, the terms of the "exemption with progression" provisions of subsection 23AG(4) are specifically limited to foreign earnings that qualify for exemption under section 23AG.

30. Accordingly, pay and allowances of members of the Defence Forces serving in special areas overseas which are exempted by section 23AC, or income derived by persons serving overseas for international organisations which is exempt under regulations made under the International Organisations (Privileges and Immunities) Act 1963, for example, are not subject to "exemption with progression."

COMMISSIONER OF TAXATION
19 October 1989