Australia/US Tax Issues
Talking Points

This document outlines issues that need attention in the Australia/US Tax Treaty and the Australia / US FATCA Intergovernmental Agreement. It was prepared by Dr Karen Alpert (karen@fixthetaxtreaty.org). For more information, see our website – fixthetaxtreaty.org.

This version prepared 24 September 2017.

Introduction

The current tax treaty between the US and Australia does not adequately protect the interests of Australian residents claimed by the US as US taxpayers or of Australian citizens living in the US. The US taxes its citizens on their world-wide income regardless of where they live; this means the US claims the right to tax Australian-resident dual citizens as well as permanent residents of Australia with US citizenship. While the tax treaty is meant to eliminate double taxation, it is inadequate in several areas. Because of the “Saving Clause” in the treaty, US citizens are unable to utilise most of the treaty provisions. The US tax treatment of Australian superannuation accounts is particularly problematic as there is no clarity on the exact rules. Furthermore, to the extent that the US government collects tax on superannuation accounts, this will reduce the assets available to Australian residents at retirement and increase their entitlement to the means tested Age Pension. Under the Passive Foreign Investment Company rules, investment in Australian managed funds by Australian-resident US taxpayers is punitively taxed, further reducing the ability of the affected Australian citizens and permanent residents to save for a self-funded retirement and prompting these individuals to invest their savings in the US rather than in Australia. For those who wish to extricate themselves from the US tax system there is not only a USD2,350 fee to renounce US citizenship, but also the possible application of a punitive US exit tax that will treat all of the individual’s superannuation balances as immediately distributed and taxable.

There are also concerns with the Automated Exchange of Information regime prompted by the US Foreign Account Tax Compliance Act (FATCA) legislation and expanded under the OECD’s Common Reporting Standard (CRS). Individuals whose data is sent to a foreign government under one of these Automated Exchange of Information agreements ought to have the right to review (and correct, if necessary) their personal information that is being shared. These schemes also raise privacy and data security issues.

The rest of this document outlines the basic issues:

- Who does this affect?
- Why does this matter to Australia?
- The main issues with the tax treaty:
    - How the saving clause works
    - How the US taxes superannuation
    - The US Exit Tax
    - US taxation of Australian investments
- The main issues with the FATCA IGA:
    - The right to be informed
    - Lack of US Reciprocity
    - Privacy and security of data

Who does this affect?

There are several groups that are affected by the inadequate tax treaty and US extra-territorial tax laws:

- US born Australian citizens
- Australians naturalised in the US who have returned to Australia
- Australian-born children of US citizens
- Australian Permanent Residents with US citizenship
- Australian citizens and former residents living in the US
- Green card holders (US Permanent Residents) regardless of where currently resident

The latest data from the Australian Bureau of Statistics shows 104,310[1] Australian residents who were born in the United States as of 2016. This group would include both US-born Australian citizens and Australian permanent residents. It would not include Australian-resident US citizens or green card holders who were born in Australia (or elsewhere outside the US). Additionally, the Australian embassy in New York estimates there were 200,000[2] Australians living in the US in 2009.

To get an idea of how large the un-measured portion of this constituency might be, consider the ways one might become a US taxpayer without being born in the US. First, any US citizen who has lived in the US for a total of 5 years, at least two of which were after their 14th birthday will pass their US citizenship to their children born outside of the US. Thus, many children born in Australia with US-emigrant parents will also be US citizens. Second, many Australians study and/or work in the US and return to Australia. Some of these will either obtain US Permanent Resident status or naturalise as US citizens while outside of Australia. When they return to Australia, their US taxpayer status continues until they either renounce US citizenship or properly give up their US Permanent Resident status. Finally, there will be a small number of Australian immigrants who were born in other countries, and became US citizens or permanent residents before moving to Australia.

Why Does This Matter to Australia?

US Citizenship based taxation allows the US to tax the Australian-source income of Australian residents. This is due to the unique US practice of citizenship based taxation. Most of the world taxes on the basis of a combination of residence and source. Residents are taxed on their worldwide income and non-residents are taxed only on income sourced from within the country. The US, however, taxes all citizens, regardless of where in the world they live, under the same rules that apply to US residents. In theory, the tax treaty should eliminate double taxation, but there are several areas where the US either taxes income that is tax-free in Australia or taxes Australian income at a punitively high rate. **Any tax on Australian source income paid to the US represents a leakage of the Australian tax base to the US** – this is money that would have been spent or invested in Australia that ends up benefiting the US economy instead.

The US tax rules on superannuation and punitive tax rules for Australian investments makes it more costly for Australians to get experience in the US economy. Any Australian working in the US for more than a minimal amount of time will be deemed a US tax resident, fully subject to US tax rules. While this is generally not a problem for younger workers, those with experience (and some super) will find re-locating to the US creates a tax nightmare. Amending the tax treaty to provide certainty on US taxation of superannuation and non-discrimination for Australian investments will improve

[1] http://stat.abs.gov.au/Index.aspx?DataSetCode=ERP_COB (accessed 23 Sept. 2017)
[2] http://newyork.usa.embassy.gov.au/nycg/ANY1Wi09.html (accessed 23 Sept. 2017)

labour mobility between the two countries allowing Australians to more easily benefit from experience working in the US economy.

Allowing the US to determine how it will tax super and certain Centrelink payments undermines Australian domestic policy and ultimately undermines Australian sovereignty. When Australian residents are required to pay US tax on the annual appreciation inside their super (one of several possible interpretations of the US tax treatment of Australian superannuation accounts), they are less able to save for their retirement. The ultimate loser is the Australian government, which will end up paying more in Age Pension payments because Australian-resident US taxpayers have not been able to save properly for their retirement.

Finally, these policies as well as the FATCA IGA discriminate against a segment of the Australian population based on their national origin and/or place of birth. FATCA, in particular, targets anyone born in the US or with other "US indicia". While banks must report on residents of other countries under CRS, US citizens are unique in being considered tax-resident in two countries at the same time due to citizenship based taxation.

Fixing the Tax Treaty

Australia is party to a tax treaty with the US that should defend Australian sovereignty in this area. Unfortunately, this treaty fails to adequately address several issues of importance to individuals caught between the US and Australian tax systems. Listed here are the main areas where the current Australia/US tax treaty is deficient in protecting the interests of Australian citizens and residents.

Saving Clause

In an ideal world, each country has sovereignty over its own territory. This means that each country should be able to tax the economic activity within its borders without interference. In semi-technical tax jargon, this can be stated as:

The Australian Source income of Australian Residents should be taxable only by Australia.

US tax treaties, however, all contain a "Saving Clause"[3] that states that the US can tax its citizens as if the treaty did not exist (regardless of where those citizens live). The saving clause then lists a small number of exceptions – parts of the treaty that are available to US citizens. The Saving Clause allows the US to reach into the Australian tax base and tax the Australian source income of those Australian resident taxpayers the US claims as citizens. This erodes the ability of the affected US Persons to take advantage of Australian public policy and tax breaks encouraging retirement savings and local investment. The Saving Clause, and the US practice of citizenship based taxation more generally, frustrates Australian domestic policy by allowing a foreign government to apply its own idiosyncratic tax rules to income earned on Australian soil by Australian residents. In the long run, this will disadvantage the affected US Persons and make them more likely to require Australian government assistance in the form of the Age Pension and other social safety net programs in Australia.

Clearly, the main problem is the US practice of taxing non-resident citizens on their worldwide income (Citizenship Based Taxation, CBT) – under CBT US citizens living outside the US are treated as tax-resident in TWO countries simultaneously: wherever they actually live and the US. Without CBT, the Saving Clause wouldn't matter. The US would still have the *right* to tax Australian source income, but US tax law wouldn't actually impose any tax on non-US source income of Australian residents.

[3] For an explanation of how the Saving Clause works, see the series of posts starting with http://fixthetaxtreaty.org/2017/01/12/explaining-the-saving-clause-i/

While Australia cannot change US law, Australia can stand up for its own interests when negotiating treaties and other international agreements with the US.

How can Australia protect its tax base from this exceptional US practice of Citizenship Based Taxation? In "Explaining the Saving Clause III"[4] we propose three possible solutions. The most comprehensive of these is to incorporate into the treaty a "Tax Base Preservation Clause", which would provide that income arising in the country of residence can only be taxed by that country. This clause should, at a minimum, apply to all citizens and permanent residents of the country of residence, regardless of what other citizenships (or right of permanent residence) that they may hold. For countries using residence based taxation, this principle is implicit in both their national tax laws and in the way they interpret their international tax treaties. In treaties with the US, however, this principle needs to be explicitly stated. The US can tax its citizens however it wants, as long as it is not taxing the Australian source income of Australian-resident US citizens. In order to have the intended effect, if a Saving Clause remains, the Tax Base Preservation clause must be among those excepted from the Saving Clause.

Superannuation

There is much uncertainty in the "correct" way to include superannuation on a US tax return. This uncertainty affects not only US citizens and green-card holders living in Australia, but also any Australian citizen or permanent resident currently living in the US who accumulated superannuation when resident in Australia. The current Australia/US Tax Treaty does not even mention superannuation. More recent US Tax Treaties contain provisions that respect the tax deferral of "foreign" retirement plans. See, for example, Articles 17 and 18 of the 2016 US Model Tax Treaty.

There are two main theories currently used in the reporting of Superannuation on a US tax return:

a. The most favourable theory for Australian Residents is that Superannuation is equivalent to US Social Security,[5] and therefore excluded from US taxation under Article 18 paragraph 2 of the tax treaty. Even among professionals who espouse this theory, there is uncertainty as to whether the treaty exemption covers only the Superannuation Guarantee contributions (the 9.5% contributions mandated by Australian law) and associated earnings or whether additional concessional or non-concessional contributions are also included. This position is controversial and very few tax professionals actually prepare US returns on this basis.
b. The second theory, used by the majority of US tax professionals, is that Superannuation is a non-qualified retirement plan under the US tax code. This can generate a number of different results depending on the nature of the superannuation fund receiving the contributions and its connection to the employer. At a minimum, concessional contributions to super, including the Superannuation Guarantee, are treated as taxable on the US return. For some taxpayers and some types of super funds, this position is interpreted as requiring all gains inside the super fund to be reported as taxable income on the US return. After retirement, any balance that has not already been taxed by the US will be taxed by the US on distribution.

Any US tax paid on superannuation contributions, earnings, or rollovers will not be offset by a tax credit for Australian tax paid because these are tax-free transactions in Australia[6]. Similarly, any US

[4] http://fixthetaxtreaty.org/2017/01/29/explaining-the-saving-clause-iii/
[5] http://fixthetaxtreaty.org/2016/09/10/is-super-equiv-to-social-security/
[6] There is some controversy among US tax professionals as to whether the 15% tax paid by the superannuation fund on contributions (and income inside the fund if this is taxable in the US) is available for use as a foreign tax credit on the US tax return.

tax due on distribution to a retiree over the age of 60 will not have an offsetting credit for Australian tax paid.

One of the biggest frustrations of US taxpayers currently or previously resident in Australia is the uncertainty of the US tax treatment of superannuation. Even before a new treaty is negotiated it is important that this uncertainty be resolved. Best would be for the IRS (possibly at the urging of the ATO) to make a ruling on how super is to be treated for US tax. In the event the IRS rules that super is taxable in the US, then this will provide impetus for urgent renegotiation of the treaty. Given the pension provisions in the current US model treaty, it is possible the IRS will be willing to rule that super is not taxable on a US tax return.

US tax on Australian superannuation of Australian residents is contrary to the interests of Australia – it reduces the ability of Australians to save to fund their retirement and increases the probability that the affected Australian citizens will be reliant on the Australian government for Age Pension once they retire. US should have no claim on super – especially of Australian residents.

Exit Tax

Like many other countries (including Australia), the US has an Exit Tax when taxpayers remove themselves from the US tax system. However, because the US taxes non-resident citizens, this tax occurs when citizenship is lost (or a green card officially surrendered), not when the taxpayer moves out of the US. The result is that the US Exit Tax catches Australian assets that US taxpayers have accumulated while living in Australia. As a second citizenship is required to renounce US citizenship, most Australian-resident US taxpayers subject to the Exit Tax will be Australian citizens.

The exit tax provisions are complicated. They apply to anyone losing US citizenship (or long-term US permanent residents who lose that status) who fails any one of three tests. For most US taxpayers living in Australia, only two of these tests are relevant: certifying *five* years of US tax compliance and documenting a net worth of LESS than USD 2 Million (which is NOT indexed for inflation). Those who fail either of these tests will owe US tax on both the unrealised capital gain on all assets owned (including principal residence) AND on the untaxed portion of their superannuation balance. For the capital gains, there is an exclusion of USD 693,000[7] - but this does not apply to any tax on accumulated superannuation.

Thus, any long-term Australian resident who is subject to the US Exit Tax is in danger of losing a large portion of their superannuation, making it less likely that individual will be a self-funded retiree and negating Australian public policy that encourages superannuation savings.

Australian citizens who renounce their US citizenship face another potential tax issue, even if they are not Covered Expatriates. Proposed US tax regulations state that renunciation triggers a deemed disposition of all non-US managed fund investments, with all unrealised gains taxed by the US at punitive rates. These regulations have been proposed for almost 20 years without being finalised, and therefore need not be followed. However, we are aware of conservative US tax preparers who require their clients to follow these proposed regulations, arguing that a contrary position is likely to be lost on audit.

Passive Foreign Investment Companies

The US Internal Revenue Code generally treats many “foreign” investments as if their only purpose were to avoid or defer US tax. One example of this is the Passive Foreign Investment Company (PFIC). The definition of PFIC is broad and encompasses most managed funds, real estate investment

[7] This figure is for 2016, the capital gain exclusion is indexed for inflation.

trusts, and listed investment companies. Start-up companies with little revenue and large cash holdings can also be classified as PFICs.

Once a company has been classified as a PFIC, the tax consequences for US taxpayers are punitive. The US-taxpayer shareholder of a PFIC can elect to be taxed annually on any unrealised gain from their investment, essentially marking the investment to market on an annual basis. This unrealised gain is taxed as ordinary income, no capital gain concession is allowed. If this election is not made in the first year that the investment is classified as a PFIC, or the year the investment is purchased by the taxpayer, then a more complex set of rules applies. Under these rules, not only are capital gains concessions denied on the investment, but any realised gain is allocated pro-rata over the entire holding period, and taxed at the highest possible marginal tax rate. While foreign tax credit is allowed against this tax, due to the combination of phantom exchange rate gains and the use of the highest possible US tax rate, foreign tax credit may offset only a small portion of the gain. On top of this, daily compound interest is computed on this deemed "deferral" over the whole holding period of the investment. All of these gain computations are done in US dollars adding exchange rate risk.

Clearly, it is not tax-effective for a US taxpayer to own a PFIC. However, while the PFIC rules have been in the Internal Revenue Code since 1986, they have only been regularly applied to foreign managed fund investments since around 2009. This means that many long-term US expats have been caught with Australian managed investments purchased years or decades before this new interpretation took hold, leaving them unable to exit their investments without punitive US taxes being applied.

One of the policy objectives of the PFIC provisions was to prevent deferral of US tax through investment in foreign entities that were not subject to the same rules as US managed funds regarding the distribution of current income. Clearly this is not a problem with any Australian managed fund that is available to retail investors. We suggest adding to the Non-Discrimination article in any new income tax treaty a clause that prohibits discrimination against investments available to retail investors in the other country. This clause would not override securities law regarding marketing of investments, but would provide relief to a mobile workforce who may have assets in place in one country when they move to the other.

Net Investment Income Tax (NIIT)

Net Investment Income Tax is a 3.8% tax on passive (unearned) income. It applies to US taxpayers with income in excess of US$200,000 for single individuals and US$250,000 for married couples filing a joint return. The tax is levied on the lower of a) total passive income including capital gains or b) the excess of income over the applicable threshold.

Net Investment Income Tax (NIIT) was added to the Internal Revenue Code by Public Law 111-152[8], The Health Care and Education Reconciliation Act of 2010, which added section 1411 to the Internal Revenue Code, effective 1 January 2013. The section of the Act that added NIIT was titled "Unearned Income Medicare Contribution," which is the title of the new Chapter 2A added to the Internal Revenue Code by the Act. Placing NIIT in Chapter 2A, rather than Chapter 1 had the intended effect of denying a Foreign Tax Credit to offset NIIT. Furthermore, NIIT was enacted to fund US Medicare, which is not used by non-resident US citizens. Australian residents who are also US taxpayers pay a Medicare Levy to Australia which does not qualify as a creditable foreign tax on their US return. For Australian resident US taxpayers, NIIT is truly double taxation.

[8] https://www.gpo.gov/fdsys/pkg/PLAW-111publ152/html/PLAW-111publ152.htm

When NIIT was enacted, the US Competent Authority should have notified the Australian Competent Authority of the substantial change in US tax law. This is required under Article 2, paragraph 2 of the current tax treaty.

Items not taxed (or preferentially taxed) by Australia

In addition to the major issues detailed above, there are several items that are taxed in the US and are either not taxed, or are preferentially taxed in Australia. These include:

- Capital gain on sale of principal residence
- Unemployment benefits
- Redundancy payouts
- Australian structures such as SMSFs, Family Trusts, Controlled foreign corporations
- Gift and inheritance taxes

Automated Exchange of Information

In 2010 the US passed the Foreign Account Tax Compliance Act which required banks around the world to report their US-taxpayer account holders to the IRS under a threat of 30% withholding from all US-source payments for banks that refused to comply. However, compliance with the US law was generally contrary to the laws of all other countries where banks operate. Given this dilemma, the IRS came up with the idea of executing agreements with other governments so that each government could require their banks to report either directly or using the local tax agency as an intermediary. Australia signed a FATCA Intergovernmental agreement (IGA)[9] in 2014 requiring all Australian financial institutions to report their US Person account holders to the ATO for subsequent transmission to the IRS. FATCA provided one-way information flow from other countries to the IRS. Once FATCA had broken the ice, the OECD was able to get member states to sign on to their Common Reporting Standard (CRS), which went into effect in Australia on 1 July 2017. These automated exchanges of information between tax authorities raise several issues around privacy and data security.

FATCA IGA

The FATCA IGA was ratified like any treaty on the Australian side. It required implementing legislation to pass through Parliament and it shows up amongst other tax treaties on the Treasury website. On the US side, however, the FATCA IGA is an agreement made only by the executive branch of government. IGAs were not authorised under the FATCA legislation and have not been ratified by Congress. While the Explanatory Memorandum[10] that accompanied the Australian FATCA IGA implementing legislation made the assertion that FATCA imposed no new US taxes, Parliament failed to realise that US taxation of Australian-resident US citizens had not been enforced for decades. FATCA data made enforcement possible and greatly increased the erosion of Australia's tax base by the unique US practice of taxing non-resident citizens.

Right to be informed

FATCA and CRS are automated exchanges of information. There is no presumption that the reported individual has done anything wrong. These regimes are an attempt to place investment outside one's country of residence on an even footing with domestic investment. When individuals' domestic interest and dividend income is reported to the ATO, they are informed about the amounts reported either through their bank statement or via the ATO. Individuals whose data is sent by their

---

[99] https://treasury.gov.au/tax-treaties/intergovernmental-agreement/

[10] https://www.legislation.gov.au/Details/C2014B00107/Explanatory%20Memorandum/Text

banks to the ATO (and by the ATO to the IRS or other foreign tax jurisdiction) also have the right to know what data is being sent. Informing account holders gives them the chance to correct any errors (hopefully prior to the data being sent to a foreign tax authority), and gives them certainty about how much of their personal data has been shared with other governments. We have attempted to get the ATO to disclose to account holders their own personal data sent under the FATCA agreement, but have not been successful.[11]

Reciprocity

It would also be helpful to get aggregate data to determine how successful schemes like FATCA and CRS are. Under CRS, the ATO must inform Parliament of the aggregate outbound data, though no such requirement exists under FATCA. In order to determine whether this data collection exercise is worth the time and money spent by the ATO and financial institutions, Parliament should also be informed of the aggregate inbound data flow from both CRS and FATCA – what taxpayer records are the ATO receiving under these schemes that it was not receiving previously? With regard to FATCA, the number of accounts and aggregate value in the first data transmission in 2015 was reported in the press, but the data sent in 2016 and 2017 have not been reported publicly. It is also unclear whether the ATO is receiving any data from the IRS that it would not have received without the FATCA agreement.

If you read the FATCA IGA, you will find that the data required to be sent by US financial institutions is not nearly as detailed as that required from Australian financial institutions. Plus, the US data is just a promise to try to get legislation to require the data; this legislation has not passed the US Congress. The IGA has a provision that directs the parties to consult on progress towards this limited reciprocity before 31 Dec 2016. It does not appear that any such consultation has occurred.

Privacy and security of data

The IRS is not known for having state-of-the-art computer systems. There have been several large breaches of IRS and US government data sets in the past several years. The data being exchanged under FATCA includes everything needed for identity theft.

[11] http://fixthetaxtreaty.org/2017/02/24/foi-take-2/