4 December, 2017

Fix the Tax Treaty!
www.fixthetaxtreaty.org

The Hon. Malcolm Turnbull, MP
Prime Minister of Australia
PO Box 6022
House of Representatives, Parliament House
Canberra ACT 2600

Re: Open Letter - Extra-territorial reach of US tax reform legislation

Dear Prime Minister,

US taxation of Australian residents is about to get worse. We are writing to express our concern about the potential **adverse effect on Australia** of the US tax reform bill, The Tax Cuts and Jobs Act (HR 1) which has now passed both houses of the US Congress. One aspect of the bill is a proposal to stop taxing US multinational companies on much of the non-US source income that they earn through non-US subsidiaries. As an anti-avoidance measure, the draft legislation includes a provision for a one-off tax of existing accumulated foreign earnings, as of 31 December 2017.

How will this affect Australian citizens and residents? While it is clear that the intention is for this tax on accumulated earnings to apply only to *corporate shareholders* of "controlled foreign corporations," the actual legislative language applies this to all shareholders of controlled foreign corporations, *even individual shareholders who are not eligible to exclude foreign income from US taxation*. If the literal interpretation is allowed, this means that **the IRS could collect up to 14% of the retained earnings of small Australian corporations controlled by Australian-US dual citizens**. As explained below, we recommend that Australia use the existing tax treaty with the US to clarify that this transition tax does not apply to individual shareholders, including those resident in (and often citizens of) Australia.

Importantly, the US is the only country to tax all citizens on their worldwide income, regardless of where they reside. Thus, a literal interpretation of the current legislative language would require Australian-resident US taxpayers (most of whom are dual Australian/US citizens) to include in their 2017 US taxable income the accumulated earnings in their *Australian*-incorporated businesses, subjecting these accumulated earnings to a one-off tax. While we believe this interpretation is contrary to the intent of Congress, there have already been at least two prominent Canadian tax advisors who have written that the bill, as currently drafted, will require individual US taxpayers who are shareholders of a controlled "foreign" corporation (that is, any corporation formed outside of the US) to include in their 2017 US taxable income their share of the accumulated earnings of that corporation.[1]

This tax would be applied even though no actual distribution from the company has occurred, with the individual shareholder again liable for Australian tax at a future date when an actual distribution is declared. Imagine the impact this unwarranted taxation might have on a small business owner, say an electrician, whose company has retained earnings in order to make possible further business growth?

[1] See http://www.skltax.com/impact-new-us-tax-law-us-citizens-canada/ - more-726 and https://www.linkedin.com/pulse/american-own-shares-foreign-corporation-get-ready-pain-nightingale/

Why is this an issue that should interest the Australian government?

1. US extra-territorial taxation affects over 200,000 Australian residents

The US is the only developed country to tax on the basis of citizenship in addition to residence. The US liberally grants citizenship based on both place of birth and descent. The ABS estimates that over 104,000 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.

2. US taxation of Australian residents drains capital from Australia

The casual observer may think that the tax treaty between Australia and the US eliminates double taxation of dual Australian/US citizens. Nothing could be further than the truth! While many find they initially owe zero additional US tax, once an immigrant from the US has been in Australia for several years, the story is quite different. Double taxation occurs both because of the "saving clause,"[2] and because of US tax rules which intentionally discriminate against all "foreign" investment and business activity. Although Australia grants tax incentives for saving and investment, those Australian residents who are claimed by the US (many of whom are Australian citizens) are unable to fully benefit from Australian domestic policy. Thus, dual Australian/US citizens are unable to invest and save in the same manner as other Australian citizens, and will be more likely to rely on Australian government support in the form of the Age Pension. In short, the US Treasury collects tax on the businesses, superannuation, investments, redundancy and other payments of a class of Australian citizens and residents, with Centrelink left to make up the difference when those citizens and residents are unable to fully fund their retirement.

3. By signing the FATCA Intergovernmental agreement, Australia has agreed to help the IRS locate US taxpayers in Australia

Prior to the enactment of the Foreign Account Tax Compliance Act (FATCA) in 2010, the compliance rate for tax reporting of US non-resident citizens was about 20% worldwide.[3] Most "non-compliant" US citizens would have owed little or no US tax other than punitive US taxes on their "foreign" superannuation and investments, all of which had already been taxed by Australia. Furthermore, the IRS had no idea where to find these "non-compliant" taxpayers and no ability to collect US tax from their assets in Australia. While the FATCA Intergovernmental Agreement (IGA) imposed no new taxes on these "non-compliant" taxpayers, it intimidated many into US compliance, often at great expense in compliance costs, excessive US tax penalties and US tax on Australian-source income that is either tax-advantaged in Australia or punitively taxed by the US.[4] As more Australian residents enter into US tax compliance, the deficiencies of the tax treaty have become very apparent; especially the lack of any treaty provision to protect the superannuation savings of Australians. Now that FATCA compliance is in full swing, the ATO annually sends the IRS a list of potential taxpayers who may owe very little in actual US tax, but could be subject to ruinous penalties for not complying with laws that many were totally unaware of.

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[2] In the Australia/US treaty, the savings clause is found in Article 1 Paragraph 3. We have explained the significance of the saving clause in a series of blog posts starting with http://fixthetaxtreaty.org/2017/01/12/explaining-the-saving-clause-i/

[3] See https://wiki.fixthetaxtreaty.org/doku/doku.php?id=wiki:contents:resources:numbers_stakeholders#irs_data

[4] See http://fixthetaxtreaty.org/about/our-stories/ for a few examples of the personal harm this has caused

What can the Australian government do?

1. Let the US government know that Australia is concerned about the extra-territorial reach of US law

US citizenship based taxation, along with punitive US tax rules for Australian investments and businesses, allow the US to impose tax in excess of Australian tax on the Australian source income of a subset of Australian citizens and residents. As currently drafted, the US tax reform legislation under consideration only exacerbates this. If the relevant provisions in the current tax reform bill are not amended prior to becoming law, a literal interpretation of the transition tax provision could mean that a subset of Australian business owners will be subject to confiscatory US tax. Australia should communicate with the US using both formal and informal channels to assert Australian sovereignty over the Australian source income of all Australian resident taxpayers.

2. Use the existing tax treaty to provide relief to Australian residents

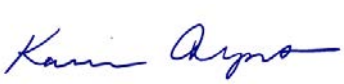
If the law is passed without correcting this problem, the literal interpretation advanced by some tax professionals will represent clear double taxation of the affected taxpayers, and assessing this tax on individual shareholders of Australian corporations would be contrary to the spirit of Article 22 of the tax treaty. The Commissioner of Taxation, as Competent Authority under the tax treaty and as authorised under Article 24 of the treaty, should request that the US Competent Authority agree that this provision does not apply to Australian-resident US taxpayers with respect to their individual ownership in any Australian corporation. Such agreement should be widely publicised among US citizens living in Australia and their US tax advisors. Consideration should be given to extending this approach to other areas of double taxation, such as superannuation.

3. Fix the Australia – US tax treaty!

Since the existing tax treaty was last re-negotiated in 2001, much has changed in both countries leading to numerous deficiencies in the current tax treaty, particularly in respect to the double taxation of individuals. As a longer-term goal, we encourage you to commence the required government actions to update this important treaty.

This is an issue of sovereignty, unnecessary economic leakage to another country and providing a fair go for all Australians. It is time for the Australian government to do what it can to mitigate the problems caused by extra-territorial application of US tax laws. By taxing non-resident citizens, the US is reaching into the tax base of every country that accepts immigrants from the US. Please address this important issue that affects over 200,000 Australian residents.

Yours faithfully,



Dr Karen Alpert
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Caroline Day
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cc:
The Hon. Mr Scott Morrison, MP, Treasurer
The Hon. Ms Julie Bishop, MP, Minister for Foreign Affairs