In the matter of tax exemption under section 23AA
of the *Income Tax Assessment Act 1936*
of the Commonwealth of Australia

I. Scope of Declaration and Instructions

1. I have been asked by former counsel Miss Kathryn Magan, Attorney at Law, and current counsel Miss Tiffany Hunt, Attorney at Law, to prepare a declaration as an Australian tax lawyer for the assistance of the Honourable United States Court as to the operation under Australian law of section 23AA of the *Income Tax Assessment Act 1936* of the Commonwealth of Australia and whether the exemption is extended or limited in any way by the Double Tax Convention between the United States and Australia.

II. Facts and Documents

2. The facts and documents on which I have relied in preparing this declaration are those set out in Annexures A-J:

    (1) **Annexure A** – Author's background and experience;

    (2) **Annexure B** – Relevant defence agreements between the Commonwealth of Australia and United States of America;

    (3) **Annexure C** – Relevant legislative extracts from United States *Internal Revenue Code;*

    (4) **Annexure D** – Relevant Australian income tax legislation;

    (5) **Annexure E** – Double Tax Conventions between the USA and Australia;

    (6) **Annexure F** – Legislative history of section 23AA;

    (7) **Annexure G** – copy of IRS letter Advice No 201313023;

    (8) **Annexure H** – Relevant Australian High Court case law interpreting "not exempt from tax" in another country - *Mutual Life and Citizens' Case*;

    (9) **Annexure I** – old Australian Tax Office guidelines on Articles 9/X of defence agreements; and

    (10) **Annexure J** – specimen "Closing Agreement" between United States Internal Revenue Service and US person employed at the Joint Defence Space Research Facility, Pine Gap, Australia.

3. In preparing this report, I have included in the Annexures, for completeness, much of the history of the background to the exemption, even though neither legally controlling nor even necessarily admissible in interpreting the key phrase "not exempt from tax" in section 23AA. These extraneous materials neither contradict the normal legal interpretation of section 23AA nor show that Parliament legislated for a mistaken understanding. Even if they did, Parliament's legislative words must prevail over what the treaty negotiators or tax administrators may – or may not - have intended.

III. Acknowledgment of My Duty

4. I understand that my paramount duty is to give unbiased opinions on matters within my expertise. This duty overrides any obligation to the person from whom I receive instruction or by whom I am paid.

5. I confirm that I have made clear which facts and matters referred to in this Declaration are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

6. This Declaration is prepared for the purposes of assisting the Court. Its contents may not be cited disseminated or used for any other purposes without express written permission of the author.

7. Prior to being engaged in this matter, neither I nor my law firm has ever represented any U.S. person on this matter in a United States lawsuit.

8. My professional fee for preparing this report and opinion was $12,500 Australian dollars.

9. I am, of course, perfectly willing to be examined on oath as to the contents of this report.

IV. List of Publication Authored in the Previous 10 Years

1. Dwyer, Dr Terry (2010) *'Purposive' interpretation of taxing statutes – a critical comment* **Australian Tax Review** Vol 39, No 1, February, pp 61-64, ISSN 0311-094X

2. Professor Terry Dwyer (2010) *Submission Re Urban Water Policy* Submission 57to Productivity Commiussion Inquiry into Australia's Urban Water, 24 November

3. Dwyer, Dr Terry (2011) *Monopoly Unleashed - Submission to Productivity Commission Inquiry into Urban Water Sector* 17 May 2011

4. Dwyer, Terry (2012) *Monopoly Pricing and Rent Seeking,* Submission 109 to Senate Select Committee on Electricity Prices, 25 October https://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=electricityprices_ctte/electricityprices/submissions.htm

5. Dwyer, Terry (2012) *Patents: An Immoral and Inefficient Anachronism* Productivity Commission, Submission 001, July 17, https://www.pc.gov.au/inquiries/completed/patents/submissions/submissions-test/submission-counter/sub01-patents.pdf

6. Dwyer, Terry (2012) *International Estate Planning* in **Offshore Investment** Issue 227, 30 June, https://www.offshoreinvestment.com/pages/index.asp?title=Search_Articles&searchtext=Terry%20Dwyer,%20Dwyer%20Lawyers,%20Canberra,%20Australia

7. Dwyer, Terry (2013) *Trash or Treasure?* Review of Nicholas Shaxson "Treasure

Island: Tax Havens and The Men who Stole the World **Offshore Investment** April

8. Dwyer, Terry (2014) *Inquiry into Tax Disputes Submission 006 - Civil Liberties Australia*, Submission to House of Representatives Standing Committee on Tax and Revenue, Submission prepared for Civil Liberties Australia, July 14 at https://www.aph.gov.au/Parliamentary_Business/Committees/House/Tax_and_Revenue/Inquiry_into_Tax_Disputes/Submissions?main_0_content_1_RadGrid1ChangePage=2 (No. 6)

9. Dwyer, Terry (2014), *Small Business and Family Enterprise Ombudsman*, Submission to the Commonwealth Treasury, May 14, at https://dwyerlawyers.com.au/small-business-and-family-enterprise-ombudsman/

10. Dwyer, Terry (2014) *The OECD/G20 Onslaught - Singapore Capitulates?*, **Offshore Investment**, Issue 245, 15 April, at http://www.dwyerlawyers.com.au/wp-content/uploads/2014/09/2014-05-29-Dwyer-245-OECD-onslaught-Singapore-capitulates.pdf

11. Dwyer, Terry (2014), *Proposed Legislation to Stop Otherwise Owed GST Refunds*, Submission to the Parliament House on GST Refunds, 28 Feb, at https://treasury.gov.au/sites/default/files/2019-03/C2014-006_Dwyer_Lawyers.pdf

12. Dwyer, Terry (2015) *The War on Privacy – Can the OECD Common Reporting Standard be Resisted?* , **Offshore Investment**, 15 Feb at http://www.dwyerlawyers. Com. au /wp-content/uploads/2015/08/2015-02-20-The-War-on-Privacy-Can-the-Common-Re porting-Standard-be-resisted.pdf

13. Dwyer, Terry (2016) *Tax Dodging and the Coming Tax Wars* Chapter 9, pp 179-198 in Fred Harrison (Editor) **RENT UNMASKED: How to Save the Global Economy and Build a Sustainable Future** Shepheard-Walwyn (Publishers) Ltd London SW14 8LS

14. Dwyer, Terry (2019) *The OECD, the EU and Tax Fraud – but Whose?* **IFC Review** *05/04/19*

15. Dwyer, Terry (2020) *The Hunting Of The Quark – The Search For The "Ultimate Beneficial Owner"* **IFC Review** *02/04/20*

16. Dwyer, Terry (2020) *The Political Economy Of Tax Wars: Fighting The Blacklists* **IFC Review** 17/06/20

V. List of all other Cases in which Expert Witness testified as an Expert at Trial

1. None in the last four years.

2. Dr Terry Dwyer was an expert witness by way of affidavit for the Crown in *Attorney General for NSW v The NSW Henry George Foundation Ltd* [2002] NSWSC 1128 before Young CJ in Equity

VI. Assumed Facts

10. It is assumed that the taxpayer, whom we shall describe as Mr. T, is placed as follows:

    (a) Mr. T is a U.S. citizen who applies for a job with a U.S. employer who happens tobe a private contractor for the U.S. government at the Joint Defence Facility at Pine Gap (JDFPG);

    (b) Upon receiving an offer of employment, Mr T, the U.S. citizen, travels to Australia towork at JDFPG;

    (c) Mr. T is not an Australian citizen and not otherwise resident in Australia;

    (d) Upon commencing employment, Mr. T is handed by his employer a contract (a "Closing Agreement", a specimen of which is annexed hereto as **Annexure J**) to sign. The Closing Agreement is between the Internal Revenue Service and Mr T and states that if he does not sign the agreement agreeing not to claim the section 911 foreign earned income exclusion on his taxes, which is a U.S. tax benefit, then his income is not exempt from Australian tax under Article 9/X of the relevant defence agreement and the employer will have to withhold Australian tax out of his paycheck;

    (e) The employer is acting on Australian Tax Office instructions that Australia has only agreed not to tax JDFPG employees if all of their income is "not exempt and is brought to tax" in the United States.

VII. Assumed US Law

The operation of the section 911 exclusion

11. It is assumed that the following is a correct statement of US revenue law as to the operation of section 911 of the *Internal Revenue Code*.

    > "A 'stacking rule' limits the benefits of the earned income and housing costs exclusions *by adding back the excluded amounts to taxable income solely for the purposes of determining the applicable marginal rate.*" Thomson Reuters *Federal Tax Handbook 2015* paragraph 4616 page 718.

12. Relevant parts of the Internal Revenue Code (IRC) section 911 "exemption" (set out in **Annexure C**) appear consistent with that summary.

13. The key point to observe at the outset, from an Australian tax law perspective, is that the foreign earned income *is not fully exempt* under United States Federal income tax law in the sense that it is *completely ignored* in the computation of tax liability. The system is "exemption with progression" whereby, rather than being *completely* excluded from computation of tax liability, the "exempt" income is added back to "bottom stack" Mr T's other income so as to increase the rate of tax applied to other income. In short, the rate of tax on his total income and the amount of tax payable are affected by including back the "exempt" foreign income.

14. That understanding seems to be confirmed by IRS Letter Advice No 201313023 (ID CCA-11281523-12) released 3/29/2013 (copy included in **Annexure G** attached) which states (emphasis added) –

> "First, the housing exclusion, housing deduction, and foreign earned income exclusion are all subtracted from total gross income on the Form 1040 at lines 21 and/or 36 to arrive at AGI on Form 1040, line 37. Next, exemptions and the itemized or standard deduction are subtracted from AGI at lines 40 and 42 to arrive at taxable income. The tax on this taxable income is determined on the Foreign Earned Income Tax Worksheet for Form 1040, line 44. *The housing exclusion, housing deduction, and foreign earned income exclusion are all added to the taxable income amount; this ensures that the taxpayer's income that exceeds the amounts allowed under section 911 will be 'stacked' on top of the 911 amounts and thereby be taxed at the appropriate rates.* The worksheet then calculates a total hypothetical tax that would apply to this grossed-up amount in the absence of section 911. Finally, the worksheet calculates a hypothetical amount of tax for the section 911 amounts. The difference between this amount and the hypothetical tax on the grossed-up amount is the taxpayer's actual tax liability.
>
> By making the section 911 housing deduction an above-the-line deduction, *adding it to taxable income to create a grossed-up amount, and then subtracting the tax attributable to that amount from the tax that would be owed on the grossed-up amount*, Forms 2555 and 1040 work together to ensure that the housing deduction and housing exclusion are effectively treated the same."

VIII. Questions as to Australian Law-

A. Question One

Does the Australian section 23AA depend on not claiming a US section 911 exclusion?

15. Whether US employees or contractors working at the JDPFG in Mr. T's situation must sign a Closing Agreement not to claim any US section 911 exclusion or else they will be not be exempt from Australian tax under section 23AA and therefore liable to be taxed by the Australian Tax Office?

B. Question Two

Does the Double Tax Convention prevent a US section 911 exclusion?

16. Does the US-Australia Double Tax Convention prohibit Mr. T from claiming the section 911 foreign earned income or housing exclusion under the Internal Revenue Code as a condition of remaining exempt from Australian income tax under section 23AA and untaxed by the Australian Tax Office?

C. Question Three

Can or must the employer withhold Australian tax?

17. If Questions One and Two are answered in the negative, does the employer have legal authority under Australian tax law to withhold Australian tax from the paycheck of Mr. T?

D. Question Four

Is the Closing Agreement enforceable under Australian law?

18. If Questions One and Two are answered in the negative, is the Closing Agreement enforceable under Australian law?

E. Answer - Question One

Does the Australian section 23AA depend on not claiming a US section 911 exclusion?

19. No.

Mr. T's employment income is exempt under section 23AA of the *Income Tax Assessment Act 1936*, *whether or not he claims the section 911 foreign earned income exclusion under US law*. The section 23AA exemption operates by force of Australian domestic law. The relevant defence force agreement upon which the Closing Agreement purports to be based is quite irrelevant since it never had the force of Australian law as regards taxation and Australian domestic legislation was therefore always necessary. Section 23AA was chosen as the legislation to give Australian domestic legal effect to the defence agreements. Whether section 23AA was more or less generous than what those writing the agreements may have contemplated is neither here nor there. It is section 23AA, as enacted by the Queen in Parliament, which is the law, not any agreement or understanding between defence forces or tax authorities.

The Federal Commissioner of Taxation (colloquially referred to as the Australian Taxation Office or ATO) is a statutory officeholder who has no power to impose tax or to revoke an exemption given by Parliament. There is nothing under Australian law which gives the Commissioner of Taxation discretionary power to deny the exemption in section 23AA if it is applicable

F. Answer - Question Two

Does the Double Tax Convention prevent a US section 911 exclusion?

20. No. The Double Tax Agreement between United States and Australia does not contain any provision authorizing the Commissioner of Taxation to impose tax on income exempted under section 23AA.

G. Answer - Question Three

Can or must the employer withhold Australian tax?

21. No. Questions One and Two being answered in the negative, the employer has no legal authority under Australian tax law to withhold Australian tax from the paycheck of Mr.T. The employer is not authorized to withhold Australian tax from income which is exempt under section 23AA nor is the Commissioner authorized to require such withholding.

H. Answer - Question Four

Is the Closing Agreement enforceable under Australian law?

22. No. Questions One, Two and Three being answered in the negative, the Closing Agreement is unenforceable under Australian law by the United States Internal Revenue Service, let alone by anyone else not being a party to the "contract". Even if made under seal and therefore without any necessity for consideration as matter of contract law, it would appear unenforceable in equity. A private contact or agreement cannot alter the incidence of Australian taxation.

I. Consideration - Question One

Does the Australian section 23AA depend on not claiming a US section 911 exclusion?

23. Under Australian income tax law, an Australian resident is generally taxable on his worldwide income and a non-resident is taxable on income from sources in Australia.

24. Residence can be a complicated question and, in Mr. T's case, there may be arguments thathe is not a resident of Australia. However, that is not to the point. Even if Mr. T were not resident of Australia, his duties as an employee in Australia for which he is paid would normally mean that Mr. T's income so gained is sourced in Australia and liable to Australian tax.

25. Section 23AA provides a special exemption in the *Income Tax Assessment Act 1936* for the incomes of persons connected with certain projects of the United States Government.

26. It was introduced to implement the relevant defence force agreement set out in **Annexure B** and similar defence agreements and projects have been brought within its scope. Relevant approved projects include the North West Cape naval communication station, the Joint Defence Space Research Facility, the Sparta project, the Joint Defence Space Communication Station, or a Force Posture Initiative.

27. The exemption is available to foreign employees who are employees of foreign contractors and not Australian citizens nor ordinarily resident in Australia and their families. The exemption is not limited to US citizens.

28. The section 23AA exemption was introduced to give legal effect to the original defence Force agreements' Articles 9 and X (see **Annexure B**) but those Articles do not control or override its legal interpretation according to established judicial precedent.

29. The relevant exemption in section 23AA operates to achieve its result through two separate limbs.

    - Section 23AA(3) deems foreign employees of foreign contractors working solely for the purpose of the approved projects *not to be residents of Australia* for the period of such service.

    - Section 23AA(5) deems income earned by a foreign employee from working on an approved project to have been *derived from sources out of Australia* if "the income *is not exempt from income tax* imposed by Chapter One of Subtitle A of the Internal Revenue Code of 1986 of the United States of America." A like exemption is given under section 23AA(6) for accompanying civilians.

    Note that the two deeming subsections operate independently. In particular, the deeming of a contractor not to be a resident of Australia may have implications for both the Australian tax rate applicable to him as a deemed a non-resident (if he is to be taxed) and his ability to invoke any benefit under the treaty as an Australian resident.

30. The effect of s 23AA is that, if both limbs apply, and Mr. T is deemed not to be an Australian resident *and* Mr. T is deemed not to be deriving income from Australia, Mr. T's income is not subject to Australian tax, because Australia (like most countries, apart from the USA and Eritrea which also tax on citizenship) does not tax the foreign-source income of non-residents.

31. *Prima facie* Mr. T satisfies both these conditions as he is working on prescribed contracts for prescribed purposes.

32. The second limb in sub-section 23AA(5) requires more explanation. The question is whether Mr. T's Australian-source income is "not exempt" (as understood by Australian law) from US tax. In particular, the question must be asked if Mr. T's claiming any personal exemption, exclusion or deduction (such as the Sec. 911 Exclusion for foreign earned income) means Mr. X's employment income is "exempt" from US income tax, as the phrase "not exempt" is interpreted *under Australian law*.

The meaning of "not exempt from tax"

33. One must look at what the phrase *"not exempt from income tax"* means in s 23AA.

34. There are some old instructions (see **Annexure I**) issued by the Commissioner of Taxation and agreed with the US Internal Revenue Service dealing with Articles 9 and X of the agreements between United States and Australian Federal Governments relating to the establishment of the Joint Defence Space Research Facility and the Joint Defence Space Communication Station. Article 9 and Article X of those agreements, according to the Commissioner, had an effect similar to section 23AA in making income of US contractors or personnel exempt from Australian tax "*provided the income is not exempt, and is brought to tax*, under taxation laws of the United States".

35. The Commissioner then interpreted section 911(a) of the Internal Revenue Code as conferring a *complete exemption* so that the Australian foreign earned income was "exempt from US tax and not brought to tax" under US law in terms of the Australian understandingof an exemption.

36. These old ATO-IRS instructions purport to be based on Article 24 of the 1982 US-Australia Double Tax Convention but, as will be noted later, section 23AA stands as domestic law outside and above the old Articles 9 and X of the defence agreements (which are not, and never were, part of Australian law as to taxation) while Article 24 appears not to be applicable in any event.

37. Whatever may have been the position previously in the 1960s as regards the US exemption system for foreign income, these old ATO-IRS instructions are (now, at least) erroneous and section 23AA *does* confer exemption from Australian tax *whether or not* a US section 911 US exclusion is taken by a US citizen,

38. Fundamentally, the words "not exempt from income tax" in subsection 23AA(5)(b) must be interpreted under Australian law. Under Australian case law, income is "not exempt from income tax" (even if it is not *directly* brought to tax) if the income is *taken into account in any way* in computing the rate of tax or amount of tax applicable to a person's income for that year.

39. The Commissioner's additional requirement "*and is brought to tax*" is not included in the text of section 23AA (though, in any event, the case law indicates this additional phrase would not change the interpretation).

40. Section 23AA is largely modelled on the former long-standing exemption provision against double taxation of foreign taxable income, section 23(q), which relevantly read as follows

> 23 ….. The following income shall be exempt from income tax –
>
> (q) income …. Derived by a resident from sources out of Australia… where that income *is not*, or those profits or gains are not, *exempt from tax* in the country where the income is, or the profits or gains are, derived….
>
> Provided that this paragraph does not apply to exempt any income, or any profits or gains of a capital nature, unless –(i) where there is a liability for tax in the country where that income is, or those profits or gains are, derived –the Commissioner is satisfied that the tax has been or will be paid; or (ii) where the outgoings incurred in producing that income or those profits or gains exceed that income or those profits or gains, as the case may be – the Commissioner is satisfied that the tax would have been paid in the country where the income is, or the profits or gains are, derived if the income, or the profits or gains, as the case may be, had exceeded the outgoings;'.

41. The analogous exemption to s 23(q) in section 23AA(5) states "Where… a foreign employee has derived income wholly and exclusively from, or from employment in connection with, the performance in Australia of a prescribed contract; … (b) the income <u>*is not exempt from income tax*</u> imposed by Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 of the United States of America… the income shall, the purposes of this Act, be deemed to have been derived from sources out of Australia."

42. The key condition for exemption from Australian income tax under section 23(q) was thus that the income not be exempt in its country of source. The phrase "not exempt from income tax" has been interpreted over the years on several occasions including by Australia's highest Court, the High Court of Australia (the Australian equivalent of the US Supreme Court).

43. The High Court held that income is not to be regarded as exempt from a foreign tax in the country of source if it *in any way* enters into the computation of *any income tax* payable by the Australian taxpayer in that country. Thus taxation at a reduced rate, or taxation of a proportion of the overseas income, or taxation by a sub-national government of the income, or another kind of income tax, such as a Federal employment or self-employment tax on income, would all entail the result that the overseas income was exempt under section 23(q) because it was "not exempt" in the country of source.

44. In the leading case of *Mutual Life and Citizens Assurance Co Ltd v Federal Commissioner of Taxation* (1959) 100 CLR 537 (see **Annexure H**) at 554 Fullager J (with whose judgement the Chief Justice Sir Owen Dixon concurred) stated that no income could be regarded as exempt from income tax either if it was required to enter into the calculation of the assessable taxable income directly as itself a part of the assessable income, or *even if, though it was excluded from the actual calculation of assessable income, the rate of tax was increased by reference to its existence*. The Court stated –

> "The general scheme of Commonwealth legislation is not to impose tax by reference to specific categories of income. It contains, of course, many special provisions as to what does and does not constitute income, but its general plan is to treat as "assessable income" gross income – whatever is income within the general conception of that term, and to require the "taxable income" to be ascertained by subtracting from assessable income what are called "allowable deductions". Consistently with this general plan *no income can be regarded as exempt from tax either if it is required to enter into the calculation directly as itself a part of the assessable income, or* ***even if, though it is excluded from the actual calculation of assessable income, the rate of tax is increased by reference to its existence***…. . It follows that the whole of the interest… which is referred to in the case stated is exempt from income tax in Australia, because the ***whole is not exempt*** in the United Kingdom." (per Fullager J in *Mutual Life and Citizens Assurance Co Ltd v FCT* (1959) 100 CLR 537; 12 ATD 9 at 13-14.

45. *Mutual Life and Citizens* has been followed ever since. Section 23(q) was in force at the time section 23AA was legislated and for many years after. Parliament never legislated to overturn the interpretation of "not exempt from tax" laid down in *Mutual Life and Citizens*.

46. Income was thus exempt under section 23(q) if it was of such a nature that it was not exempt from income tax in the country where it was derived. It did not matter that the particular taxpayer who received it was actually not liable to pay tax on it in that country because, for example, he fell within a tax-free threshold or a general personal deduction. Thus the Commonwealth Taxation Board of Review held that income derived in New Zealand by a resident of Australia which was of such a nature that it was not exempt from New Zealand income tax (but which was not actually subject to tax because it was under the New Zealand statutory minimum) was nonetheless exempt income in Australia under

section 23(q) – since the income had entered into the computation of tax even if the tax liability was nil in New Zealand (1950) 1 TBRD Case No 24 p 70.

47. In one respect, section 23AA is narrower than section 23(q) in that the overseas exemption must be of the US Federal income tax imposed under Chapter One of Subtitle A of the US *Internal Revenue Code* of 1986. US State or city income taxes or employment taxes on income are not sufficient to enliven the exemption in section 23AA(5). Section 23AA also works differently to the former section 23(q) in that it operates to confer Australian exemption by deeming the US taxpayer concerned to be a non-resident of Australia ***and*** to be deriving his income from non-Australian sources. This double deeming then triggered Australian exemption under the former section 23(r) in the 1936 Act which (naturally enough) exempted the foreign source income of persons not resident in Australia from Australian income tax. The *Income Tax Assessment Act 1997* achieves the same result in section 6-5(3).

48. Section 23AA is, however, wider than section 23(q) in a different respect since the exemption which it triggers is available not only to the US taxpayer earning the employment or contract income but also exempts the incomes of his US or non-Australian spouse and dependent family members from Australian tax. The US taxpayer *and his household members* are *all* deemed non-residents deriving foreign source income.

49. Applying the above judicial observations to Mr. T's case, we note that even if Mr. T claims the section 911 exclusion the rate of tax applicable to his other income from US and other sources is increased by reference to the existence of the excluded income. Thus, from an Australian law perspective, Mr. T's earnings are *not exempt* from US income tax *even if Mr. T claims the section 911 exclusion* as well as other exemptions or deductions, including the section 911 housing deduction, under US taxation law.

50. Accordingly, Mr. T's eligibility for the Australian s 23AA exemption is not affected by his ability to claim any US Federal income tax concessions or exclusions in relation to his employment income from working in Australia on the specified defence projects. The operation of Australian law gives exemption under section 23AA - because Mr. T's income from Australia is ***not completely ignored*** in the computation of US Federal income tax.

51. It therefore follows that it is not necessary for Mr. T to sign any agreement of the kind described requiring him to forego a claim under section 911 of the US Internal Revenue Code in order to qualify for the exemption granted by Australia under section 23AA of the *Income Tax Assessment Act 1936*.

J. Consideration – Question Two

Does the Double Tax Convention prevent a US section 911 exclusion?

52. The Double Tax Convention between United States and Australia does not contain anything to prevent Mr. T from claiming a section 911 exclusion as a pre-condition for exemption from Australian tax under section 23AA. Nor does it contain any provision authorizing the Commissioner of Taxation to impose tax on income otherwise exempted under section 23AA.

53. On the contrary, if it applies, the US-Australia Double Tax Agreement preserve a taxpayer's right to claim "any exclusion, exemption, deduction, rebate, credit or other allowance accorded from time to time" available to him under the relevant domestic law of either State.

54. Article 1 reads as follows –

Article 1

Personal scope

(1) *Except as otherwise provided in this Convention, this Convention shall apply to persons who are residents of one or both of the Contracting States.*

(2) *This Convention* ***shall not restrict in any manner any exclusion, exemption, deduction****, rebate, credit or other allowance accorded from time to time*:

(a) *by the laws of either Contracting State*; or

(b) by any other agreement between the Contracting States.

(3) Notwithstanding any provision of this Convention, except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)) and individuals electing under its domestic law to be taxed as residents of that State, *and by reason of citizenship may tax its citizens, as if this Convention had not entered into force*. For this purpose, the term "citizen" shall, with respect to United States source income according to United States law relating to United States tax, include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

(4) The provisions of paragraph (3) shall not affect:

(a) the benefits conferred by a Contracting State under paragraph (2) of Article 9 (Associated enterprises), paragraph (2) or (6) of Article 18 (Pensions, annuities, alimony and child support), Article 22 (Relief from double taxation), 23 (Non-discrimination), 24 (Mutual agreement procedure) or paragraph (1) of Article 27 (Miscellaneous); or

(b) the benefits conferred by a Contracting State under Article 19 (Governmental remuneration), 20 (Students) or 26 (Diplomatic and consular privileges) upon individuals who are neither citizens of, nor have immigrant status in, that State (in the case of benefits conferred by the United States), or who are not ordinarily resident in that State (in the case of benefits conferred by Australia).

55. Clearly the US reservation of its rights to tax its citizens means that a US citizen cannot claim a benefit under the Convention *as against the United States*, but that does not mean a taxpayer cannot claim any benefit otherwise available directly under the *domestic* law of *either* country and the exemption in section 23AA is given directly by Australian domestic law, *not* by the Double Tax Convention.

56. Not only does the Convention *not* require a US citizen to forego the Australian section 23AA exemption but, on the contrary, Article 1(2)(a) expressly states that neither the

IRS nor Australia can require him to forgo "any exclusion, exemption, deduction…" available under the domestic law of either country. The choice of words is interesting in that it recognizes that an "exclusion" or "deduction" may not necessarily be the same thing as an"exemption". It is consistent with the conclusion expressed an answering Question One that a US section 911 exclusion or deduction is not necessarily the same thing as what an exemption would be under Australian law.

57. Clearly, the Convention will apply to Mr. T to the extent not otherwise provided, if he is a resident of one or both countries as defined under the treaty. The Convention does provide otherwise to the extent of permitting the United States to tax him as a US citizen.

58. However, the Convention does not authorize the ATO to deny him any exemption or deduction available under the Australian domestic law, whether of its own volition or at the request of the IRS. Likewise, it appears the Convention does not seem to authorize theIRS to deny a US taxpayer any domestic tax law concession, such as a section 911 foreign income exclusion, but that is a question of US law on which no opinion is expressed here.

59. From an Australian legal perspective, nothing in the Double Tax Convention appears to support the validity of the Closing Agreement insofar as it purports to deprive Mr. T of his entitlement to claim exemption under section 23AA.

60. An interesting question is raised as to whether Mr. T may not be within the personal scope of the Convention at all. The deeming under section 23AA of person such as Mr. T to be non-residents of Australia means that the Convention can only apply to them if they are also residents of the United States. If Mr. T is being taxed on the basis of his citizenship but is otherwise treated by US tax law is not being a resident of the United States, then it would follow he is not a resident of either country for the purposes of the Double Tax Convention. If that be so, then the Double Tax Convention cannot be invoked either by him or by any authority against him.

K. Consideration - Question Three

Can or must the employer withhold Australian tax?

61. To withhold some of his wages or salary from an employee such as Mr T under Australian law, it is elementary that an employer needs Australian statutory authority.

62. The withholding by employers of monies from salaries of amounts to meet expected tax liabilities is authorized by the pay-as-you-go provisions which were originally introduced in 1942 when the Australian Federal Government took over State taxation in order to have the revenue to fight the Empire of Japan (Australia's alliance with the USA dates from that great conflict.)

63. However, it would not make sense for employers to be required to withhold amounts in anticipation of employee tax liabilities if the relevant payments were exempt from income tax.

64. That common sense is reflected in the *Taxation Administration Act 1953* Schedule I (see **Annexure D**) which clearly provides by way of a general exception in section 12-1 that exempt income is not subject to withholding.

65. Therefore, the employer is not authorized by statute to withhold "tax" from wages or salary and has no defence under Australian law against an employee such as Mr. T demanding his salary be paid in full.

66. No view is expressed here as to any US law which may govern the contract of employment.

L. Consideration - Question Four

Is the Closing Agreement enforceable under Australian law?

67. Assuming the Closing Agreement is made in Australia and subject to Australian law, Questions One, Two and Three being answered in the negative, the Closing Agreement appears unenforceable under Australian law.

68. If the Closing Agreement is made under US law, the question of whether it is legally enforceable under US law is a question we cannot answer.

69. The Closing Agreement is quite curious in certain respects from an Australian law perspective.

70. In the third recital on the first page, the Closing Agreement refers to Article 9 and Article X of the agreements between United States and Australia concerning the Joint Defence Space Research Facility and the Joint Defence Space Communication Station. However, these agreements do not have any force of law as regards either imposing Australian tax or relieving any person of an Australian tax liability. It is section 23AA, not the antecedent intergovernmental agreements, which governs Australian tax liability in the case of Mr. T. If the agreements could be acted upon, as the Closing Agreement assumes, section 23AA would simply not have been necessary. However, the clear law is that the Executive Government of the Commonwealth has no power to impose a tax or to dispense with one in the absence of enabling legislation. A treaty has no legislative force unless enacted into law by the Australian Federal Parliament. These two propositions are simply elementary constitutional law in Australia and no authority is needed for them.

71. By way of an aside, one notes that if Australian taxes could have lawfully been waived under Article 9 in the treaty establishing Pine Gap (the Joint Defence Space Research facility) then it should have exempted most US persons anyway since the phrase "provided that it is not exempt, and is brought to tax, under the taxation laws of the United States" embraces State and city taxes or Federal employment or self-employment taxes on income as enough to trigger exemption and, unlike 23AA, was not limited to being triggered by exemption from Federal income tax. One also notes as an aside that Article 6 of the 1963 Status of Forces Agreement seems to have been made on the basis that Australia would only tax civilian income which was completely exempt from US tax. However, none of this history controls in any way the interpretation of an Act of Parliament.

72. The third recital on the second page states that "such waiver is pursuant to an agreement with and a determination by the Competent Authority for the United States after

consultation with the Competent Authority for Australia in accordance with Article 24 of the Income Tax Convention between the United States and Australia".

73. However Article 24(1)(a) states that "*Where a resident* of one of the Contracting States *considers that the action of one or both of the Contracting States results or will result for him in taxation not in accordance with this Convention, he may,* notwithstanding the remedies provided by the domestic laws of those States, *present his case* to the competent authority of the Contracting State of which he is a resident or citizen." The approach by Mr. T to a Competent Authority is a condition precedent for any action under Article 24. Unless Mr. T has requested the Internal Revenue Service to take action to eliminate a perceived tax problem for him under the Convention, such as inappropriate double taxation, then the purported exercise of power by either the ATO or the IRS as the Competent Authority under Article 24 lacks an essential precondition for its effective operation.

74. Further it is hard to see on what basis Mr. T can claim there is a breach of the Convention since, in the first place, he is excluded by Article 1 from claiming treaty benefits to reduce his US tax liability and, more to the point, in the second place, he is completely exempted from Australian income tax by section 23AA, so Mr. T has no need to approach the Internal Revenue Service to solve a non-existent double tax problem.

75. As noted above, Article 1 of the Convention states that –

> (1) Except as otherwise provided in this Convention, this Convention shall apply to persons who are residents of one or both of the Contracting States.
>
> (2) This *Convention shall not restrict in any manner any exclusion, exemption, deduction, rebate, credit or other allowance accorded from time to time*:
>
> (a) by the laws of either Contracting State; or
> (b) by any other agreement between the Contracting States.
>
> (3) Notwithstanding any provision of this Convention, except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)) and individuals electing under its domestic law to be taxed as residents of that State, and by reason of citizenship may tax its citizens, as if this Convention had not entered into force.

76. Article 1(2) means that from an Australian legal point of view, the Commissioner of Taxation cannot use the Convention to remove the benefit of the 23AA exemption provided by Australian domestic law directly in the *Income Tax Assessment Act 1936.* One might expect that, likewise, Article 1(2) would equally mean that the Commissioner of the Internal Revenue Service could not remove the benefit of a section 911 exclusion by Mr. T but that is a question of US law on which we can offer no opinion.

77. It is also again noted that, because section 23AA(3) deems Mr. T not to be a resident of Australia, *if* Mr. T has also ceased to be a US resident under US domestic tax law, then he is not within the personal scope of the Convention, having become an actual or deemed non-resident of both countries. If that be the case, then, after section 23AA applies by force of Australian law, the Convention does not apply to him at all and any Closing Agreement purportedly made pursuant to Article 24 of the Convention may lack

a further basic pre-condition for validity, since Mr. T may then be a non-resident of both countries.

78. Further, one notes that the Australian Taxation Office and the employer are *not* parties to the Closing Agreement. If the Closing Agreement is to be enforceable at all, it would appear to be enforceable only by the Internal Revenue Service of the United States Government.

79. However, if the Closing "Agreement" is between the IRS and the employee, and not executed as a deed under seal, it would appear unenforceable as a matter of Australian contract law, for want of consideration, since the "consideration" of non-taxation by the ATO, offered by the IRS, appears fundamentally illusory.

80. It is difficult to see what consideration the Internal Revenue Service is actually providing to the employee under the Closing Agreement. If the "consideration" is the IRS shall procure that the Australian Commissioner of Taxation not to impose tax, that is a form of consideration which, first, does not appear to be within the power of the IRS to provide and, secondly, would be a *quid pro quo* to which the Commissioner of Taxation is not authorized to agree.

81. The duty of the Commissioner of Taxation is to collect Australian taxes according to law. He may compromise claims in litigation but his primary duty is to raise the legally correct assessment so far as he genuinely sees it. If there is a liability to Australian tax, he must raise an assessment and collect the tax; if there is not, he must not do so. If there is an exemption, he must apply it in making his assessment.

82. It would be misfeasance in public office for the Commissioner, at the request of a third party, be it the IRS or anyone else, to offer not to raise an assessment against a taxpayer where, in fact, the assessment was not sustainable in law. If the assessment is not warranted because the income is exempt from Australian tax, the Commissioner's duty is not to issue it. Nor can the Commissioner require that the employer withhold "tax instalments" in anticipation. He has no general authority to either raise or waive Australian tax assessments for the benefit of foreign tax authorities.

83. Fundamentally, it is well-established law that no conduct of the Commissioner can operate as an estoppel against the Act, most recently applied in *Clark v Commissioner of Taxation* [2010] FCA 415. The Commissioner must apply the Act as it stands, and in accordance with the decisions of the Courts. If an exemption is available to a taxpayer, it is the Commissioner's duty to allow it accordingly. He may, of course, take a different view *in good faith* and leave it to the taxpayer to test that view in the Courts.

84. Even if the Closing Agreement were made under seal, questions of unconscionability and duress may arise.

85. There would also be the further issue of whether an agreement to forego a statutory right may be void as contrary to Australian public policy. For example, the High Court has held that agreements to make contracts regarding the disposition of an estate are void as against public policy and are not effective to take property out of an estate for the purposes of claims being made under State family provision legislation, see *Barns v Barns* [2003] HCA 9.

M. Summary of Conclusions

86. I am of opinion that where a taxpayer in Mr. T's position claims a United States section 911 exclusion or deduction, he is nonetheless exempt from Australian tax under section 23AA of the Australian *Income Tax Assessment Act 1936*. I am of opinion that section 23AA exempts Mr. T's income from Australian income tax in the circumstances described above, regardless of whether he claims any US section 911 "exclusion" or "deduction".

87. I am of opinion that the Commissioner of Taxation is not authorized by the Australian *Taxation Administration Act 1953* to require the withholding by the employer of tax instalment deductions in respect of income earned by Mr. T in the assumed circumstances.

88. I am of opinion that any "Closing Agreement" made by Mr. T with the Internal RevenueService not to claim the US section 911 exclusion or exemption as a precondition of claiming the Australian section 23AA exemption is void or unenforceable, if the Closing Agreement is made under Australian law.

89. I declare my willingness to swear under oath that this declaration (including the Annexures hereto) is my true, honest, and complete understanding and opinion as to the application of Australian law to the facts assumed herein and I declare my willingness to be examined before the Honourable Court in relation to the matters herein.

I state under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on 20 April 2022

_____

Dr. Terry Dwyer

Before me ……..

Deborah Royal Dwyer