

Part 2 | International Tax Series

Australian Superannuation (Retirement) Accounts and The US-Australia Tax Treaty: Pensions, Annuities and Social Security

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Continuing on from our previous post on superannuation accounts, retirement accounts can form a significant part of an individual's estate. Where there are inconsistencies in the tax treatment of such accounts, both the income from and the balances of such accounts can be considerably affected. In this blog, we examine this issue in the US-Australia cross-border context.

The US-Australia Income Tax Treaty 1 (Treaty)

The Treaty¹ came into effect in 1983 and does not refer to superannuation.

Article 18² of the Treaty addresses “Pensions, Annuities, Alimony and Child Support”, and allocates the taxing rights to “pensions and other similar remuneration”:

1. Subject to Article 19 (Governmental Remuneration)³, 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.
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.
3. Annuities paid to an individual who is a resident of one of the Contracting States shall be taxable only in that State.
4. The term and “pensions and other similar remuneration” as used in this Article, means periodic payments made from retirement or death, in consideration for services rendered.

Is superannuation a “pension”, “annuity” or “social security”?

If classified as a “pension” or “annuity”, superannuation distributions would not be subject to tax in Australia, but due to Articles 1 and 23 of the Treaty, such payments would be taxable if paid to a

U.S. citizen, regardless of residency. It is conceivable that the superannuation guarantee component (mandatory under superannuation law) is akin to the U.S. social security tax. However, the IRS has not commented on this. While such payments would generally not be subject to tax in Australia, due to Articles 1 and 23 of the Treaty they, would be taxable if paid to a U.S. citizen, regardless of their residency.

Pensions and Annuities

The Treaty states that pensions are “periodic payment made by reason of retirement or death”. Hence, they could apply to distributions from superannuation funds.⁴

In its publication Pensions and Annuity Income,⁵ the IRS defines a “pension” as determinable payments made to you after you retire from work made regularly and based on such factors as years of service and prior compensation. An “annuity” is defined as a contract that requires regular payments for more than one full year to the person entitled to receive the payments (annuitant) and provides examples of an annuity being for a definite period, with fixed or variable payments.⁶

In the U.S., annuities arise in retirement benefits – for example, qualified employee annuities purchased by employers for employees, as part of a qualified retirement plan, or tax-sheltered annuities⁷ that certain classes of employees are eligible for. Such annuities may be taxable or tax-sheltered, depending on the retirement plan and whether contributions were pre-tax or post-tax.

U.S. Federal income tax withholding applies to employer pensions and annuities, with periodic payments being treated as wages for withholding purposes.⁸ This means that as “pensions” or annuities”, superannuation distributions are taxable in the U.S.

In contrast to the U.S. tax treatment of pensions and annuities, for an Australian tax resident who has reached preservation age,⁹ both lump sum superannuation withdrawals, and income stream payments, are generally tax-free in Australia. However, due to operating Articles 1 and 23 of the

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Treaty, a U.S. person resident in Australia would be subject to tax in the U.S. on those superannuation payments. This is despite Articles 18(1) and 18(2) providing for the right to tax pensions and annuities to be based on the recipient's residency.¹⁰

Articles 1 & 23

Article 1 defines the Treaty and states that the U.S. has unequivocal taxing rights regarding its citizens, and as if the Convention had not been entered:

(3) Notwithstanding any provision of this Convention, except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)) and individuals electing under its domestic law to be taxed as residents of that state, and from citizenship may tax its citizens, as if this Convention had not entered into force. For this purpose, the term "citizen" shall, regarding United States source income according to United States law relating to United States tax, include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for 10 years following such loss.

Further, Article 23 of the Treaty (the Treaty's Non-discrimination clause) has limited effect due to the U.S.'s right to tax citizens on worldwide income. Article 23 states:

(1) Each Contracting State in enacting tax measures shall ensure that:

(a) citizens of a Contracting State who are residents of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith which is more burdensome than the taxation or connected requirements to which citizens of that other State who are residents of that other State in the same circumstances are or may be subjected.

So, in simple terms, the effect of Article 23 should mean that:

a U.S. citizen resident in Australia, cannot be subject to tax more burdensome than that to which Australian citizens in Australia are subject, and

an Australian citizen resident in the U.S. cannot be subject to tax more burdensome than that to which a U.S. citizen, resident in the U.S. is subject.

The nondiscrimination clauses attempt to limit the U.S. tax on a foreign national to that which the US could impose on a U.S. national, where the individuals are "in the same circumstances". However, this does not work in a differential tax treatment where U.S. citizens are subject to tax on worldwide income and Australian citizens are subject to tax in Australia based on residency they are, at the outset, not "in the same circumstances" as required under Art 23(1)(a). That, for U.S. tax, a U.S. citizen who is not a resident of the United States and a foreign national who is not a resident of the United States are not "in the same circumstances" because the U.S. citizen is subject to U.S. tax on worldwide income, has been recognized in the U.S. Tax Court¹¹. There is no violation of the nondiscrimination clause in Article 23 when the U.S. taxes U.S. persons on superannuation distributions.

Social Security

"Social Security payments and other public pensions" (these are not defined in the Treaty), are taxable by the payor State (the first-mentioned Contracting State for Article 18(2) purposes). This follows ATO ID 2001/382 which states that a U.S. Social Security benefit received by an Australian resident taxpayer is not assessable income under section 6-5 of the Australian Income Tax Assessment Act 1997 but may be subject to tax in the USA.¹² Similarly, if an Australian is a U.S. person, and receives an Australian government (public) pension, then (if that payment was taxable in Australia), Australia could tax that pension, not the U.S.

The Australian and U.S. concepts of "social security" differ in many respects

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In the US, social security is a defined benefit program to provide retirement, disability, and survivor benefits to eligible individuals based on years of employment (for retirement benefits), or their inability to work (for disability benefits). It is funded by a tax imposed on employers and employees. Social security benefits, when paid, are subject to Federal tax, and in some States, at the state level too.¹³

In Australia, “social security” is a form of government assistance and is not taxable to the recipient. The only social tax levied in Australia, is the Medicare Levy, imposed on the taxable income of residents (at 2%), and used to fund public health care.

Although there is a bilateral U.S.-Australia Social Security Agreement,¹⁴ deals with the allocation of the obligations of employers to pay either the U.S. Social Security tax or the Australian Superannuation Guarantee for employees who are temporarily based in the other country.¹⁵ Its aim is to prevent the “double payment of super”,¹⁶ and not the allocation of taxing rights regarding benefits paid under either government.

Privatised Social Security

It was argued, in the recent case involving Alan Dixon that superannuation is a form of “privatized social security”, taxable exclusively in Australia. The IRS did not address whether superannuation could be privatized social security, but rather, challenged Mr. Dixon’s position on the basis that Mr. Dixon had not identified or substantiated any social security or other public pension payments eligible for a benefit under the Treaty.¹⁷ The U.S. Court of Federal Claims did not decide this issue, instead, dismissing the case for lack of subject matter jurisdiction and failure to state a claim, based on administrative matters.¹⁸

Note, the U.S. has recognized the concept of “privatized social security” in relation to countries such as Chile. The Chilean funds (AFPs) have similarities to superannuation funds in

terms of tax-deferred contributions and pooled investments, but there are significant differences in how they are structured –such as mandatory deductions from earnings for disability and survivors’ insurance and health benefits, and payments from AFPs are subject to tax in Chile (unlike distributions from superannuation funds).¹⁹

Even if the Superannuation Guarantee component of 10.5% (the employer contributions) is considered a form of social security tax (paid by the employer on behalf of the employee), Article 18(2) envisages benefit payments being made by the State. This is the case in the U.S., where social security payments are made by the Federal Government – i.e., a Contracting State. However, most superannuation funds are private managed funds of pooled member investment accounts, and except for funds administered for government employees, are not paid by a Contracting State. Even if superannuation payments were “social security payments” it is unclear how Article 18(2) as it is worded, would apply. Article 18(2) specifically mentions payment by a Contracting State and contrasts with other Articles in the Treaty where payments may be made by companies, employers, and residents of a Contracting State.²⁰ The Treaty would need to be amended to make it clear that social security payments may be made by persons other than the Contracting States.

What is clear in this context is that the Treaty needs to be amended to address the discrepancy in the tax treatment of superannuation between the U.S. and Australia. This affects almost every Australian in the U.S.

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