IT 2542 - Income tax : taxation position of United States non-government pensions

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TAXATION RULING NO. IT 2542

INCOME TAX : TAXATION POSITION OF UNITED STATES NON-GOVERNMENT PENSIONS

F.O.I. EMBARGO: May be released

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I 1011352	UNITED STATES NON-GOVERNMENT PENSIONS DOUBLE TAX RELIEF	INCOME TAX (INTERNATIONAL AGREEMENTS) ACT 1953: SCHEDULE 2 - ARTICLES 1(3), 18(1), 22, 27(1)(c) INCOME TAX ASSESSMENT ACT 1936: 160AF(1)

PREAMBLE The purpose of this Ruling is to clarify the interaction of paragraph (3) of Article 1 and paragraph (1) of Article 18 of the Australia/United States Comprehensive Taxation Convention ("the Convention") in relation to a non-government pension derived from the United States by a United States citizen who is a resident of Australia for the purposes of the Convention. It is also designed to clarify the present operation of the double taxation relief provisions of Article 22 of the Convention where, by reason of that interaction, such a pension is taxed by both countries.

RULING 2. Except for government-service pensions to which Article 19 of the Convention applies, paragraph (1) of Article 18 provides that a pension paid in consideration of past employment shall be taxable only in the country of residence of the recipient. However, so far as is relevant, paragraph (3) of Article 1 operates to reserve to each country the right to tax pensions to which paragraph (1) of Article 18 applies derived by its own citizens "as if the Convention had not entered into force". This provision is a saving clause designed to remove any suggestion that the Convention may prevent the application of a country's domestic laws, especially anti-avoidance provisions, in relation to its own citizens and/or residents.

3. As a result, both countries may tax a United States non-government pension derived by a United States citizen resident in Australia - Australia under paragraph (1) of Article 18 of the Convention and the United States under its domestic law by reason of paragraph (3) of Article 1.

4. Notwithstanding the taxing right accorded to Australia by paragraph (1) of Article 18, it was formerly the case that where the United States exercised its domestic law taxing right

permitted by paragraph (3) of Article 1, the relevant pension derived by the Australian resident was treated as exempt from income tax in Australia pursuant to paragraph 23(q) of the Income Tax Assessment Act 1936 ("the Assessment Act"), i.e., as foreign source income not exempt from tax in the country of source. As a result, only United States tax was paid in respect of the pension.

5. Upon the introduction in Australia of the general foreign tax credit system from the commencement of the 1987-88 year of income, paragraph 23(q) was repealed. As a result, both countries now exercise their respective rights under the Convention to impose income tax in relation to such pensions, with the ultimate result of where tax is actually paid being determined by the operation of the double tax relief provisions of Article 22 of the Convention.

6. Article 22 is designed to apply where an item of income may, in accordance with the Convention, be taxed by both countries. The broad scheme of the Article is to require the country of residence of the recipient of the income to provide a tax credit in respect of the other country's tax against its own tax on that income. Accordingly, paragraph (1) of Article 22 of the Convention generally guarantees the granting by the United States of a tax credit to its residents and citizens in respect of Australian tax. Conversely, paragraph (2) of Article 22 requires Australia to grant to its residents a credit for United States tax imposed (and paid) other than by reason of citizenship.

7. As the United States tax on the pensions to which this Ruling applies is imposed only by the operation of paragraph (3) of Article 1, i.e., because of citizenship, Australia is thus not obliged by the Convention to give a tax credit for that United States tax.

8. In the light of the further explanation contained in the following paragraph, nor is the pension recipient entitled under the general foreign tax credit provisions of subsection 160AF(1) of the Assessment Act to claim a credit for the United States tax on the pension against the Australian tax liability in respect of that income - even though it represents foreign tax in respect of foreign source income included in the pension recipient's assessable income. This is because that subsection requires a taxpayer to first look for relief in the foreign country before claiming any foreign tax credit against Australian tax under the subsection.

9. In that respect, paragraph (4) of Article 22 of the Convention requires the United States to grant to its citizens resident in Australia a credit for Australian tax paid on the relevant pensions. (This credit is for the amount of Australian tax paid after the allowance by Australia pursuant to paragraph (2) of Article 22 of a tax credit for United States tax paid. However, as explained above, the amount of tax credit allowable by Australia pursuant to paragraph (2) of Article 22 is in these cases nil). Hence, the recipient of the pension income is

entitled to have the full amount of the Australian tax paid on the pension allowed as a credit against the United States tax payable in respect of the pension. Since such a credit would not be allowable under the foreign tax credit provisions of the United States domestic laws (because it would not be a credit in respect of income tax on foreign-sourced income), subparagraph (1) (c) of Article 27 of the Convention deems the relevant pensions to have a source in Australia to the extent necessary to enable the United States to grant the tax credit provided for by paragraph (4) of Article 22 in respect of the Australian tax on such pensions.

10. Australia's average rates of tax have been higher than the United States' rates for the whole of the period relevant to all known cases. Accordingly, the net effect is that although the relevant pensions are fully taxable in both countries, only Australian tax is paid on pensions derived after 1 July 1987.

11. It is relevant that in some cases United States tax has been withheld at source from these pensions, but in others it has not. This is mainly due to the fact that a United States citizen is not subject to United States withholding tax on pensions unless that person elects to have income tax withheld at source. That person may choose to do so if, for example, he or she has other United States source income subject to a United States tax liability, and the tax withheld from the pension is designed to meet, at least in part, the United States tax payable in respect of that other United States income. In other cases, where the pension payer is not aware that the pension recipient is a United States citizen or where a Taxpayer Identification Number is not provided by the recipient, the United States payer will assume that the taxpayer is not a United States citizen and withhold tax as though the pension recipient were a non-resident alien for United States tax purposes. Because of the situation described in this Ruling, any United Sates tax withheld at source from the relevant pensions that is not required to offset United States tax on other income of the pension recipient could normally be expected to be refundable to that person.

COMMISSIONER OF TAXATION
29 June 1989