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US Tax Treatment Of Australian Superannuation

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The views and opinions are those of the author and do not constitute legal advice upon which anyone may rely. The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser.

Introduction

Whenever a US taxpayer is confronted with an international tax issue, they should understand that there are two separate and distinct bodies of law that could potentially apply to the issue. First, there is domestic US tax law: Title 26 of the United States Code, which is known as the Internal Revenue Code. Second, there is international treaty law; the Convention Between the Government on the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, which is more commonly known as the US–Australia Income Tax Treaty. Domestic US tax law applies by default unless a taxpayer affirmatively elects to apply the treaty and explains the application on IRS Form 8833. A taxpayer that takes a treaty position without disclosing it on IRS Form 8833 will be liable for civil tax penalties for which there is no statute of limitations. You may also be exposed to criminal tax penalties if your failure to file IRS Form 8833 was intentional.

The growth within and distributions from Australian Superannuation Funds are undoubtedly subject to US taxation under domestic US tax law since gross income includes all income from whatever source derived, but is there an opportunity under the US–Australia Income Tax Treaty that would allow individuals to avoid US tax on their superannuation funds? To answer this question, we must first explore the interaction between domestic US tax law and international treaty law followed by an analysis of superannuation.

Treaties And Federal Laws

The Internal Revenue Code (the "Code") states that "neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." [1] As the United States Court of Appeals for the DC Circuit has explained, Congress intended to codify the so-called "later-in-time" principle when it enacted Code section 7852(d)(1), which focuses on timing to find which controls regardless of whether there is a conflict.[2] Thus, it's not the character that controls; it's the timing.

The DC Circuit's position of an Absolute "Later-in-Time" Rule even in the absence of a conflict or express intent to supersede has led some to believe that it is inconsistent with international law, which generally requires a conflict or clear intent to supersede a treaty.[3] However, although international law generally requires a conflict or intent to supersede, these commentators fail to comprehend another principle of international law: a treaty cannot supersede a nation's constitution.[4] Pursuant to the Supremacy Clause of the US Constitution, federal laws passed by Congress and treaties ratified by the Senate have equal weight and authority.[5]

In other words, if one views a treaty just like any other law passed by Congress and signed into law by the President, it becomes clear that a future law will only *supersede* a prior law to the extent that it is more specific than the previous or cannot be reconciled with the prior law. Because treaties are always more specific than general laws, a treaty will almost always be deemed to supersede domestic US tax law when a taxpayer elects its application.

The Australian Social Security System

The US Social Security Administration's 2010 publication titled "Social Security Programs Throughout the World" analyzes Australia's overall comprehensive social security system. The publication identifies the 1908 Invalid and Old-age Pensions Act and the 1942 Widows' Pensions Act as the first set of laws that formed Australia's first social security system. The current regulatory framework of Australia's overall comprehensive social security system is the 1991 Social Security Act, the 1992

Superannuation Guarantee Administration Act, and the 1999 New Tax System Family Assistance Act. The 1991 Social Security Act provides the traditional, minimal, and basic means-tested social assistance, but it also introduced the concept of "superannuation guarantees" to replace the general social security contributions that started with the 1945 Social Services Contribution Act.[6] The 1999 Superannuation Guarantee Administration Act mandated compulsory employer contributions to state-mandated occupational pensions that are privately managed. Under current Australian law, employers must contribute 9.5 percent of an employee's salary to state-mandated occupational pension funds called "superannuation funds." These state-mandated employer contributions are referred to as the "superannuation guarantee." There are no longer any social security contributions to publicly managed social security accounts in Australia due to Amending Acts from 1945 to 1969 and the final 2014 Repeal Act; they have been entirely replaced by the superannuation guarantee. This represents the privatization of Australia's government-run social security pensions.

There are various types of superannuation schemes identified in the 1991 Social Security Act, including, but not limited to, public sector funds established for federal and state government employees, corporate funds established by medium to large private sector companies for their employees, industry or multi-employer funds, retail funds or public offer funds, and self-managed superannuation funds.

Australia's current social security system has two components: a means-tested Age Pension funded through general revenue; and the superannuation guarantee funded through compulsory employer contributions to state-mandated superannuation funds, which are similar to compulsory contributions under the US Federal Insurance Contributions Act. This is supported by a report published by the United States Congress Joint Committee on Taxation, which stated" "The social security system in Australia is comprised of two tiers. The first tier is called the 'age pension' benefit and the second tier is called the 'superannuation guarantee'." [7]

In Australia, the Superannuation Guarantee Act of 1992 was adopted in recognition of the fact that Australia, along with many other industrialized nations, had and would continue to experience significant increases to life expectancy due to advances in the field of medicine, which would slowly make their social security system insolvent over time. The proposed solution was the privatization of their social security system that included a very basic need-based age pension system that served as a safety net, private savings generated by state-mandated employer contributions to a superannuation fund that served as the centerpiece of the privatization proposal, and the option for voluntary quasi-after-tax contributions to a superannuation fund.

Australian superannuation funds can most aptly be characterized as state-mandated occupational pensions with the primary purpose of providing for benefits at retirement, and it is specifically recognized as social security by the US Social Security Administration.[8] Furthermore, a state-mandated "occupational pension scheme" fits the precise definition of social security according to the OECD.[9] Under Australian law, any contribution to an Australian superannuation fund is inaccessible until death, disability, or retirement – a classic trait of traditional, publicly-managed social security. Even the International Social Security Association, of which Australia and the United States are members, also recognizes Australian Superannuation as forming part of Australia's overall comprehensive social security system.[10]

Therefore, based on the foregoing substantial and compelling authorities, it is indisputable that Australian Superannuation Funds are privatized social security accounts forming a part of Australia's overall comprehensive social security system.

The US–Australian Social Security Totalization Agreement

Moreover, the United States signed the *Totalization Agreement with Australia* that went into effect on October 1, 2002, which specifically recognizes "superannuation guarantee" contributions as being social security contributions since the funds are part of Australia's larger, comprehensive national social security system.[11] In essence, by covering superannuation contributions under the US–Australia Social Security Totalization Agreement, US federal law recognized that Australian superannuation funds are privatized social security accounts.

International Treaty Law And Social Security

If both the US and a treaty partner were members of the Organisation for Economic Cooperation and Development ("OECD") when a treaty was drafted, US courts are legally bound to mandatorily refer to OECD commentary, which is published every four years, to interpret terms in that income tax treaty.[12] The United States joined the OECD in 1961 while Australia joined in 1971. The US–Australia Income Tax Treaty was signed in 1982 and went into effect in 1983.

According to the OECD, the term "social security" generally "refers to a system of mandatory protection that a State puts in place in order to provide its population with … retirement benefits." [13] However, the OECD Model Income Tax Treaty does not specifically cover social security; it merely suggests that "payments under a social security system … could fall under Article 18, 19 or 21," which reference pensions from government service, private sector service or other income,

respectively.[14] On the other hand, the US–Australia Income Tax Treaty, unlike the OECD Model Income Tax Treaty, *does* specifically have a provision addressing taxing rights with regard to social security. Nevertheless, the OECD commentary broadly interpret "payments under a social security *system*" to include payments under a "worker's compensation fund," which is not generally considered "social security" in the United States. Moreover, the OECD has impliedly recognized Australian superannuation as a part of Australia's social security system.[15]

Therefore, the OECD takes a very broad and inclusive approach as to what constitutes "social security" under international treaty law.

US Tax Treatment Of Social Security Payments

Under domestic US tax law, with regard to reporting requirements for contributions to a nonqualified deferred compensation plan, Congress specifically exempted contributions to a foreign social security account.[16] This clearly evidences Congressional intent to disregard contributions to foreign social security for US tax purposes.[17] Moreover, the IRS has specifically stated that, under domestic US tax law, "foreign social security benefits … are taxable as annuities." [18] Gains within annuities are tax-deferred until the contract annuitizes and payments begin or when the owner cashes out the annuity and takes a lump sum.[19] Although many practitioners have asserted that Australian superannuation funds are reportable as foreign grantor trusts on IRS Forms 3520 and 3520-A, doing so would subject the gains within the fund to immediate US taxation, which is contrary to IRS guidance.[20] However, because gains will still be subject to US taxation at maturity of the Australian superannuation fund based on disability or retirement, one must still consider the application of the US–Australia Income Tax Treaty and the outcome thereunder.

Under Article 18, Paragraph 2, of the US–Australia Income Tax Treaty, "social security payments and other public pensions paid by one of the Contracting States to an individual who is a resident of the other Contracting State or a citizen of the United States shall be taxable *only* in the first-mentioned State." In other words, the country of *source* has exclusive taxing rights to social security income. With regard to an Australian superannuation fund, Australia would have exclusive taxing rights to the income.

With regard to treaty claims by US citizens, however, one must consider the application of the Saving Clause, which allows the United States to "tax its citizens as if this Convention had not entered into force." [21] It should be noted that the Saving Clause is merely a reserved right and does

not automatically apply to prevent claims by US citizens and treaty-determined residents.[22] The Saving Clause, however, does not affect claims made by US citizens with regard to social security payments.[23] Therefore, the Saving Clause is inapplicable to claims by US citizens with regard to income associated with an Australian superannuation fund.

Proper Reporting Method For US Tax Purposes

Code section 6114 requires any person relying on a tax treaty to disclose such position on his or her federal income tax return unless an exception applies.[24] IRS Form 8833 is used to make a disclosure regarding a treaty-based return position.[25] A separate form is required for each treaty-based return position taken by the taxpayer. If the treaty position results in no taxation whatsoever, then IRS Form 8833 must be filed along with a federal income tax return that only includes the taxpayer's name, address, taxpayer identification number and signature under the penalty of perjury. This effectively creates a *de facto* treaty election procedure.

If a taxpayer "fails in a material way to disclose one or more" treaty-based return positions, then a penalty is imposed on each separate payment of income or article of income even if "received from the same" payor.[26] For individuals, there is a USD1,000 penalty for each non-disclosure.[27]

Therefore, IRS Form 8833 must be filed to fully disclose to the Internal Revenue Service that the taxpayer is excluding gains within and/or distributions from their Australian Superannuation Fund on the basis that it constitutes foreign social security.

Lastly, "payments or the rights to receive the foreign equivalent of social security" are *not* specified foreign financial assets or foreign financial accounts subject to reporting on IRS Form 8938 or FinCEN Form 114a, respectively, pursuant to regulations promulgated under the Internal Revenue Code and Bank Secrecy Act, respectively.[28] Therefore, Australian Superannuation Funds need not be disclosed on IRS Form 8938 or FinCEN Form 114a.

Conclusion

In conclusion, it is this author's firm belief that Australian Superannuation Funds are properly covered under paragraph (2) of Article 18 of the US–Australia Income Tax Treaty as privatized individual social security accounts that are exclusively taxable in the country of source, Australia. As such, it is properly excludible from their US tax return with proper disclosure on IRS Form 8833.

ENDNOTES

1 See IRC § 7852(d).

2 *See Kappus v. C.I.R.*, 337 F.3d 1053, 1057 (DC Cir. 2003) (citing S. Rep. No. 100-445, at 316–28 (1988)).

3 *See Whitney v. Robertson*, 124 US 190 (1888); *The Chinese Exclusion Cases*, 130 US 581 (1889); *The Cherokee Tobacco*, 78 US 616 (1871); *Diggs v. Schultz*, 470 F.2d 461 (DC Cir. 1972); *also see* Restatement (Third) of Foreign Relations Law of the United States, § 115(1)(a) ("An act of Congress supersedes an earlier … international agreement as law of the United States if the purpose of the act to supersede the [treaty] is clear or … cannot be fairly reconciled [due to a conflict]").

4 *See* Restatement (Third) of Foreign Relations Law of the United States, § 115(3).

5 *See Ware v. Hylton*, 3 US 199 (1796) (because a treaty is the equivalent of a law passed by Congress, a state law conflicting with the treaty was nullified by the US Supreme Court). Although treaty protocols relate-back to the original adoption of the treaty, regulations do not relate-back to the original adoption of the statute, so it's not possible for treasury to promulgate regulations inconsistent with treaty obligations.

6 *See* Australia Social Security Act, s.9(1).

7 *See* Analysis Of Issues Relating To Social Security Individual Private Accounts Scheduled For A Public Hearing Before The Senate Committee On Finance On March 16, 1999, JCX-14-99 (1999). One federal court case also recognized superannuation as social security *in dicta*. *See McCubbin v. McCubbin*, No. 06-4110-CV-C-NKL, (W.D. Mo. June 28, 2006) ("Before she left Australia, Sheree McCubbin cashed out her Superannuation fund, a kind of social security fund").

8 *See* Social Programs Throughout the World, US Social Security Administration's Office of Retirement and Disability Policy, http://www.ssa.gov/policy/docs/progdesc/ssptw/2010-2011/asia/australia.html (September 1, 2015); *also see* Individual Accounts in Other Countries, US Social Security Administration's Office of Policy, http://www.ssa.gov/policy/docs/ssb/v66n1/v66n1p31.html (September 1, 2015).

9 *See* 2014 OECD Commentary on Article 18, para. 10.

10 *See* Social Security Country Profiles, International Social Security Association, https://www.issa.int/country-details?countryId=AU®ionId=ASI (September 1, 2015).

11 "For Australia, the agreement covers 'Superannuation Guarantee' (SG) contributions that employers must make to retirement plans for their employees." Totalization Agreement with Australia, SSA Publication No. 05-10176 (2004). However, according to a vague IRS Chief Counsel Memorandum, Australian superannuation funds may be treated like any other private retirement plan. *See* IRS CCA 200604023 (October 24, 2005) – though the Chief Counsel Memorandum made an inexplicable leap

in logic by assuming that an Australian superannuation fund is simply a private pension without any legal analysis whatsoever. It is, quite simply, unauthoritative and unreliable given its extremely poor legal approach to a complex international legal issue.

12 *See Podd v. C.I.R.*, 76 T.C.M. 906 (1998) (citing *US v. A.L. Burbank & Co.*, 525 F.2d 9, 15 (2d Cir. 1975); *North W. Life Assurance Co. of Canada v. C.I.R.*, 107 T.C. 363 (1996); *Taisei Fire & Marine Ins. Co. v. C.I.R.*, 104 T.C. 535, 546 (1995) (construing the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, March 8, 1971, US–Japan, 23 UST. 969, with reference to the Model Treaty and its commentary)).

13 *See* 2014 OECD Commentary on Article 18, para. 28.

14 *See* 2014 OECD Commentary on Article 15, para. 2.14.

15 *See* Pensions at a Glance 2013: County Profiles – Australia, OECD, http://www.oecd.org/els/public-pensions/PAG2013-profile-Australia.pdf (September 1, 2015). Although the report refers to superannuation as a private pension, it is referring to the fact that it is privately managed. For example, in the same report analyzing the US social security system, it refers to social security as a "publicly provided pension benefit" since it is managed and provided by the government. *See* Pensions at a Glance 2013: County Profiles – United States, OECD, http://www.oecd.org/els/public-pensions/PAG2013-profile-United-States.pdf (September 1, 2015). It is important to keep in mind that the purpose of the OECD publication is to analyze each country's social security system and distinguish between government-mandated programs and voluntary retirement savings.

16 *See* Treas. Reg. § 1.409A-1(a)(3)(iv).

17 *See Dominion Res., Inc. v. US*, 681 F.3d 1313 (Fed. Cir. 2012) (Treasury cannot interfere with the unambiguously expressed intent of Congress).

18 *See* IRS Publication 17, p.84.

19 *See* IRC § 72.

20 If Australian superannuation funds were foreign pension plans, they would certainly be subject to reporting on IRS Forms 3520 and 3520-A. However, being social security, they are not subject to reporting since they constitute foreign social security, which is taxable in the same manner as an annuity in accordance with IRS Publication 17.

21 *See* US–Australia Income Tax Treaty, Art. 1(3).

22 *See* Technical Explanation of the US–Australia Income Tax, Art. 1(3).

23 *See* US–Australia Income Tax Treaty, Art. 1(4)(a).

24 *See* IRC § 6114.

25 *See* Treas. Reg. § 301.7701(b)-7.

26 *See* Treas. Reg. § 301.6712-1(a).

27 *See* Treas. Reg. § 301.6114-1(a)(1)(ii).

[28] *See* Treas. Reg. § 1.6038D-3; 31 C.F.R. § 1010.350; *also see* "FATCA – FAQs General," Internal Revenue Service, http://www.irs.gov/Businesses/Corporations/Frequently-Asked-Questions-FAQs-FATCA--Compliance-Legal (September 1, 2015).