Australian Superannuation reforms may negatively impact US citizens

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Last May 4, President Trump and Prime Minister Turnbull celebrated the 75th anniversary of the Battle of the Coral Sea in New York aboard the *USS Intrepid*, a World War II aircraft carrier. In his commemorative speech, President Trump renewed friendship and lasting partnership with Australia noting that the ties that bind the two countries had been "sealed with the blood of their fathers and grandfathers".[2] This recent warming of relations between Trump and Turnbull since the purportedly "combative phone call" [3] between the two leaders last February 2017 is fortuitous indeed. Perhaps it will provide the political momentum for much needed amendments to update the Australia-US tax treaty, [4] particularly Article XVIII which does not definitively address whether the United States can impose tax on contributions, earnings and distributions from Australian superannuation funds that are owned by US citizens residing in Australia (US expat).(http://moodysgartner.com/u-s-taxation-australian-superannuation-funds-super-not-super/)

Absent bilateral treaty renegotiations, US expats, who are obligated to pay US taxes on their worldwide income, have no other recourse except to trundle through the byzantine tax laws of both countries in order to arrive at a defensible (though uncertain) position on why Australian superannuation funds should not subject to US taxation. Thus far, the certainty and clarity of that solution has remained elusive. US expats who become fully compliant with their US tax obligations have done so at a price so steep that many have decided to renounce their US citizenship (http://moodysgartner.com/renouncing-your-u-s-citizenship-is-divorcing-uncle-sam-right-for-you/) (http://moodysgartner.com/super-reason-australians-renouncing-us-citizenship/)

While the need for clarity on the US tax treatment of superannuation funds is needed, recent changes to Australian taxation and superannuation law significantly raise the need for this clarification. Indeed, on July 1, 2017, recent legislative reforms to Australian Superannuation laws will take effect. [5] These reforms complicate the US tax filing obligations for US expats (http://moodysgartner.com/u-s-citizens-living-australia-u-s-tax-filing-obligations/) in the following ways:

1. **Lowered Concessional (Pre-Tax) Contribution Cap and Decreased Income Thresholds for Additional 15 Percent Tax**

An Australian superannuation account is funded primarily by concessional contributions which are paid by an employer and an eligible employee up to a maximum amount of AUD $30,000 per annum.[6] Neither compulsory employer contributions nor the voluntary pre-tax employee contributions are taxable to the employee in Australia. However, such amounts constitute assessable income subject to a 15 percent tax upon entry to the superannuation fund trustee (contributions tax) Further, employees earning above a "high income threshold" of AUD $300,000 per annum are required to pay an additional tax of 15 percent on their "low tax" contributions. [7] Effective July 1, 2017, the income threshold for liability to Division 293 tax will reduce to AUD $250,000 per annum and the maximum concessional contribution amount will be reduced from AUD $30,000 to AUD $25,000 per annum.

From Double to Triple Taxation?

The US tax laws generally do not recognize concessional employer and employee contributions to a superannuation fund as non-taxable income to a US expat. On the contrary, both concessional contributions and earnings accrued on such amounts are treated as a gross income to a US expat, subject to US tax at ordinary income rates. Starting in 2017-2018, Australia will now impose an additional 15 percent tax on concessional contributions if the US expat has a “High Income Threshold” above AUD $250,000 per year. Depending on how concessional contributions are classified under US law, this could be bad news for individuals who are subject to US tax, because the additional 15 percent tax could result in triple taxation.

2. **Reduction in Annual Non-Concessional Contributions Cap**

Currently, individuals under 65 years old are allowed to make non-concessional contributions of AUD $180,000 per year (or AUD $540,000 by “bringing forward” the next two contribution years). These non-concessional contributions are from after-tax (or post-tax) monies, so there is no tax payable either by the individual or the superannuation fund on these contributions. Earnings from these amounts are subject to a flat rate tax of 15 percent in the accumulation phase and can be transferred tax-free into a retirement account or pension when the superannuation member retires or meets another condition of release from the preserved superannuation environment. Under the new law effective July 1, 2017, individuals under 65 years will have reduced annual non-concessional contributions of AUD $100,000 per year with a three-year bring forward AUD $300,000.[8] However, there is a transitional period for individuals who have made their annual non-concessional contributions and triggered their three-year bring-forward amounts prior to July 1, 2017. Such individuals will be allowed to access their bring-forward contribution amounts at the reduced thresholds, depending on when they triggered their bring-forward. Importantly, individuals with a superannuation of AUD $1.6m or more (based on their “total superannuation balance” as at 30 June of the financial year prior the year of contribution) will not be allowed to make any additional non-concessional contributions

US may Tax Both the Annual and Bring Forward Amounts Contributed by US Expats

Unless the issue is clarified under the Treaty or under US domestic law, non-concessional contributions and earnings accrued on such amounts are currently subject to US tax. The fact that such amounts are off-limits to a US expat while deposited in a superannuation savings account until retirement does not change the current taxability. From a US perspective, superannuation savings accounts funded with after-tax monies are generally classified as non-exempt foreign pension plans that are taxable to the US individual it benefits. While these accounts are functionally similar to Roth IRA or 401K (which are funded with after-tax monies and accumulate in a 401K account tax-free) the tax consequences are completely different. After-tax monies contributed to a Superannuation account that represent annual caps and three-year bring-forward amounts are taxed at ordinary income tax rates for US tax purposes. US expats that are incentivized by Australian legislation to max out their annual non-concessional contributions cap to trigger their three-year bring-forward contribution amounts within the transitional period may also incur substantial US tax liabilities for doing so.

3. **Introduction of an AUD $1.6m Lifetime Transfer Balance Cap**

Starting July 1, 2017, there will be a cap of AUD $1.6m on the total amount of superannuation savings that can be transferred from an accumulation account to a tax-exempt retirement account. To enforce the transfer balance cap, individuals will be required to commute one or more of their superannuation income streams where they have an excess transfer balance.[9] Unless the US tax law is clarified, US expats with amounts in excess of AUD $1.6m in their superannuation savings who will be transitioning to retirement and those who are already in retirement with more than AUD $1.6m in their retirement accounts will generally have two options: leave the excess amounts in their accumulation account where earnings are taxed at the standard 15 percent rate or withdraw the excess amounts from superannuation which may be subject to tax for Australian tax purposes where the member is less that age 60.[10] We note that a third option, which involves the use of limited recourse borrowing arrangements (LRBAs) by SMSFs is the subject of recently proposed legislation which will severely restrict the use of LRBAs as a workaround to the total superannuation balance non-concessional contribution cap rules and effectively transfer growth from accumulation phase to retirement phase without being counted towards the transfer balance cap.[11]

More Adverse US Tax Consequences?

The imposition of an AUD $1.6m lifetime balance transfer cap from an accumulation account to a retirement account holds potentially disastrous tax consequences for a US expat with superannuation accounts in excess of AUD $1.6m. Such an individual has the two options[12] referenced above, and unless clarification of US law is forthcoming, both options potentially increase their US tax liabilities.

A US expat whose superannuation savings are in accumulation phase generally[13] has no ability to withdraw, pledge or dispose of those savings until he or she reaches retirement age. Until such time, earnings generated in the accumulation account are taxed to the fund at concessional rates of 15 percent and do not constitute assessable income to the US expat for Australian tax purposes. Both the principal amounts and earnings generated therein arguably do not constitute current taxable income to the US expat because of very strict restrictions and conditions that bar access to such superannuation funds by the US expat.

However, under the US tax doctrines of economic performance and constructive receipt, the presence of substantial impediments to a US expat's ability to access and control the use of such funds negate inferences that the US expat has gross income equivalent to such contribution and earnings. The introduction of options to transfer or withdraw such superannuation amounts to meet the AUD $1.6m transfer balance cap by July 1, 2017, gives a US expat constructive receipt of such funds, *i.e.,* they can either re-invest it back into the superannuation savings account or withdraw it permanently from superannuation by cashing out of the system. This ability to invest or withdraw at their discretion arguably provides the US expat with the ability to access and control the disposition of the superannuation account, notwithstanding that rolling back monies from the retirement phase to accumulation phase does not result in the US expat actually receiving any of the money. Consequently, the US expat would recognize such excess amounts that are transferred or withdrawn as current gross income, which is subject to current US tax under the US tax doctrine of constructive receipt.

4. **Spousal Contributions**

With the uncertainty and potential negative US tax consequences appurtenant to Australian superannuation, many US expats are tempted to address their unenviable position by transferring a portion of their Super as a contribution to the Super of their non-working non-US citizen spouse. Australian law allows a limited tax offset of up to AUD $540 for contributions made to the Superannuation account of a low income or unemployed spouse of up to AUD $3,000.[14] However, Australian law does not limit the US expat from contributing more than that amount, possibly up to the

AUD $180,000 non-concessional contribution cap for the non-citizen spouse. Under Australian law, these contributions are not taxable to either spouse.

While transfers of property between US citizen spouses are technically not subject to tax under domestic US tax laws under IRC Section 1042 (incident to divorce or separation), gifts to spouses are subject to the same annual gift tax exclusion (USD $14,000) and lifetime unified gift and estate tax exemption (USD $11m for two US citizen spouses). However, a US expat with a non-US citizen spouse is also entitled to claim a unified exemption of half that amount of USD $5.49m. Any amounts in excess of such exemption are subject to a hefty US estate and gift tax of 40 percent in addition to US tax reporting obligations. We would caution US expats from transferring amounts in excess of the AUD $1.6m balance from their superannuation savings accumulation account or retirement account to their non-citizen spouses without considering the potential US gift taxes payable on any amounts that exceed the annual and lifetime unified exemption thresholds.

US expats in Australia are stuck between the devil and the deep blue sea. This is because complying with Australian superannuation reforms by July 1 would trigger not just double but triple taxation by the US on their superannuation contributions, earnings, and distributions. With "damned if you do and damned if you don't" consequences to becoming compliant, US expats may simply ignore the problem and hope it goes away. However, ignoring the problem may not be the most prudent course, especially for those in Australia and Asia-Pacific. This is because, in December 2016, IRS Commissioner Koskinen stated that the IRS plans to expand and further modify its OVDP operations to "turn around and look West…to Hong Kong, Singapore and all of Asia."[15] Indeed, the window of opportunity for US expats in Australia to become fully compliant is likely to run out as the IRS "tin man" will be skipping down that yellow brick road in the merry land of Oz.

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[2] See, Katharine Murphy, *Trump Vows "lasting partnership" with Australia 75 years after Battle of Coral Sea,* https://www.theguardian.com/us-news/2017/may/05/trump-vows-lasting-partnership-with-australia-75-years-after-battle-of-coral-sea

[3] http://www.theage.com.au/federal-politics/political-news/this-is-the-worst-deal-ever-donald-trump-badgers-and-brags-in-call-with-malcolm-turnbull-20170202-gu3r6u.html (site visited February 2, 2017).

[4] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–AUD., Aug. 6, 1982, 35 U.S.T. 1999 (hereinafter the "**Treaty**"), *as amended by* Protocol signed on Sept. 27, 2001.

[5] In November of 2016, the Australian Parliament passed legislation to implement superannuation reforms to make the widely popular superannuation system more sustainable for its aging population by increasing flexibility and incentives for savings. See Superannuation (Objective) Bill 2016 which sets out a clear objective for Superannuation: to provide income in retirement to substitute or supplement the Age Pension. See http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/Superannuation-Reforms (site visited February 2, 2017). The provisions of the Superannuation Reform package pertaining to a formal legislated objective for the superannuation system was split from the other elements of the reform package that was passed by Senate in November 2016. Rather, the legislated objective provision was referred by the Senate to the Senate Economics Legislation Committee (SECL) for inquiry and report by February 14, 2017. The SECL report, issued last February 2017 recommended passage of the Superannuation Bill 2016 provision on legislated objective and can be accessed at the following link: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/SuperObjectiveBill2016/Report (as of March 21, 2017).

[6] For people who are 49 years of age as at 30 June of the year prior to the year of contribution, the maximum annual cap on contributions is AUD $35,000 per annum. An Australian employer must make a compulsory tax-deductible contribution (the Superannuation Guarantee) of at least 9.5 percent of the employee's salary or wages, while an eligible employee can make voluntary pre-tax and after-tax contributions. From 1 July 2017, and employee will also be able to make personal deductible contributions to superannuation in addition to employer pre-tax contributions subject to the reduced concessional contributions cap of AUD $25,000 per annum.

[7] A superannuation member's "low tax contributions" are essentially her or his "concessional contributions" (as modified by the special rules for certain defined benefit interests) less any excess concessional contributions for the financial year (if any): § 293-25 and 293-30 ITAA 1997. Broadly, "low tax contributions" include all employer contributions, such as superannuation guarantee and salary sacrifice contributions, and personal contributions for which a deduction has been claimed.

[8] http://www.budget.gov.au/2016-17/content/glossies/tax_super/downloads/FS-Super/04-SFS-NClifetime_cap-161109.pdf.

[9] The excess transfer balance arises where the balance in the transfer balance account exceed the transfer balance cap (which in this case is $1.6m for the 2017/18 year). The ATO has recently issued new commutation guidelines which will allow SMSF members to place a commutation request to comply with the $1.6m balance cap without physically having to move excess amounts back to accumulation phase before July 1. See ATO PCG 2017/5 released April 27, 2017, at https://www.ato.gov.au/law/view/document?...

[10] See http://www.budget.gov.au/2016-17/content/glossies/tax_super/downloads/FS-Super/02-SFS-Retirement_transfer_balance_cap-161209.pdf

[11] See SMSF Adviser, "Government releases draft legislation on LRBA changes", as viewed on April 27, 2017 at https://www.smsfadviser.com/news/15413-govt-releases-draft-legislation-on-lrba-changes. To avert potential for abuse, the draft legislation has proposed taking into account a member's outstanding LRBA balance in determining a member's superannuation balance. *See,* Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: Limited Recourse Borrowing Arrangements – Exposure Draft Explanatory Materials at http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2017/Integrity...

[12] In light of recently proposed legislation to quash the use of LRBAs to circumvent contribution caps and transfer balance caps, we are not addressing the US tax impact of the use of LRBAs by US expats. We note however, that it would likely result in an adverse result.

[13] There are some provisions that enable superannuation can be accessed under preservation age on compassionate grounds or due to severe financial hardship.

[14] Under Australian tax laws, the contributor will receive a tax offset of 18 percent of the contribution amount subject to certain thresholds. See https://www.ato.gov.au/Individuals/Tax-return/2015/Supplementary-tax-return/Tax-offset-questions-T3-T9/T3-Superannuation-contributions-on-behalf-of-your-spouse/ (site visited February 2, 2017).

[15] At the GW-IRS International Tax Institute Luncheon held in Washington DC last December 14, 2016, IRS Commissioner Koskinen confirmed that the next area for IRS international tax enforcement efforts will be the Asian-Pacific region. See, Tax Analysts Exclusive: Conversations: Koskinen Looks to Future of Tax Administration, IRS Budget, TNT Doc 2016-24229 at pp.14-15.