To whom it may concern,

I submit my heartiest endorsement of the 4 key recommendations outlined in the submission to Treasury by *Fix the Tax Treaty!* (see next page). As a dual Australian-US citizen living in Australia, I find myself squarely in the cohort of Aussies that face the onerous and unfair taxation practices this submission exists to try and rectify.

I became a first-time homeowner in Melbourne this year and was shocked to learn that down the road when the time comes to upgrade or move to a new home, I will likely be required to pay capital gains tax to the USA on the sale of my residence, whereas I won't even pay this to the Australian Government thanks to the 'primary residence' exemption. This clearly goes against the spirit of tax treaties, which are intended to prevent double taxation and improve cross-border tax efficiencies.

Similarly, the fact that the eventual drawdown of my superannuation in retirement will be taxed by the USA seems wrong on the very face of it. These are points which could be easily addressed in clear terms in the Australia-US Tax Treaty, but currently bear real-world and potentially serious consequences for dual citizens like myself.

I believe that the Australia-US tax treaty is in urgent need of updating and improvement and that the current program of tax treaty negotiations provides an important opportunity to positively address a number of significant issues. Please consider implementing the 4 key recommendations outlined in the proposal below for the financial security and mental and emotional health of Australian citizens like me and many others.

Thank you,
Jason Triolo

Update Proposal for the Outdated Australia-US Tax Treaty

Submission to Treasury by Fix the Tax Treaty!

30 October 2021

Introduction

We are pleased to provide this submission to Treasury recommending updates to the Australia-US tax treaty. These updates are aligned with the plans recently announced by the Australian Treasurer, the Hon Josh Frydenberg MP, to enter into a number of new and updated tax treaties by 2023.

Targeted Australia–US tax treaty reform will enhance labour mobility between our countries, preserve Australian sovereignty and intent over domestic policies, minimise unwarranted tax leakage and, most importantly, provide the same fair go for all Australians.

Australia has long employed a tax treaty framework with the US, underpinning important economic, taxation, and business aspects of our relationship with our third largest trading partner and key ally. However, the current Australia-US tax treaty is over two decades old[1] and fails to appropriately address the taxation of superannuation or take account of the modern investment environment with structures such as managed funds and exchange traded funds. The present invitation to consider issues relating to Australia's tax treaty network provides an important opportunity to modernise and improve the tax treaty framework between our two countries.

Although treaty modernisation and update will no doubt enhance foreign investment and trade opportunities, the focus of this submission is on much-needed improvements which will positively impact individuals, specifically taxpayers with tax obligations in both countries. The United States' unique practice of citizenship-based taxation means that reforming the Australia-US tax treaty is particularly important to individual taxpayers – including dual Australian-US citizens living in Australia.

The current tax treaty has numerous gaps and anomalies resulting in punitive and double taxation. For brevity's sake, this submission focuses on a few of the most critical issues, some of which would be effectively addressed by updating the treaty to reflect the current OECD and US model tax treaty framework. Please see the Appendix to this submission for a table detailing a more extensive improvement opportunity list. These issues are also widely discussed on the Fix the Tax Treaty! website.[2]

Let’s Fix the Tax Treaty! (FTT) is an Australian focused advocacy group representing individuals, including dual Australian-US citizens, who are adversely impacted by inadequate tax treaty protection for Australian-sourced income under the current Australia-US tax treaty. We advocate for changes to the Treaty to seek relief from the considerable cost of compliance complexity, as well as penalties and discrimination against a subclass of Australian citizens and tax residents while also reducing the resulting negative impacts and costs to the Australian economy and therefore to all Australians.

FTT currently has nearly 1,500 directly affiliated members with our efforts undertaken on behalf of a large and diverse stakeholder group of impacted Australians, estimated to be in excess of 400,000 persons, including dual citizens, permanent residents and their dependants living in both countries.

Why the Australia US Tax Treaty needs to be updated

Tax treaties are intended to prevent double taxation, improve cross-border tax efficiencies and eliminate tax evasion. Many of the failings of the current treaty are due to the unique[3] US practice of taxing on the basis of citizenship, rather than country of residence, which is the convention accepted by the rest of the world. This leads to instances of double taxation, considerable compliance complexity and material financial risks that directly impact most dual-country taxpayers. In fact, the current treaty guarantees unfair taxation by the US of some Australian source income, including superannuation. The excessive compliance burden is felt particularly by low- and middle-income individuals who are less able to afford the cost of both tax preparation and the sophisticated financial planning required to effectively save for retirement while simultaneously subject to two different tax systems.

This submission focuses on four material areas requiring reform: 1) Retirement savings, most importantly US tax treatment of superannuation; 2) US tax treatment of Australian domiciled managed fund investments;

3) non-alignment of capital gains taxation on the sale of a personal residence; and 4) the inclusion of a “saving clause” in the treaty which guarantees the ability of the US to collect US tax on the Australian income of Australian residents. Improvement opportunities are identified in this discussion and summarised again in the recommendations.

Key Reform Issues

Retirement Savings

Labour mobility is impeded when the destination country can tax funds that are invested in source country retirement savings that are not currently accessible due to preservation requirements. The current OECD and US model tax treaties address this problem, both during the accumulation phase and the drawdown (post-retirement) phase. Essentially, the treaty should require each country to respect the tax-deferred accounts available in the other country, align taxation of retirement savings

and defer any individual taxation until funds are withdrawn. Pragmatically, it is in neither country's interest to permit inter-country tax leakage from key retirement saving programs.

For internationally mobile workers, the current tax treaty framework discourages use of tax advantaged retirement savings schemes as the promised tax benefits may not be available once they have moved to a different country. Guaranteeing that these workers will receive the tax benefits promised will better incentivise prudent retirement planning and reduce reliance on government funded programs such as the Age Pension.

Superannuation

The 2001 Australia-US Tax Treaty does not even mention superannuation, despite it being widely mandated in Australia since 1992. As superannuation is not addressed in the existing tax treaty, nor has either country issued any formal taxation guidance, there has been, and continues to be, much uncertainty about the "correct" way to include superannuation on a US tax return, even among IRS agents.[4]

This uncertainty affects not only US citizens and green-card holders living in Australia, but also any Australian citizen or former resident currently living in the US who accumulated superannuation while resident in Australia, thereby discouraging labour mobility. Retirement savings taxation is recognised in more contemporary treaties; with the more recent US Tax Treaties containing provisions that respect the tax deferral of "foreign" retirement plans. See, for example, Articles 17 and 18 of the 2016 US Model Tax Treaty. With regard to retirement plans, both the UK and Canada have more favourable US tax treaties than Australia.

In the case of Australian residents, US tax on Australian superannuation of Australian residents is contrary to the interests of Australia as it reduces the ability of Australians to save to fund their retirement and increases the probability that the affected Australian citizens will be reliant on the Australian government for Age Pension once they retire. The US should have no claim on super – especially of Australian residents.

Given the lack of tax treaty clarity or IRS guidance on the taxation treatment of superannuation, it has been left to the individual taxpayers and the compliance industry to classify superannuation based on the US foreign entity classification regulations for federal tax purposes. This complex task is made even more difficult by the range of permitted superannuation types, including industry, retail, public sector (including defined benefit plans) and self-managed super funds (SMSFs).

While most US tax professionals include superannuation contributions in the US taxable income of the individual recipient, there is uncertainty around whether contribution taxes paid by the fund are available as foreign tax credits to offset US tax on the contributions. As well, certain types of

superannuation arrangements require extensive information reporting because they are treated by the US as “foreign” grantor trusts. There are also a small number of US tax professionals who argue that Superannuation is equivalent to US Social Security,[5] and therefore some or all of the contributions and subsequent withdrawals are excluded from US taxation under Article 18 paragraph 2 of the tax treaty. Finally, since superannuation is not a qualified US retirement plan, any movement of super balances between funds may be treated as a taxable distribution. This includes consolidation of fund balances or rollovers when changing employment, all of which are tax free transactions under Australian tax law.

Any US tax owing on superannuation contributions, earnings, rollovers, or distributions will not be offset by a tax credit for Australian tax paid because these are either tax-free transactions in Australia (for transactions arising from an account in pension mode), or any tax on investment income or realised gains has been paid directly by the superannuation fund and not by the individual. Thus, US taxpayers with superannuation accounts are guaranteed to pay double tax on those accounts – once for income taxed inside their superannuation fund and once by the US.

Arguably, the major frustration of US taxpayers currently or previously resident in Australia is the uncertainty of the US tax treatment of superannuation. It would be preferable for this uncertainty to be resolved even before a new treaty is negotiated. As the competent authority with respect to the current treaty, the ATO should be actively lobbying the IRS to agree that the superannuation guarantee (at a minimum) is exempt from US tax under Article 18 paragraph 2 of the current treaty. Given the pension provisions in the current US model treaty, Australia should adopt a strong position that Australian superannuation not be subject to tax by the US.

In summary, the tax treaty should clarify the treatment of Superannuation commensurate with Australian domestic public policy and not selectively disadvantage those Australian residents who are also US taxpayers from the benefit of funding their retirement through the superannuation system, as provided by Australian domestic tax law.

US retirement accounts

For Australians who spend some time working in the US, the opposite situation also poses tax problems which can discourage labour mobility. For lower income workers, the US has created what are known as “Roth” accounts (available both as Individual Retirement Accounts and in a 401(k) account). Taxpayers deposit after-tax funds into the Roth account with the promise that withdrawals in retirement will be tax free. This contrasts with “Traditional” retirement accounts where funds are deposited tax free (either exempt from taxation or deducted from taxable income) while withdrawals in retirement are included in taxable income.

Australian tax rules, however, do not recognise the difference between the Roth and Traditional variants of US retirement accounts, treating both as foreign trusts where the originally deposited

funds are withdrawn tax free, but the appreciation earned since that initial deposit is taxed as current income. This treatment makes US Roth retirement accounts toxic for returning Australians who must either pay an early withdrawal penalty to wind up the Roth account prior to moving back to Australia or pay Australian tax on what they had thought was a tax-free investment. Incorporation of the retirement provisions in the OECD and US model treaties will go a long way towards fixing this problem. The treaty should also address the specific types of retirement accounts available in each country and ensure that the tax benefits promised when and where the accounts were established will be available to those who move between the US and Australia.

Managed Fund Investments: Passive Foreign Investment Companies

For middle class savers, the most efficient savings vehicle is often a managed fund or exchange traded ~~fund. For internationally mobile~~ individuals and those Australian residents taxed by the US, the US tax treatment of certain types of Australian domiciled investments is exceptionally punitive. The US Internal Revenue Code generally treats many "foreign" investments as if their only purpose were to avoid or defer US tax, with no ownership distinction made between US and overseas residents. One example of this is the Passive Foreign Investment Company (PFIC) regulations. PFICs are defined in Section 1297[6] of the Internal Revenue Code as any foreign (non-US) corporation with either more than 75% passive income or holding more than 50% of assets for the production of passive income. This is a broad definition and encompasses most managed funds, exchange traded funds (ETFs), real estate investment trusts and listed investment companies. Start-up companies with little revenue and large cash holdings can also be classified as PFICs.

Once a company has been classified as a PFIC, the tax consequences for US taxpayers are punitive. The US-taxpayer shareholder of a PFIC can elect to be taxed annually on any unrealised gain from their investment, essentially marking the investment to market on an annual basis. This unrealised gain is taxed as ordinary income, no capital gain concession is allowed. If this election is not made in the first year that the investment is classified as a PFIC, or the year the investment is purchased by the taxpayer, then a more complex set of rules applies. Under these rules, not only are capital gains concessions denied on the investment, but any realised gain is allocated pro-rata over the entire holding period and taxed at the highest available marginal rate applicable in the year the gain is allocated to (even if the taxpayer's actual marginal tax rate in that year was much lower). While foreign tax credit is allowed against this tax, due to the combination of phantom exchange rate gains and the use of the highest possible US tax rate, foreign tax credit may offset only a small portion of the gain. On top of this, daily compound interest is computed on this deemed "deferral" over the whole holding period of the investment. All these gain computations are done in US dollars adding exchange rate risk. Furthermore, any distributions in excess of 125% of the 3-year rolling average are treated as excess distributions subject to the same imputation of deferred tax and daily compound interest. No surprise that many tax professionals describe the PFIC regime as "confiscatory in nature".

Clearly, it is not tax-effective for a US taxpayer to own a PFIC. However, while the PFIC rules have been in the Internal Revenue Code since 1986, they were obscure, and anecdotal evidence suggests that PFIC rules have only been regularly applied to non-US domiciled public managed fund investments since around 2009. This means that many long-term US expats have been caught with Australian managed investments purchased years or decades before this new interpretation took hold, leaving them unable to exit their investments without punitive US taxes being applied. The US tax reporting form for PFICs is also notoriously complex and time-consuming, adding greatly to compliance costs.

One of the policy objectives of the PFIC provisions was to prevent deferral of US tax through investment in foreign entities that were not subject to the same rules as US managed funds regarding the distribution of current income. Clearly this is not a problem with any Australian managed fund that is available to retail investors.

We suggest adding to the Non-Discrimination article in any new treaty a clause that prohibits discrimination against investments available to retail investors in the other country. This clause would not override securities law regarding marketing of investments but would provide relief to a mobile workforce who may have assets in place in one country when they move to the other.

Alternatively, the treaty should include a clause in Article 10, Dividends, that states that Australian investment structures that are sold to retail investors are not to be considered "foreign corporations" under the PFIC rules. That is, the treaty should stipulate that retail investments domiciled in one country should not be more punitively taxed by the other country than their own similar domestic investments.

Gain on sale of personal residence

For individuals in Australia with US tax obligations, capital gain on the sale of a personal residence is taxable in the US (with a US$250,000 exemption per person). This gain is computed as if the purchase and sale were in US dollars, potentially leading to currency "phantom gains". In addition, since US tax rules assume that the US dollar is the functional currency of all individual taxpayers, discharge of an AUD denominated mortgage can result in taxable foreign currency gains. When exchange rates have changed since home purchase, individuals selling a home with a mortgage will have taxable currency related gains on either the home itself, or the mortgage with an offsetting currency loss on the other side of the transaction. Furthermore, since the residence is a personal use asset, losses are not allowed, so only the gain side of the currency transaction will be recognised and taxed.

These rules are particularly problematic for US citizens and green card holders residing in Australia, where no capital gains tax is paid on the sale of a primary personal residence. Allowing the US to tax capital gains on Australian real estate owned by Australian residents is contrary to the economic interests of Australia. The Tax Treaty should:

> seek to align treatment of the sale of a personal residence with Australian taxation policy, particularly as extremely high housing costs in Australia force many to tie up a large proportion of their net assets in their primary residence;

stipulate that real property located in one country and owned by a resident of that country cannot be taxed by the other country. This provision should be included in the list of saving clause exemptions in Article 1 paragraph 4 of the treaty.

Saving Clause

All US tax treaties contain some form of "Saving Clause" that guarantees the right of the US to tax its citizens as if the treaty did not exist.[7] In the current Australia-US Tax Treaty, the Saving Clause is found in Article 1 paragraph 3, with a limited list of exceptions in Article 1 paragraph 4. As we have noted, no other developed country asserts tax jurisdition based on citizenship alone. The Saving Clause allows the US to reach into the Australian tax base and tax the Australian source income of Australian resident taxpayers. This erodes the ability of the affected US Persons to take advantage of Australian public policy and legislated tax concessions designed to encourage retirement savings and local investment.

The Saving Clause, and the US practice of citizenship-based taxation more generally, frustrates Australian domestic policy by allowing a foreign government to apply its own idiosyncratic tax rules to income earned on Australian soil by Australian residents. This disadvantages the affected US Persons and increases the likelihood that they will require Australian government assistance in the form of the Age Pension and other Australian social safety net programs.

It is a matter for the US Government to determine its own domestic laws, and it is unlikely that the US will agree to completely remove the Saving Clause from an amended treaty. However, Australia should insist that the Australian tax base is respected under the treaty. The Australian source income of Australian residents should be taxable only by Australia.

Summary

There are many other taxation areas that should be addressed, such as taxation of Australian benefits and issues with business legal structures. These areas are listed in the Appendix to this submission.

The exceptional US practice of citizenship-based taxation mandates tax reporting and compliance from all US Persons within Australia, of which many are dual citizen, long-term Australian residents of only modest means. Citizenship-based taxation exposes them, unlike citizens of any other developed country in the world, to the Sisyphean task of reconciling two complex and disparate domestic tax systems, frequently leading to instances of double taxation, high compliance costs and increasingly unreasonable penalties and fines. These are exactly the sorts of issues that a well-crafted tax treaty can help mitigate and an important driver as to why the Australia-US tax treaty should be prioritised by Treasury and the Morrison Government for reform and update.

Key Recommendations

To summarise, we believe that the Australia-US tax treaty is in urgent need of updating and improvement and that the current program of tax treaty negotiations provides an important opportunity to positively address a number of significant issues.

We propose the following key recommendations:

1. The treaty should be updated to reflect the retirement account provisions in the current OECD and US model treaties. Each country should recognise the tax deferred nature of retirement accounts and ensure that moving between countries does not materially alter the tax benefits promised when and where the accounts were established. Contributions to and benefits from any form of pension or retirement plan should be exempt from the saving clause. At a minimum, SG contributions made on behalf of Australian residents should be taxable only by Australia and excluded from US taxation.
2. The treaty should stipulate that retail investments in one country should not be more punitively taxed in the other country than their own similar domestic investments.
3. The treaty should include a provision that real property located in one country and owned by a resident of that country cannot be taxed by the other country.
4. The treaty should specify that the Australian source income of Australian residents is taxable only by Australia.

We appreciate the opportunity to address the areas in which the US-Australia tax treaty can be modernised and updated to provide more certainty and reduce double taxation for individual taxpayers subject to tax by both countries. The US practice of taxing based on citizenship rather than residence is particularly harmful to Australian residents with US citizenship, most of whom are Australian citizens.

Respectfully submitted on behalf of Fix the Tax Treaty! by

Dr Karen Alpert

Founder and Chairperson, Fix the Tax Treaty!