# CLARIFYING THE UNITED STATES INCOME TAX TREATMENT OF AUSTRALIAN SUPERANNUATION FUNDS OWNED BY U.S. PERSONS

*This paper was written by Roy A. Berg[1] and Marsha-laine Dungog[2], members of the California State Bar,[3] as part of the annual Washington DC delegation submissions co-sponsored by the State Bar of California and Los Angeles County Bar Association Taxation Sections. A version of this paper was presented and discussed with attorney advisors at the U.S. Internal Revenue Service Chief Counsel's Office and National Taxpayer Advocate, tax advisors at the U.S. Department of Treasury Assistant Secretary (Tax Policy), U.S. House Ways & Means Committee, the U.S. Senate Committee on Finance and the U.S. Joint Committee on Taxation on May 2 & 3, 2016 in Washington D.C.[4] Although authors might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, none of the authors has been specifically engaged by a client to participate on this submission.*

## EXECUTIVE SUMMARY OF PROPOSAL

Over the past several years the United States has analyzed, and rejected, numerous different proposals to modify its Social Security Programs.[5] As a result it currently bears the following hallmarks that are

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**[3] The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.**

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[5] CONGRESSIONAL BUDGET OFFICE, CBO PAPER: SOCIAL SECURITY PRIVATIZATION EXPERIENCES ABROAD (January 1999); STAFF OF THE JOINT COMMITTEE ON TAXATION, ANALYSIS OF ISSUES RELATING TO SOCIAL SECURITY INDIVIDUAL PRIVATE ACCOUNTS (March 1999)(hereinafter, "**JCX-14-99**"); *See also*, *International Pension Reform: Lessons for the United States*, 19 TEMP. INT'L & COMP. L.J. 133 (2005);

important to the analysis that follows: First, payment into the system is mandatory for all those who are employed or self-employed. Second, a participant's benefits are unfunded and unsecured: they are simply a promise (though not a binding promise) by the State to pay some amount (which is subject to change) at some time (which is also subject to change) in the future.[6] Third, since a participant's ultimate benefit under the program is unfunded and unsecured, the participant can expect to receive her benefit, (whatever that may be) whenever U.S. law entitles her to receive it. In sum, it is mandatory, publically administered, unfunded, and unsecured ("**Unfunded and Unsecured**").

In the past two decades approximately 32 countries have modified their mandatory social insurance programs to provide that the mandatory withholding is deposited into a State-regulated account over which the participant has at least some investment control.[7] Australia and eight other members of the Organization for Economic Cooperation and Development ("**OECD**") have modified their social insurance programs in this manner.[8] In sum, these social insurance programs are mandatory, publically regulated (though not publically administered as in the United States) funded, and secured ("**Funded and Secured**").

While there are a multitude of differences between U.S. Social Security and the Australian Superannuation, our paper focuses on the U.S. tax differences that result from the Unfunded Unsecured nature of the U.S. program and the Funded and Secured nature of the Australian program. In particular this paper identifies the overlaps and gaps between the U.S.-

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[6] Federal court decisions have held that an individual claimant acquires "no vested rights" in gratuity-type benefits paid by the Federal government to a veteran or his dependent *See*, Elmer F. Wollenberg, *Vested Rights in Social-Security Benefits*, 37 OREGON L REV. 360, 304 (1957-58); *United States v. Teller,* 107 U.S. 64, 68 (1982); *United States v Cook*, 257 U.S. 523, 527 (1922).

[7] Barbara E. Kritzer, *Individual Accounts in Other Countries*, 66 SOC. SEC. BULL. No. 1 (2005). The countries referenced in the bulletin include Argentina, Australia, Bolivia, Bulgaria, Chile, China, Colombia, Costa Rica, Croatia, Denmark, Dominican Republic, El Salvador, Estonia, Hong Kong, Hungary, Italy, Kazakhstan, Kosovo, Kyrgyzstan, Latvia, Mexico, Mongolia, Nigeria, Peru, Poland, Russia, Singapore, Slovakia, Sweden, United Kingdom, and Uruguay.

[8] The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

Australia Income Tax Treaty[9] (the "**Tax Treaty**") and Social Security Totalization Agreement[10] (the "**Totalization Agreement**") with respect to the Australian Superannuation Fund,[11] and provides recommendations for Treasury and the Internal Revenue Service ("**IRS**") to issue clarifying guidance to affected parties.[12]

An Australian Superannuation Fund (the "**Super**") is a tax-effective investment structure for investment because it offers taxpayers an opportunity to increase their investment in a host of assets at reduced tax rates.[13] Funding for the Super is primarily sourced from mandatory employer contributions (the "**Superannuation Guarantee**" or "**SG Contributions**") and voluntary employee contributions (the "**VEC**") that are pre-tax (the "**concessional contributions**") and post-tax (the **"non-concessional contributions**").[14]

The pressing U.S. tax issue with respect to the Super is whether the SG Contributions and VEC amounts paid to the Super should constitute part of a U.S. Person's[15] worldwide income subject to tax by the United States if such person has a beneficial interest in the Super (hereinafter, the "USP employee-beneficiary"). From an Australian tax perspective, all contributions to the Super are portable, fully-funded and fully-preserved to benefit USP employee-beneficiary and taxable to the Super itself, not the USP employee-

[9] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S. –AUS., Aug. 6, 1982, 35 U.S.T. 1999 (hereinafter the "**Tax Treaty**").

[10] Agreement between the Government of the United States of America and the Government of Australia on Social Security (Canberra, September 21, 2001) ("**Totalization Agreement**").

[11] See, Subsection 295-95(2) of the Australia Income Tax Assessment Act of 1997; see also T.R. 2008/D5 (June 4, 2008).

[12] This scope of this paper is limited to identifying the U.S. income tax consequences of contributions, accretions and distributions from an Australian Superannuation Fund to U.S. citizens and residents of Australia under current U.S. tax laws. It is not intended to provide a comprehensive analysis of the U.S. tax treatment of Australian Superannuation Funds.

[13] See generally, Henderson, Sam, and SMSF: DIY Guide (2012). *See* ROBIN WOELLNER, STEPHEN BARKOCZY, SHIRLEY MURPHY, CHRIS EVANS & DALE PINTO, CCH AUSTRALIAN TAXATION LAW (2013) at ¶23-030.

[14] See Superannuation Guarantee (Administration) Act 1992, the Superannuation Guarantee Charge Act 1992 and the Superannuation Guarantee (Administration) Regulations.

[15] The term U.S. Person refers exclusively to individual are citizens and lawful permanent residents of the United States as defined pursuant to §7701(a)(30) of the Internal Revenue Code of 1986, as amended (the "IRC" or "Code").

beneficiary. Under the U.S.-Australia Income Tax Treaty,[16] the Super constitutes a pension that would be primarily taxed by Australia under Article 18(1) and concurrently subject to tax by the United States under the Saving Clause of Article 1(3). The U.S. right to tax would come into play if the Australian resident is a U.S. citizen who is a beneficial owner in the Super (a "US employee-beneficiary").

Double taxation arises in the case of a US employee-beneficiary of a Super. Under the U.S. Saving Clause, the United States would have a right to tax a U.S. person's worldwide income from whatever source derived as if the Tax Treaty was never entered. In the case of the Super, there is no clear definitive guidance on the Super's classification and tax treatment for U.S. income tax purposes. Under U.S. domestic tax laws, the Super may be classified as a (1) Section 402(b) nonexempt pension plan; or (2) an employee's grantor trust under Treasury Regulations Section 1.402(b)-1(b)(6); or (3) a grantor trust under Sections 673-679. As a Section 402(b) plan, contributions and accretions of income in the Super are deemed constructively received by the US employee-beneficiary as taxable income subject to US tax. Consequently, this option would result in substantial US income taxes and reporting obligations for the U.S. employee-beneficiary without any relief available under the Tax Treaty. As an employees' grantor trust under Treasury Regulations Section 1.402(b)-1(b)(6), or alternatively, US grantor trust under Sections 673-679, all realized gains directly held by the Super are attributed to the U.S. employee-beneficiary deemed grantor-owner, resulting in capital gains taxes or alternatively, annual passive foreign investment company ("**PFIC**") reporting and PFIC taxes for foreign mutual funds owned by the Super. While the latter option results in arguable less current income taxes to the USP employee-beneficiary up front, it effectively creates more fees and costs for the U.S. employee-beneficiary to become fully tax compliant with U.S. tax reporting obligations.

The double income taxation faced by a USP employee-beneficiary of a Super is not shared by U.S. Persons in other countries with more sophisticated tax provisions in their respective U.S. tax treaties. The overbroad application of Section 402(b) to foreign funded pension plans is not unique to the Super. There are other non-U.S. trust arrangements such as the

[16] *See e.g.,* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, entered into force August 6, 1982, 35 U.S.T. 1999 (hereinafter the "Tax Treaty").

New Zealand superannuation plan, Dutch *Stichtings*, provident funds in Hong Kong Provident, Singapore, India and Israel, Irish Employee Benefit Trusts ("**EBT**"s), United Kingdom EBTs and arrangements within Swiss "foundations" which are potentially subject to the burdensome tax impact of Section 402(b) on contributions and earnings. The main distinction however, is that some of the countries have used totalization agreements and tax treaties to override Section 402(b) consequences to a U.S. person who has beneficial interests in a non-U.S. trust arrangement.[17] Such tax treaties track the U.S. model tax treaty provision which exempts from current U.S. income taxation both contributions to and accretions in a foreign pension fund that does not constitute a qualified pension plan under U.S. domestic tax laws. Indeed, U.S. employee-beneficiaries of Supers in Australia do not enjoy the same protections from double taxation of their social security and retirement benefits as U.S. persons in other countries do.

Our paper takes the position that the Super's classification and treatment under U.S. tax laws should be bifurcated. First, the Superannuation Guarantee component of the Super should be recognized as a social security tax that constitutes an excise tax on employers and outside the scope of the Tax Treaty. The Superannuation Guarantee and accretions of income in the Super attributable to such amounts are governed by the U.S.-Australia Social Security Totalization Agreement[18] which coordinates social insurance coverage and prevents double taxation from payment of social security taxes in both countries. The Superannuation Guarantee should also be classified as a part of a government-mandated social insurance program and not a nonexempt pension plan governed by Section 402(b) because it does not arise out of the employer-employee relationship but from the taxing authority of the Australian Commonwealth. Therefore, Superannuation Guarantee contributions, accretions of income and distributions attributable to such amounts do not constitute property of the employer transferred to the employee "in consideration for the performance of services" such that Section 83 should not apply.

We further assert that the SG component of the Super constitutes a foreign grantor trust with the Commonwealth as grantor and owner (the '**SG**

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[17] *See* Veena K. Murthy, *Selected Cross-Border Equity and Deferred Compensation Issues with Funded Foreign Plans*, 42 COMPENSATION PLANNING JOURNAL 67 (Bloomberg BNA, 2014).

[18] United States-Australia Social Security Totalization Agreement, September 27, 2001, 2208 U.N.T.S. 435 ("US-Australia Totalization Agreement").

**Trust**"). The Commonwealth exercises dominion and control over the SG Trust under Section 673-679 principles such that all SG Contributions and accruals are attributable to the Commonwealth as the owner and not the USP employee-beneficiary. Further, the foreign grantor trust status of the SG Trust meets Section 672(f) and Treas. Reg. Section 1.672(f)-3 because the Commonwealth has the power to revest SG Trust assets back to itself. Ultimately, neither the SG Contributions, accruals nor distributions should be taxable to the USP employee-beneficiary because these would constitute foreign social security taxes and social security payments thereon under Article 18 of the Tax Treaty; and further, SG Contributions and accruals constitute income to the Commonwealth as the grantor-owner of the SG Trust and not the USP employee-beneficiary.

We are also of the opinion that the employee portion of the Super, i.e., the VEC amount, is also not appropriately classified under Section 402(b) in the absence of any employer-employee arrangement to defer compensation. The Super's structural framework varies significantly from other non-US trust arrangements [19]where the employee's right to the trust assets may be subject to service or performance conditions that must be satisfied in order for the employee's right to be non-forfeitable, and in order for the employee to receive a future distribution of cash or a transfer of legal ownership in the shares from the trustee.[20] Our position is that VEC cannot be treated as constructively received into gross income of such person under Section 61 principles, or Section 402(b) and the employee grantor trust rules of Treasury Regulation 1.402-1(b)(6). As previously stated, a USP employee-beneficiary's interest in a Super is characterized by Australian courts as one that is inchoate, equitable and proprietary in nature but not one which carries an immediate right to payment of benefits, no more than a mere expectancy of future entitlements until the prescribed event occurs.

Assuming the USP employee-beneficiary of a Super is treated for U.S. tax purposes as taxable on the VEC amounts and accruals of income within

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[19] *See* VEENA K. MURTHY, SELECTED CROSS-BORDER EQUITY AND DEFERRED COMPENSATION ISSUES WITH FUNDED FOREIGN PLANS, 42 COMPENSATION PLANNING JOURNAL 67 (Bloomberg BNA, 2014). According to Ms. Murthy, non-US trust arrangements include Australian and New Zealand superannuation plans, arrangements within Dutch Stichtings, Hong Kong provident funds (as well as provident funds in other countries such as Singapore, India, Israel etc.), Irish Employee Benefit Trusts (EBTS) , arrangements within Swiss Foundations, and United Kingdom EBTS.

[20] *See*, DAVID W. ELLIS, ESQ., STRUCTURING INTERNATIONAL TRANSFERS OF EXECUTIVES §27:5.01(c); VEENA K. MURTHY, SELECTED CROSS-BORDER EQUITY AND DEFERRED COMPENSATION ISSUES WITH FUNDED FOREIGN PLANS, 42 COMPENSATION PLANNING JOURNAL 67 (Bloomberg BNA, 2014)

the Super under Section 402(b) and Treasury Regulations 1.402(b)-1(b)(6), we would propose that the USP employee-beneficiary of the Super should be allowed to claim either a direct or deemed paid foreign tax credit against his or her U.S. income tax for Australian taxes paid by the Super pursuant to Article 22 of the Tax Treaty.

The portion of the Super which corresponds to the VEC amounts paid (and accretions thereto) would constitute a private individual retirement account ("**IRA**") with the USP employee-beneficiary as grantor owner of the IRA trust. As grantor-owner of an IRA, it would be more likely than not that the IRA contributions, accretions and distributions would be subject to tax by the United States unless specifically exempted under Article 18 of the Tax Treaty. Unfortunately, the Tax Treaty does not possess comprehensive pension provisions under Article 18 to exempt an IRA with a USP employee-beneficiary and grantor owner from U.S. taxes. We would therefore urge the IRS and Congress to fashion an administrative remedy for this issue such that only actual distributions from an Australian IRA would be taxable by the US. Consequently, all Voluntary Employee contribution amounts and accruals thereon would be deemed received by the USP employee-beneficiary as grantor-owner and exempted from U.S. taxes.

We would further propose the following actions to be undertaken to harmonize the U.S. tax treatment of the Australian Superannuation Fund (and all Social Insurance Programs subject to an SSTA) with the U.S. tax treatment of U.S. social security taxes:

> **Proposal 1:** ***26 C.F.R. Section 1.402 should be amended to clarify that arrangements subject to an SSTA are excluded from the application of the statute.***
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> **Proposal 2:** ***26 C.F.R. Section 1.83 should be amended to clarify that arrangements to an SSTA are excluded from the application of the statute.***
>
> **Proposal 3:** ***31 C.F.R. Section 1010.350(c) (4) should be amended to clarify that arrangements subject to an SSTA are excluded from reporting on Form FinCEN 114.***

**<u>Proposal 4:</u>** ***26 C.F.R. 1.6048 should be amended to clarify that arrangements subject to an SSTA are exempt from reporting on the Forms 3520 and 3520-A.***

**<u>Proposal 5:</u>** ***26 C.F.R. Section 31.3111 should be amended to clarify that accretions of benefits under Social Insurance Programs subject to an SSTA are excluded from an individual's income in a manner similar to the exclusion of income found in IRC 3111(c).***[21]

**<u>Proposal 6:</u>** ***26 C.F.R. Section 1.1298-1T (b) (3) (ii) should be amended to clarify that passive foreign investment companies ("PFIC"s) owned by an arrangement subject to an SSTA be exempt from reporting on the Form 8621.***

It is our belief that Treasury and the IRS could affect the foregoing recommendations in a General Legal Advice Memorandum ("**GLAM**").[22] Doing so would afford Treasury the time to make the recommended changes to the regulations while providing affected U.S. persons' certainty of their tax and reporting positions without the fear of civil and criminal for failing to file the aforementioned forms.

## MERITS OF THE PROPOSAL

The lack of a clear and uniform classification for U.S. tax purposes of the Australian Superannuation Fund has resulted in egregious double taxation of amounts contributed to such Fund upon receipt and income accrued to the Fund prior to distribution for which there is no relief under the Tax Treaty. U.S. Persons in other countries who participate in foreign nonqualified retirement plans do not experience the same acute double taxation experienced by U.S. Persons in Australia. Currently, Australia ranks among the Top 10 countries with U.S. expat populations estimated at 102,176 as of

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[21] §3111(c) provides "During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement exclusively to the laws applicable to the social security system of such foreign country."

[22] We note that several of the citied statutes do not delegate legislative rule-making authority to Treasury, however we believe the clarifications to the regulations in our recommendations are within the IRS's authority to enact as interpretative regulations subject to 5U.S.C. 553 of the Administrative Procedures Act.

2010.[23] Other countries ahead of Australia on the Top 10 list such as Canada and the United Kingdom have tax treaty provisions which exempt foreign nonqualified plan income accruals and distributions from current U.S. income taxation. The Tax Treaty does not provide for similar relief.

## FEASIBILITY OF THE PROPOSAL

The proposal is politically and economically feasible because it provides clear and consistent classification and treatment for U.S. tax purposes of amounts contributed and accrued in an Australian Superannuation Fund. The lack of legislative and administrative guidance on the U.S. tax treatment of Supers has had a chilling effect on U.S. citizens in Australia who wish to become tax compliant under existing voluntary disclosure programs. The proposal would also provide relief to the double taxation dilemma faced by U.S. Persons in Australia on their Superannuation Funds perpetuated under the current Tax Treaty.

[23] A Model for Developing Estimates of U.S. Citizens Abroad: Final Technical Report by Fors Marsh Group (July 2013). See Table 8 at page 39.