An Overview of the U.S. Tax System for Australian Expats

EFPR GROUP LLP

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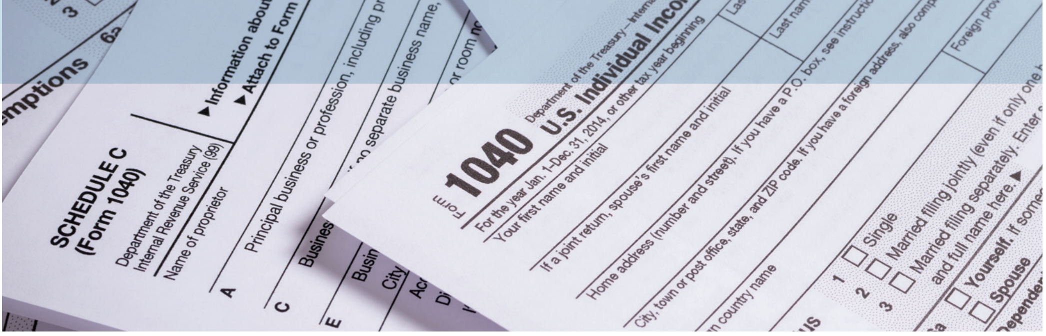


Introduction

More than one million Australians lived and worked abroad by 2013, with the majority relocating to New Zealand, the U.K. and the U.S.[1] Today, thousands of Australian citizens move to the U.S. each year and are immediately subject to the U.S. tax system, yet many Aussie expats either do not understand how the U.S. tax code will affect their overall financial holdings, or do not have an effective tax strategy in place to gain the most advantageous tax position.

If you have recently arrived in the U.S. or are considering relocation, you likely have a number of questions. For example, how will the Internal Revenue Service (IRS) view your holdings in Australia—especially your Superannuation funds? Are you aware of tax reporting deadlines, and penalties for noncompliance?

By reading this book, you will better understand:

- How relocating to the U.S. will affect your tax liability
- Tax reporting requirements for worldwide assets, including income from foreign accounts
- Why Superannuation funds must be addressed
- Elements of the U.S. tax reporting system that affect Australian expats

While not intended to be a comprehensive review of every U.S. tax requirement, this book highlights some of the most important U.S. tax principles for Australian expats to understand. As you will discover, the U.S tax system requires complex reporting with significant penalties for noncompliance. With advance preparation, you can plan your move strategically and position yourself for financial success.

Contents

[1] Advance Research

CHAPTER 1

U.S. Individual Income Tax Principles

Generally speaking, if you are considered a tax resident in the U.S., you will be subject to tax on your worldwide income, including income generated from a tax-deferred account in another country. This can present challenges for Australians moving to the U.S. who still have assets that earn income in Australia, especially when those assets don't quite match up with similar instruments in the U.S.

Taxes can be complex anywhere, so the best place to start is with an understanding of the various levels of taxation in the U.S.

Four Levels of U.S. Taxation

Australians working in the U.S. should be aware of four levels of taxation in the U.S. Federal Income Tax.

1. Federal Income Tax

The U.S. government imposes a federal income tax that is based on income levels. The federal government recently enacted tax reform, which retained seven tax brackets but changed the rates, ranging from 10% to 37%.

2. State Income Tax

It is important to determine how state taxation will factor into where you decide to live. Most states impose personal income tax, with the exception of Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. State income taxes vary, but are generally in the range of 0-12.3%.

3. Social Security Tax and Medicare/FICA

This tax is based on "earned" income such as salary paid to an employee or a sole proprietor's earnings. The U.S. Social Security tax of 6.2% is paid on wages up to a maximum of $147,000 (for 2022). The Medicare tax is 1.45% on wages (in which there is no maximum). Combined, this tax is commonly referred to as FICA, Social Security or Self-employment tax. If you are an employee, the employer pays FICA tax of 6.2% and Medicare tax of 1.45% on wages. If you are a sole proprietor, you pay both the employee and employer portion which is 12.4% for FICA and 2.9% for Medicare.

4. Local Income Tax

Local income tax, which generally refers to additional city or county tax, depends on your work location. Generally speaking, local taxes are not higher than 1-2%, with the exception of New York City.

Income Tax Year for Filing Purposes

The U.S. income tax year is based on the calendar year. Tax returns and payment must generally be filed by April 15 of the following year. While extensions may be filed, interest and penalty may be charged on any tax paid after April 15.

As previously mentioned, the U.S. taxes its citizens and individuals, who are residents for income tax purposes, on their worldwide income. When income is sourced in a foreign country, the U.S. generally allows a credit for the tax paid on that same taxed income.

Tax Filing Options

In the U.S., married couples have the option to file jointly or separately on their federal income tax returns. By filing a joint tax return, you can benefit from several tax breaks compared to filing separately. In some cases, it could make more sense to file separate returns.

Taxpayer Identification Numbers

All individuals filing tax returns must have a U.S. Social Security number (SSN) or an individual tax identification number (ITIN). ITINs are important for selling residences, obtaining driver's licenses, opening certain bank accounts and more.

Differences Between Australian – U.S. Business Structures

Australians planning to work in the U.S. should be aware that the U.S. has different business entities. Australia generally has six main structures: sole trader, company, partnership, trust, unlimited proprietary (Pty) and proprietary limited (Pty Ltd).

The U.S. business structures also include several entities, including limited liability companies (LLCs), partnerships, C corporations, S corporations and single-member LLCs.

For U.S. tax purposes, a C corporation pays income tax at the corporate level separate from its owners. Conversely, the income of a pass-through entity (S corporation, LLC, partnership, and single-member LLC) flows through to its individual owner's personal income tax return. A pass-through entity generally does not pay federal income tax on its own.

Keep in mind that the business structure you have in Australia may be treated differently in the U.S.

2022 U.S. Tax Brackets

Rate	Individuals	Married Filing Jointly
10%	Up to $10,275	Up to $20,550
12%	$10,275– $41,775	$20,550 – $83,550
22%	$41,775 – $89,075	$83,550 – $178,150
24%	$89,075 – $170,050	$178,150 – $340,100
32%	$170,050 – $215,950	$340,100 – $431,900
35%	$215,950 – $539,900	$431,900– $647,850
37%	Over $539,900	Over $647,850
	Standard Deduction: $12,950 Personal Exemption: Eliminated	Standard Deduction: $25,900 Personal Exemption: Eliminated

Please consult your tax advisor who may confirm the applicability of the U.S. tax law to your U.S. tax situation.

CHAPTER 2

The Australian – U.S. Tax Treaty

A formal bilateral agreement between two countries, a tax treaty — commonly known as a double tax agreement (DTA) — exists mostly for the purpose of preventing double taxation. A tax treaty fosters cooperation between countries and allows each to enforce its respective tax laws. DTAs also exist to specify rules to resolve dual claims in relation to the residential status of a taxpayer and the source of income.

For Australians, tax treaties relate to their residency status and how tax applies to the income and business profits they earn, or tax relief they receive, in the U.S. Of particular interest for Australian individuals living in the U.S.:

- If you are considered to be an Australian resident for tax purposes (under Australian domestic law) and a U.S. resident for U.S. tax purposes (under U.S. domestic law), the tax treaty provides rules to ensure you are only a tax resident of one country.
- If you are earning income from both countries, the tax treaty allocates taxing rights over certain categories of income between Australia and the U.S.

Foreign Tax Credit Example

If you earned $140,000 of income in Australia and pay $42,000 of income tax as a nonresident Australian, you may qualify to claim a FTC of up to $42,000. In this example, you would make a claim for a Foreign Tax Credit (Form 1116) on your U.S. tax return. A foreign tax credit is generally offered by countries with income tax systems that tax residents on worldwide income. These tax credits mitigate double taxation.

Australian Dividend Income

A common question for Australian expats in the U.S. is how to treat Australian dividend income for U.S. tax purposes. The franked amount should be reported as qualified dividends in the U.S. The imputation credit is not income and is not considered a credit on the U.S. tax return.

> Australia's tax treaty with the U.S. dates back to the 1950s, and has been amended through the years. It was one of the first DTAs.

Treaty Tiebreaker

The treaty tiebreaker is a provision meant to prevent an individual from being deemed a resident in both treaty countries. Typically, a multistep procedure will be applied to resolve the problem of dual residence. In most cases, the location of a permanent home will be the critical determinant in resolving residency.

The treaty tiebreaker only applies to the calculation of U.S. income tax by treating the taxpayer as a nonresident of the U.S., but only for income tax purposes. Any informational forms that would be required of a resident will still need to be filed.

The Substantial Presence Test

What happens when you leave Australia halfway through the year? Are you a resident or a nonresident for individual tax purposes? The Substantial Presence Test (SPT) is a criterion that the IRS uses to ensure that an individual qualifies as either a resident or nonresident for tax purposes.

To meet this test, you must be physically present in the U.S. on at least:

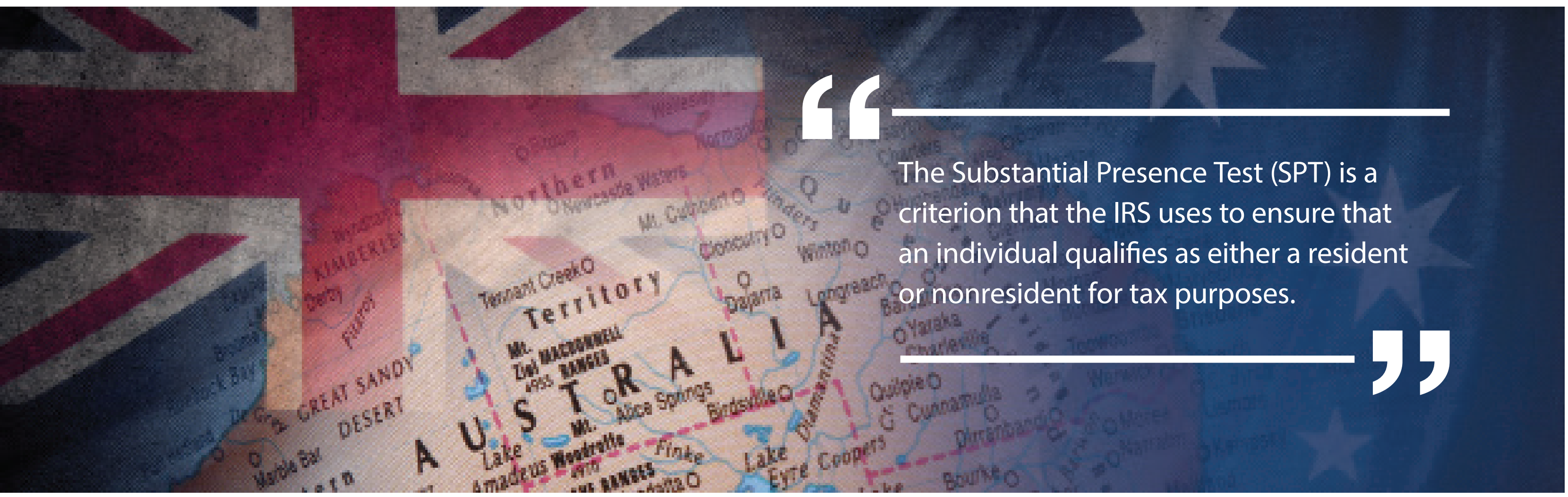
- 31 days during the current year, and
- 183 days during the three-year period that includes the current year and the two years immediately before that, counting:
  - ✓ All the days you were present in the current year, and
  - ✓ 1/3 of the days you were present in the first year before the current year, and
  - ✓ 1/6 of the days you were present in the second year before the current year

Under the U.S. tax code, a First-Year Election can be used by nonresident individuals who arrive in the U.S. after the midway point of the tax year and do not obtain a green card in that year, but do qualify as a resident individual in the following year under the SPT.

Therefore, an individual who makes the First-Year Election will be treated as a nonresident individual for part of the tax year and a resident individual for the other part of the tax year. To make the First-Year Election, the individual generally must satisfy five requirements:

1. Must have been a nonresident in the prior year
2. Must not meet the SPT or Green Card Test in the current year
3. Must satisfy the 31-consecutive-day requirement
4. Must satisfy the period of continuous presence requirement
5. Must meet the SPT in the subsequent year

There are also additional elections for individuals who are married and want to file jointly.



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CHAPTER 3

Sale of Assets and the Capital Gains Tax

Australian residents receive a full exemption from capital gains tax on the sale of a home that has served as their main residence throughout ownership. Until recently, they benefited from an “absence rule,” which allowed them to treat a dwelling as their main residence for capital gains tax (CGT) purposes for an unlimited period of time, as long as they kept it empty and didn’t rent it out.

Under recent reform, Australian homeowners who sell their main residence while they’re working overseas will lose the CGT exemption. The new law was specifically intended to exclude foreigners from obtaining the capital gains exemption, and expats were included in this measure. This means Australian homeowners had until June 30, 2020, to sell their homes without being subject to the capital gains tax.

Sale of Principal Residence

Because the U.S. taxes worldwide income, some of the proceeds from the sale of your home may be included in that amount. As earlier stated, there is no tax in the U.S. if you resided in the Australian residence for two of the past five years. The capital gain exclusion is $250,000 for a single person and $500,000 for married persons filing jointly.

If you pay tax on the transaction in Australia, those taxes can potentially be claimed as a Foreign Tax Credit on your U.S. return. However, if you sell your Australian home before the June 2020 deadline, you will need to include the income from the sale on your U.S. tax return, as part of your worldwide income, even though there is no capital gains tax prior to June 2020 in Australia. You may or may not owe taxes on this overall sale in the U.S.

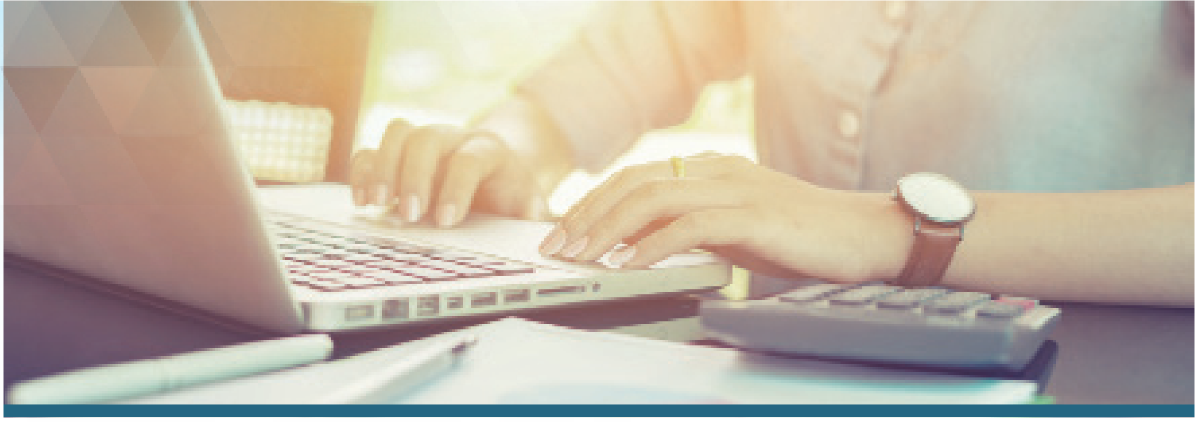
Also, if you own rental property in Australia, you must report any income on that property in the U.S. You are entitled to the same deductions you would normally receive in Australia, plus you are entitled to depreciation over a 40-year period—an added benefit that the IRS allows in its tax code.

Sale of Other Assets

You’ll also want to give careful consideration to the disposal of your Australian assets and the potential tax ramifications of doing so. As a U.S. resident for tax purposes, any sale of Australian assets would be subject to U.S. taxation. Any Australian taxes paid would be subject to the foreign tax credit calculations.

You will want to be strategic about the timing of paying off a mortgage as it could trigger ordinary income from a mortgage disposition exchange gain. Other considerations include managed fund or other trust distributions.

You will want to work with your tax advisor to ensure that your Australian investment assets are managed and structured in the most advantageous way. The income generated from those assets will affect your U.S. taxes and must be reported on the appropriate forms to avoid any penalties.



CHAPTER 4

Reporting Requirements: Banks, Financial Accounts and Assets

As we addressed in Chapter 2, Australia has an international tax law treaty with the U.S. and has signed a FATCA (Foreign Asset Tax Compliance Act) agreement. The type of assets, investments and income you maintain overseas will dictate the layers of complexity for the reporting requirements you will have in the U.S. The information in this chapter provides a guide to what these reports are, and how they may apply to you.

FinCEN 114 (FBAR)

FBAR is a "Report of Foreign Bank and Financial Accounts," or more simply, a foreign bank account report. The FBAR form is filed electronically with the Financial Crimes Enforcement Network, a division of the U.S. Department of Treasury, when a person owns or has signature authority of an account or accounts with an annual aggregate balance that exceeds $10,000 in foreign and overseas accounts on any given day during the calendar year.

It is important to note that taxpayers who must file this report in the U.S. include legal permanent residents (green card holders), individuals claiming a treaty tie breaker and U.S. part-year tax residents. Foreign accounts include bank, investment and financial accounts and insurance policies with a combined value of more than $10,000. Note: Superannuation funds, which we will address in Chapter 5, must be reported on an FBAR form each year.

> **IMPORTANT:** The penalty for not filing each one of these information returns is $10,000.

The penalty for failing to file an FBAR is $10,000 and can be levied in cases of willful violation.

FATCA

FATCA is intended to prevent tax evasion by U.S. taxpayers using offshore accounts. FATCA requires certain U.S. taxpayers who hold foreign financial assets with an aggregate value of more than the reporting threshold (at least $50,000) to report information about those assets on Form 8938, which must be attached to the taxpayer's annual income tax return.

Please consult your tax advisor who may confirm the applicability of the U.S. tax law to your U.S. tax situation.

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Statement of Foreign Financial Assets (FATCA Form 8938)

As mentioned above, this form is used to report specified foreign financial assets if the total value of all the specified foreign assets in which you have an interest is more than the appropriate reporting threshold.

Passive Foreign Investment Company (PFIC) – Form 8621

Generally, if a Australian citizen who becomes a tax resident of the U.S. and owns a mutual fund in a non-U.S. account, this would be considered a PFIC. The IRS requires that anyone with an interest in a PFIC file an annual disclosure and indicate any growth in this investment and any income generated. It is important to disclose PFICs in your initial year of U.S. residency as certain elections can only be made in the first year.

Other Asset Filing Requirements

Do you own an Australian mutual fund and plan to live in the U.S.? What about foreign trusts, partnership or a Pty Ltd?

Disposal of any Australian assets must be carefully planned with regard to both Australian and U.S. capital gains laws. Of course, any of these assets will be factored into the worldwide income calculations with regard to U.S. taxation and filing requirements.

For example, there are a host of international reporting requirements, which include, but are not limited to:

- Foreign Gift Form (3520)
- Foreign Corporation or Foreign Partnership (5471 or 8865)
- Foreign Trust (3520-A)
- Passive Foreign Investment Companies (Form 8621)

Your requirement to file certain forms will depend on what percentage of ownership you have in a business.

CHAPTER 5

The Superannuation Tax Conundrum

As you know, Superannuation funds ("Supers") are required of most individuals working in Australia. In most cases, both the employer and employee deposit funds into the Super, which offers preferential tax rates on future investment earnings.

More specifically, the Super is funded by mandatory employer contributions, which are generally tax-deductible contributions made by the employer as a percentage of the employee's salary. They can also contain concessional voluntary employee pretax contributions and nonconcessional voluntary pretax contributions, which are not tax-deductible but can include contributions from take-home pay, inheritances and proceeds from asset sales.

In our earlier discussion about tax treaties, we addressed how the U.S. and Australia resolve tax conflicts in a cooperative fashion to avoid double taxation. That works well when dealing with similar financial instruments. Supers, which are generally run as trusts, do not have an exact U.S. counterpart and are more of a hybrid of several U.S. savings and retirement accounts.

Currently there is no definitive guidance from the IRS on how to treat these accounts for U.S. tax purposes. As a result, opinions vary on how the income from these accounts should be taxed on your U.S. income tax return. Typically, a Super is treated as an employee benefits trust or a foreign grantor trust.

The IRS looks at the contributions made into the Super to determine grantor trust status. If an employee's contribution is equal or less than the employer's, then it's an employee trust considered owned by the foreign employer. If the individual personally funded more than 50% of the Super, it is more likely to be a grantor trust.

Supers, which are generally run as trusts, do not have an exact U.S. counterpart and are more of a hybrid of several U.S. savings and retirement accounts.

Foreign Grantor Trust

The Super may be considered a grantor trust in the U.S. under certain conditions, such as when the relevant grantor individual directly or indirectly made a transfer to the trust within five years of becoming a U.S. resident. This matters from a U.S. tax perspective because the grantor will be taxed on their income and capital gains from trust assets regardless of whether those amounts are actually distributed.

If the Super is treated as a "foreign grantor trust", additional reporting is required. Account ownership and annual income from the account is required to be reported on Forms 3520 and 3520A. Contributions and any other growth in the account are taxed on the U.S. Form 1040. PFIC investments within the account also require the filing of Form 8621 each year. As with the employee benefit trusts, Form 8938 and the FinCEN 114 form may also be required if you meet the reporting requirements.

Those are the general parameters in the U.S. taxation of Supers, but given the complexity and lack of good guidance in the area, you should work with your tax advisor to determine the proper tax treatment.

Employee Benefits Trust

If the account is categorized as an “employee benefits trust,” where the foreign employer is considered the owner, any contributions to the account are taxable in the U.S. in the year of contribution even if Australian tax is deferred. Income deemed to be taxable in the U.S. needs to be reported on your U.S. tax return and the account ownership is required to be reported on Form 8938 if you meet the filing requirements.

Examples

U.S. treatment of Supers vary on a case-by-case basis. Here are two examples of how contributions and fund growth would be treated under the U.S. tax system.

EXAMPLE A

Background:

An Australian/U.S. citizen is living and working in Australia. They are self-employed and operate a self-directed and self-funded Super.

Likely U.S. Tax Filings:

The Super would be considered a grantor trust and would face the following U.S tax treatment:

- Employer contributions, made on behalf of the employee, are 100 percent taxable
- Employee contributions are not considered tax deferred in the U.S.
- Growth attributable to the employer is fully taxable as ordinary income.
- Growth attributable to the employee is taxed as a grantor trust on form 3520-A
- Distributions are tax-free in the U.S. to the extent of basis
- PFIC reporting is required if the fund holds mutual fund-type investments

EXAMPLE B

Background:

An Australian individual and spouse relocate to the U.S. on a three-year assignment, arriving on March 1, 2017. Later that year, the spouse acquires a U.S. job. Their children remain at home in Australia attending university.

The couple has joint ownership over a non-U.S. bank checking account, and each has a Superannuation fund in their name. The combined growth in value of the funds is $4,000 during the U.S. tax year with no fund distributions. The majority of contributions were funded by each individual's employer throughout their careers so far.

Likely U.S. Tax Filings:

- The couple elect to file as full-year U.S. tax residents on a joint tax return as it results in a lower overall U.S. federal and state tax liability
- Their children are not eligible to be claimed as dependents as they are not considered residents in the U.S.
- Both spouses are not considered "highly compensated" individuals under U.S. tax law (i.e., earned less than $120,000 in the preceding year)
- Both spouses report their share of interest income earned on their non-U.S. savings account
- Both spouses report their interest in non-U.S. bank accounts and the Superannuation accounts on Form 8938
- Both spouses report their interest in non-U.S. bank accounts and the Superannuation accounts on FinCEN 114 (FBAR)
- The $4,000 growth in value of the Superannuation fund is not reported as income during the tax year
- The Super funds are considered non-U.S. trusts "owned" by the Australian employers — so there is no additional U.S. information reporting (i.e., Form 3520-A)
- Neither individual is considered a "highly compensated" individual resulting in deferred taxation of the unrealized gains (i.e., subject to tax upon distribution)

Please consult your tax advisor who may confirm the applicability of the U.S. tax law to your U.S. tax situation.

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CONCLUSION

Helping You Navigate the Process

The last thing you want when you relocate from Australia to the U.S. is to pay extra taxes or penalties that could be avoided with pre-departure planning. The information presented in our book provides you with an overview of the issues you should be aware of and raises questions that could merit further discussion.

As we discussed, tax treaties are useful instruments for two countries to determine fair taxation of an individual. However, given complexities that don't neatly fit the tax treaty framework, it is best to learn how to proficiently navigate the process and ensure that you comply with all required filing rules.

The International Tax team at EFPR Group works closely with their clients to arrive at the best approaches for your particular set of circumstances. Ideally, we work with individuals and businesses pre-departure and upon arrival—advanced planning is critical to attain maximum tax savings for you.

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