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U.S. TAX TREATMENT OF AUSTRALIAN SUPERANNUATION

John Anthony Castro, J.D., LL.M.*

INTRODUCTION

The Organization for Economic Cooperation and Development (OECD) estimates that more than 100,000 Australian citizens are living and working in the U.S. Those Australian nationals almost certainly have some sort of Superannuation Fund, which is a state-mandated occupational pension scheme in Australia. The problem is that nearly every accounting firm in the U.S. is treating Australian Superannuation as a taxable foreign grantor trust. This presents a serious issue since the funds within Superannuation Funds are completely inaccessible until retirement, disability, or death. For an Australian national living in the U.S., this would result in immediate U.S. taxation on all gains within the fund. Because of the lack of liquidity, an Australian national will be taxed on gains they did not truly experience. The problem is that there are differing views as to what Australian superannuation actually is. Is it a private pension? Is it a foreign grantor trust? Or is it a novel form of privatized social security? The correct answer could mean the difference between a client being burdened with U.S. tax on unrealized gains and a client being able to lawfully exclude gain and even future distributions from the superannuation fund from their U.S. tax return.

Whenever a U.S. taxpayer is confronted with an international tax issue, he or she should understand that there are two separate and distinct bodies of law that could potentially apply to the issue. First, there is domestic U.S. 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 U.S.-Australia Income Tax Treaty. 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. A taxpayer may also be exposed to criminal tax penalties if his

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or her failure to file IRS Form 8833 was intentional.

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

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 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.² 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.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 U.S. 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.

¹ See I.R.C. § 7852(d) (2012).

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

³ See *Whitney v. Robertson*, 124 U.S. 190 (1888); *The Chinese Exclusion Cases*, 130 U.S. 581 (1889); *The Cherokee Tobacco*, 78 U.S. 616 (1871); *Diggs v. Schultz*, 470 F.2d 461 (D.C. Cir. 1972); see also *RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES* § 115(1)(a) (AM. LAW INST. 1987) (“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 OF FOREIGN RELATIONS LAW*, *supra* note 3, § 115(3).

⁵ See *Ware v. Hylton*, 3 U.S. 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 U.S. 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.

THE AUSTRALIAN SOCIAL SECURITY SYSTEM

The U.S. 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 1999. 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% 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." Additional employee contributions to superannuation funds are optional, but, when contributed, they are treated no different: they are fully preserved, restricted, and inaccessible until retirement. Therefore, regardless of whether the contribution is a "superannuation guarantee" or a "concessional contribution," they both form a part of the same fully preserved and restricted fund. 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 traditionally 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 fund 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 U.S. Federal Insurance Contributions Act.⁷ This is supported by a re-

⁶ See *Social Security Act 1991* (Cth) S. 9(1) (Austral.).

⁷ See I.R.C. §§ 3101, 3111 (2012). Because Superannuation Guarantee contributions are effectively a social security tax collected by the employer and contributed to the superannuation fund, it is not includible in the employee's gross income for U.S. federal income tax

port 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.’”⁸

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 U.S. Social Security Administration.⁹ Furthermore, a state-mandated “occupational pension scheme” fits the precise definition of social security according to the OECD.¹⁰ 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 the Australia and the United States are members, also recognizes Australian Superannuation as forming part of Australia’s overall comprehensive social security system.¹¹

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.

purposes. However, voluntary contributions made the employee remain a part of the employee’s U.S. gross income if not otherwise excludible on other grounds.

⁸ See STAFF OF J. COMM. ON TAXATION, JCX-14-99, ANALYSIS OF ISSUES RELATING TO SOCIAL SECURITY INDIVIDUAL PRIVATE ACCOUNTS (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.”).

⁹ See *Social Programs Throughout the World: Asia and the Pacific, 2010*, U.S. SOC. SECURITY ADMIN.: OFF. OF RETIREMENT AND DISABILITY POL’Y, <http://www.ssa.gov/policy/docs/progdsc/ssptw/2010-2011/asia/australia.html> (last visited Feb. 27, 2018) [<https://perma.cc/D6QY-CA8J>]; see also Barbara E. Kritzer, *Individual Accounts in Other Countries*, 66 SOC. SECURITY BULL. 31 (2005), <http://www.ssa.gov/policy/docs/ssb/v66n1/v66n1p31.html> [<https://perma.cc/T44Y-5CU9>].

¹⁰ See MODEL TAX CONVENTION ON INCOME AND ON CAPITAL art. 18 cmt. ¶ 10 (OECD 2014).

¹¹ See *Social Security Country Profiles*, INT’L SOC. SECURITY ASS’N, <https://www.issa.int/en/country-profiles> [<https://perma.cc/SJ4J-FTRP>] (last visited Feb. 27, 2018) (select “Australia” under the “Asia and the Pacific” dropdown menu).

THE U.S.-AUSTRALIAN SOCIAL SECURITY TOTALIZATION AGREEMENT

Moreover, the United States signed the *Totalization Agreement with Australia* that went into effect on October 1, 2002, specifically recognizing “superannuation guarantee” contributions as being social security contributions since the funds are part of Australia’s larger, comprehensive national social security system.¹² In essence, by covering superannuation contributions under the U.S.-Australia Social Security Totalization Agreement, U.S. federal law recognized that Australian superannuation funds are privatized social security accounts.

INTERNATIONAL TREATY LAW AND SOCIAL SECURITY

If both the U.S. and a treaty partner were members of the 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, 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.”¹⁴ 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.¹⁵ On the other hand, the U.S.-Australia Income Tax, 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 interprets “payments under a social security system” to include payments under a “worker’s compensation fund,” which is not

¹² SOC. SECURITY ADMIN., TOTALIZATION AGREEMENT WITH AUSTRALIA, SSA Pub. No. 05-10176 (2004) (“For Australia, the agreement covers ‘Superannuation Guarantee’ (SG) contributions that employers must make to retirement plans for their employees.”). However, according to a vague IRS Chief Counsel Memorandum, Australian superannuation funds may be treated like any other private retirement plan. *See* I.R.S. Chief Couns. Mem. (CCA) 200604023 (October 24, 2005). However, 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.

¹³ *See* *Podd v. C.I.R.*, 76 T.C.M. 906 (1998) (citing *U.S. 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*, U.S.-Japan, Mar. 8, 1971, 23 U.S.T. 969, and referencing the OECD’s Model Tax Treaty, *supra* note 10, and its commentary)).

¹⁴ *See* MODEL TAX CONVENTION, *supra* note 10, art. 18 cmt. ¶ 28.

¹⁵ *See id.* art. 15 cmt. ¶ 2.14.

considered “social security” in the United States. Moreover, the OECD has impliedly recognized Australian superannuation as a part of Australia’s social security system.¹⁶

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

U.S. TAX TREATMENT OF SOCIAL SECURITY PAYMENTS

Under domestic U.S. tax law, with regard to informational reporting requirements for contributions to a nonqualified deferred compensation plan, Congress specifically exempted contributions to a foreign social security account.¹⁷ This clearly evidences Congressional intent to disregard contributions to foreign social security for U.S. informational reporting purposes on IRS Form 3520 and 3520-A.¹⁸ Moreover, the IRS has specifically stated that, under domestic U.S. tax law, “foreign social security benefits[] . . . are taxable as annuities[.]”¹⁹ 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.²⁰ Although the IRS has issued private letter rulings that classify superannuation funds as foreign trusts, the rulings did not indicate which country they are analyzing and also specifically stated that the IRS is making “no determination concerning whether [the taxpayers] are entitled to any benefits . . . under the income tax treaty.”²¹ Furthermore, the rulings’ conclusions clearly state that the ruling is “based solely on facts submitted,” and the facts submitted had stated that the fund was “organized as a trust,” which prevented the IRS from rul-

¹⁶ See OECD, PENSIONS AT A GLANCE 2013: OECD AND G20 INDICATORS 211–14 (2013). 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 U.S. social security system, it refers to social security as a “publicly provided pension benefit” since it is managed and provided by the government. See *id.* 362–64. It is important to keep in mind that the purpose of the OECD publication is to analyze each country’s social security system and distinguishes between government-mandated programs and voluntary retirement savings.

¹⁷ See Treas. Reg. § 1.409A-1(a)(3)(iv) (2017).

¹⁸ See *Dominion Res., Inc. v. U.S.*, 681 F.3d 1313 (Fed. Cir. 2012) (U.S. Treasury Department cannot interfere with the unambiguously expressed intent of Congress).

¹⁹ See I.R.S., Pub. No. 17, TAX GUIDE 2017: FOR INDIVIDUALS 85 (2017); see also *The Taxation of Foreign Pension and Annuity Distributions*, IRS: THE INT’L TAX GAP SERIES (Sept. 30, 2017), <https://www.irs.gov/businesses/the-taxation-of-foreign-pension-and-annuity-distributions> [<https://perma.cc/PQ3X-B5LT>] (“Most income tax treaties have special rules for social security payments. In many cases, foreign social security payments are taxable by the country making the payments. Unless specified otherwise in an income tax treaty, foreign social security pensions are generally taxed as if they were foreign pensions or foreign annuities. Unless a tax treaty allows it (see, e.g., the USA-Canada treaty), they are not eligible for exclusion from taxable income the way a U.S. social security pension might be.”).

²⁰ See I.R.C. § 72 (2012).

²¹ See I.R.S. Priv. Ltr. Ruls. 139650-14, 139636-14, 124608-14 (Sept. 18, 2015); see also I.R.S. Priv. Ltr. Rul. 123060-07 (Feb. 15, 2008). Numerous countries offer “superannuation funds” that vary greatly from state-mandated to voluntary participation. The characteristics vary greatly between countries.

ing otherwise.

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 U.S. taxation, which is contrary to IRS guidance.²² However, because gains will still be subject to U.S. taxation at maturity of the Australian superannuation fund based on disability or retirement, one must still consider the application of the U.S.-Australia Income Tax Treaty and the outcome thereunder.²³

Under Article 18, Paragraph 2, of the U.S.-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.

THE “SAVING CLAUSE” FOR U.S. CITIZENS AND U.S. TAX RESIDENTS

With regard to treaty claims by U.S. citizens and U.S. tax residents, however, one must consider the application of the Saving Clause, which allows the United States to “tax its residents . . . [and] citizens, as if this Convention had not entered into force.”²⁴ Put plainly, the U.S. may disregard most treaty claims made by U.S. citizens and U.S. tax residents. It should be noted that the Saving Clause is merely a reserved right and does not automatically apply to prevent claims by U.S. citizens and U.S. tax residents.²⁵ The Saving Clause, however, has a few specifically enumerated exceptions, one of which is for claims by U.S. citizens and U.S. tax residents pursuant to Article 18, Paragraph 2, which covers social security gains and reserves exclusive taxing rights to the country

²² 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, *supra* note 19.

²³ Even the IRS issued a revenue ruling indicating that due regard must be given to an applicable income tax treaty to determine whether foreign social security is exempt from U.S. tax. *See* Rev. Rul. 66-34, 1966-1 C.B. 22. Therefore, any assertion that the U.S. would not acknowledge a foreign social security system contradicts the fact that it’s addressed in more than 60 bilateral income tax treaties and specifically required in accordance with the aforementioned revenue ruling as well as Treasury regulations. *See* Treas. Reg. § 1.894-1(a) (2017) (“Income of *any kind* is not included in gross income and is exempt from tax . . . to the extent required by any income tax convention to which the United States is a party.”).

²⁴ *See* Convention on Double Taxation Taxes on Income art. 1, ¶ 3, U.S.-Austl., Aug. 6, 1982, <https://www.irs.gov/pub/irs-trty/aus.pdf> [<https://perma.cc/3XCV-9MKQ>] [hereinafter U.S.-Australia Income Tax Treaty].

²⁵ *See* U.S. TREASURY DEP’T, TECHNICAL EXPLANATION OF 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 2 (1983) (explanation of U.S.-Australia Income Tax Treaty art. 1, ¶ 3, *supra* note 24).

of source.²⁶ Therefore, the Saving Clause is inapplicable to claims by U.S. citizens and U.S. tax residents with regard to gains, distributions, or any other income associated with an Australian superannuation fund. Even the plain language of Article 18, Paragraph 2, unmistakably allows U.S. citizens to make claims under that provision.²⁷

PROPER REPORTING METHOD 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.²⁸ IRS Form 8833 is used to make a disclosure regarding a treaty-based return position.²⁹ 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.³⁰ For individuals, there is a \$1,000 penalty for each non-disclosure.³¹ There are several items for which reporting is specifically waived.³² A position by a taxpayer that a treaty reduces or modifies the taxation of income from social security or other public pensions is exempt from disclosure regardless of the amount.³³ Furthermore, payments or the rights to receive social security benefits, the foreign equivalent of social security, or another similar program of a foreign government are not specified foreign financial assets subject to reporting on IRS Form 8938 or FinCEN Form 114.³⁴

CONCLUSION

In conclusion, Australian Superannuation Funds are covered under Paragraph 2 of Article 18 as privatized individual social security accounts that are exclusively taxable in the country of source, Australia. As such, it is properly excludible from their U.S. tax return with proper disclosure on IRS Form 8833.

²⁶ See U.S.-Australia Income Tax Treaty, *supra* note 24, art. 1, ¶ 4(a).

²⁷ See *id.* art. 18, ¶ 2 ("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.").

²⁸ See I.R.C. § 6114 (2012).

²⁹ See Treas. Reg. § 301.7701(b)-7 (2017).

³⁰ See *id.* § 301.6712-1(a).

³¹ See *id.* § 301.6114-1(a)(1)(ii).

³² See *id.* § 301.6114-1(c)(1)-(8).

³³ See *id.* § 301.6114-1(c)(1)(iv).

³⁴ See *id.* § 1.6038D-3; 31 C.F.R. § 1010.350 (2017); see also *FATCA – FAQs General*, IRS (Feb. 26, 2018), <http://www.irs.gov/Businesses/Corporations/Frequently-Asked-Questions-FAQs-FATCA-Compliance-Legal> [<https://perma.cc/4UZU-KFBP>].