

# Investing with one hand tied behind your back – An Australian perspective on United States tax rules for non-resident citizens

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## **Abstract**

The United States is unique in taxing non-resident citizens under the same rules as residents. For Australian citizens and residents who are also US taxpayers, the impact of this is much greater than the generally minimal amount of US tax due each year. The US grants citizenship broadly and makes it difficult and expensive to cleanly exit the US tax system. Planning one's tax affairs under two very different tax systems is complex and often results in sub-optimal financial outcomes. Australian citizens and permanent residents who are required to file US tax returns will find it more difficult to effectively save for retirement than their peers, and will be more likely to rely on the Australian government's social safety net in their later years.

The US tax code significantly discriminates against many non-US investments and business structures, which constrains the options of affected Australian-resident taxpayers, many of whom are also Australian citizens. The treatment of Australian superannuation on a US tax return is the subject of some disagreement among tax professionals. Australian investment opportunities outside of superannuation are also limited for US taxpayers. Australian managed funds are punitively taxed under the Passive Foreign Investment Company (PFIC) rules. For entrepreneurs and small business owners, the US tax treatment of "foreign" corporations owned or controlled by a US person can unravel any Australian tax advantages. Family trust structures often recommended for asset protection and tax planning purposes in Australia would likely be treated as disregarded entities on a US tax return. Finally, US law may make it difficult for non-resident US citizens to open financial accounts in the US making it difficult to avoid the punitive US tax treatment of Australian investments. Although this paper focuses on Australia and the interplay between US and Australian tax rules, the issues raised are broadly applicable to US citizens residing anywhere outside of the US.

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## Introduction

The United States is unique among developed nations in taxing its citizens (and legal permanent residents) on worldwide income regardless of where those citizens live. Until the passage of the *Foreign Account Tax Compliance Act (FATCA)*<sup>1</sup> in 2010, however, there was little enforcement of US taxation on non-resident citizens. FATCA requires financial institutions around the globe to report their US citizen clients to the Internal Revenue Service (IRS) either directly or via their local tax agency (the ATO here in Australia). Prior to receiving a FATCA notification from their bank, many non-resident US citizens were unaware of their US tax filing obligations, and some were unaware that the US considered them citizens in the first place.<sup>2</sup> This increased awareness of US tax filing obligations has brought with it an increased appreciation for the difficulty of simultaneous compliance and planning under two different tax systems.

US tax law penalises all things “foreign,” even when assets and investments are held locally, where the taxpayer resides and may even be a citizen. Furthermore, all US tax computations and thresholds are in US dollars, subjecting the taxpayer to significant currency risk. For investments, gain or loss is computed by converting all values to USD at the time each transaction occurs. The change in currency value between purchase and sale can either increase or decrease the computed USD gain, resulting in phantom gains and losses that do not reflect the taxpayer’s actual change in net worth as measured in AUD, the currency that an Australian-resident taxpayer will be using for everyday transactions. And, when dealing with personal use assets, gains are taxable, but losses are not allowed. While the US tax code recognises that businesses may have a “functional currency” other than USD,<sup>3,4</sup> individual taxpayers are required to use USD as their functional currency.

US law requires disclosure of all foreign financial accounts when the aggregate balance of such accounts exceeds USD 10,000.<sup>5</sup> There are punitive tax rules and onerous disclosure requirements for taxpayers who own foreign corporations,<sup>6</sup> invest in foreign managed funds,<sup>7</sup> or are owners or beneficiaries of foreign trusts.<sup>8</sup> The tax benefits accorded to qualified retirement accounts in the US (e.g. 401(k) accounts) do not apply to retirement funds that are not organised under US law. And the US has a complex and convoluted set of rules governing income earned inside Controlled Foreign Corporations (CFCs). Australian residents who are US citizens or legal permanent residents are essentially engaging in cross-border tax transactions on a daily basis. As a general rule, the tax and financial planning advice that is appropriate for most Australian taxpayers, can be quite costly when applied to a dual Australian-US taxpayer.

Given the difficulty of navigating these two tax systems simultaneously, it is unsurprising that a number of affected taxpayers have taken steps to remove themselves from the jurisdiction of one of the two tax authorities. There are no statistics on how many affected taxpayers have simply moved back to the US, thereby losing tax residence in Australia. However, the number removing themselves from the US tax

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<sup>1</sup> FATCA is found in Chapter 4 of the Internal Revenue Code. It was enacted as part of the *Hiring Incentives to Restore Employment (HIRE) Act of 2010* (Pub. Law No. 111-147).

<sup>2</sup> See A Christians, *A Global Perspective on Citizenship Taxation*, Michigan Journal of International Law, (38:2), 2017.

<sup>3</sup> §985 allows “qualified business units” (as defined in §989(a)) to use the currency in which the business conducts its activities and maintains its books and records as a functional currency, computing income, gains, and losses in that currency and translating the resulting gain or loss to USD for US tax reporting.

<sup>4</sup> References to section numbers with the symbol § and without other qualifiers are references to the Internal Revenue Code (Title 26 of the US Code).

<sup>5</sup> FinCEN Report 114, colloquially known as FBAR (Foreign Bank Account Report), filed with the Financial Crimes Enforcement Network (FinCEN) annually. The USD 10,000 aggregate account balance threshold has remained unchanged since the original enactment in the *Bank Secrecy Act of 1970* (Pub. Law No. 91-508). Those with higher balances may also be required to file IRS Form 8938 “Statement of Foreign Financial Assets” with their annual US income tax return.

<sup>6</sup> IRS Form 5471 “Information Return of US Persons With Respect to Certain Foreign Corporations”.

<sup>7</sup> IRS Form 8621 “Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund”.

<sup>8</sup> IRS Form 3520 “Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts” and Form 3520-A “Annual Information Return of Foreign Trust With a US Owner”.

system by renouncing their US citizenship has grown exponentially since 2010,<sup>9</sup> despite the dramatic increase in the renunciation fee charged by the US government. Cleanly exiting the US tax system requires more than simply renouncing US citizenship; the US expatriation tax rules found in §877A require specific disclosures and thresholds that must be met to avoid the application of an exit tax and the punitive status of “covered expatriate”.

This paper discusses the main areas of concern for dual Australian-US taxpayers: superannuation, real estate, equity investments, business ownership, and trusts. Having covered the costs of being a US taxpayer in Australia, the paper then explains the costs and procedures involved in cleanly exiting the US tax system. The paper concludes with a discussion of and the impact of the extra-territorial reach of US law on Australia.

## Application and Enforcement of US Tax Rules on Australian Residents

While US tax law has claimed the right to tax non-resident citizens since the Civil War, the application of extraterritorial taxation on the US diaspora has been ineffective and inconsistent. Several legal scholars have examined the justification for using citizenship as a basis for taxation,<sup>10</sup> with most concluding that non-resident citizens did not have sufficient connection or receive sufficient benefits to justify taxation. Furthermore, no other country taxes non-resident citizens under the same rules as residents. The ABS estimates that over 104,000<sup>11</sup> Australian residents are US-born with US taxation also affecting their children, their solely Australian spouses and partners as well as Australians who have obtained US citizenship by naturalisation before returning to Australia. Given the wide net cast by US taxation of non-resident citizens, well over 200,000 Australians could be affected by US extra-territorial taxation in one form or another.

In 2010, the US passed the Foreign Account Tax Compliance Act (FATCA) with the aim of locating an estimated USD 100 billion in lost tax revenue from tax evasion. Actual collection of this “lost tax revenue” in the 7 years since passage has been minimal.<sup>12</sup> As enacted, FATCA put the non-US financial system in an untenable position. FATCA threatened to withhold 30% from *all* payments made to non-compliant “foreign” financial institutions of US-source income or gross proceeds from the sale of securities that generate US-source income. However, compliance with FATCA required non-US financial institutions to violate local privacy law by sending account holder information to a foreign government. The solution arrived at by the US Treasury, with the cooperation of the G5, was to develop intergovernmental agreements (IGAs) that used the force of local law to facilitate exchange of information with the IRS.<sup>13</sup> One problem with the IGAs is that, while each partner jurisdiction has implemented the IGAs as full treaties,<sup>14</sup> the agreements are “sole executive agreements” under US law.<sup>15</sup> This makes it more difficult for the US to implement the information exchange undertaken in the IGAs, and raises questions about the legitimacy of the IGAs.

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<sup>9</sup> See, for example, C Morris, *Americans Are Ditching Their U.S. Citizenship at a Record Rate*, *Fortune*, 6 Nov 2017; or Isaac Brock Society, *1,376 published expatriates in Q3 2017 Federal Register list of people giving up US citizenship*, 1 Nov 2017 (<http://isaacbrocksociety.ca/2017/11/01/1376-published-expatriates-in-q3-2017-federal-register-list-of-people-giving-up-us-citizenship/>).

<sup>10</sup> See, for example, MS Kirsch, *Taxing Citizens in a Global Economy*, *NYU Law Review* (82), 2007; A Christians, *Human Rights at the Borders of Tax Sovereignty*, <https://ssrn.com/abstract=2924925>, 2017; R Mason, *Citizenship Taxation*, *Southern California Law Review* (89), 2016; and M Cabezas, *Reasons for Citizenship-Based Taxation?*, *Penn State Law Review* (121), 2016.

<sup>11</sup> ABS data accessed from [http://stat.data.abs.gov.au/Index.aspx?DatasetCode=ERP\\_COB](http://stat.data.abs.gov.au/Index.aspx?DatasetCode=ERP_COB) on 7 Jan 2018.

<sup>12</sup> W Byrnes, *Background and Current Status of FATCA and CRS (Sept 2017 edition)*, Texas A&M University School of Law Legal Studies Research Paper No. 17-75, 29 Sep 2017.

<sup>13</sup> A Pross, *How tax transparency went global in 2014*, *International Tax Review* (26), March 2015.

<sup>14</sup> Australia’s IGA can be found at [2014] ATS 14, and was implemented by the Tax Laws Amendment (Implementation of the FATCA Agreement) Bill 2014.

<sup>15</sup> A Christians, *Interpretation or Override? Introducing the Hybrid Tax Agreement*, *Tax Notes International*, 5 Oct 2015, p. 51.

FATCA does not add new taxes, but recruits Australian banks, at considerable cost, to do the job of the IRS in locating non-compliant US taxpayers, many of whom are Australian residents and citizens. ATO data shows over 860,000 account records including AUD denominated accounts in excess of AUD 180 billion were forwarded to the IRS under FATCA for 2016. Records for AUD denominated accounts reported dividend income in excess of AUD 500 million, interest income in excess of AUD 2 billion, gross proceeds from sales in excess of AUD 51 billion and other income in excess of AUD 1 billion. Approximately 60% of the accounts held by individuals were owned by Australian residents.<sup>16</sup>

For many non-resident US taxpayers in high tax jurisdictions such as Australia, a combination of foreign tax credits (FTC) and the Foreign Earned Income Exclusion (FEIE)<sup>17</sup> will mean that little US tax is actually due. Thus, since much of the income and account balance information sent to the IRS under FATCA will be Australian-source income, Australian FATCA reporting on Australian residents will result in little additional US tax due. However, arranging one's financial affairs to avoid the most xenophobic sections of the US tax code severely constrains the ability of Australian-resident US taxpayers to effectively plan their financial and tax affairs. For US citizens, application of the double tax agreement (DTA) with the United States<sup>18</sup> is severely limited by the "saving clause" found in Article 1, paragraph 3 of the DTA, which reserves the right of the US to tax Australian-resident US citizens as if almost all of the DTA did not exist. Furthermore, the complexity of US tax compliance for non-resident citizens will often result in professional tax preparer fees that exceed the actual balance of US tax due.

## Areas of Concern for Australian-resident US Taxpayers

The standard tax and financial planning advice given to most Australian residents is not appropriate for those who are also US taxpayers. The major areas of concern are superannuation, real estate, equity investments, small corporations, and trusts.

### Superannuation

Tax advantaged retirement savings is rarely internationally portable. The structures and accounts that are tax advantaged in one jurisdiction are not as effective for an internationally mobile labour force. This is especially true for US taxpayers living in Australia. Australian employers are required to contribute to superannuation for their employees, so Australian-resident US taxpayers must figure out how to report that superannuation on their US tax returns. Unfortunately, the DTA provides no guidance. While Article 18, paragraph 1 would appear to treat "...periodic payments made by reason of retirement..." as taxable only in the resident country, the saving clause allows the US to ignore this provision with respect to US citizens resident in Australia. Furthermore, the treaty addresses only retirement income streams, and not the tax treatment of contributions to, or earnings within superannuation.<sup>19</sup> When the original treaty was drafted in 1982, compulsory superannuation was not yet law in Australia. However, when the protocol was signed in 2001, the Superannuation Guarantee (SG) had been a feature of the Australian economy for 9 years. It is unclear why this obvious change was not incorporated in the amendments made to the treaty in 2001. The lack of clarity in the tax treaty, coupled with conservative interpretations of tax compliance professionals end up creating precedent and expectations on the part of the IRS. The end

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<sup>16</sup> Data obtained from the ATO via Freedom of Information request. The ATO noted that this number includes duplicate records sent due to data validation problems, but gave no indication of the magnitude of duplication. Information on account holder residence is incomplete, and there is no indication of the relative value of resident vs non-resident accounts.

<sup>17</sup> §911 allows non-resident taxpayers to exclude an indexed amount of foreign earned income from their US taxable income. In 2018 the exclusion amount is USD 104,100, which applies to earned income only.

<sup>18</sup> *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 6 Aug 1982 and amended via protocol signed 27 Sep 2001.

<sup>19</sup> Compare this treatment with Articles 17 and 18 in the US 2016 Model Income Tax Treaty available at <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf>.

result is a movement towards compliance that maximises US tax due and constrains the ability of dual citizens to effectively save for their retirement in Australia.

Most tax professionals treat Australian superannuation as a non-qualified retirement plan for US tax purposes, taxable either as an employees' trust under §402(b)<sup>20</sup> or as a "foreign grantor trust" under §679. In both cases, all concessional superannuation contributions will be included in the employee's US taxable income as the contributions are made. For a §402(b) employees' trust, the treatment of income inside the fund will depend on whether the employee is considered "highly compensated."<sup>21</sup> Highly compensated employees must determine whether the plan is discriminatory (covering mostly highly compensated employees); but under §414(q)(8) this determination is done without counting any employees who are non-resident aliens with respect to the US. As this determination is not possible for most highly compensated employees, many tax professionals simply treat all highly compensated employees as subject to the rules for discriminatory plans. If the plan is discriminatory and the employee is highly compensated, then the employee is taxed under §402(b)(4), which requires the inclusion of the change in value of the account in US taxable income annually. For non-highly compensated employees, or those in non-discriminatory plans, contributions are included in income as made, and withdrawals are allocated between previously taxed contributions, which are not taxed, and account earnings, which are taxable as withdrawn. §402(b) treatment applies only to employer contributions (and incidental employee contributions). When employee contributions are more than half of the account, then the portion of the account funded by employee contributions will be treated as a foreign grantor trust.<sup>22</sup> Grantor trust treatment will also apply to self-managed funds and to balances that have been rolled over from previous funds. When superannuation is treated as a foreign grantor trust, every transaction inside the fund is taxable directly to the individual; the superannuation fund is essentially a disregarded entity for US tax.<sup>23</sup> Whichever set of rules apply, there is a mis-match between the timing of taxation between the US and Australia, which will result in double taxation of superannuation benefits. Contributions are earned income, and therefore qualify for the FEIE<sup>24</sup>. Withdrawals, however, are not earned income and will not be eligible for exclusion. As Australia does not tax withdrawals after age 60, there will be little Australian tax to use as FTC<sup>25</sup> on the US return. The US allows unused FTC to be carried over for 10 years,<sup>26</sup> so it is advisable to maximise FTC carryovers in the decade before retirement. Note also that the income and assets test for the Australian Age Pension will not be adjusted due to US tax liability, so US taxpayers who qualify for the Age Pension while still holding superannuation will have lower after-tax income than other similarly-situated Australians.

While not yet widely accepted, a small number of tax compliance professionals<sup>27</sup> have recently explored whether superannuation should be treated as equivalent to social security, and therefore, taxable only by the resident country under Article 18(2) of the DTA. Unfortunately, the DTA does not specifically define the term "social security," leaving interpretation up to the IRS, ATO and compliance professionals. While superannuation differs from US Social Security in many key respects, both are government-mandated

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<sup>20</sup> Section references are to the Internal Revenue Code. See note 4.

<sup>21</sup> This threshold is defined in §414(q)(1)(B) and indexed for inflation. For 2018, an employee earning more than USD 120,000 per year is considered highly compensated (IRS Notice 2017-64).

<sup>22</sup> 26 CFR 1.402(b)-1(b)(6).

<sup>23</sup> This paragraph has focused on income tax consequences. There are also reporting requirements for foreign grantor trusts on forms 3520 and 3520A. For participants in APRA regulated funds, the information required to be reported may not be readily available to the account holder.

<sup>24</sup> See note 17.

<sup>25</sup> Foreign Tax Credit. The US allows tax paid in Australia on Australian source income to offset US tax on that same income. Australia similarly allows an offset against Australian tax for US tax paid on US source income. The net effect is that the taxpayer ends up paying the higher of the two tax rates.

<sup>26</sup> §904(c).

<sup>27</sup> See RA Berg and M Dungog, *U.S. Income Tax Treatment of Australian Superannuation Funds*, Tax Notes International, 10 Oct 2016, p. 177; and JA Castro, *US Tax Treatment of Australian Superannuation*, Global Tax Weekly: A Closer Look Issue 171, 18 Feb 2016.

retirement savings systems. In the Social Security Agreement between the US and Australia,<sup>28</sup> Australian Superannuation Guarantee legislation is expressly included within the scope of the agreement.<sup>29</sup> US Social Security benefits can be reduced under the Windfall Elimination Provision<sup>30</sup> if the recipient also receives a pension from their superannuation account. Given that the SG portion of superannuation contributions is mandated by the Australian law, it should be possible to argue that at least a portion of superannuation should be treated as social security, exempt from US tax for Australian residents under the DTA.

## Real Estate

The tax implications of owning real estate depend on whether the property is owned as an investment or as a personal use asset. In both Australia and the US, homeownership is a major savings vehicle for many households. Each country provides tax incentives for homeowners, but not the same tax incentives. In the US home mortgage interest is tax-deductible<sup>31</sup> and when the home is sold the first USD 250,000 (per taxpayer) is excluded from taxable income. In Australia, there is no deduction for home mortgage interest, and all of the gain on the sale of a personal residence is excluded from taxable income. Australian-resident US taxpayers can be caught out by the differences.<sup>32</sup> While some Australian-resident US taxpayers may be tempted to ignore the mortgage interest deduction as they may already be paying zero US tax, claiming the deduction will maximise the FTC carryover, which may help reduce any US tax liability if the house is sold before the carryovers expire.

Over the last decade, house prices in Sydney and Melbourne have more than doubled, and the average price of residential real estate in the capital cities has grown at an average rate of 5.8% per year. Given this appreciation, it is important to consider the US tax consequences of any capital gain realised. If a principal residence is owned jointly with a non-US partner, then only half of the total gain will be included in US taxable income. When computing the gain, the cost base can be adjusted by adding the cost of renovations to the original cost, something many Australians may not be keeping track of. All US tax computations are done in US dollars. The purchase price will be converted to USD on the date of purchase, and the sales price will be converted on the date of sale. This means that currency fluctuations can lead to phantom gains or losses.

The sale of any real estate may also involve the repayment of an outstanding mortgage, which will be treated as a completely separate transaction under US tax rules. This is another danger area for US taxpayers, again because US tax is computed using the fiction that all transactions are executed in US dollars. If the Australian dollar depreciates between the time the mortgage loan is initiated and the time the loan is extinguished, the US tax code will treat this as a gain.<sup>33</sup> In effect, the IRS thinks the taxpayer has borrowed USD 100,000 (when the exchange rate was AUD 1 = USD 1) and paid back USD 75,000 (when the exchange rate was AUD 1 = USD 0.75) for a gain of USD 25,000. And, since a principal residence is a personal use asset, the US tax code will only recognise gains on discharge of a home mortgage; losses will be disallowed.<sup>34</sup> For the IRS, substantial currency fluctuations generate a no-lose proposition on the sale of a principal residence with an offsetting mortgage. The mortgage and the underlying property will offset each other – but the gain side of the transaction is taxed, while the loss is disallowed.

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<sup>28</sup> Social Security Agreement between Australia and the United States of America, available on the Department of Social Services website at <https://www.dss.gov.au/international/international-social-security-agreements>.

<sup>29</sup> Social Security Agreement, Article 2(1)(b)(ii).

<sup>30</sup> 42 USC 415(a)(7).

<sup>31</sup> For mortgages closed on or before 15 December 2017, interest on the first USD 1m of mortgage indebtedness is deductible. For new mortgages, only interest on the first USD 750k is deductible.

<sup>32</sup> This is well illustrated by the experience of then London mayor Boris Johnson (see RW Wood, *Brit Boris Johnson Renounces America; Why We Should Care*, Forbes, 9 Feb 2017).

<sup>33</sup> §988.

<sup>34</sup> §165(c). See also *Congress knew about diaspora's "phantom gains" problem in 1986 & refused to fix it* at <http://isaacbrocksociety.ca/2015/05/31/congress-knew-about-diaspora-phantom-gains-problem-1986-refused-fix/>.

When real estate is purchased for investment, any gain on the property will be taxed in Australia as well as the US, generating foreign tax credits to offset any US tax due. And any phantom currency loss on the mortgage will be available to offset the currency gain on the property. However, there are still some differences in the way the US and Australia tax investment properties. Under US tax rules, unless substantial time is spent managing a rental real estate portfolio, rental real estate is considered a “passive activity”. Under US tax rules, passive activity losses<sup>35</sup> can only be deducted to the extent of passive activity income; that is, losses from rental real estate cannot be used to offset salary and other active income. Any losses that are disallowed are carried forward and used to offset future passive activity income. There is a special exception<sup>36</sup> from the passive activity loss rules for rental real estate when the taxpayer actively participates<sup>37</sup> whereby a taxpayer can deduct as much as USD 25,000 of rental losses against ordinary income unless they are filing as Married Filing Separate (MFS). Most US taxpayers who are married to non-US citizens will file MFS unless their spouse elects to be taxed as a US taxpayer on their worldwide income. The trade-off for this election is that filing a joint tax return will help the US spouse avoid the higher tax rates and punitive rules applied on a MFS return.

## Equity Investments

Managed funds are an important part of a diversified portfolio. They are a cost-effective choice for small investors as they provide diversification and the transactions costs are spread across all investors in the fund. Unfortunately for Australian citizens and residents who are US taxpayers, many US tax compliance professionals classify Australian managed funds as Passive Foreign Investment Companies (PFICs) for US tax reporting. PFICs are foreign (non-US) corporations meeting either of two conditions:<sup>38</sup>

1. 75% of the company’s income is passive income (interest, dividends, etc.) or
2. 50% of the company’s assets produce, or could produce, passive income.

The PFIC rules were added to the US tax code by the Tax Reform Act of 1986.<sup>39</sup> Non-US mutual funds are not all subject to rules that require current distribution of realised income, and this was seen by US mutual funds as an unfair advantage. However, many countries, such as Australia, have income distribution requirements that are similar to those in the US. By imposing a “one-size-fits-all” approach to taxing “foreign” investments, the PFIC rules are excessively punitive to investments in countries with tax systems that are roughly equivalent to the US.

US taxpayers who hold PFICs have two choices: either pay US tax on a “mark-to-market” basis each year,<sup>40</sup> or apply an extremely punitive anti-deferral regime that allocates gains across the entire holding period and taxes all gains at the highest possible marginal rate for each year then charges daily compounded interest on the deemed deferral of tax. A third alternative, Qualified Electing Fund<sup>41</sup> treatment requires an election and reporting by the foreign mutual fund directly to the IRS, which is unlikely to be cost effective for managed funds available to retail investors. The record keeping and reporting required for PFICs is extremely complex, with the IRS estimating that record keeping, learning the relevant law, and preparing Form 8621 will take the average taxpayer almost 50 hours in total!

Taxpayers can avoid the costs of owning PFICs by purchasing shares directly on the ASX, as long as they avoid companies that meet the PFIC definition, such as non-US domiciled exchange traded funds, Listed Investment Companies, Real Estate Investment Trusts, early stage start-up companies with no operating revenue, and any company whose assets are mainly investments in other companies. For regular operating

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<sup>35</sup> §469.

<sup>36</sup> §469(c)(7).

<sup>37</sup> Active participation is defined as owning more than 10% of the property and making management decisions or arranging for others to provide services such as repairs.

<sup>38</sup> §1297(a).

<sup>39</sup> Pub. Law 99-514 section 1235(a).

<sup>40</sup> §1296.

<sup>41</sup> §1293.

companies, the US tax rules for Australian equity will be similar to the rules applied to US-listed companies. Dividends received from a company incorporated in Australia (or any country with an appropriate US tax treaty) are considered Qualified Dividends<sup>42</sup> and taxed at the same rates as long-term capital gains (currently a top rate of 23.8%)<sup>43</sup> as long as the shares are held for at least 60 days in a 121-day window centred on the ex-dividend date.<sup>44</sup> When computing US tax on franked dividends from Australian shares, only the cash dividend is included in US taxable income. Franking credits will reduce the Australian tax available for FTC to reduce US tax payable.

Investing directly in the US is a viable alternative, as Australia does not treat foreign investments nearly as punitively as the US does. This may be a good choice for temporary migrants, but permanent immigrants to Australia who invest in the US will face extra currency risk as most US investments will be denominated in USD. Even for those willing to bear the currency risk, opening a new investment account, or even maintaining an existing one, in the US can be difficult. While the USA PATRIOT Act<sup>45</sup> is often cited as a reason for US bank closures of non-residents' accounts (even US citizens), it does not appear that the Act directly prohibits these accounts. What the PATRIOT Act did was to strengthen Anti-Money-Laundering (AML) and Know Your Client (KYC) rules. This, along with increased visibility of compliance obligations brought about by FATCA and the highly publicised Department of Justice Swiss Bank Program,<sup>46</sup> has prompted some US financial institutions to decide that denying accounts to overseas customers was just easier than ensuring compliance. Institutions offering brokerage and mutual fund accounts have to consider whether having non-US resident accounts violates foreign securities regulations and marketing laws as well as the complexity of complying with US withholding of tax at source for dividends paid to non-resident aliens. For all of these reasons, it can be very difficult to find an institution willing to open more than a simple transaction account for an Australian resident unless there are significant funds involved. For those who wish to invest in managed funds, US-domiciled ETFs, some of which are traded on the ASX, are a useful workaround.

## Corporations and Trusts

Australian tax and financial planning for small businesses will often involve use of a corporation or family trust, or both. In a purely Australian context, these structures can provide asset protection, estate or succession planning, and tax-efficient allocation of income. On the US side, however, these structures can be ineffective at best, and sometimes toxic.

Discretionary trusts (including family trusts) will likely be treated under US tax law as foreign grantor trusts, owned by the individual(s) transferring assets to the trust. As grantor trusts, the trust is essentially a disregarded entity for US tax reporting. All income, gains and losses inside the trust will be reported as taxable income on the owner's US tax return, negating most of the benefits of establishing the trust in the first place. Taxpayers with foreign grantor trusts are required to file Form 3520-A as well as Form 3520 with their annual US tax return. Failure to file an annual Form 3520 for an existing foreign trust can generate a penalty equal to the greater of USD 10,000 or 5% of the value of the trust's assets.<sup>47</sup> Failure to file form 3520-A incurs an additional penalty computed in the same manner.

Interests in foreign corporations are reported to the IRS on Form 5471. Failure to file this form when required could subject the taxpayer to a penalty of USD 10,000 per year. Furthermore, the statute of

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<sup>42</sup> §1(h)(11)(C).

<sup>43</sup> Capital gains on assets held for more than a year qualify for a top tax rate of 20% and may also be subject to Net Investment Income Tax of 3.8%.

<sup>44</sup> §1(h)(11)(B)(iii).

<sup>45</sup> Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. Law 107-56.

<sup>46</sup> See <https://www.justice.gov/tax/swiss-bank-program>.

<sup>47</sup> §6677(b). Once notified by the IRS the penalty increases by USD 10,000 for each 30-day period starting 90 days after notification up to a maximum of the entire value of the trust. Failure to notify the IRS of the creation of a foreign trust or transfer of assets to a foreign trust will attract a penalty of the greater of USD 10,000 or 35% of the value that should have been reported.

limitations on the entire tax return does not start running until Form 5471 is filed. A Canadian-resident US citizen recently lost a case where the US had imposed this penalty for 12 years of missing Forms 5471, resulting in a penalty of USD 120,000 plus interest.<sup>48</sup> The level of disclosure required on Form 5471 will depend on filing category as defined in the regulations.<sup>49</sup> A small, closely held Australian corporation will be treated as a US Controlled Foreign Corporation (CFC) if US taxpayers who individually own<sup>50</sup> at least 10% of the shares, own in aggregate more than 50% of the shares.<sup>51</sup> For a CFC controlled by the taxpayer, the following items are among those required to be reported by US Shareholders on Form 5471:

- Income Statement, prepared in accordance with US GAAP, in both functional currency and USD;
- List of all foreign “Income, War Profits, and Excess Profits Taxes” paid or accrued during the year, in both foreign currency and USD;
- Beginning and ending balance sheet, prepared in accordance with US GAAP, in USD; and
- A reconciliation of the differences between income shown on the company’s books (according to local accounting principles) and US Earnings and Profits for the period, computed in functional currency, then converted to USD at an average annual exchange rate.

Note that a CFC is required to report on Form 5471 using a tax year that ends at the same time as (or no more than one month prior to) the US tax year of the majority shareholder,<sup>52</sup> regardless of the accounting period used locally. Most individuals compute their US taxes on a calendar year basis, though it is possible to apply for a change in tax year.<sup>53</sup> Clearly, the recordkeeping required for a US-reportable CFC is substantially more technically complex than that required for any other domestic Australian small corporation.

The US tax implications of owning a CFC are covered in what are known as the subpart F rules.<sup>54</sup> The subpart F rules are very complex, but the essential idea is that passive income earned inside a CFC is taxed directly to the shareholders as a “subpart F inclusion”,<sup>55</sup> while active business income is taxed to the shareholders only when distributed as a dividend. Any income taxed directly to an individual shareholder under the subpart F rules is considered Previously Taxed Income (PTI).<sup>56</sup> PTI increases the taxpayer’s cost base<sup>57</sup> in CFC shares, and future distributions from the CFC will be treated as tax-free return of capital to the extent of PTI. Alternatively, individual shareholders of CFCs have the option under §962 to elect to be taxed at corporate rates on their subpart F inclusion. This election has the advantage of allowing FTC for the income tax paid at the corporate level, and the disadvantage that any subpart F inclusion taxed under §962 is not added to PTI (and does not increase the cost base of the shares).

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<sup>48</sup> *Deweese v. United States*, 2017 U.S. Dist. LEXIS 124989 (D.C. D.C. 2017), discussed at <http://federaltaxcrimes.blogspot.com.au/2017/08/court-sustains-10000-per-year-6038b.html>.

<sup>49</sup> Those required to file under 26 CFR 1.6046-1(a) (category 2) include US taxpayers who are directors or officers of a foreign corporation when a US person acquires a 10% interest in the corporation. Those required to file under 26 CFR 1.6046-1(c) (category 3) include any US taxpayer who acquires 10% of a foreign corporation, or disposes of sufficient stock to reduce his interest in the foreign corporation below 10%. Those required to file under 26 CFR 1.6038-2(a) (category 4) include any US taxpayer who owned more than 50% of a foreign corporation for at least 30 days during the corporation’s annual accounting period. US taxpayers who own 10% or more of a corporation that is a CFC are also required to file Form 5471 (category 5).

<sup>50</sup> Attribution rules in §958(b) and §318(a) will attribute shares owned by certain relatives to the taxpayer. These rules will not attribute shares actually owned by non-resident aliens to US taxpayers and, therefore, cannot be used to attribute ownership of a corporation solely owned by a NRA to her US citizen spouse.

<sup>51</sup> §957(a).

<sup>52</sup> §898(c).

<sup>53</sup> §442 and 26 CFR 601.204 govern changes in accounting periods.

<sup>54</sup> The US income tax code is Title 26 of the US Code. Subtitle A, Chapter 1, Subchapter N, Part III, Subpart F (sections 951-965) govern the taxation of CFCs.

<sup>55</sup> §951(a).

<sup>56</sup> §959.

<sup>57</sup> §961.

As if this complexity were not enough, the recently enacted Tax Cuts and Jobs Act<sup>58</sup> has several provisions that could increase both US tax and compliance costs for CFCs. All CFCs are subject to a deemed repatriation tax under new §965. This provision is a one-off tax on all current accumulated earnings and profits (approximately equal to retained earnings) at effective tax rates that vary from 8% to over 17%. There is currently some confusion as to whether this tax applies to foreign companies owned by non-resident individuals. While the Conference Report clearly states that the provision applies to individual shareholders of CFCs,<sup>59</sup> recent IRS guidance<sup>60</sup> refers only to subsidiaries of domestic corporations. Several Canadian tax professionals are advising their clients that this provision will apply to their private Canadian corporations owned by US taxpayers,<sup>61</sup> with one stating that “This is a “gotcha” tax. For Americans living abroad and owning corporations in the country where they reside, this is tantamount to retroactive taxation.”<sup>62</sup> Imposition of this tax on a deemed “repatriation” to the US of accumulated earnings from an Australian company owned by Australian residents (many of whom are Australian citizens) who happen to be claimed as US taxpayers is contrary to the spirit of the Australia/US DTA, and drains capital from Australia. Another provision of TCJA which could adversely affect Australian owners of US CFCs is the imposition of tax on Global Intangible Low Taxed Income (GILTI).<sup>63</sup> This is an additional tax on active business earnings of CFCs. For individual US shareholders of CFCs, GILTI is computed as the excess of CFC net income over a 10% return (reduced by interest expense) on the cost base of tangible assets used for the production of income. There are several classes of income that are excluded from the GILTI computation, including income effectively connected to a US trade or business and foreign income that has incurred an effective foreign tax rate greater than 90% of the applicable US corporate tax rate. Given that TCJA reduces the US corporate tax rate to 21%, a CFC paying an effective tax of greater than 18.9% will not be subject to GILTI. While most small Australian companies will be paying more than 18.9% in Australian tax, the actual computation will be complicated by exchange rate fluctuations, and differences in accounting periods and methods.

## Exiting the US Tax System

With all of the complexity and constraints involved, it is not surprising that those who have permanently immigrated to Australia may wish to terminate their obligation to file US tax returns. As the US taxes based on citizenship, this requires a relinquishment of US citizenship. In addition, US tax law imposes several obligations upon expatriation in the §877A exit tax regime, the current version of which was enacted in 2008.<sup>64</sup>

## Relinquishing Citizenship

US nationality law lists several relinquishing acts<sup>65</sup> that can terminate US citizenship. Most of these relinquishing acts must be performed with the intent of losing US citizenship in order to be effective.<sup>66</sup> Many US emigrants prior to 1967 were told that naturalising in another country would terminate their US

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<sup>58</sup> *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*, Pub Law 115-97. Originally submitted to Congress with a short title of *The Tax Cuts and Jobs Act* (TCJA), this short title was ruled out of order in the final Senate vote on the bill, but has become the popular name for the legislation.

<sup>59</sup> See the Conference Report (H. Rept. 115-466 - TAX CUTS AND JOBS ACT) pp 489-492 available at <https://www.congress.gov/congressional-report/115th-congress/house-report/466/1>.

<sup>60</sup> IRS Notice 2018-17, available at <https://www.irs.gov/pub/irs-drop/n-17-17.pdf>.

<sup>61</sup> M Reed, *Impact of New US Tax Law on US Citizens in Canada*, <http://www.skltax.com/impact-new-us-tax-law-us-citizens-canada/>; and B Bouw, *U.S. owners of Canadian firms wary of Trump's tax plan*, *The Globe and Mail*, 28 Nov 2017; K Nightingale, *U.S. Tax Changes – Implications to Canadian Businesses*, available at <http://www.mnp.ca/en/posts/us-tax-changes-implications-to-canadian-businesses>.

<sup>62</sup> K Nightingale, *op. cit.*

<sup>63</sup> §951A added by Sec. 14201 of TCJA.

<sup>64</sup> §877A was added by Title III, sec 301(a) of the *Heroes Earnings Assistance and Relief Tax Act of 2008*, Pub Law 110-245, known as the HEART Act.

<sup>65</sup> 8 USC 1481, also known as sec 349 of the Immigration and Nationality Act (INA).

<sup>66</sup> In *Afroyim v. Rusk*, 387 U.S. 253 (1967), the US Supreme Court ruled that Congress could not make laws that revoked citizenship involuntarily. As a result, many former citizens who thought their previous relinquishing acts had terminated their US citizenship were able to reclaim that citizenship.

citizenship, but were not provided with any documentation of that relinquishment. Proving intent, especially when the relinquishing act occurred years or decades earlier, can be difficult. For those who have not performed (or cannot prove) a prior relinquishment, US citizenship can be relinquished by renunciation of that citizenship before a consular official. As relinquishment of US citizenship requires intent, minors are not able to relinquish their US citizenship, and their parent or legal guardian is not able to renounce for them. Officially documenting loss of citizenship requires a Certificate of Loss of Nationality (CLN), which currently costs USD 2,350.<sup>67</sup> A CLN is issued automatically in the case of a renunciation. In order to document a prior relinquishment, the fee is currently the same, but the process involves a determination by the US Department of State that the relinquishing act and requisite intent to lose US citizenship have been proved by the preponderance of the evidence.<sup>68</sup> §6039G<sup>69</sup> requires that the names of all persons who renounce US citizenship and all long-term permanent residents who terminate that status be published quarterly in the Federal Register. This list is widely thought to be incomplete,<sup>70</sup> but shows an exponentially increasing number of persons terminating their US taxpayer status, with 5,411 expatriates listed for 2016, and 4,448 during the first three quarters of 2017.<sup>71</sup>

## Section 877A Exit Tax Regime

In addition to the administrative fee of USD 2,350 for a CLN, the US tax code provides for an exit tax regime under §877A.<sup>72</sup> The exit tax regime applies to “covered expatriates” which are defined as those who either relinquish US citizenship or terminate their legal permanent resident (green-card) status after holding that status for 8 of the prior 15 years AND meet at least one of three criteria found in §877(a)(2):

1. Average US tax liability (after application of credits) over the prior 5 years in excess of USD 165,000.<sup>73</sup>
2. Net worth in excess of USD 2million, which was set in 2008 and is not indexed for inflation.
3. Failure to certify compliance with US tax law during the five years prior to expatriation.

All individuals who lose US citizenship or abandon permanent residence status after holding such status for more than 8 years are required to file Form 8854 with their final (usually partial year) US tax return, on which they will certify compliance and provide a balance sheet as of the day before expatriation to allow the IRS to determine whether they are a covered expatriate. For most long-term Australian residents, the net worth criterion will come into play long before their average US tax liability exceeds USD 165,000.

One of the consequences of covered expatriate status is that the US will impose a deemed disposition of all assets and deemed distribution of all “foreign” retirement accounts on the day before expatriation. There is an exclusion for the first USD 713,000<sup>74</sup> of deemed capital gain, but no exclusion for income

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<sup>67</sup> Prior to 13 Jul 2010, there was no cost for applying for a CLN. The fee for renunciations was raised to USD 450 (75 FR 36522) at that time, then to USD 2350 as of 6 Sep 2014 (79 FR 51247). The fee for documenting a prior relinquishment was raised from 0 to USD 2350 as of 9 Nov 2015 (80 FR 53704).

<sup>68</sup> Under 8 USC 1481, the burden of proof lies with the party desiring to show loss of citizenship.

<sup>69</sup> 6039G was added by Title V, sec 512(a) of the *Health Insurance Portability and Accountability Act of 1996*, Pub Law 104-191, known as HIPAA.

<sup>70</sup> See for example, RW Woods, *IRS and FBI Track Americans Who Renounce Citizenship. Why Is FBI List Longer?*, Forbes, 21 Sep 2015.

<sup>71</sup> Detailed statistics and links to Federal Register documents is maintained on the Isaac Brock Society website, with the latest edition at <http://isaacbrocksociety.ca/2017/11/01/1376-published-expatriates-in-q3-2017-federal-register-list-of-people-giving-up-us-citizenship/>.

<sup>72</sup> The discussion in this section applies to current expatriates. For those who receive a CLN based on prior relinquishment, the exit tax rules in effect on the date of their relinquishment should apply, rather than the rules in effect on the date the CLN is granted. See MJ Miller, and ES Brody, *Anti-Deferral and anti-Tax Avoidance: Expats Live in Fear of Malevolent Time Machine*, Int'l Tax J. (39), 2013 for further discussion.

<sup>73</sup> §877(a)(2)(A). This amount is indexed for inflation. The number cited applies to those who expatriate in 2018.

<sup>74</sup> §877A(a)(3)(A). This amount is indexed for inflation. The number cited applies to those who expatriate in 2018.

resulting from the deemed distribution of foreign retirement accounts.<sup>75</sup> For long-term Australian residents, the deemed disposition of superannuation would be costly, unless the position is taken that superannuation is equivalent to social security.<sup>76</sup> The deemed distribution of “foreign” pensions on expatriation is taxed in full, as ordinary income without benefit of the capital gain exclusion. In addition to the exit tax, any assets that the covered expatriate subsequently bequeaths to US heirs will be subject to tax under §2801. At current estate tax rates, this means that any US heirs will owe tax equal to 40% of the value of any inheritance received from the estate of a covered expatriate.

In sum, for a family with two US citizen parents and two young adult US citizen offspring, renouncing US citizenship and cleanly exiting the US tax system will require, in addition to any exit tax owed, administrative fees to the US Department of State of USD 9,400 plus the cost of travel to one of the three US consulates in Australia (Sydney, Melbourne, or Perth), the cost of ensuring US tax compliance for the preceding five calendar years, the cost of preparing four final US tax returns including Form 8854,<sup>77</sup> plus any legal advice needed to navigate the complex combination of US tax and nationality law.

## Conclusion

Australian citizens and permanent residents who are also US citizens or permanent residents are subject to a confusing and complex set of US tax laws, and are poorly protected by the existing DTA. Complying with US tax law while tax-resident in Australia places these taxpayers at a disadvantage compared to similarly situated Australians. As many as 200,000 Australian residents are affected either directly or indirectly. These Australian residents may send significant amounts of US tax and compliance fees out of the Australian economy to the US Treasury and tax compliance industry. If the affected individuals are ineffective in saving for retirement (or if the US exit tax decimates their retirement savings) it is the Australian government safety net, in the form of the means-tested Age Pension, which will support them during their retirement. While this article has focused on the effects of US tax law on Australian residents, Australians immigrating to the US face similar punishing issues with respect to their established Australian superannuation and investments.

Clearly, the Australian government can do nothing to change US tax law. However, Australia can advocate amendment of the DTA or work toward agreement with the US to interpret DTA provisions in a manner that will mitigate some of the problems identified. Article 24 of the current DTA includes a Mutual Agreement procedure that could be used to agree on what “social security” means in Article 18(2). A future protocol or revised DTA could include provisions to eliminate or reduce discrimination in US tax law against Australian investments, superannuation accounts, or small businesses owned by Australian residents.

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<sup>75</sup> It is unclear whether Article 13 (5) of the DTA (added by Article 9 of the 2001 Protocol amending the 1982 DTA), which was clearly written with the Australian exit tax provisions in mind, would apply to assets deemed sold under §877A as no change in residence has occurred.

<sup>76</sup> See the discussion of US tax treatment of superannuation above.

<sup>77</sup> The final return is a Dual-Status return and married couples are not able to file jointly.