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Part 3 | International Tax Series

The Taxation of Superannuation (Australian Retirement) Accounts

By Gary Altman & Renuka Somers

U.S. Income tax, Estate tax, and Inheritance tax

In Part 1 and Part 2 of this series, we discussed that having an Australian superannuation account can create additional U.S. tax and reporting obligations, and these obligations were not adequately addressed in treaties between the U.S. and Australia. We now delve into the Internal Revenue Code and IRS Rulings that could be relied on by the IRS to tax superannuation accounts both during an account holder's lifetime and on death, eroding the retirement income and savings, and the value of a decedent's estate, where that person is a "U.S. person" (a U.S. citizen, green card holder, or substantially present individual), with an Australian retirement account.

1. Contributions

Employer contributions and salary sacrificed pre-tax income could be treated as income for U.S. tax purposes because these amounts are part of the taxpayer's "remuneration package" even though such contributions are not taxable in Australia.

Why?

The IRS treats superannuation funds as foreign trusts.1 While untested, this approach follows the IRS approach to the taxation of beneficiaries of funded employee benefit trusts that are "nonexempt trusts" under IRC section 402(b)(1). This provision states:

(b)Taxability of beneficiary of a nonexempt trust

(1) Contributions

Contributions to an employee's trust made by an employer during a taxable year of the employer which ends with or within a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee under section 83 (relating to property transferred with a performance of services), except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property to apply such a section.

Nonexempt trusts are trusts that do not satisfy the requirements of IRC section 401(a) which covers trusts created or organized in the United States, and which form part of a stock bonus, pension, or profit-sharing plan of an employer exclusively to benefit the employees or their beneficiaries. Exempt trusts include qualifying U.S. retirement plans such as 401(k) plans.

The Treasury Regulations to section 402(b) state that the contributions are included in the gross income of the employee for the taxable year during which the contribution is made, but only if the employee's interest in such contribution is substantially vested when the contribution is made. 2 Property is substantially vested when it is transferable or not subject to a substantial risk of forfeiture. 3 These features may be construed as being present with superannuation accounts.

A superannuation account holder has a defined interest in their superannuation account on any given date and may transfer the account balance to another fund. There is also no risk of forfeiture of their account balance – the account balance is theirs (even if they cannot access the benefits until a later date), and the account may not be returned to the employer if the employee is discharged for cause or based on a non-compete clause. 4

This approach also follows the IRS' treatment of other foreign government-mandated retirement plans such as the Singaporean Central Provident Funds which have similar features to superannuation funds.

2. Earnings

In Australia, earnings on the superannuation account balances in complying superannuation funds are taxable to the trustee of the fund at 15% and are not taxable to the taxpayer. 6

Sometimes, vested accrued benefits of employees may be taxable under IRC section 402(b)(4) where a fund fails to satisfy the requirements of IRC sections 401(a)(26) or 410(b). 7 These rules state that where

Annapolis, MD
839 Bestgate Road,
Suite 400
Annapolis, MD 21401

Rockville, MD
11300 Rockville Pike,
Suite 708
Rockville, MD 20852

Washington, D.C.
Suite 500
1050 Connecticut Ave NW,
Washington, DC 20036

Northern VA
8000 Towers Crescent Drive.
13th Floor
Vienna, VA 222182

the trust is "discriminatory" (and does not meet minimum participation requirements), highly compensated employees 8 are taxed under IRC section 402(b)(4), on their vested accrued benefit as of the close of the trust's tax year, less the employee's investment in the contract.

IRS commentary on this issue was covered in IRS Revenue Ruling Rev. Rul. 2007-48. 9 However, that ruling did not extend to foreign funds, so it is unclear how earnings in superannuation funds would be treated. Further, these rules are complex and require a detailed review of a taxpayer's individual circumstances, to determine their potential applicability to superannuation.

If the superannuation guarantee component is accepted as a social security tax (see Part 2), then it is arguable that earnings accrued on the superannuation guarantee component of contributions could conceivably also be accrued social security benefits and excluded from tax in the U.S. under Article 18(2) of the US-Australia Income Tax Treaty, if the deficiencies in Article 18(2) regarding the payer (see discussion in Part 2)are first addressed. However, as noted in Part 2, that exclusion would not apply to U.S. citizens resident in Australia due to Articles 1 and 23 of the Treaty.

3. Distributions

For an Australian tax resident, superannuation distributions are generally tax-free to eligible taxpayers, where the earnings were already taxed in the fund. However, such distributions could be taxable in the U.S, as an annuity under IRC section 402(b)(2). 10The IRS has commented in a Private Letter Ruling that superannuation distributions paid from an Australian superannuation fund to a U.S. citizen are subject to U.S. tax. 11 The IRS relied on Article 1 of the Treaty (discussed in Part 2) which provides the U.S. with overriding taxing rights regarding its citizens:

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 as one of its principal purposes avoids tax, but only for 10 years following such loss.

(4) The provisions of paragraph (3) shall not affect: (a) the benefits conferred by a Contracting State under paragraph (2) of Article 9 (Associated Enterprises), paragraph (2), or (6) of Article 18 (Pensions, Annuities, Alimony, and Child Support), Article 22 (Relief from Double Taxation), 23(Non-Discrimination), 24 (Mutual Agreement Procedure) or paragraph (1) of Article 27(Miscellaneous); or (b) the benefits conferred by a Contracting State under Article 19(Governmental Remuneration), 20 (Students) or 26 (Diplomatic and Consular Privileges) upon individuals who are neither citizens of, nor have immigrant status in, that State (in the case of benefits conferred by the United States), or who are not ordinarily resident in that State (in the case of benefits conferred by Australia).

It is notable that the Ruling made no comment on superannuation distributions being a form of social security. Regardless, that argument has limited benefit to U.S. citizens, due to Articles 1 and 23 of the Treaty.

4. Death benefits

In Australia, the superannuation account balance of a deceased may be distributed tax-free to superannuation dependents (generally, a current or former spouse, minor children, adult children who are disabled or financial dependent on the deceased, and a person in an interdependency relationship with the deceased).

In the U.S. absent IRS opinion on this matter, consistent with the treatment discussed in

Annapolis, MD
839 Bestgate Road,
Suite 400
Annapolis, MD 21401

Rockville, MD
11300 Rockville Pike,
Suite 708
Rockville, MD 20852

Washington, D.C.
Suite 500
1050 Connecticut Ave NW,
Washington, DC 20036

Northern VA
8000 Towers Crescent Drive.
13th Floor
Vienna, VA 222182

section 3 above, distributions of superannuation benefits may be subject to income tax when inherited by a U.S. person. This also follows the general domestic treatment where in the U.S., beneficiaries of a deceased estate are subject to income tax on the balances of a deceased's retirement accounts such as 401(k) accounts and IRA accounts, as the balances are withdrawn. There are limited exceptions to the domestic rule on death – for example, a Roth IRA may be inherited income-tax-free (these accounts having been funded from post-tax contributions), and a surviving spouse may roll over the deceased spouse's 401(k) account into their own retirement plan account.

Remember retirement plan benefits are included in the value of the deceased's gross estate for estate tax purposes. So, for a U.S. person with a superannuation account, the value of that account will be included in their gross estate for both Federal and State estate tax purposes. Further, some U.S. states also tax inheritances.

It is important, therefore, to obtain appropriate legal and tax advice, to ensure that you comply with the laws.

The concepts discussed in this blog are complex, and the preceding discussion is for general informational purposes only. It is not intended to constitute tax or legal advice, or a recommended course of action, and does not create an attorney-client relationship between the reader and Altman & Associates, a Division of Frost Law.

Contributed By Renuka Somers, Senior Associate

Gary Altman, Esq. is the Estate Planning Partner of Altman & Associates, A Divison of Frost Law serving MD, DC, VA, NY and FL.
Gary can be reached at 301-468-3220 or via e-mail at Gary.Altman@frosttaxlaw.com.

Renuka Somers, Senior Associate. She can be reached at 301-468-3220 or via e-mail at Renuka.Somers@frosttaxlaw.com

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/altmanassociates

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Annapolis, MD
839 Bestgate Road,
Suite 400
Annapolis, MD 21401

Rockville, MD
11300 Rockville Pike,
Suite 708
Rockville, MD 20852

Washington, D.C.
Suite 500
1050 Connecticut Ave NW,
Washington, DC 20036

Northern VA
8000 Towers Crescent Drive.
13th Floor
Vienna, VA 222182