

TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

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The 2019 Harding case received a lot of media attention. And put the spot light onto our highly contentious tax residency rules for individuals – again.

The 2019 Harding Case

The latest big court case around our individual residency rules is the 2019 Harding case. We asked Andrew Henshaw of Velocity Legal in Sydney what this was about.

Here is what we learned but please listen to the episode itself since Andrew explains this much better than we ever could.

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Different

Having a new court case about our individual tax residency rules is nothing new. So in that respect the 2019 Harding case does not stand out. The courts have seen a long parade of residency disputes over the years.

The 2019 Harding case is different though in three ways. The case received an enormous amount of media attention. That is quite unusual for a tax case.

Most tax disputes stay at the Administrative Appeals Tribunal level and maybe make it to the Federal Court. But the Harding case went all the way to the Full Federal Court and is now on its way to the High Court.

And the case also changed one important concept in our tax residency rules. A permanent place of abode no longer needs to be a certain dwelling. It can also be a city or country. This sounds like a minor detail but can make all the difference in a residency dispute.

So in these three ways the Harding 2019 case is different. But before we talk more about this case, let's look at our general tax residency rules and the court cases that came before Harding in 2019. This will place the Harding 2019 case in a better context.

No Change So Far

The individual tax residency rules have been a point of contention for many years. There have been many calls for change. The Board of Taxation submitted its review of these rules to Treasury close to 2 years ago but at least to outsiders not much seems to have happened.

But the courts are busy as ever dealing with the shortcomings of our tax residency rules – bearing the brunt of what our legislators seem unable to fix.

Two Doors

Australia's tax system has two doors in – tax residency and source. If you fit through neither of these, the Australian tax system won't be able to tax you.

Tax residency is the larger of these two doors. If you fit through this one, you are in with everything you have and earn.

If you don't fit through the tax residency door, there is a second much smaller door – the source of any income you might derive. You won't fit through this door, but some income you derived in Australia might. If it does, it is taxed in Australia.

Tax Implications

Your tax residency will have tax implications. It will affect what income – including capital gains – is assessable income in Australia at what rates with what concessions. And it will also affect to what extent the CFC rules apply to you.

Assessable Income

As an Australian tax resident you are assessed on your worldwide income – be it Australian or foreign sourced income. As a foreign resident you are only assessed on income derived in Australia.

Tax Rates

As a tax resident you receive a tax-free threshold plus a low marginal tax rate of 19% up to a certain amount. As a non-resident you don't receive that. Different – higher – tax rates apply to non-residents.

As a tax resident any interest is assessed at marginal tax rates. As a non-resident there is a 10% withholding tax on any interest, but subject to a Double Taxation Agreement that might apply.

CGT

As a tax resident you are assessed on any capital gains from your worldwide assets for capital gains tax (CGT) purposes. As a non-resident CGT only applies to taxable Australian property (TAP), so property in Australia.

As a tax resident you receive a 50% CGT discount and the main residence CGT exemption. As a non-resident you don't.

Since 8 May 2012 the 50% CGT discount no longer applies to non-residents. And since 1 July 2016 there is a CGT withholding regime. Whether the main resident CGT exemption no longer applies to non-residents from 8 May 2017 onwards is still in the air.

CFC

As a tax resident the Controlled Foreign Company (CFC) and trust rules apply to you. As a non-resident they don't.

Becoming a Resident

When you become a resident, section 855-45 ITAA97 determines what happens to your assets at that moment.

You are deemed to have acquired your assets at market value the moment you become a resident. So the first element of the cost base and reduced cost base of the asset is the market value at that time.

However, this obviously does not apply to pre-CGT assets. Nor does it apply to taxable Australian property (TAP) since TAP was already a CGT asset right from the start when you acquired it. And it also doesn't apply to CFCs since they live under different rules.

Ceasing To be a Resident

When you cease to be a resident, section 104-160 ITAA97 determines what happens to your assets.

When an individual or company ceases to be a resident, CGT event I1 occurs. For a trust it is CGT event I2.

The moment you cease to be a tax resident, you are deemed to dispose of assets you own just before the CGT event at market value.

As when you became a tax resident, this does neither apply to pre-CGT assets nor to taxable Australian property.

However, there is one exception per subsection 104-165(2) ITAA97. You have the option to deem an asset as taxable Australian property even though it isn't. This way the asset stays within the Australian CGT net. And you can disregard the capital gain or loss that would otherwise arise under CGT event I1 or I2.

Four Tests

To determine whether you are a tax resident or not, you apply four tests. If you pass one of these four tests, you are a tax resident of Australia.

Test # 1 Resides Test

Test # 2 Permanent Place of Abode Test (also called Domicile Test)

Test # 3 183-Day Test

Test # 4 Commonwealth Superannuation Fund Test.

1 Resides Test

You are a tax resident if you 'reside' in Australia according to 'ordinary concepts'.

Subsection 6 (1) ITAA 1936 (Cth) talks of

...a person, other than a company, who 'resides' in Australia...

'Reside' means 'to dwell permanently or for a considerable time, to have one's settled or usual abode, or to live in or at a particular place'.

The definition can be wide. It is a question of fact and degree – 'quality of presence and time' and 'strong family ties' – and habits. The courts are looking for a break in habits at the time of the alleged change in residency.

Levene v IR Commrs [1928] AC 217, 222 looked at the meaning of 'reside' and decided that it follows its ordinary meaning.

Reid v The Commissioner of IR (1926) 10 TC 673 decided that a person may be a resident in more than one place.

And in *Federal Commissioner of Taxation v Miller (1946) 73 CLR 93* there had been a similar mode of life before and after the alleged change in residence, so the court decided that there had been no change in residency. So

from that point forward the courts have been looking for a break in habits.

2 Permanent Place of Abode Test

You are a tax resident if your domicile is in Australia unless you have a permanent place of abode outside of Australia.

In *Federal Commissioner of Taxation v Applegate (1979) 79 ATC 4307* the court decided that a permanent place of abode is a 'fixed and habitual place of abode, which is contrasted with a temporary or transitory place of abode'.

In *Federal Commissioner of Taxation v Jenkins (1982) 82 ATC 4098* the court decided that a stay outside of Australia by a person for a fixed period may still be considered 'permanent' despite the fact that the limits of the stay are fixed and ascertainable.

In *Harding v Federal Commissioner of Taxation [2019] FCAFC 29* the court decided that the individual must have an intention that a place of abode be the permanent place where they live while staying in that particular locality.

And they also decided – and this is important – that a 'permanent place of abode' can be broader than a specific dwelling (e.g. fully-furnished apartment). It can also be a city or country.

3 183- Day Test

You are a tax resident in Australia if you are physically present in Australia (continuously or intermittently) during more than one-half of the year of income unless the Commissioner is satisfied that the person's usual place of abode is outside Australia AND that the person does not intend to take up residence in Australia.

More than half of 265 days is 183 days, hence its name. However, if you are in Australia for less than 183 days, this doesn't mean that you are automatically a non-resident. You might still be a resident under the Resides or Permanent Place of Abode test.

4 Commonwealth Superannuation Fund Test

You are a tax resident of Australia if you are a member of the Public Sector Superannuation Scheme (PSS), an eligible employee for the purposes of the Commonwealth Superannuation Scheme (CSS) or the spouse or child under 16 of a person in one of those schemes.

This test has very limited relevance going forward, since the CSS closed to new members from 1 July 1990 and the PSS closed to new members from 1 July 2005 onwards. So this test will literally 'die out' with time.

Critical Factors

There are four tests but the two most relevant and most disputed ones are the resides test and the permanent place of abode test (also called the domicile test). And these were also the tests in dispute for Mr Harding.

To establish whether you pass one or the other or neither, there are the following critical factors to consider.

Days Spent

How many days did you spend in Australia? Length and frequency? What was your duration and continuity of presence in the overseas country?

Family

Did your spouse and dependent children stay in Australia? Do you have family ties in the overseas country? Where do your children go to school or uni?

Living Arrangements

Where do you stay when in Australia? Is it a temporary (like a hotel room) or permanent (like your family home) type of dwelling? Do you have a residence or place of abode in Australia or did you give that up?

Why do you come back to Australia when you visit? What is the purpose of presence in Australia?

Do you have a home or permanent place of abode outside of Australia? The nature of 'place' widened in *Harding v FCT* and no longer needs to be just a dwelling, but can be a city or country.

Assets

What personal or business assets do you have in Australia and overseas?

Business / Employment

Do you have a business in Australia or overseas? Are you employed in Australia or overseas?

Durability of Association

Do you maintain bank accounts in Australia? Do you have a Medicare card? Are you enrolled on the electoral roll? What are your social ties in Australia?

What is your association with the overseas country? Do you maintain bank accounts over there? Health insurance? Social ties?

Before The Harding Case

Before Mr Harding went to court again in 2019, there had been a number of relevant court cases that we should take into account.

Shord [2015]

In *Shord v Commissioner of Taxation [2015] AATA 355* the court looked at both the resides test as well as the domicile/permanent place of abode test.

Mr Short lost the case on both counts. The court held that Mr. Shord 'resided' in Australia according to 'ordinary concepts' – so Mr Shord lost the first test. And the court also held that Mr. Shord's 'domicile' was in Australia without a permanent place of abode outside of Australia – so he lost the second test as well.

So although Mr Shord spent less than 183 days in Australia, the court found that Mr Shord was a resident of Australia for tax purposes, both through the resides and the domicile test, due to his substantial ties to Australia and little ties outside of Australia apart from employment.

Engineering Manager [2014]

The Engineering Manager v Federal Commissioner of Taxation [2014] AATA 969

The Federal Court held that Mr M did not reside in Australia within the ordinary meaning of the term (1st test). And the court also found based on the facts, Mr M had indeed a permanent place of abode outside of Australia in Oman due a permanent house and significant ties in Oman (2nd test). Family ties to Australia were negated by being estranged from his wife.

So on this basis Mr M was not a resident of Australia for tax purposes, although his wife and children lived in Australia.

Dempsey [2014]

In *Dempsey v Commissioner of Taxation [2014] AAT 335* the dispute again rested on the resides and domicile test.

Mr Dempsey had spent less than 30 days per year in Australia during the period contested. Mr Dempsey had a vacant property and children in Australia but no wife.

The Federal Court held that Mr Dempsey did not reside in Australia within the ordinary meaning of the term (1st test), but that his domicile was in Australia. However, the court accepted that Mr Dempsey had a permanent place of abode outside of Australia in Saudi Arabia (2nd test).

So on this basis the court found that Mr Dempsey was not a resident of Australia for tax purposes.

Harding [2018]

So this is the Harding [2018] case, not the 2019 case. Mr Harding lost the 2018 case in *Harding v Commissioner of Taxation [2018] FCA 837*

The court considered both the resides and domicile test again and found that Mr Harding did indeed not reside in Australia. So Mr Harding won the 1st test.

But the court held that Mr Harding's 'domicile' was in Australia without a permanent place of abode outside of Australia, since his accommodation in Bahrain was only temporary – fully furnished lease and not designed for family living – and not a permanent place to stay. So Mr Harding was a tax resident of Australia based on this decision.

But then both Mr Harding and the ATO appealed this case and it went to the Full Federal Court (FFC). And so this – finally – takes us to the Harding 2019 case.

Harding 2019 Case

In *Harding v Commissioner of Taxation [2019] FCAFC 29* the Full Federal Court (FFC) had to decide again whether Mr Harding passed the reside or domicile test.

The central question was whether Mr Harding's temporary accommodation in Bahrain could count as a permanent place of abode. In Harding [2018] the Federal Court had decided that it couldn't. In 2019 the Full Federal Court decided that it could since a permanent place of abode did not have to be a dwelling – that was temporary – but could also be a city or country. Mr Harding was not permanently residing in his apartment – he moved a few times – but he was permanently residing in Bahrain, hence he had a permanent place of abode.

The Full Federal Court confirmed the Federal Court's decision that Mr Harding did not reside in Australia in the ordinary meaning of the term.

So on this basis Mr Harding was not an Australian tax resident since he had a permanent place of abode outside of Australia and did not reside in Australia.

Proposed Changes

The Board of Taxation released its Consultation Guide for Review of the Income Tax Residency Rules for Individuals in September 2018. Here is a rough overview of what they propose.

Primary Test

The Board suggests a primary bright-line test based on time spent in Australia. This day count would automatically determine the residency status of the majority of individuals.

The actual threshold would depend on whether the person had previously been a resident or not. There would be a different threshold for Australians working overseas.

All up the adhesive principle should be that it is harder to cease than establish individual tax residency.

Secondary Test

The Board suggests to implement a secondary test that is closer to what we currently have. Residency would be determined based on the level of connection to Australia.

Factors to consider would be time spent in Australia, immigration status, family, Australian accommodation and economic ties.

So most individuals would be assessed under the primary test, but there is the possibility to look at the quality of ties to Australia through the secondary test.

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