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Abstract

The media in Australia clamours about reports that Google pays a very small tax bill on their income of several hundreds of millions of dollars. The perceived 'failure' of Australia's tax laws to capture income/gains that it was believed should have been taxed in Australia, has been much criticised. This article discusses the problems, which include inadequate domestic residence and source 'rules'; cross border domestic residence and source 'rules' mis-matches; and domestic courts' encountering in the domestic transfer pricing legislation.

Keywords

Australian, tax, laws, legislation, OECD guidelines

'... NOWHERE MAN SITTING IN HIS NOWHERE LAND':¹ THE CONTINUING SAGA OF CROSS BORDER ARBITRAGE

MICHAEL DIRKIS*

The media in Australia clamours about reports that Google pays a very small tax bill on their income of several hundreds of millions of dollars. The perceived 'failure' of Australia's tax laws to capture income/gains that it was believed should have been taxed in Australia, has been much criticised. This article discusses the problems, which include inadequate domestic residence and source 'rules'; cross border domestic residence and source 'rules' mis-matches; and domestic courts' encountering difficulties in applying OECD Guidelines in the context of aged domestic transfer pricing legislation.

INTRODUCTION

The media debate in Australia, concerning the perceived 'failure' of Australia's tax laws in capturing income/gains that it was believed should have been taxed in Australia, has been ongoing since late 2009. This debate involved reports that Google had only paid \$74,176 of company tax on revenue of \$201 million in 2011, despite earning an estimated total of \$1.1 billion² from advertising in Australia. Further, the inability of the Australian Taxation Office (ATO) to claw back \$628 million in tax and penalties levied on the profit arising from the 2009 sale by private equity investors of their 81 per cent stake in a retail group (Myer) to private investors offshore added to the debate.³

This has occurred at the same time that revenue authorities in other jurisdictions are facing similar hurdles. The Canada Revenue Agency is experiencing difficulties in successfully applying their domestic transfer pricing laws, as is the ATO in Australia.⁴ In India, during January 2012, the source rules in s 9(1) of the *Income*

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¹ The title is drawn from the lyrics of *Nowhere Man*, a song written by John Lennon.

² Stephen Bartos, 'Google spurs debate in an electronic age', *Australian Financial Review* (Sydney), 29 May 2012, 2.

³ Susannah Moran and Andrew Main, 'Tax office misses its share of \$2.3bn Myer float', *The Australian* (Sydney), 13 November 2009.

⁴ For example, the ongoing transfer pricing litigation in Canada in such cases as *GlaxoSmithKline Inc v The Queen* [2010] FCA 201 and *The Queen v General Electric Capital Canada Inc* [2010] FCA 344. In Australia the litigation was undertaken in *Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 639 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74. In SNF the Full Federal Court concluded that the Transactional Net Margin Method (TNMM) (and by extension any other profit-based transfer pricing method such as the profit split method) are not a valid methods of establishing an arm's length consideration for the purpose of Australia's transfer pricing rules.

Tax Act 1961 were found not to encompass indirect transfers of capital assets located in India.⁵ The response in Australia and India to these court decisions has been to enact retrospective domestic legislative change.⁶

These issues have arisen despite the G20 nations' renewed focus, since 2007, on countering international tax evasion.⁷ Australia, like other G20 nations, has devoted significant resources to international cooperation focusing on eliminating double taxation and countering fiscal evasion.⁸

The OECD's outputs in recent times have been significant. They include the adoption of a Revised Article 7 of the *2010 OECD Model Tax Convention on Income and on Capital* (OECD Model Convention),⁹ the development of 'model' transfer pricing legislation and explanatory notes¹⁰ and transfer pricing guidelines,¹¹ and the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*.¹² Despite these reforms, member states appear not to have addressed the inadequacy in their domestic laws.

The causes of tax arbitrage are well researched and known. In the incidences discussed above, the causes of these outcomes can be attributable to a combination of:

- inadequate domestic residence and source 'rules';

⁵ *Vodafone International Holdings v Union of India* (2012) 341 ITR 1. Also see Nishith Desai and Mahesh Kumar, 'India: The Vodafone Saga – An Analysis of the Indian Supreme Court's Decision' (2012) 66 *Bulletin for International Taxation* 366 and Terry Hayes, 'Source-based taxation: Vodafone wins in Indian Supreme Court - *Vodafone International Holdings BV v Union of India* [2012] *Weekly Tax Bulletin* [90].

⁶ *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No 1) 2012* (Cth) and Desai and Kumar, above n 5, 373. The *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No 1) 2012* (Cth) retrospectively amends the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) to ensure that the transfer pricing articles contained in Australia's tax treaties are able to be applied and operate to provide assessment authority independent of transfer pricing rules in Division 13 of *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) through explicit incorporation into the ITAA 1997; and to require the arm's length principle to be interpreted as consistently as possible with relevant OECD guidance material. These amendments apply to income years commencing on or after 1 July 2004.

⁷ For example, *Leaders' Statement, The Pittsburgh Summit, September 24–25 2009* (25 September 2009), U.S. Department of the Treasury, <http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf>.

⁸ Since 1919 Australia has had a continuing involvement in multilateral international forums dealing with tax matters. The then-dominions of Australia (represented by Mr GH Knibbs CMG (Commonwealth Statistician)), Canada, India, New Zealand and South Africa participated in a sub-committee of the United Kingdom's *Royal Commission on the Income Tax* to discuss their views on double taxation within the empire – see Commonwealth Royal Commission on Taxation, *Reports* (1920-24), 32; Edwin RA Seligman, *Double Taxation and International Fiscal Co-operation* (1928), 47-50; and United Kingdom Royal Commission on the Income Tax, *Report of the Royal Commission on the Income Tax* Cmd 615 (1920). Australia is currently a member of the OECD Committee on Fiscal Affairs (CFA), the five OECD Working Parties (Working Parties Nos 1, 2, 6, 9 and 10), OECD Industry consultation forums include the Business and Industry Advisory Committee to the OECD (BIAC) and Technical Advisory Groups (TAGs), OECD's Forum on Tax Administration (FTA), OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, and other non-OECD taxation administrator organisations, including: Leeds Castle group, Seven-country working group on tax havens, Study Group on Asian Tax Administration and Research (SGATAR), Commonwealth Association of Tax Administrators (CATA), Financial Action Task Force on Money Laundering (FATF) and Joint International Tax Shelter Information Centre (JITSIC).

⁹ *Model Tax Convention on Income and on Capital 2010* (OECD).

¹⁰ Secretariat, *Transfer Pricing Legislation – A Suggested Approach* (2011) Organisation for Economic Cooperation and Development <<http://www.oecd.org/ctp/transferpricing/45765682.pdf>>.

¹¹ Organisation for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (OECD, 2010).

¹² *Convention on Mutual Administrative Assistance in Tax Matters*, opened for signature 25 January 1988, CETS 127 (entered into force 1 April 1995); as amended by the Protocol amending the Convention on Mutual Administrative Assistance in Tax Matters, opened for signature 27 May 2010, CETS 208 (entered into force 1 June 2011).

- cross border domestic residence and source 'rules' mis-matches; and
- domestic courts' encountering difficulties in applying OECD Guidelines in the context of aged domestic transfer pricing legislation.¹³

By the use of two case studies, which deal with the 'nowhere man' issues that arise from the inadequacy of Australia's domestic residence rules and cross border domestic residence rule mis-matches, this article seeks to highlight that many of these cross border arbitrage issues are best resolved from a policy perspective through domestic law reform rather than through the use of tax treaties. Given the commonality in perceived problems in other jurisdictions, this work will inform debate around solutions that can be adopted in those jurisdictions.

Scenario 1

Actor, an Australian citizen, married a citizen of the United States and they have a child. Actor lived in the United States periodically but resided in Australia for the past three years. Actor decides, 28 days before the end of the calendar year, to make his permanent home the United States. During that 28 day window, Actor receives a significant distribution from a foundation located in Switzerland. The distribution consists of film royalties received under contracts made in Switzerland and interest income. The interest was earned from the investment by the foundation of those royalties in Swiss banks over the last 20 years. This income has not been subjected to tax in either the United States or Australia.

*Australian position*¹⁴

Australian residents are taxed on all the income they derive, regardless of its source, under ss 6-5 and 6-10 of *Income Tax Assessment Act 1997* (Cth) (ITAA 1997). However, if Actor is not a resident, he can only be taxed on the distribution if it has an Australian source.¹⁵

Under Australian common law the crucial factors in determining the source of a royalty are the location of the property¹⁶ and, in the absence of a property right, the place of where the contract, under which the rights give

¹³ There is some discussion by the Australia's Federal Court (see *Commissioner of Taxation v SNF (Australia) Pty Limited* [2011] FCAFC 74 and *Russell v Commissioner of Taxation* [2011] FCAFC 10) that there has been a shift by the High Court (Australia's superior court) in the interpretation of treaties. In *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338 the High Court made it clear that in interpreting treaties reference could be made to the OECD commentary on the Model Convention in appropriate circumstances. However, Dowsett J in *Russell* at [26] stated that *Thiel* and the Full Court in *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134 at [42] may no longer be the final word on the matter:

However both of those cases were decided prior to the decisions of the High Court in *Minister for Immigration and Multicultural and Indigenous Affairs v QAAH* (2006) 231 CLR 1 and *NBGM v Minister for Immigration and Multicultural Affairs* (2006) 221 CLR 52. In both cases the Court emphasized the primary position of the words used in Australian legislation and the Australian rules of statutory interpretation in construing legislation which gives effect to international obligations, including treaties.

That approach was reinforced by the High Court in its recent decision in *Minister for Home Affairs of the Commonwealth v Charles Zentai* [2012] HCA 28; (2012) 289 ALR 644. It is believed by many commentators that the interpretation of double tax agreements will be less influenced by the fact they are bilateral treaties, and that the role of the OECD Commentary on the Model Convention and its United Nations (UN) equivalent is likely to be reduced when it comes to interpretation (see John Balazs, 'Interpreting double tax agreements following a recent High Court decision' [2012] *Weekly Tax Bulletin* [1457]). The consequence of the shift is that a literal approach to interpretation of a tax treaty text is likely to be preferred to a purposive or intentional approach.

¹⁴ The description of the operation of the law is drawn from the author's earlier work: Michael Dirkis, *Is it Australia's? Residency and source analysed*, Research Study No 44, Australian Tax Research Foundation (2005) and Michael Dirkis, 'Chapter 10: Australia' in Guglielmo Maisto (ed), *Residence of Individuals under Tax Treaties and EC Law* (IBFD, 2010), 197-239.

¹⁵ ITAA 1997, ss 6-5 and 6-10.

rise to the income, was concluded.¹⁷ As the royalties were derived from contracts entered into in Switzerland, the source of the film royalties is likely to be Switzerland.

Under Australian common law there are a number of factors that indicate the source of interest income, including the place the contract was made, the place the money was lent, where a lender is incorporated and where the lender's business is carried on.¹⁸ The source of interest is determined by weighing all the above factors, with the factors surrounding the making of the loan carrying a heavier weighting. Thus, the place of contract is often crucial.¹⁹ As the interest was derived from funds deposited in a Swiss bank account, the place of contract is likely to be Switzerland and therefore the source of the interest income is likely to be Switzerland.

Therefore, as the distribution consists of film royalties and interest income which have been derived from sources outside Australia, Actor will only be taxed on it if he is an 'Australian resident'.²⁰ An 'Australian resident' is defined in s 995-1 of the ITAA 1997 as a person who is a resident under the *Income Tax Assessment Act 1936 Act* (Cth) (ITAA 1936). The definition of a resident individual is found in s 6(1) of ITAA 1936. It contains four distinct residency tests. The first is the primary or common law test, which classifies an individual as a resident if he or she can be said to be actually 'residing in Australia'.²¹ The three other tests, being:

- a domicile test;
- a significant presence test (ie, presence for more than half a year); and
- a Commonwealth superannuation test;

extend residency to individuals who may not reside in Australia in terms of the primary test.

Where an individual resides will depend upon their individual circumstances.²² The major factors, distilled from the case law, that are indicative of where an individual resides are:

- physical presence;
- term of any employment or appointment;
- nature of the person's family,
- business and social ties;
- frequency and regularity of a person's movements; and
- intention (purpose) of visit or trip.²³

As Actor no longer has a physical presence in Australia and his family ties, occupation and other criteria are in the United States, he no longer 'resides' in Australia.

¹⁶ *Curtis Brown Ltd (as agent for Stella Brown) v Jarvis* (1929) 14 TC 744 and *International Combustion Ltd v Inland Revenue Commissioner* (1932) 16 TC 532.

¹⁷ *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525; 2 AITR 458; 7 ATD 318.

¹⁸ *Spotless Services v Federal Commissioner of Taxation* (1993) 25 ATR 344, 359-60; 93 ATC 4397, 4410 (Lockhart J).

¹⁹ *Webb v Campbell* (1900) 25 VLR 506; *Studebaker Corporation of Australia Ltd v Federal Commissioner (NSW)* (1921) 1929 CLR 255; *R & McG 165* and *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* [1955] NZLR 868; (1954) 6 AITR 158; 10 ATD 435.

²⁰ ITAA 1997, ss 6-5 and 6-10.

²¹ If a person is in fact residing in Australia then, irrespective of his nationality, citizenship or domicile, he is to be treated as a resident for the purposes of the Act; see note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 9.

²² *Federal Commissioner of Taxation v Miller* (1946) 73 CLR 93.

²³ In two recent Administrative Appeal Tribunal (AAT) decisions (*Sneddon and Commissioner of Taxation* [2012] AATA 516 and *Iyengar and Commissioner of Taxation* [2011] AATA 856) the following eight factors were applied: physical presence in Australia; nationality; history of residence and movements; habits and 'mode of life'; frequency, regularity and duration of visits to Australia; purpose of visits to or absences from Australia; family and business ties with Australia compared to the foreign country concerned; and maintenance of a place of abode.

Under s 6(1)(a)(i) persons whose domicile is Australia are treated as residents regardless of any physical presence in Australia. Domicile is a general common law concept, received from the United Kingdom upon settlement, which has been modified in Australia by the *Domicile Act 1982* (Cth) (*Domicile Act*).²⁴ The *Domicile Act* moves away from using the concept of domicile based on legitimacy to domicile using the place of residence. Domicile is a legal relationship between a person and a country by which the person is able to invoke the country's laws as their own.²⁵ In other words, a person's domicile is his or her 'permanent' home rather than where he or she resides.

To establish domicile, the person must have residence in a country, and have the intention to reside there permanently or indefinitely. There must be a combination of both of these elements for domicile to exist.²⁶ A 'domicile of choice' is acquired in a country where a person voluntarily fixes their sole or chief residence in that country with the intention to continue to reside there indefinitely.²⁷ A person may only have one domicile at any time.

Arguably, Actor has abandoned his domicile as he has acquired a domicile of choice in the United States. Even if he is unable to establish he acquired a domicile of choice in the United States, a finding that a person is domiciled in Australia will not equate with residence under s 6(1)(a)(i), as the person may avoid residency if the person can prove that he or she has established a 'permanent place of abode' elsewhere.²⁸

The purpose for the introduction of this limitation was to ensure that persons who had abandoned their Australian residence would not continue to be treated as residents. Such a protection was crucial in 1929 as, in the absence of tax treaties, those persons would have been potentially subjected to double taxation in respect of the income earned in their new place of residence.²⁹

As the existence of a permanent place of abode limitation results in taxpayers escaping the domicile test, it is important to determine what constitutes a 'permanent place of abode'. Justice Fisher in *Applegate v Federal*

²⁴ The concept of domicile has its origins in the Roman Empire: Denzil Davies, *Booth: Residence, Domicile and UK Taxation* (LexisNexis Butterworths, 1995) 167. Domicile has a greater component of pure intention or emotional permanence than residency and is found in expressions such as 'Home is where the heart is' and 'Once an Englishman, always an Englishman': see Joseph Isenbergh, *International Taxation* (2003) Vol 1, [P6.3].

²⁵ *Henderson v Henderson* [1965] All ER 179.

²⁶ *Case 78* (1944) 11 CTBR. The common law interpretation of 'domicile' is very different to the civil law concept of domicile, which is akin to a 'place of habitual abode', similar to the United Kingdom's 'ordinary residence' concept: see Denis Sheridan, 'Residence in the United Kingdom: Observations on the Inland Revenue Consultative Document' (1988) 29 *European Taxation* 17, 20.

²⁷ *Domicile Act 1982* (Cth), s 10.

²⁸ An illustration is *AAT Case 4833* (1988) 20 ATR 3117; *Case W14 89* ATC 201. Here, an Australian born taxpayer who had left Australia for almost nine years, residing in Greece and the United States, was found to no longer be resident in Australia under s 6(1)(a)(i) domicile test. Although his domicile in Australia was conceded, the taxpayer was found to have permanent place of abode outside Australia. The AAT found that the '... applicant's intention to remain outside Australia for a prolonged and undefined duration, is fatal to his cause' (at 3120 and 204 respectively). Similar limitation glosses appear in residency tests in other jurisdictions, for example, Canada's 183 day test is not based upon mere presence, but rather a person 'sojourning' (*Income Tax Act (Can)* RSC C 1985, s 250). The operation of the limitation is illustrated by *R & L Food Distributors Ltd v Minister for National Revenue* [1977] CTC 2579; 77 DTC 411. Here, the shareholders of a company spent more than 183 working days in Canada during the year but returned to their permanent homes in the United States at night (except for only 6 to 7 nights during the year). The Tax Review Board found that this lifestyle did not amount to a presence (a sojourn) in Canada for a period of 183 days nor had they established temporary residence in Canada.

²⁹ Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10. The Explanatory Notes do not explicitly spell out the double tax concern, but major concerns about double taxation existed during this period: see Edwin RA Seligman, *Double Taxation and International Fiscal Cooperation* (Macmillan, 1928) 47-50.

*Commissioner of Taxation*³⁰ explained the scope of the words, in particular the significance of the word permanent, which he believed:

... is used to qualify the expression 'place of abode' ie the physical surroundings in which the person lives, and to describe that place. It does not necessarily direct attention to the taxpayer's state of mind in respect of that or any other place ...

To my mind the proper construction to place upon the phrase 'permanent place of abode' is that it is the taxpayer's fixed and habitual place of abode. It is his home, but not his permanent home. It connotes a more enduring relationship with the particular place of abode than that of a person who is ordinarily resident there or who has there his usual place of abode. Material factors for consideration will be the continuity or otherwise of the taxpayer's presence, the duration of his presence and the durability of his association with the particular place.³¹

Although the taxpayer's intention to return is a factor to be considered, the taxpayer's objective intention in respect of the place of abode is crucial in determining whether he or she has established a permanent place of abode — the stay must not be intended to be temporary or transitory.³² The fact that a taxpayer's appointment is for a fixed term is not crucial in determining if the taxpayer has a 'permanent place of abode' elsewhere, nor is a subsequent change in intention.³³

Actor would have established a permanent place of abode in the United States as he has established a home (his 'fixed and habitual place of abode') with his family in the United States.

Therefore, Actor is not taxable on the foundation's distribution in Australia.

United States position

Under the *Internal Revenue Code of 1986* (US), all citizens³⁴ of the United States, wherever resident, are liable for income tax on their worldwide income ('citizen test').³⁵ Similarly, 'resident aliens' are deemed to be residents

³⁰ *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899, 910-11; 79 ATC 4307, 4317.

³¹ Applegate, a solicitor, was asked by his firm to go to the New Hebrides (now Vanuatu) to establish a branch office and manage it. Applegate gave up the lease on his flat and moved with his family. Although his stay was for an unspecified time, he was forced by illness to return within two years. He claimed his foreign source income was exempt because he was a non-resident for tax purposes. Although the Full Federal Court held that he had retained his Australian domicile, they found that he had established a permanent place of abode elsewhere.

³² Ibid. In *AAT Case 12551* (1998) 37 ATR 1263; *Case 2/98 98 ATC 105* the AAT found that a physiotherapist who had been overseas from mid 1992 to mid-1997 was still a resident as she had not abandoned her domicile nor established a 'permanent place of abode' elsewhere. She had '... maintained her touring activities satisfying me that she had never lost the essential character of a tourist. She was ... a typical Australian tourist seeing the world and obtaining work experience.' (at 1267 and 108 respectively). In contrast in *Case [2002] AATA 670 re Wessling v Federal Commissioner of Taxation* (2002) 50 ATR 1187; 2002 ATC 2097 the AAT (BJ McCabe) found that the taxpayer, who took special leave from her job to accompany her husband on his three year contract of employment in Fiji, had made her home overseas with her three children, albeit for a limited time.

³³ See, eg, *Federal Commissioner of Taxation v Jenkins* (1982) 12 ATR 745; 82 ATC 4098 where a bank officer, appointed to the New Hebrides for three years, who returned home unexpectedly after 18 months, was found to have established a 'permanent place of abode' in the New Hebrides. See also *Case R92 84 ATC 615*; *Case 145 27 CTBR (NS) 1131* where an engineer returned earlier than expected to Australia after a project in the Philippines, predicted to last a minimum of three to four years, was completed in little over two years. See also the Commissioner's view on the decision in *Taxation Ruling IT 2221, Income Tax: Income Derived by Non-Resident from ex-Australian Source, Permanent Place of Abode*.

³⁴ A citizen is a person born or naturalised in the United States: Reg 1.1-1(c).

³⁵ *Internal Revenue Code of 1986*, 26 USC § 1.

and liable for taxes on a worldwide basis.³⁶ A 'resident alien' is an individual that has lawfully entered the United States as a permanent resident ('green card' test). Actor does not satisfy these tests.

Actor could be caught by the 'substantial presence' test. There are two tests. Actor fails the first test, which deems a taxpayer to be a resident if they are present in the United States for more than 183 days.³⁷ Actor also appears to fail the second test. Under this test a taxpayer is deemed to be resident if the taxpayer is present in the United States for more than a notional 183 days, calculated with reference to the days in the current year and the number of 'deemed' days in the preceding two years. The individual must be present for a minimum 31 days during the calendar year for the test to apply.³⁸ Therefore, Actor is not taxable on the foundation distribution in the United States.

Tax treaty

Under Article 4 of the Australia/United States tax treaty, Actor would only be a resident of Australia if he is considered a resident under the law of Australia. Similarly, Actor would only be a resident of the United States if he is a resident in the United States for purposes of its tax. As Actor is not a resident under the domestic law of either country, the treaty is of no assistance resolving double non-taxation. This is a consistent policy outcome as tax treaties are concerned in part with providing benefits of the treaty only to the persons covered by the treaty.

Thus, Actor is in effect a 'nowhere man'.

Scenario 2

State Government Employee is appointed to its Business and Event Promotion Office in Rome in 2002. She has resided in Rome for 10 years, having married an Italian citizen and given birth to two children. She was an only child and her parents are deceased. Thus, all her family and social ties are in Rome. Her principal source of income is her official salary paid by the Australian State Government.

Australian position

There are no statutory source rules in relation to income from personal service under the ITAA 1936 or ITAA 1997. Therefore, the principles applicable are derived from the common law. There are several factors that determine the source of personal exertion income, being the places of '... negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining payment.'³⁹ If there is nothing special about the contract or in the payment, then the all important factor is where the work is done.⁴⁰

A number of pre 1950's court decisions found that the source of the income was a jurisdiction other than the one in which the employee performed the services. In these cases the place of payment was crucial (due to the nature of the payments⁴¹ or the terms of the contract^{42, 43}).

³⁶ *Internal Revenue Code of 1986*, 26 USC § 7701(b)(1)(A)(i). However, unlike the citizen test these rules do not apply to estate or gift taxes, which are determined upon concepts akin to domicile: see Joseph Isenbergh, *International Taxation* (Thomson Reuters, 1st ed, 2000) 19.

³⁷ *Internal Revenue Code of 1986*, 26 USC § 7701(b).

³⁸ *Ibid* § 7701(b)(3)(A)(i).

³⁹ *Commissioner of Taxation (NSW) v Cam & Sons Ltd* (Jordon CJ) (1936) 36 SR (NSW) 544, 548; 4 ATD 32, 33 and see *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405; 7 AITR 76, 82; 11 ATD 288, 293 (Williams J). However, place of negotiating and obtaining the contract is a factor not in question in *French*.

⁴⁰ In *Commissioner of Taxation (NSW) v Cam & Sons Ltd* (1936) 36 SR (NSW) 544 the men were employed at shipside on the morning of sailing, spent the days fishing outside territorial waters and they were paid off immediately after the ship berthed after the voyage.

⁴¹ *Richard Teece v Commissioner of Taxation* [1914] R & McG, NSW Court of Review Decisions (1927), 19 (Murray DCJ) found that salary received while the taxpayer was on leave of absence for nine months in London was from sources in New

Despite these early cases, the courts have since found that the place where personal services are rendered (where the personal service takes place) is the determinative factor in finding source.⁴⁴ This approach to determining the source of dependent personal service income has traditionally been adopted by the Commonwealth Attorney General,⁴⁵ the ATO⁴⁶ and tax commentators.⁴⁷ Although there are exceptions,⁴⁸ on

South Wales as it '... is paid in consideration of services which the officer has rendered and will render in the future ... and ... he is still receiving ... income because it was the reward or the price of services rendered in the taxing country.' Cf *Robertson v Federal Commissioner of Taxation* (1937) 57 CLR 147; 1 AITR 152; 4 ATD 355, where a governing director of a Victorian company, who abroad for two years, had his salary treated as arising from sources outside Australia (due to the Commissioner incorrectly conceding its source was outside Australia): see *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405; 7 AITR 76, 79; 11 ATD 288, 290 (Dixon CJ)) and *Case 40* (1928) 2 DITBR 43, where a director on a trip to America, England and the Continent was able to show he was actively engaged in the day to day business affairs of the company, thus a proportional part of his salary was found to have a source outside Australia.

⁴² In *Hall v Federal Commissioner of Taxation* (1950) 5 AITR 450; 9 ATD 161, Herron J, in distinguishing the similar fact case of *Federal Commissioner of Taxation v Miller* (1946) 73 CLR 93; 8 ATD 146; 3 AITR 333 on the basis that it involved residency, found that a taxpayer employed as a fourth engineer by the United States Army and serving 5 months in Milne Bay in 1944-5 was taxable on the income as it was sourced in Australia. 'The source of the appellant's income was the contract under which the work was performed...It was the contract which entitled him to be paid the moneys, and not the place where the work was actually performed'. Herron J relied upon the English decisions of *Bennett v Marshall* (1938) 1 KB 591; 22 TC 73, *Colquhoun v Brooks* (1889) 14 AC 493 and *Foulsham v Pickles* (1925) AC 458. He concluded that the test for ascertaining the source of income is to look at the place where the income comes into the employee. Thus, the source was the place the contract was entered into, his home port, the place where his money was paid to his wife, the place where he was to be returned.

⁴³ One case was decided due to limitations on the scope of the taxing jurisdiction: see *Kingsford-Smith v Commissioner of Taxation* [1924] R & McG NSW Court of Review Decisions (1927), 111. The Court found that a salary earned by an Australian naval officer on Commonwealth naval vessel in New South Wales waters was not sourced in New South Wales as the vessel was a 'public vessel belonging to a friendly power' and therefore did not fall within the local jurisdiction (applying the principles in *Exchange v McFaddon* [1812] 7 Cranch 116).

⁴⁴ In *Diamond v Commissioner of Taxes (Qld)* [1941] Qld SR 218, 2 AITR 190, 6 ATD 111 the Supreme Court of Queensland held, implicitly (as the issue involved power to tax in Territorial waters), that part of income derived by a NSW resident ship pilot, who piloted foreign vessels down Australia's east coast (spending 16.9 percent of the journey within three miles of the Queensland coast), was derived in Queensland as that was where the services were performed. Also see *Commissioner of Taxation (NSW) v Cam & Sons Ltd*, (1936) 36 SR (NSW) 544, *Federal Commissioner of Taxation v French* (1957) 98 CLR 398; 11 ATD 288; 7 AITR 76 and *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 867, 871; 79 ATC 4256.

⁴⁵ In opinion 660 issued by RR Garran Secretary of the Attorney-General's Department on 20 October 1915, Garran stated that source salary income was where the services were preformed. Thus, an Australian marine superintendent supervising the construction of a steamship in England on behalf of his Australian company was found to have income source outside Australia, while employee of an English company in Australia has his income source in Australia. Patrick Brazil and Bevan Mitchell (eds), *Opinions of Attorneys-General of the Commonwealth of Australia Volume 2: 1914-23* (1988), 133.

⁴⁶ This view has existed from the time the 1936 Act was introduced (see John Vincent Ratcliffe, John York McGrath and JWR Hughes, *The Law of Income Tax (The Commonwealth)* (1938), 169. They cite the example of *Robertson v Federal Commissioner of Taxation* (1937) 57 CLR 147, 150; 1 AITR 152, 155; 4 ATD 355, 356 (Dixon J) who noted '... It does not appear to me to be altogether clear that the source of his remuneration during his absence was outside Australia, but for some reason it was admitted on behalf of the Commissioner that in respect of the income in question this condition of the Commonwealth exemption was satisfied'). Currently, Australian Taxation Office, *Taxation and the Internet: Second Report* (1999), [5.3.42], states that '[e]mployment is considered to be exercised in the place where the employee is physically present when performing the activities for which the employment income is paid'.

⁴⁷ John Peter Hannan, *A Treatise on the Principles of Income Taxation* (Simmons, 1946), 272 refers to the judgment of Evatt J in *Hillsdon Watts Ltd v Commissioner of Taxation (NSW)* (1937) 57 CLR 36, 54; 1 AITR 42, 53; 4 ATD 199, 210, who stated obiter '[i]n ascertaining the territorial sources of income derived from personal exertion, it is necessary to ascertain where the material efforts of the taxpayer were in fact exerted.' Similarly, Norman Bede Rydge, *Federal Income Tax Law* (Butterworths, 1921), 89 cites *In re Gunter* (1895) reported in *D'Arcy-Irvine Land and Income Tax Law of New South Wales* (1905), 429, where the Court of Review held the income was earned where the taxpayer worked, not where he was paid.

balance, the place where services are performed is a good starting point in determining source — but the place where services are performed is not a rule of law and not always determinative.⁴⁹

Therefore, under Australian source rules, the source of State Government Employee's income would be Italy.

As the income has a non Australian source, State Government Employee can only be taxed on it in Australia if she is an 'Australian resident'.⁵⁰ As Australia, unlike Canada,⁵¹ does not generally deem persons engaged in government service to be residents, the general resident tests described above need to apply.⁵² Although the common law does recognise that absence from Australia will not prevent a finding that an individual is a resident,⁵³ her lack of presence in Australia for 10 years when combined with the nature of her family ties, the place of her work and the other criteria makes it difficult to say that she was actually 'residing in Australia' in the context of the test contained in s 6(1)(a).

As she does not reside in Australia the appropriate test is the domicile test. Although this test was intended to place public officials located abroad in the same position as foreign public officials representing their governments in Australia,⁵⁴ it may no longer achieve this intended objective in light of the *Applegate* decision. As discussed above, under the domicile test, a finding that a person is domicile in Australia will not equate

⁴⁸ In *In re Taxpayer* (1929) 24 Tas LR 14 the Supreme Court of Tasmania found that although the salary was derived in Tasmania, the bonus paid had a Victorian source as it was a voluntary payment by a Victorian company and it did not arise or accrue and was not derived or received in Tasmania.

⁴⁹ In *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401, 408; 13 ATD 497, 502; 9 AITR 559, 568 (Taylor J) noted 'I do not feel compelled or persuaded by the decision of the Court in French's case to hold that in every case where work forms the consideration for wages or salary paid the source of the income constituted by the wages or salary is in the place where the work is done.'

⁵⁰ ITAA 1997, ss 6-5 and 6-10.

⁵¹ *Income Tax Act (Can)* RSC C 1985, s 250(1).

⁵² The s 6(1)(a)(iii) ITAA 1936 definition of resident of Australia does deem some Commonwealth public servants (the spouse and children under 16 years of such persons) of who are a member of 'named' superannuation schemes to be residents. It was originally introduced in 1939 to bring within the Australian taxable field the salaries paid to locally engaged High Commission staff, who had recently been extended the benefits of the Commonwealth superannuation scheme (Commonwealth, *Parliamentary Debates*, House of Representatives, 21 September 1939, 964 (Sir Percy Spender, Assistant Treasurer)). However the rule does not extend to the vast majority of other Commonwealth, State and Local Government employees, including military personnel and diplomatic staff (including locally engaged staff), who are not covered by these schemes.

⁵³ This is illustrated by the Scottish mariner's cases where the seamen were found to be 'ordinary residents' despite being at sea for the greater part of the year (*In Re Young* (1875) 1 TC 57) or the entire year (*Rogers v Inland Revenue Commissioners* (1879) 1 TC 225) and only returning home between voyages. Also see Case [2002] AATA 610 re *Joachim and Federal Commissioner of Taxation* (2002) 50 ATR 1072; 2002 ATC 2089) where the taxpayer, who was a permanent resident of Australia, spent 316 days during the year of income as a first Officer on a Sri Lankan flagged ship. Senior Member MD Allen found that as he maintained a home for his wife and children in Australia he was a resident of Australia. These consistent decisions are explained by the statement of Rowlatt J in *Pickles v Fulsham* (1923) 9 TC 261 at 275 that 'a sailor resides at the port where his wife and children live'.

Further, in *Slater v Commissioner of Taxes* [1949] NZLR 678; 4 AITR 249; 9 ATD 1 a medical practitioner, held as a prisoner of war between 1940 and 1944, was found to be 'ordinarily resident' in New Zealand as his home was always in New Zealand, his family had been maintained there during his absence and he had not been resident elsewhere. Northcroft J stated that he was no more than a sojourner and, although he had continued presence in prisoner of war camps, he could not said to be resident in the camps (683-4, 253 and 4 respectively).

⁵⁴ Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10. The Government had identified that the High Commissioner for Australia in London did not pay tax in Australia as services were rendered outside Australia; they were exempt from British income tax and received the general exemption available to residents on their Australian source income. A J Baldwin and J A L Gunn, *The Income Tax Laws of Australia* (1937) 61, in 1937 note that, '... since 1930 High Commissioners for Australia and Agents-General for the Australian States, together with members of their staffs and other public officials who are located abroad, have been treated as residents of Australia.'

with residence if a person can prove that he or she has established a permanent place of abode elsewhere. The scope of this limitation has been expanded by the decision in *Applegate*.⁵⁵

Italian position

Under Art 2, paragraph 2 of Legislative Decree No 917/1986, an individual who, for most of the tax period, is in the General Register of the resident population, or who has their domicile or residence in Italy within the meaning of Art 43 of the Civil Code (Italy), is a fiscal resident of Italy for tax purposes and their worldwide income is taxable. The words ‘most of the tax period’ imply that a person must be present in Italian territory for more than 183 days in the year.⁵⁶ Domicile under Art 43 arises where the individual has set the centre of her business and interests, while residence is determined on the location of an individual’s habitual dwelling.

As State Government Employee has her ‘habitual dwelling’ in Italy and has been present in Italy for more than 183 days, she is a fiscal resident of Italy.

Treaty impact

The Australia/Italy tax treaty would apply in this case, as under Article 4(1)(b), State Government Employee is a resident of Italy for the purposes of Italian tax. However, Article 19(1) of the Australia/Italy tax treaty allocates the taxing rights, in respect of government (federal, state and local) service payments made to individuals, to the country making the payments (provided the employee is a national of the country and did not become a resident of that country solely for the purposes of rendering services). As State Government Employee is an Australian citizen and is rendering services to the State Government, the income will be only taxable in Australia.⁵⁷ This is a consistent policy outcome, as tax treaties are concerned in part with ensuring that there is no double taxation of Government employees who may become resident of another state.

In summary, as State Government Employee, having an Australian domicile, has established an abode in Italy that is not a temporary or transitory abode, she is not a resident under Australian tax law.⁵⁸ As the income is sourced where it is earned,⁵⁹ and as non-residents are only taxable under s 6-1 of the ITAA 1997 on income with an Australian source, State Government Employee would escape Australian tax. She also escapes Italian tax due to the operation of Article 19 of the Australia/Italy tax treaty. Therefore, State Government Employee is in effect a ‘nowhere man’.

A similar outcome could arise if State Government Employee was located in the United States. She still would not be a resident of Australia but is a resident for United States tax purposes as she satisfies the ‘substantial presence’ test.⁶⁰ The Australia/United States tax treaty applies, as under Article 4(1)(b)(ii) she is a United States resident. Again, under Article 19, each country gives up the right to impose income tax on wages, paid to a citizen of the other contracting state, for personal services performed in their jurisdiction, provided the services performed relate to governmental functions. Thus, State Government Employee would be exempt from income tax on her personal service income derived in the United States. This is confirmed domestically under the

⁵⁵ *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899, 910-11; 79 ATC 4307, 4317.

⁵⁶ Stefano Dorigo, ‘Chapter 16: Italy’ in Guglielmo Maisto (ed), *Residence of Individuals under Tax Treaties and EC Law* (IBFD, 2010) 406.

⁵⁷ See Taxation Ruling TR 2005/8: *Income tax: the meaning of particular terms in the Government Service Articles of Australia’s tax treaties*.

⁵⁸ *Ibid.*

⁵⁹ *Federal Commissioner of Taxation v French* (1957) 7 ATR 76, 86; 98 CLR 398, 415; 11 ATD 288, 296 (Williams J): ‘... the real source of the income in any practical sense must be the place where this personal exertion takes place.’

⁶⁰ *Internal Revenue Code of 1986*, 26 USC § 7701(b).

Internal Revenue Code of 1986.⁶¹ State Government Employee would also be a 'nowhere (wo)man' in this context.

Possible resolution

In Scenario 1 the tax arbitrage is created by the domestic law of both countries using very different criteria for assigning liability to worldwide taxation. In Scenario 2 the tax arbitrage arises from a deficiency in Australia's domestic law.

The Scenario 1 problem could be resolved in a number of ways. First, the 'permanent place of abode' limitation in the domicile test could be amended to restore its original intent by expressly overriding *Applegate*. This would be a difficult drafting exercise.

A second solution may be to remove such words on limitation and rely on the tie breaker rules in comprehensive bilateral tax treaties to resolve double taxation issues. The risk with this approach is that it will give rise to potential double taxation where an individual is found to be both a resident of Australia and a resident of a non-treaty country.⁶²

The third alternative solution may be to adopt a domestic limitation that Australian residents cannot relinquish residence status until they have established residence status in another country. This change would have the effect of meeting the original jurisdictional claim and reduce the scope for manipulation.

For Scenario 2, the solutions are similar to those discussed in respect of Scenario 1. The first option would be to change the Australian law to restore the original intent of the 'permanent place of abode' limitation. In this context this is easily done by deeming all Government employees to be residents. The second option is to remove the 'permanent place of abode' limitation leaving double taxation issues resolved through the tie breaker rules in comprehensive bilateral tax treaties.

The change that best meets the 'essential objective' of the prevention of tax avoidance within the intended jurisdictional framework is probably the removal of the words of limitation in the domicile test.

Conclusion

In summary, the article illustrates by the use of the two 'nowhere man' case studies that double non-taxation can occur in the Australian context due to the inadequacy of domestic residence rules and cross border domestic residence rule mis-matches. The solution to these problems appears to be reform of domestic laws, not treaties.

However, despite these issues being known for many years, recent Australian governmental reviews, such as the 1999 broad inquiry into Australia's business tax regime by the Review of Business Taxation,⁶³ the 2002 Treasury *Review of International Taxation Arrangements*,⁶⁴ and the 2010 Australia's Future Tax System Review⁶⁵ have not focused on a comprehensive review of the key jurisdictional boundaries of the Australian tax system,

⁶¹ Under the *Internal Revenue Code of 1986*, 26 USC § 893 such income is exempt provided the employee is not an US citizen, the services performed are of a character similar to those performed by US employees in the foreign country, that country must grant a similar exemption for US employees and that the government body is not a commercial entity.

⁶² In *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82, 86; 78 ATC 4486 that taxpayer was a Greek national, who had in August 1968 received assisted migrant passage to Australia, married and resided in Australia for 11 years, but was on the staff of the Sydney Greek Press & Information Service (Greek government agency). The taxpayer was held by the Federal Court to be a resident deriving a salary from an Australian source. The taxpayer was also taxable in Greece as she was under Greek law domicile in Greece. In the absence of a treaty there was no scope for relief from double taxation.

⁶³ Commonwealth of Australia, *Review of Business Taxation; A Tax System Redesigned* (1999).

⁶⁴ Treasury, *Review of International Taxation Arrangements: Consultation Paper* (2002) (the Consultation Paper).

⁶⁵ Australian Government (Ken Henry (Chair)), *Australia's future tax system: Report to the Treasurer* (2 May 2010) (commonly called the Henry Report).

residency and source. The 'nowhere man' issues will only be resolved by a fundamental reevaluation of Australia's jurisdictional taxation claim, rather than the adoption of piecemeal solutions that merely fiddle at the edges.⁶⁶

⁶⁶ Alice Abreu, 'The difference between expatriates and Mrs Gregory - Citizenship can matter' (1995) *Tax Notes International* 1613, 1615: '[i]t would be nice if we could stop reacting to problems in the tax system by attempting to design new and improved Band-Aids and could turn instead to a comprehensive examination of the structural features of the system that cause the problem to arise in the first place.'
