TECHNICAL NOTE
TRANSFERRING US 401K AND IRA ACCOUNTS TO AUSTRALIA

ITEM

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TECH NOTE: TRANSFERRING US 401(K) AND IRA ACCOUNTS TO AUSTRALIA

1. INTRODUCTION AND OVERVIEW

As with all transfers from foreign funds, there is a timing decision to be made. Also, if the foreign fund allows benefits to be taken in a pension for life format, this should not be lightly given up. However, for the rest of this note, I assume the decision has been to move the US monies to Australia.

The Australian Tax Office does not regard the movement of US Individual Retirement Account (IRA) and presumably 401K benefits as being from a foreign superannuation fund. Consequently, it is going to have very different treatment than from (say) a New Zealand fund. Because the Commissioner doesn’t consider it as a transfer from a “foreign superannuation fund”, the Section 305-75 of the Income Tax Assessment Act 1997 for working out the assessable income component does not apply (see Section 7 of this note on how the transfer will be treated for Australian tax).

The reason for the ATO view is set out in ATO Private Ruling 1012759666109. US IRA and 401K benefits can be assessed at any time subject to penalties. Indeed, they are accessed by Americans for health and college expenses.

Once the proceeds have been received in Australia, then – subject to normal contribution requirements – the net proceeds could be contributed to an Australian super fund.

The issues to be evaluated should be more than simply tax ramifications. Moving monies may eliminate currency risk but raise current exchange rate timing issues. Fee and investment aspects are likely to be different. Insurance protections could be disrupted. Moving monies may eliminate protections and guarantees that would be difficult or impossible to recreate in Australia – especially with regard to annuity options.
PART A – THE AMERICAN SIDE OF THE EQUATION

2. U.S. FUND WITHDRAWALS

US pension funds are quite flexible in allowing access to monies. However, such access may bring forward the taxes that need to be paid to the IRS and, especially if under age 59 ½, trigger early withdrawal penalties. There will also be the issue of withholding tax and having to lodge US IRS returns. The penalty tax that applies to an early distributions before age 59 ½ is normally an additional 10% and is there to discourage the use of monies for other than retirement purposes. There are exceptions for death, disablement, qualified first homebuyer etc withdrawals. The penalty tax is in addition to normal federal taxes. US Federal income tax is imposed on citizens and US residents working abroad on worldwide income. There may be State surcharge and withholding taxes.

A 30% withholding rate is normally required for non resident aliens. A reduced rate applies for certain countries including Australia as provided for in the tax treaty. This rate under the US tax treaty is 15% on lump sums and zero withholding on pensions. To be able to claim the reduced rate normally requires a completed IRS Form W-8BEN to be lodged with the US retirement fund. As a non-resident alien, if an Individual Taxpayer Identification Number (ITIN) is needed, IRS Form W7 can be lodged. It may be possible to argue that Article 21(1) of the Australia-US agreement provides that items of income of a resident of Australia, wherever arising, not dealt with in the other Articles of the Convention shall be taxable only in Australia.

The 59 ½ age penalty can be avoided if you take traditional IRA distributions as substantially equal periodic payments. There is no minimum age to start these distributions, but you must have at least a 5 year payment duration or wait until you’re aged 59 ½. These regular payments are taxed by the IRS as ordinary income. However, the Australian taxes may be increased by the benefits being received in a pension (not lump sum) format.

The next section will look at the types of US retirement products and note the important difference between Traditional and ROTH variations.
3. TYPES OF US RETIREMENT FUNDS
Ignoring the US social-insurance program and older defined benefit employer-sponsored plans, the usual company plan encountered is a 401(K) plan. It is a defined contribution plan. On rollover after resignation – and also for anyone with earned income but no company plan – Individual Retirement Accounts (IRA) are common. There are different types of accounts within each of these two streams. It is important to know the differences because the tax ramification of distributions and withdrawals are very different. Here is a summary.

**Traditional IRA**
- Must be less than age 70 to open an account.
- Contributions made with pre tax monies. Distributions taxed at normal personal income tax rates.
- Contribution limit is US$5,500 p.a. (2013-14) unless you are older than 50 – then the limit is US$6,500.
- A withdrawal penalty (with exceptions) of 10% of the Fund balance applies to withdrawal before age 59 ½ except in hardship withdrawals (extreme medical costs, first home purchase deposit up to $10,000, higher education costs). State surcharges may exist.
- A minimum distribution required by age 70½

**Roth IRA**
- No age restriction.
- Contributions are made post tax. Usually no tax on withdrawals.
- Same contribution limits as traditional.
- Ability to access contributions (not earnings) any time after funds after 5 years of the account being opened
- Qualified distribution applicable after age 59 ½.

**Simple IRA (Savings Incentive Match Plan for Employees)**
- Offered by employer who has no other plan and the employer must have less than 100 employees.
- Contributions can’t exceed $12,000 (2014).
- Employer matches up to 3% of salary.
- Same withdrawal rules apply except a withdrawal within 2 years incurs a 25% of fund balance penalty instead of 10%.
Traditional 401K
- Contribution tax deferred. Distributions taxed at normal personal income tax rate.
- Contribution limit is US$17,500 p.a. (2014) or US$23,000 if older than age 50.

Roth 401K
- Contributions are made post tax. No tax on distributions.
- Contribution limit is US$17,500 p.a. (2014) or US$23,000 if older than age 50.

There can be a number of other type products. Capital gains, dividends and interest normally accumulate tax free inside these accounts. Conversion of all or part of a Traditional IRA to a Roth IRA results in the converted funds being taxed as income in the year they are converted.

4. EARLY WITHDRAWAL RULES
There are exceptions to the 10% early distribution penalty tax that apply if you have not reached at least age 59 ½ when you take your distribution. These scenarios are:
- If you die the account is paid to your beneficiary;
- If you become disabled;
- Termination of employment after age 55;
- Certain mutual costs in excess of 7.5% of adjusted gross income; or
- A qualified domestic relations order is made.

401K withdrawals can be delayed until 1st April of the year following the year you reach 70 ½.
Rollovers to other 401k or IRA plans within 60 days of leaving don’t incur the penalty. Withdrawals include non-cash withdrawals. There are also hardship provisions. It is possible to get a 401K loan instead of a withdrawal.

Federal tax and withholding tax will be incurred on non-Roth accounts. There is a flat 30% withholding tax on IRA distributions to non-resident aliens. It may be possible to get an exemption from the withholding tax under the tax treaty if the distribution is considered to be a “pension” distribution under the US – Australian income tax treaty.
5. PENSION RECEIPTS

Foreign pensions received in Australia are not assessed under the Income Tax Assessment Act 1997 but rather are treated as assessable income under the ITAA 1936 with a deductible amount representing the return of contribution capital made. Article 18 of the US-Australia Income Tax Treaty covers this aspect. It may be possible to achieve a zero withholding rate. Whether the transactions are accepted as a pension distribution is complex and dependant on factors such as age, length of employment, type of service exit etc. It is possible to seek an IRS ruling in advance of the transaction confirming the pension distribution status.

Paragraph 1 of Article 18 (Pensions, Annuities, Alimony and Child Support) of the Treaty states that “pensions and other similar remuneration paid to an individual who is a resident of one of the Contracting State in consideration of past employment” is taxable only in that Contracting State. The word “periodic” in Article 18(4) does not preclude the application of Article 18(1) to a single lump sum distribution.

6. US FEDERAL TAX BRACKETS

Foreign individuals are subject to a US tax rate of 30% on US sourced income subject to Tax Treaty reductions.

For US citizens, the tax brackets of ordinary income for 2015 are:

<table>
<thead>
<tr>
<th>Filing Status Single</th>
<th>Filing Status Married filing separately</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $9,225</td>
<td>$0 - $9,225</td>
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<tr>
<td>$9,225 - $37,450</td>
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</tr>
<tr>
<td>$37,450 - $90,750</td>
<td>$37,450 - $75,600</td>
</tr>
<tr>
<td>$90,750 - $189,300</td>
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<tr>
<td>$411,500 - $413,200</td>
<td>$205,750 - $232,425</td>
</tr>
<tr>
<td>Above $413,200</td>
<td>Above $232,425</td>
</tr>
</tbody>
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There are other tax statuses such as married filing jointly and head of household. Beginning in 2013 an additional tax of 3.8% applies to net investment income in excess of certain thresholds. There is a Social Security Tax at a rate of 12.4% on wages and self employed income up to a base of $118,500. Long term gains and qualified dividends are taxed at different rates to income.
PART B – THE AUSTRALIAN SIDE OF THE EQUATION

7. AUSTRALIAN TAX ISSUES

ATO rulings clarify how proceeds received by a resident individual upon closing a traditional Individual Retirement Account (IRA) held in the United States of America (and presumably a 401K) are dealt with. It was confirmed that the amount received should be included in the individual’s income for Australian tax purposes less:

- Amounts upon which tax has been paid under Foreign Investment Fund provisions (in the proposed Foreign Accumulation Fund provisions).
- The corpus of the trust i.e. the contributions made by the individual and the employer.

In other words, it is the gain that is taxed. It may be that this is on a receipt basis rather than splitting between Australia and USA tax residency, although this should be checked. Assessable income of an Australian Tax Resident includes statutory income from all sources – whether in or out of Australia.

In determining liability to Australian tax on foreign sourced income, it is necessary to consider not only the income tax laws but also any applicable tax treaty contained in the Agreements Act. Consequently, there should be a credit for tax paid in the USA to avoid double taxation of income. There are limits to the amount that can be claimed as a foreign income tax offset. If the foreign tax credit is reduced to zero, the excess is not refundable or available to be carried forward.

The US fund is not regarded as a “foreign superannuation fund” as pre-retirement access to monies exist – usually with an early retirement penalty. Consequently, Section 305-70 of ITAA 1997 has no application and the lump sum received from the UK fund will be treated as a receipt (distribution) of trust income and assessed in accordance with 99B of the Income Tax Assessment Act 1936.

Income accumulation in the Fund (that has not previously in taxed in Australia) is normally assessable. In practice, this means contributions paid and amounts dealt with previously under the foreign investment fund (FIF) provisions are excluded.
8. **FIF/FAF LEGISLATION**

The Foreign Investment Fund (FIF) rules were repealed on 14th July 2010. The Foreign Accumulation Fund (FAF) to replace the FIS rules has a released exposure draft of the legislation but has not been enacted. Consequently despite the time that has elapsed, currently there remains uncertainty about the exact treatment of foreign sourced income.

The FIF rules had exemptions from including accrued gains annually for small holdings below A$50,000 and occupational retirement funds. In other cases there will be attribution accounts for the assessable income already reported and tax paid. The new FAF rules are anticipated to have “lightly taxed” structure exemptions for all types of retirement funds to exclude them from annual inclusion requirements.

**PART C – PRACTICAL ISSUES**

9. **CONTRIBUTING THE PROCEEDS TO AN AUSTRALIAN FUND**

This is not a fund to fund transfer such as from the UK. The USA proceeds need to be recontributed, meeting the Australian contribution caps for non-concessional contributions. There may be the opportunity to bring forward two years’ cap if under age 65. After age 65 and before age 75 the work test will have to be met. Contributions could also be made to a spouse account and/or a drip feed in strategy adopted. Due to the existence of a tax free threshold and the Senior Australian Tax offset it may not be necessary for tax efficiency to try to get all assets into a superannuation structure.

10. **PROCEDURE CHECKLIST**

Since there are multiple parties and multiple tax authorities and regulators involved, these international transfers can take a considerable time to finalise. For US transfers the following is a start to the steps that may need to be taken:

1. Ascertain from the US fund what would be the payout value; what discharge and other documentation will be needed; whether a withdrawal penalty will apply; what is needed to ensure a lower withholding tax rate applies as provided for under the US - Australia Tax Treaty; any State tax surcharges; processing fees and if any access to guarantees and/or life time pension conversions are being given up.
2. Evaluate whether it would be better to postpone the transfer to a later date to avoid penalties or achieve a better exchange rate or indeed whether to access the foreign benefit via a periodic pension payment to Australia.

3. Check entitlements to any social security entitlements and how these can be maximised.

4. Clarify what IRS returns will be involved, the total tax payable including State surcharges and whether the result will be a refund or a further amount to be paid.

5. Ascertain whether any tax has previously been reported in Australia for these entitlements under the Foreign Investment Fund rules and if so, obtain copies of the attribution account information.

6. Clarify with the ATO before actioning any transaction via a private ruling, that it is not possible to access the complying fund 15% tax election, the treatment of US tax paid, and what is the assessable amount.

7. If the above is satisfactory, complete the necessary paperwork and choose a mode of transferring the monies to Australia to be exchange rate efficient.

8. Consider whether the monies received are net of tax to be recontributed to an Australian super fund via the individual or their spouse and take eligibility and caps into account.

9. Ensure the various tax returns are lodged at year end and attend to financial planning, insurance and investment flow on ramifications.

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This note should not be relied upon without confirming with the fund’s administrators and the relevant tax authorities. For further information please contact NetActuary. Our email address is mail@netactuary.com.au – or telephone Brian on (03) 6223 2320.