U.S.-Australia Income Tax Treaty 2020

Topics
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2. The Hidden Mortgage Interest Deduction for Australian Mortgage Offset Accounts
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4. Treaty-Based Synthetic Basis Step-Up Election for Australian Nationals
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CASTRO & CO. INTERNATIONAL
Whenever a U.S. 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.

1. **Domestic U.S. Tax Law**: Title 26 of the United States Code, which is known as the Internal Revenue Code.

Domestic U.S. 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.

How Are Australian Superannuation Funds Treated in the U.S.?

Under domestic U.S. tax law, Australian Superannuation Funds can be treated as either a foreign grantor trust or an annuity depending on whether the assets within the fund are preserved or non-preserved. There may also be hybrid treatment where a portion of the Superannuation Fund is treated as an annuity and the other portion is treated as a foreign grantor trust. Generally, gains within a foreign grantor trust are taxable in the U.S., which can result in a tremendous tax burden, especially if an Australian national does a rollover from one Superannuation fund to another while a U.S. tax resident.

Under the U.S.-Australia Income Tax Treaty, however, there is an opportunity to lawfully avoid U.S. taxation on Australian Superannuation Funds. This legal position has even been referenced by the Sydney Morning Herald and the SMSF Tax Advisor magazine. By taking this legal position, Australia would have exclusive taxing rights over Australian Superannuation Funds, which effectively allows Australian nationals residing in the U.S. to lawfully exclude any gains within or even future distributions from their Australian Superannuation Fund from their U.S. federal income tax returns.

Will My Funds Be Taxed?

In order to obtain the legal basis to take this position regarding US tax Australian superannuation, it is necessary to obtain a Tax Opinion from Castro & Co. A Tax Opinion is a legal opinion issued by a U.S. tax firm that shields taxpayers from certain tax penalties and interest thereon. Without a formal, written Tax Opinion, you risk severe penalties.

The Tax Opinion also guarantees that, in the event of an audit, our firm will represent you without additional charge and fully defend the position to shield you from any and all liability. The Tax Opinion perpetually exempts the Australian Superannuation Fund from U.S. taxation regardless of the amount of gains within, distributions from, and income attributable to the fund.

Moreover, if you've paid U.S. tax on your Australian Superannuation Fund in prior tax years, we can file amended tax returns to recover those taxes. Contact our firm today to obtain the Tax Opinion and shield your Australian Superannuation Fund from U.S. taxation.
THE HIDDEN MORTGAGE INTEREST DEDUCTION
AUSTRALIAN MORTGAGE OFFSET ACCOUNTS

For tax professionals that are inexperienced with Australia-specific issues, they’ve likely never heard of this type of financial account. Put plainly, it’s a bank account that an Australian can use to neutralize their interest on their home mortgage in Australia.

In other words, if you have a mortgage for $300,000 and a Mortgage Offset Account with $100,000, then your mortgage interest rate only applies to $200,000 of your $300,000 mortgage. It’s actually quite amazing.

A Mortgage Offset Account is simply a bank account. It gets reported on FinCEN Form 114 (Foreign Bank Account Report) as well as IRS Form 8938.

However, even for the most experienced international tax practitioner, this next part will surprise you: there’s a hidden mortgage interest deduction.

Your client will certainly tell you how much mortgage interest they paid, but, using the example above, they will only know the amount of mortgage interest paid on the $200,000.

Their mortgage is for $300,000. They only didn't pay interest on the other $100,000 because of the Mortgage Offset Account.

It’s a *de facto* imputed mortgage interest payment. The IRS uses the concept of imputed income throughout the Internal Revenue Code, but imputation is a double-edged sword. In this case, the mortgage interest payment was effectively made by the action of having a Mortgage Offset Account with $100,000. But for the existence of the Mortgage Offset Account, mortgage interest would have been actually paid.
Our firm takes the position that there’s an imputed de facto mortgage interest payment on the interest that would otherwise be attributable to the portion of the mortgage loan balance offset by the balance of the Mortgage Offset Account.

Please note that this legal position applies both to a personal residence, even if secondary, that is not rented at any time during the year as well as a rental property.

It’s also important to note that penalties do not apply to legal positions that are adequately disclosed on the tax return. By disclosing this legal position on IRS Form 8275, which our firm always does, the possibility of penalties is neutralized. Worst case scenario is a denial of the deduction.

“Ensuring that Australian Nationals have the most up-to-date information regarding U.S. Taxation is our first priority.”
It sounded like a good deal; you got a free vacation to Panama or Switzerland and all you had to do was sign a few bank forms while you were at the beach or ski resort. Well, little did you know that you just became a part of Pablo Escobar’s international money laundering network. In order to combat this, Congress passed the Bank Secrecy Act to force Americans to disclose whether they had bank accounts with more than $10,000 USD overseas and made it criminal to knowingly fail to disclose it.

HOW TO FILE YOUR OWN FBAR

Unlike other firms, our firm puts the interests of our clients first. To the extent a client wants to be empowered with the knowledge to handle their own tax affairs, we actively encourage that; however, you do so at your own peril.

Introduction
Firstly, it’s not an “eff-bee-ay-are.” It’s an acronym, which means you pronounce it like a word: “eff-bar,” which stands for Foreign Bank Account Report (FBAR).

Secondly, an FBAR is not filed with the Internal Revenue Service. It’s filed with the Financial Crimes Enforcement Network (FinCEN); pronounced “fin-sin.” More specifically, it’s filed on FinCEN Form 114.

Therefore, FinCEN Form 114 is the Foreign Bank Account Report (FBAR).

Background
The FBAR became a requirement when Congress passed the Bank Secrecy Act of 1970. This was the time of Pablo Escobar, and the Bank Secrecy Act was targeting criminal organizations like the Medellin Cartel. You see, back then, attorneys were approaching people in Miami and offering them money in exchange for opening a bank account under their own name in places like Panama and Switzerland.
U.S. citizens and U.S. lawful permanent resident “green card holders” worldwide must file the FBAR each year. The due date is the same as the due date for your tax return. If you saw another website with a different date, ignore it. It’s an outdated article. The comment we hear most often: “But I saw a different date on the FinCEN website itself.” Well, guess what, welcome to your incept government that does not even have the sense to update their own website. You see, that’s the problem with confusing Google with quality legal advice. Attorneys exist because we’re better at interpreting the law than government employees. The due date changed in 2015 with the passage of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Section 2006(b)(11). Look it up for yourself.

Under U.S. law, if the cumulative balance of all of your non-U.S. financial accounts (checking/saving, investment, etc.), when converted to U.S. dollars, exceeds $10,000 USD in the aggregate, you are required to file an FBAR. In other words, if you have 5 accounts with $2,000 USD each, you have to file the FBAR.

The penalty for merely negligently not filing by your tax deadline (including extensions) is a whopping $10,000 per year with a six-year statute of limitation, which means they can assess penalties going six years back. And if the IRS has reason to believe the failure to file was intentional, the annual penalty increases to an astonishing $100,000 plus the potential for criminal prosecution. Long story made short is: don't mess with this. It's not a joke. It's just an informational report. You can argue constitutional freedoms and liberty after you file the FBAR. Just give the U.S. government what they want.

FILE YOUR OWN FBAR ONLINE

01

Go to this webpage: https://bsaefiling.fincen.treas.gov/NoRegFBARFiler.html

02

Click Start Now under the “Online Form” e-Filing Method.

03

Enter your contact information on the Filer Contact Information page. The email address you enter will only be used to send correspondence regarding the status

04

Click Start FBAR at the bottom of the Filer Contact Information page to access the FBAR Home page.

05

In the Filing name field, enter a descriptive name to identify your FBAR (e.g. SMITH FBAR 2019). This filing name is also useful when contacting the BSA E-Filing Help Desk for assistance.

06

Complete the FBAR in its entirety. Additional parts or accounts can be entered by clicking on the small plus (+) signs located on the report. At the very least, all required fields – identified with an asterisk (*) – must be completed.

07

When you are ready to submit, return to the Home tab and click Sign the Form to accept the signature agreement. If you need to make changes to the FBAR after it has been signed, simply click Remove Signature from the Home tab.
When the form is free of any validation errors and electronically signed, return to the Home tab and click Submit. A confirmation page will be displayed at this point.

Click Download Copy of My FBAR on the confirmation page to retain a read-only copy of your FBAR submission. Save the confirmation page for your records as well by selecting to save from your browser menu. When saving your FBAR information, be sure to enter a file name and save to a familiar location on your computer to make it easy to find your file in the future.

Shortly after submission, you will receive an email notification regarding the status of your FBAR submission. Save this email for your records.

In approximately two (2) business days, you will receive a second and final email notification informing you that your FBAR submission has been acknowledged by FinCEN and assigned a unique BSA ID. Save this email for your records. Your FBAR filing is now complete! In the event that you need to amend your FBAR, you must enter the BSA ID assigned to your FBAR on your amendment.

**ADDITIONAL ASSISTANCE**

If you still need assistance, I would recommend simply letting us handle it. Nevertheless, for all the die-hard do-it-yourselfers out there, you can contact the BSA E-Filing Help Desk by phone at 1-866-346-9478 or via email at BSAEFileHelp@fincen.gov.
TREATY-BASED SYNTHETIC BASIS
STEP-UP ELECTION FOR AUSTRALIAN NATIONALS

One issue that comes up quite frequently from Australian nationals in the U.S. is the fear that the U.S. will tax capital gains from the sale of their home in Australia. As most people know, the U.S. inherits the taxability of built-in gains in worldwide assets upon becoming a U.S. tax resident. Without pre-immigration tax planning, by default, it’s taxable; however, the treaty changes the answer. Under the treaty, it’s effectively exempt.

Background

Unlike the U.S. that has a limited capital gain of only $250,000 for a single filer or $500,000 for a married filer under Section 121, Australia has an unlimited capital gain exclusion for the sale of a primary residence. Coupled with a red hot real estate market in Sydney where home values have tripled, this has resulted in situations where even the $500,000 USD exclusion is insufficient to cover the total amount of capital gain.

Thankfully, Article 13(5) of the U.S.-Australia Income Tax Treaty provides relief.
The D.C. 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. 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. Pursuant to the Supremacy Clause of the U.S. Constitution, federal laws passed by Congress and treaties ratified by the Senate have equal weight and authority.

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.

The Internal Revenue Code (herein the “Code”) states that “neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.” As the United States Court of Appeals for the D.C. 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. Thus, it’s not the character that controls; it’s the timing.

In 1983, the United States and Australia concluded U.S.-Australia Income Tax Treaty. It was ratified by the United States Senate and signed into law by President Ronald Reagan. Article 13 only had 4 paragraphs.

In 2001, the United States and Australia concluded “Protocol Amending the Convention Between the Government of 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” (herein the “2001 Protocol”). It was ratified by the United States Senate and signed into law by President George W. Bush. The 2001 Protocol added Paragraph 5 to Article 13. Article 13, Paragraph 5, of the U.S.-Australia Income Tax Treaty states “an individual… upon ceasing to be a resident of one of the Contracting States… may elect to be treated for the purposes of taxation in the other Contracting State as if the individual had, immediately before ceasing to be a resident of the first-mentioned State, alienated and re-acquired the property for an amount equal to its fair market value at that time.”

In applying the “later-in-time” rule, protocols (i.e., amendments) to an income tax treaty are effectively disregarded since they relate-back to the original enactment; therefore, only the original effective date of the treaty is relevant, so a proper legal analysis would disregard the protocol ratification date.
U.S. Tax Treatment of the Article 13(5) Election

The Technical Explanations (akin to Treasury regulations) to the U.S.-Australia Income Tax Treaty explain that “[p]aragraph (5) permits an individual who changes residence from Australia to the United States to elect to be treated for U.S. tax purposes as if he had, immediately before ceasing to be a resident of Australia, sold property and reacquired it for an amount equal to its fair market value... Second, the ‘deemed sale and repurchase’ will result in the individual (now a U.S. resident) having a ‘stepped up’ basis equal to fair market value in all assets subject to the deemed sale and repurchase, regardless of whether any U.S. tax was triggered by the deemed sale.” There is no requirement that the election be made in the year of the change in residency. However, it is clear the election can be made only once. If the election is made in a year in which the individual is a U.S. tax resident, gain is calculated “as if” the sale took place “immediately before ceasing to be a resident of Australia,” which will be prior to the individual having established U.S. tax residency. Capital gain is sourced to the country of residence. Therefore, if the election is made in a subsequent year after the change in residency, it triggers no U.S. taxation, which was foreseen in the Technical Explanation that said the deemed sale would be recognized “regardless of whether any U.S. tax was triggered by the deemed sale.” However, if the asset for which the election is being made has already been reported, it must be reported as sold without any resulting capital gain.

As stated in the Technical Explanations, the election applies strictly for “U.S. tax purposes.” Therefore, the election requires no consistency reporting to the Australian Tax Office since it exclusively applies strictly only for U.S. 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. IRS Form 8833 is used to make a disclosure regarding a treaty-based return position. 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. For individuals, there is a $1,000 penalty for each non-disclosure.

There are several items for which reporting is specifically waived.
TAX-FREE WITHDRAWAL OF U.S.-BASED RETIREMENT FUNDS BY NON-U.S. CITIZEN AUSTRALIANS

One of the most common inquiries we get from Australian nationals is how to handle their IRA or 401(k) fund when they are planning leave.

For example, you came to the U.S. on an E-3 or L-1 Visa for a short-term assignment. Now you’re planning to or already did return to Australia, and you want to withdraw funds from your 401(k), Individual Retirement Account (IRA), 403(b), or similar U.S.-based retirement fund.

You’re told there’s a generally applicable 20% withholding tax. This may increase to 30% if the retirement fund discovers you’re a nonresident non-U.S. citizen. You’ve also been told there’s a 10% early withdrawal penalty if you’re under the age of 59.

All of that is true except there’s a solution under the U.S.-Australia Income Tax Treaty that avoids any and all U.S. tax. Pay close attention.
Taxation of Pension Distributions Under U.S. Tax Law

Under the Internal Revenue Code, any distribution from a qualified plan to any participant is an eligible rollover-distribution unless it is paid over the life expectancy of the participant or the joint life expectancies of the participant and the beneficiary, or as part of a substantially equal series of payments that were paid in excess of 10 years, or is made solely to satisfy the minimum distribution requirements of Internal Revenue Code section 401(a)(9). If an eligible rollover distribution is not rolled over, it is generally subject to a mandatory 20% income tax withholding.

The rationale for providing preferential tax status to the various retirement savings vehicles is to encourage current saving for consumption after retirement. In order to discourage the taking of early distributions, Internal Revenue Code section 72(t) imposes a 10% additional income tax on the distributions which fail to meet certain requirements. The additional tax is imposed on the portion of a distribution that is included in gross income, and it does not apply to any portion of a distribution that is a return of employee contributions or nondeductible contributions or any amount rolled over into another retirement plan. The additional tax is in addition to any income tax due on the distribution.

The Effect of Income Tax Treaties

The Internal Revenue Code is not the only body of law that is applicable. The Internal Revenue Code provides that all provisions “shall be applied to any taxpayer [but] with due regard to any treaty obligation of the United States which applies to such taxpayer.” In other words, tax treaties provide an additional legal forum for tax planning. Treaties typically reduce or eliminate the rate of tax on certain articles of income. When a taxpayer elects to apply the provisions of an income tax treaty, the election applies to all of the taxpayer’s activities and articles of income covered by the treaty; at that point, the treaty overrules the provisions of the Internal Revenue Code.

Under the Internal Revenue Code, retirement benefits and pension distributions are sourced in the same manner as personal employment services; the situs of the income-producing services. In the context of distributions from a retirement plan, the source is the area of performance which gave rise the benefit and pension payments. Under income tax treaties, however, the rules are different.

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.” As the United States Court of Appeals for the D.C. 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. Thus, it’s not the character that controls; it’s the timing.

The D.C. 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. 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. Pursuant to the Supremacy Clause of the U.S. Constitution, federal laws passed by Congress and treaties ratified by the Senate have equal weight and authority.

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.
International Treaty Law and Pensions

If both the U.S. and a treaty partner were members of the Organization for Economic Cooperation and Development ("OECD") when a treaty was drafted, U.S. courts are legally bound to mandatorily refer to OECD commentary, which is published every four years, to interpret terms in that income tax treaty.[13] The United States joined the OECD in 1961 while Australia joined in 1971. The U.S.-Australia Income Tax Treaty was signed in 1982 and went into effect in 1983 with an amending protocol signed in 2001. Therefore, U.S. courts are legally bound to defer to the OECD with regard to interpreting treaty terms, which promotes international consistency.

According to the OECD, “while the word ‘pension,’ under the ordinary meaning of the word, covers only periodic payments, the words ‘other similar remuneration’ are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.” The IRS has agreed with this interpretation in private letter rulings. Treasury Regulations and Treaty Technical Explanations cannot supersede international law.

Therefore, the OECD takes a very broad approach as to what constitutes a “pension distribution” under international treaty law, which the U.S. is legally bound to recognize.

The U.S.-Australia Income Tax Treaty

Under Article 18, Paragraph 1, of the U.S.-Australia Income Tax Treaty, “pensions and other similar remuneration paid to an individual who is a resident of one of the Contracting States in consideration of past employment shall be taxable only in that State.” The Technical Explanations to the treaty further explain that “Paragraph 1 provides that pensions derived and beneficially owned by a resident of one of the Contracting States in consideration of past employment... shall be taxable only in that State [of residency].” In other words, under the provisions of the U.S.-Australia Income Tax Treaty, “the country of residence has exclusive taxing rights over pension distributions. Furthermore, the IRS has clarified that Individual Retirement Accounts (IRAs) are covered by the pensions article in U.S. income tax treaties.

Although Article 18, Paragraph 4, makes a reference to “periodic payments,” the IRS has clarified that the “word ‘periodic’ in Article 18(4) does not preclude the application of Article 18(1) to lump sum distributions. Again, although it sounds counterintuitive, the IRS has issued a Private Letter Ruling clarifying that, under international treaty law, the “word ‘periodic’ in Article 18(4) does not preclude the application of Article 18(1) to lump sum distributions.” Residency for tax treaty purposes is determined under the domestic law of each country. A tax resident is a person that is “liable to tax” in that country on the basis of residency or domicile.
When the domestic law of two countries results in claimed residency by both countries, however, the taxpayer must apply the treaty’s “residency tie-breaker” provisions. The reason it is important is because residency determines the taxation of many important types of income, such as dividends, interest, royalties, capital gain, pension distributions, retirement pay, annuities, and alimony. In other words, the country of residence generally gets the vast majority of exclusive taxing rights.

When an individual is determined to be a tax resident under the domestic law of two countries that have an income tax treaty with one another, there are a set of factors that “break the tie.” The first tie-breaker provision to apply will determine which country is the true country of residence. If one is undeterminable or too close to call, the analysis should continue until one of the factors clearly controls.

Under the U.S.-Australia Income Tax Treaty, the first residency tie-breaker provision favors the country in which the taxpayer “maintains [his or her] permanent home.” If the taxpayer “has [his or her] permanent home in both Contracting States or in neither of the Contracting States,” the second residency tie-breaker provision favors the country in which the taxpayer “has an habitual abode,” which is generally where the taxpayer spend more time throughout the tax year.

If the taxpayer “has an habitual abode in both Contracting States or in neither of the Contracting States,” the third and final residency tie-breaker provision favors the country “with which [his or her] personal and economic relations are closer.”

The Concern for Financial Institutions

The Internal Revenue Code explains that all persons, in any capacity, that have control, receipt, custody, disposal, or payment of any class of income items of any nonresident alien individual shall deduct and withhold tax at a rate of either 30 or 14 percent. The classes of income include interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical income, such as pension income.

Financial institutions don’t have the best legal departments. For that reason, they can be difficult to work with. Our firm has extensive experience in supplying the necessary documentation to alleviate their concerns and legally relieve them of liability.
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