

Both Australia and the United States recognise the need for their citizens to be able to self-fund their retirement, and the importance of having a globally mobile workforce. This article assesses the tax impact that Art 18, “Pension, Annuities, Alimony and Child Support”, of the US Australia double tax treaty would have on the mobility of human capital between Australia and the US. In the author’s view, in its current form, Art 18 has the potential to significantly hinder the free flow of human capital, for reasons which are discussed in the article. The article outlines the current position, including the Australian and US tax treatment of retirement benefits. The article then examines the US domestic treatment of Australian superannuation, and the current Australian treatment of US pensions. The author recommends that Art 18 be amended so that Australian and US-sourced benefits are taxed in accordance with the rules of the country in which the benefits were derived.

Introduction

Both Australia and the United States (US) are staunch advocates of self-funded retirement and of the important role that superannuation funds and pension funds have on the economic development of our respective countries. They also recognise the importance of accommodating a globally mobile executive workforce.¹

This article assesses the tax impact that Art 18, “Pension, Annuities, Alimony and Child Support” of the US Australia income tax treaty² (Australian treaty) would have on the mobility of human capital between Australia and the US.

In my opinion, in its current form, Art 18 of the Australian treaty has the potential to significantly hinder the free flow of human capital. Under the current rules:

1. any contribution made to an Australian superannuation fund while an Australian citizen is living in the US (or US citizen living in Australia) is income taxable in the US;³ and
2. it is unclear as to the precise manner in which accumulated earnings and vested pension benefits may be taxed.

The rules may be interpreted in two very different ways:

- a. annual earnings accumulating in an Australian superannuation plan⁴ and superannuation benefits that are distributed to a US resident taxpayer on retirement,⁵ may be considered income, taxable in the US; or
- b. the alternative view is that the entirety of an Australian citizen’s pre-tax superannuation benefits (ie concessional contributions and accumulated earnings (which includes the government guaranteed 9%)) may be considered income, taxable in the US, upon such a citizen becoming a US resident taxpayer.⁶

The above tax treatment will impact corporations and executives differently but in equally concerning ways. For corporations, they may find themselves contractually bound to equalise the tax cost so that their employee has the same net compensation that they receive in Australia. This could significantly increase their operating costs. For executives not protected by tax equalisation provisions, they may see their retirement savings decimated and may not have access to sufficient capital to pay the US tax bill (ie because the retirement savings cannot be withdrawn before retirement).

Unfortunately, unless Art 18 is amended, the adverse tax impact US migration may have on a taxpayer’s superannuation benefits (such as those referred to above) may become a determining factor as to whether or not an executive migrates to the US.

Support for position

Residency

Australia taxes its residents on their worldwide income and non-residents on their Australian-sourced income.⁷ An Australian citizen who does not reside in Australia and who maintains a permanent place of abode in a jurisdiction other than Australia is a non-resident of Australia for tax purposes and, therefore, only taxable on Australian-sourced income.⁸ Whereas, the US taxes its citizens and resident aliens⁹ (US persons) on their worldwide income, regardless of how much time they spend in the US and whether or not they maintain a permanent place of abode in the US.

When you couple the worldwide taxation of US persons with the global nature of the various US attribution regimes,¹⁰ it becomes clear that it is difficult for US persons (who are also residents of Australia) to utilise Australian trusts or funds for tax planning. This includes Australian superannuation funds. The impact of these regimes is that they will, in certain circumstances, ignore the existence of the entity (ie the trust or fund) and attribute the profits derived by such an entity to a US person without regard to the domestic tax law of the jurisdiction in which the entity was established.

Australian tax treatment of retirement benefits

There are three phases in the tax treatment of a superannuation plan: the contributions phase (where contributions are made to a fund); the investments phase (where contributions are invested and earnings accumulate); and the benefits phase (where contributions and the accumulated earnings are distributed from the fund).¹¹

In Australia, employers receive a deduction for compulsory contributions that are made to a complying superannuation fund.¹² Employees receive a deduction for additional “salary sacrificed” contributions made in addition to compulsory employer contributions that do not exceed the concessional contributions cap.¹³ The concessional contributions cap for the 2011-12 financial year is A\$50,000 for taxpayers who are 50 years or older and A\$25,000 for taxpayers who have not yet attained the age of 50. Concessional contributions that are deductible to the employer or the employee¹⁴ are assessable income of the superannuation provider (ie the superannuation trustee) taxed at the rate of 15%.¹⁵

Further contributions (ie non-concessional contributions or post-tax contributions) can be made to a complying superannuation fund, provided they do not exceed the non-concessional contributions cap.¹⁶ The non-concessional contributions cap for the 2011-12 financial year is A\$150,000 per annum or, if a taxpayer has not yet attained 65 years of age, the taxpayer can bring forward three years of non-concessional contributions and contribute up to A\$450,000.¹⁷ These “non-concessional” contributions are not deductible and are not assessable income of the superannuation provider.¹⁸

Earnings on the investment of amounts in a superannuation plan are assessable income (ie ordinary income) of the superannuation provider. The superannuation provider’s taxable income is generally taxed at the rate of 15%,¹⁹ although franked dividend income is effectively “tax-free” by virtue of Australia’s dividend imputation system.

With respect to distributions, if a taxpayer is aged 60 or over, regardless of whether the superannuation benefits are distributed by way of lump sum or pension, the benefits are tax-free if they have already been subject to tax in the fund (that is, where the benefits comprise a taxed element). This tax treatment covers the majority of taxpayers.²⁰

US taxation of retirement benefits

In the US, like Australia, there are three taxable components of a tax-exempt pension plan (ie a “qualified plan”): contributions; accumulated earnings; and distributed benefits. Rather than provide a detailed outline of the domestic treatment of US pensions (as I have done above for Australian superannuation), I believe it would be more beneficial to note the key differences (rather than similarities) in how US pensions are taxed when compared with Australian superannuation.

Accordingly, I note the following:

1. employer-sponsored contributions are not taxed to the trustee of the pension plan upon contribution (ie they are not taxed at all);
2. annual earnings derived by a pension fund are not taxable until the taxpayer attains retirement age; and
3. the contributions and accumulated earnings referred to at (1) and (2) above become wholly taxable when a taxpayer is in constructive receipt of their benefits. A taxpayer will be in constructive receipt of their benefits upon attainment of retirement age or upon some other event (ie disability or death). These benefits will be taxed at this time at the relevant federal, state and city (where applicable) marginal income tax rates.

US Australia income tax treaty

The purpose of the Australian treaty is to prevent double taxation and fiscal evasion.

Without adequate treaty protection, given the differences in the manner in which the Australian superannuation laws and US pension laws tax pension benefits, a US resident could perceivably relocate from the US to Australia and never pay income tax on contributions, accumulated earnings or the payment of pension benefits that accrued while the employee worked in the U.S (ie because the US does not tax contributions or accumulated earnings and Australia does not tax the distribution of benefits).

For this reason, Art 18 was written into the Australian treaty. Article 18 was specifically designed to protect against fiscal evasion in the manner described above. However, that is probably Art 18’s limit (ie it does not adequately protect against double taxation). Obvious absences from Art 18 are references to the taxation of contributions and earnings derived by a pension plan prior to an individual being in receipt of their benefits.

Specifically, at para (1) it states:

“Subject to the provisions of Article 19 (Government Remuneration), pensions and other similar remuneration paid to an individual who is a resident of one of the Contracting States [Australia or the US] in consideration of past employment shall be taxable only in that state [ie only in the state in which the taxpayer is a resident].” (emphasis added)

Further, at paragraph (4) it states:

“The term ‘pensions and other similar remuneration’, as used in this Article, means periodic payments made by reason of retirement or death in consideration for services rendered, or by way of compensation paid after retirement for injuries received in connection with past employment.” (emphasis added)

Accordingly, it is my view that, while Art 18 of the Australian treaty may protect against the double taxation of periodic pension benefits as they are paid out

of a pension plan, *it does nothing to protect against the double taxation of contributions and income accumulating within a pension plan.*

Comparison with UK treaty

Further support for this view can be seen when comparing the Australian Treaty with the US United Kingdom income tax treaty²¹ (UK treaty).

Specifically, Art 17 of the UK treaty states:

1.
 - a. Pensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that State.
 - b. Notwithstanding sub-paragraph a) of this paragraph, the amount of any such pension or remuneration paid from a pension scheme established in the other Contracting State that would be exempt from taxation in that other State if the beneficial owner were a resident thereof shall be exempt from taxation in the first-mentioned State.
2. Notwithstanding the provisions of 1 of this Article, a lump sum payment derived from a pension scheme established in a Contracting State [ie the UK] and beneficially owned by a resident of the other Contracting State [ie the US] shall be taxable only in the first mentioned state [ie the UK].” (emphasis added)

Further, at Art 18, the UK treaty states:

1. Where an individual who is a resident of a Contracting State is a member or beneficiary of, or participant in, a pension scheme established in the other Contracting State, income earned by the pension scheme may be taxed as income of that individual only when, and, subject to paragraphs 1 and 2 of Article 17...of this Convention, to the extent that, it is paid to, or for the benefit of, that individual from the pension scheme (and not transferred to another pension scheme).
2. Where an individual who is a member or beneficiary of, or participant in, a pension scheme established in a Contracting State exercises an employment or self-employment in the other Contracting State:
 - a. contributions paid by or on behalf of that individual to the pension scheme during the period that he exercises an employment or self-employment in the other State shall be deductible (or excludable) in computing his taxable income in that other State; and
 - b. any benefits accrued under the pension scheme, or contributions made to the pension scheme by or on behalf of the individual’s employer, during that period shall not be treated as part of the employee’s taxable income and any such contributions shall be allowed as a deduction in computing the business profits of his employer in that other State.” (emphasis added)

The approach set out in the UK treaty is effective because it individually addresses each taxable component of a pension plan and ensures that, regardless of where a taxpayer resides, benefits will always be taxed in accordance with laws and policy of the country where they were derived.

Further, if this approach was adopted, a taxpayer would not be subject to double taxation, would not receive a tax benefit upon migration (like the benefit referred to above), nor would it influence whether or not a taxpayer accepts an offer of employment in either Australia or the US.

For these reasons, it is my opinion that the Australian treaty should be amended to accord with the UK treaty. However, until this occurs, given that the Australian treaty only deals with the taxation of distributed benefits and the domestic tax regimes of both Australia and the US are structured around three (potentially) taxable components,²² it is necessary to consider the domestic tax treatment in the US and Australia of foreign-sourced pension benefits.

US domestic treatment of Australian superannuation

Following from the above, the US domestic treatment of Australian superannuation is as follows:

1. the US has taxing authority over vested Australian superannuation benefits pursuant to Art 18 of the Australian treaty; and
2. in the absence of a specific Article dealing with contributions and annual income derived by pension schemes (as exist in the UK treaty), the US retains the right under Art 1 of the Australian treaty to tax contributions and accumulated earnings under its domestic tax laws.

The manner in which the US domestic tax laws tax Australian superannuation is set out below.

The three phases of tax treatment

Contributions

Subchapter D23 contains the rules pertaining to the taxation of “deferred compensation” (pension plans) in the US. In order for a pension plan to be tax-exempt, the plan must satisfy the requirements contained in § 401 Internal Revenue Code 1986 (IRC). Section 401(a) IRC specifically provides that, for a pension plan to be a “qualified plan” (and therefore exempt from tax under § 501 IRC), it must be organised in the US.

Accordingly, this means that no Australian superannuation plan (whether retail or self-managed) can be a “qualified plan”. Trusts constituting retirement plans that are not qualified plans are known as “non-exempt trusts” and are taxed under § 402(b) IRC. As a result, contributions made to Australian superannuation plans once a taxpayer has become a US person may be taxable. The amount of the contribution that will be taxable is determined under § 402(b)(1) IRC.

Generally, any contributions made by a taxpayer to a non-exempt trust will be taxable as compensation to the taxpayer in the US if the benefits are “substantially vested”. The benefits will be substantially vested if the contributions are not subject to a substantial risk of forfeiture.²⁴

Most contributions made to modern Australian superannuation plans will not be subject to a substantial risk of forfeiture because the plan balance will be payable to the taxpayer upon retirement, incapacity or to a nominated beneficiary upon the death of the taxpayer. Accordingly, there is no risk that the benefit will be forfeited to the superannuation provider. Therefore, if contributions are made to an Australian superannuation fund after an Australian citizen

becomes a US person (or a US citizen becomes an Australian resident), the contributions will be taxable in the US under § 402(b)(1) IRC.

Earnings derived within a superannuation plan after an Australian citizen becomes a US person

Subchapter J25 contains the general rules concerning estates, trusts, beneficiaries and decedents, and specifically, the grantor trust rules.²⁶ The grantor trust rules are designed to attribute the income tax liability associated with income derived by a trust (whether domestic or foreign) to the person that is considered to be the “controller” of the trust, regardless of who the income has been distributed to. While it is critical that an individual assessment of the circumstances of every taxpayer be undertaken, most superannuation plans (or portions thereof) in Australia would be classified as grantor trusts for US tax purposes.²⁷

Accordingly, unless a specific provision of the IRC excludes the application of the grantor trust rules to non-exempt trusts, which include Australian superannuation plans, the annual earnings accumulating within such plans would be attributed to the owners of such plans and be taxable in the US under § 671 to 679 IRC.

While § 402(b)(3) IRC specifically excludes the application of the grantor trust rules to beneficiaries of non-exempt trusts,²⁸ and therefore excludes the application of the grantor trust rules to many Australian superannuation plans, § 402(b)(3) IRC needs to be read in conjunction with Treasury Regulation, § 1.402(b) to 1(b)(6), which provides as follows:

“In general, a beneficiary of a trust to which this section applies may not be considered to be the owner under subpart E, part 1, subchapter J, chapter I of the Code of any portion of such trust which is attributable to contributions to such trust made by the employer after August 1, 1969, or to incidental contributions made by the employee after such date. However, where contributions made by the employee are not incidental when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employee, if applicable requirements of such subpart E are satisfied. For the purposes of this paragraph (6) contributions made by an employee are not incidental when compared to contributions made by the employer if the employee’s total contributions as of any date exceed the employer’s total contributions on behalf of the employee as of such date.”

Essentially, this means that, if the personal contributions made by a taxpayer exceed the employer contributions made by their employer, then the grantor trust exclusion set out in § 402(b)(3) IRC will not apply to the taxpayer’s circumstances, and earnings derived within the superannuation plan attributed to the personal contributions that the taxpayer has made (while it is in benefits phase) will be taxable in the US, even though the taxpayer cannot access the accumulating income until they retire.

Example

Barry works for Mining Limited in Australia for 10 years, where he earns A\$300,000 per year. On 1 January 2010, he is appointed CEO of the US parent and migrates to the US. In the 10 years prior to Barry’s migration, Mining Limited contributes a total of A\$270,000 to an Australian superannuation plan on Barry’s behalf and Barry personally contributes A\$500,000 in concessional and non-concessional contributions to the plan. In the 2010 calendar year, Barry’s superannuation plan earns income of A\$77,000. As Barry’s

personal contributions exceed his employer contributions, the income attributable to his personal contributions will be taxable in the US.

Barry's personal contributions account for 64.93% of the funds corpus. Accordingly, in 2010, Barry will be liable to pay tax in the US on A\$49,996.10 (ie 64.93% of A\$77,000).

While Barry will get a credit for the tax the superannuation fund pays in Australia, he will still have to pay further federal, state and city income tax (where applicable) at marginal income tax rates.

Distribution of benefits

In my opinion there are two possible ways in which accrued Australian superannuation benefits (contributions and earnings) may be taxed in the US.

The first is that Australian superannuation benefits of a US person will be taxable upon such a person attaining 60 years of age (the Australian retirement age). The taxpayer will first be liable for tax in Australia, receive foreign tax credits in the US (creditable only against US federal income tax) for the Australian tax paid (which will be nil if the account is in benefits phase), and in the event of any shortfall, pay further federal, state and city income tax (where applicable).

The second view (the alternate view) concerns highly compensated employees (HCE) and the application of § 402(b)(4) IRC, which states:

“402(b)(4)(A) If 1 of the reasons a trust is not exempt from tax under section 501(a) is the failure of the plan of which it is a part to meet the requirements of section 401(a)(26) or 410(b), then a highly compensated employee shall, in lieu of the amount determined under paragraph (1) or (2) include in gross income for the taxable year with or within which the taxable year of the trust ends an amount equal to the vested accrued benefit of such employee (other than the employee's investment in the contract) as of the close of such taxable year of the trust.

402(b)(4)(B) Failure to meet coverage tests ... If a trust is not exempt from tax under section 501(a) for any taxable year solely because such trust is part of a plan which fails to meet the requirements of section 401(a)(26) or 410(b) [coverage tests], paragraphs [402(b)] (1) and [402(b)](2) [concerning contributions and distributions] shall not apply by reason of such failure to any employee who was not a highly compensated employee during —

402(b)(4)(B)(i) such taxable year, or 402(b)(4)(B)(ii) any preceding period for which service was creditable to such employee under the plan.” (emphasis added)

This section only applies if a taxpayer is an HCE and the relevant plan fails the minimum coverage tests (ie the ratio percentage test and the average benefits test).²⁹ An employee will, on balance, be an HCE if they derive more than US\$110,000 per annum.³⁰ The purpose of the minimum coverage tests is to ensure that employers do not only offer retirement benefits to HCEs.³¹ These tests work on the ratio of HCEs to non-HCEs and the percentage of benefits contributed by HCEs as compared with the percentage of benefits contributed by non-HCEs.³²

If an employee is a highly compensated US person who is also a member of a foreign pension plan (ie an Australian superannuation plan), technically, on a literal reading of § 410(b)(3)(C) IRC, there is a high likelihood that the foreign pension plan will fail the minimum coverage tests because contributions made in favour of non-resident aliens with no US-source income are not included for the purposes of determining whether the coverage tests have been satisfied.

Example

An Australian retail superannuation plan has 20,000 members. Twenty of the 20,000 members are highly compensated US persons. None of the members that are US persons are non-highly compensated. Of the members, 19,980 are non-resident aliens with no US-sourced income.

Accordingly, for the purposes of determining whether the plan fails the minimum coverage tests, you only consider the circumstances of the 20 highly compensated US persons. As all of the tested individuals are highly compensated, the minimum coverage tests cannot be satisfied.

The mechanics of this test can be highlighted through the following example.

If § 402(b)(4) IRC were to apply, § 402(b)(1) IRC33 and § 402(b)(2) IRC34 would not apply and the taxpayer would, upon becoming a US person, be liable to tax on their vested accrued benefits, less their investment in the contract, at that time. You do not have an investment in the contract unless you contribute post-tax moneys. This is hugely problematic when you consider what it actually means. Again, it is best highlighted by way of an example.

Example

An Australian citizen (the taxpayer) migrates to the US on 1 January 2010 (migration date) and remains in the US for the entirety of the 2010 calendar year — he is an HCE.

The taxpayer's circumstances are as follows:

1. he has only ever had government guaranteed contributions of 9% of his annual salary paid to an Australian superannuation plan on his behalf (ie he has not made any after tax contributions to the plan);
2. as at the Migration Date the value of the Taxpayer's benefits total \$300,000;
3. 100% of his benefits are vested and accrued to him (ie they are not subject to a substantial risk of forfeiture);
4. he moved to the US on the Migration Date and will therefore be a US Person for the 2010 calendar year; and
5. as at 12/ 31/ 2010 the value of the Taxpayer's benefits have increased to \$350,000.
Under a literal interpretation of § 402(b)(4) IRC, the taxpayer is not taxed on the increase in the value of his accumulated benefits (\$50,000), but

rather on his vested accrued benefits (\$350,000) less his investment in the contract (\$0). Accordingly, if the provision were to apply, the taxpayer would be taxed on the entire superannuation balance of \$350,000 the first year he became a US person.

Recommended changes to the Australian treaty

In light of the deficiencies highlighted in this article, it is my recommendation that Art 18 of the Australian treaty be amended so that:

1. it separately addresses each of the following components of pensions: contributions, earnings and distributions; and
2. the taxing rights of the contracting state in which a taxpayer is a resident is limited to the manner in which the benefits would have been taxed in the contracting state in which the benefits were derived.

Current Australian treatment of US pensions (qualified plans)

While a detailed review of the manner in which the Australian tax rules will impact US domiciled pension schemes is beyond the scope of this article, it is prudent that I mention my view with respect to the following:

1. contributions that are made to a US pension plan after a US citizen or resident alien³⁵ becomes an Australian tax resident will be assessable income, taxable in Australia;
2. annual earnings derived within a qualified US pension plan will not be taxable in Australia in the 2011-12 financial year due to the repeal of the foreign investment fund rules; however, they may, upon the introduction of the new foreign accumulated fund rules, become taxable in Australia in 2012-13; and
3. distributions from US pension plans will be taxed as assessable income at marginal Australian income tax rates because under the Australian treaty the income will be treated as though it was Australian sourced.³⁶ The US will then grant a federal income tax credit for taxes paid in Australia.³⁷

Conclusion

Both Australia and the US recognise the need for their citizens to be able to self-fund their retirement. This is clear when you look at the concessional tax treatment offered for individuals who maximise superannuation and pension contributions, and the current impact government-supported pension plans are having on federal and state budgets.

Both countries also recognise the importance of having a globally mobile workforce.

The inadequacies in the Australian treaty arise because it approaches Australian superannuation and US pensions as though they are only taxed at one point, upon distribution.

If the Australian treaty was amended as recommended above, Australian and US-sourced benefits would be taxed in accordance with the rules of the country in which the benefits were derived. This would clearly accord with the retirement planning policies of both Australia and the US, maintain the

legislative purpose of the Australian treaty to protect against double taxation and fiscal evasion, and avoid a negative impact on the tax bases of either country.

Unfortunately, unless Art 18 of the Australian treaty is amended, the adverse tax impact US migration will have on a taxpayer's superannuation benefits may become a determining factor as to whether or not an executive migrates between Australia and the US.