

TAXATION LAW RESEARCH PROGRAMME (TLRP)

ASIAN INSTITUTE OF INTERNATIONAL FINANCIAL LAW

www.AIIFL.com

FACULTY OF LAW, THE UNIVERSITY OF HONG KONG

TLRP Tax Comments – Working Paper Series

TTC Working Paper No 1

March 2017

DTA Pensions Clause Fails Preservation, Portability and Long Duration Capital Formation Tests

Ross Smith

PhD Candidate

Faculty of Law, The University of Hong Kong

This paper is written by Ross Smith who is a PhD Candidate in the Faculty of Law at The University of Hong Kong. Ross would be very pleased to receive any comments which readers may have. He can be contacted by email at rossmithhk@gmail.com.



© March 2017 the author. All rights reserved. Short text extracts may be quoted without explicit permission provided that full credit is given to the source.

DTA Pensions Clause Fails Preservation, Portability and Long Duration Capital Formation Tests

ABSTRACT

Pension accruals for retirement funding are included in domestic assets, then are subject to tax in International transfer transactions, which should not be in the scope of transnational tax avoidance issues. Existing Double Taxation Agreements (DTA) only have a single objective of tax rights, which unfortunately conflicts with the needs of overseas mobile citizens to enable adequate funding of pension retirement income streams, that should function with the ‘Sole Purpose Test’ in respect of SISA¹ Legislation under the Australian Constitution’s ‘Pension Powers’ (S51xxiii). An actuarial model may suggest that a funded CPI indexed pension commencing at 66% of pre-retirement salary, should obviate a Government’s liability in the provision of old-age pensions.

Regrettably in Australian public administration, there appears to be a co-existence conflict when its taxation regime eliminated its 1946 national pensions scheme that left the Government’s liability unfunded for the provision of old-age pensions.

Changing jobs between tax jurisdictions several times before retirement causes pension payments to be taxed and paid out, which is also an opportunity cost to primary capital markets and causes a serious shortage of long duration capital for large scale investment projects.

As a partial solution to co-existence conflict, this paper advocates that a ‘Preservation and Portability’ Instrument should be included in Article 17 Pensions Clause in DTAs that preserves pension accruals until retirement age, allows for the tax-free portability transactions between respective tax jurisdictions, supports adequate funding of pensions in retirement, and adds significant economic value to primary capital markets with higher volume, long duration capital formation retention. The retention generates tax revenue as a secondary derivative to successful funding arrangement in the first instance.

By Ross Smith

PhD Candidate, The Faculty of Law, University of Hong Kong

March 2017

¹ SISA – Superannuation Industry Supervision ACT

Contents

1. INTRODUCTION	3
2. How the Circumstances have Changed with increasing Globalisation?	5
3. How has the Australia Law on Taxing Pensions from a taxed superannuation fund has recently Changed?	5
4. Co-existence Failure between Pensions Funding & Tax Regimes	6
4.1 Constitution: Pensions Power	7
4.2 1946 National Welfare Fund	7
4.3 Singapore Central Provident Fund	8
4.4 Co-existence Failure between Pensions Funding & Tax Regimes	8
4.5 Australian Constitution 'Pensions Power' and Fiduciary Doctrine	9
5. To what extend existing DTA Pensions' provisions is insufficient?	10
6. WHY SHOULD HONG KONG'S DTA PENSIONS CLAUSE BE MODERNISED?	11
7. WHAT LIMITATION IN PENSION FUNDING SHOULD CURRENTLY APPLY?	11
8. DTA PENSION TAX AT SOURCE CAUSES REDUCTION IN INVESTMENT DURATION.....	12
9. HONG KONG DTA PENSIONS' PRESERVATION PORTABILITY MODEL	12
10. Policies Against More Residential Investment.....	15
11. DTA WITH INFORMATION EXCHANGE	15
12. 2009 Australian DTA With New Zealand: To what extent are existing DTA Pension Article 18 provisions insufficient?	16
13. SUMMARY	16
Appendix A - UK Overseas Pensions Transfer – International Best Practice Model	19
HMRC Changes for UK Pension transfers post 9 March 2017	19
Appendix B	20
Other points in support of AU-HK DTA limiting taxing rights with respect to pensions:.....	20
3. OECD Model Tax Convention (2014).....	20
4. Multilateral Instrument (negotiations recently concluded between more than 100 jurisdictions).....	20
5. Australia's DTAs with neighbouring Asian countries: China (signed in 1988; in force from 1990) and Singapore (signed in 1969; in force from 1969)	21
6. Australia's recent renegotiated DTA with Germany (signed in 2015; in force from 2016) ..	21

1. INTRODUCTION

International double taxation occurs when two or more states impose taxes on the same taxpayer for the same subject matter. Most commonly, double taxation arises because states tax not only domestic assets and transactions but also assets and transactions in other states which benefit resident taxpayers, resulting in the overlap of the states' tax claims. Bilateral double tax treaties address and reduce the extent of this double taxation. The efficacy of the treaty approach, however, depends on common and workable interpretations of the treaty terms.²

HK-CANADA DTA (Article 17) (signed in 2012; in force 2013):

Pensions (including lump sums) arising in a Party and paid to a resident of the other Party in consideration of past employment may be taxed in the Party in which they arise and according to the laws of that Party.

HK-NZ DTA (Article 17) (signed in 2010; in force from 2011):

“Subject to the provisions of paragraph 2 of Article 18, pensions and other similar remuneration paid to a resident of a Contracting Party in consideration of past employment or self-employment shall be taxable only in that Party. Notwithstanding the provisions of paragraph 1, lump sums paid under a mandatory provident fund scheme, and any other schemes or arrangements that may be established to replace the said scheme, shall be taxable only in the Hong Kong Special Administrative Region’.

The reason why above DTA Pension Clauses is out of date with current effort to update international tax laws, is because employees’ pension accrual is taxed in source country when changing jobs between jurisdictions, when unfortunately, there is no Pensions’ preservation and portability instrument operating in DTAs *between* tax jurisdictions. The instrument only functions within a jurisdiction, e.g., within Australia, not *between* tax jurisdictions.

DTA Pensions’ tax rights tragically ignore the need of employees to accumulate fair and equitable provision for an adequate pension income stream in their retirement.

Included in the ESG ten principles of the United Nations Global Compact concerning labour is the elimination of discrimination in respect of employment and occupation³. Secondly, the International Labour Organisation has five flagship programmes, one of which includes The Programme on Social Protection Floors (SPFs)⁴ for All, which acts to extend social protection

² Vogel, Klaus 1986, Double Tax Treaties and Their Interpretation, Berkeley Journal of International Law, 4 Int'l Tax & Bus. Law. 1

³ <https://www.unglobalcompact.org/what-is-gc/mission/principles/principle-6>

⁴ <http://www.ilo.org/secsoc/areas-of-work/policy-development-and-applied-research/social-protection-floor/lang--ja/index.htm>

to the 5 billion people who are partially covered or living without social protection and the dignity it affords.

When employees change jobs *between* tax jurisdictions, the tax discriminates against their retirement funding need, pushes their pension accrual out of the retirement funding system, and fails social protection in their retirement. I would intuitively think that the tax revenue from this DTA tax right is relatively small in proportion to the tragedy where employees should have instead, been able to fund an adequate pension income stream.

An actuarial model may suggest that a funded CPI indexed pension commencing at 66% of pre-retirement salary, should obviate a Government's liability in the provision of old-age pensions. The equivalent lump sum to fund this level of pension should maintain lifestyle needs thereafter, based on demographic life expectancies.

In respect to life expectancies, 2010-12 Australian Bureau of Statistics estimated that at age 60, the life expectancy of males was 23.37 years and females was 26.47 years. To calculate equivalent lump sums of funding term pensions, the Australian Government Actuary calculated that the Pension Payment Factor for 23 years is 15.62 and for 26 years is 16.89. Since 2010-12, demographics have shown that life expectancies are increasing and the gap between males and females is reducing. Instead of taxing pension accruals, Governments should focus on policy, based in demographics, statistical analysis and actuarial calculations for more effective functional instruments that can assure citizen tax payers of a long term, funded pension regime.

This paper advocates the introduction of a preservation and portability instrument in DTAs, which is needs-based for Internationally mobile labour forces that eliminates tax discrimination in respect of employment and occupation when changing jobs between jurisdictions. Secondly, an adequately funded pension income streams provides social protection and dignity in retirement, with significantly increasing old-age life expectancies.

2. How the Circumstances have Changed with increasing Globalisation?

In the course of continued diversification in globalisation, some of the factors relevant to Hong Kong as the third financial capital in the world are:

- (1) Increasing types of professional occupations
- (2) Increasing numbers of globally mobile professionals
- (3) Multinational organisations move their mobile professionals across different jurisdictions and market sophistication develops in different jurisdictions
- (4) Increasing numbers of bespoke professionals work for set contract terms, then move on to new opportunities in other jurisdictions
- (5) Growth in the number of International schools with IB (International Baccalaureate) qualifications in different jurisdictions allows families to raise children with appropriate education, so their professional expatriate parents can continue working in organisations for longer periods, before changing jurisdictions or moving back home.
- (6) Australian government should have an interest in bilateral negotiations with Hong Kong to get the taxation of pensions right in a globalised world.
- (7) The taxation of pensions transferred from Hong Kong to Australia is an area that affects a large and growing group of people.
- (8) Hong Kong and Australia have both been involved in developing the Multilateral Instrument (signing ceremony in June 2017). The Instrument is part of the international effort to update international tax laws to keep pace with global and digital environment. Multilateral Instrument operates to modify existing DTAs (subject to reservations of particular jurisdictions).

3. How has the Australia Law on Taxing Pensions from a taxed superannuation fund has recently Changed?

The internal earnings of pension fund accounts are tax free.

Occupational Superannuation (Reasonable Benefit Limits) Amendment Act 1990 allowed from 1 July 1994 for tax payers to all have a flat dollar Reasonable Benefit Limit (RBL).

These flat dollar RBLs were indexed every 1st July by movements in average weekly earnings. The flat dollar pension RBL was \$800,000 in 1994/95 and is now worth almost \$1.298 million in 2005/06. The lump sum RBL was worth \$400,000 and is worth just under \$649,000 in 2005/06.⁵ RBLs were subsequently repealed and then there was no accrual limit until 2016 Federal Budget Announcements. Subsequent Legislation from 1 July 2017 requires the maximum allowable funding in a pension account cannot exceed \$1.6 million for the purpose of generating a tax-free superannuation pension. Any excess above A\$1.6

⁵ http://www.atcbiz.com.au/self_managed_super_fund_smsf_articles.php?new=ye1g68s35g&num=&np=YES

million must be transferred back into a taxed superannuation account or withdrawn from the retirement funding system.

In respect of a tax payer receiving a superannuation pension, prior to 30 June 2007, UUPP (Unused Undeducted Purchase Price) of a pension, divided by the ABS Statistical life expectancy of the pension recipient, formed the tax free component of pension income called the Annual Deductible Amount. The taxable component of pension income qualified for a 15% tax rebate, when sourced from a prior taxed superannuation account, then subjected to personal income tax rates.

From 1 July 2007, those under the age of 60 continued to be subject the above tax system. Those over the age of 60 would receive the super pension tax free.

Even with a bipartisan political approach over the last 25 years, tax payers continue to be bewildered circular nature of confusing rules, so how did funding go wrong from when Australia became of age after World War 2?

4. Co-existence Failure between Pensions Funding & Tax Regimes

A constitution is a set of rules by which a country or state is run. The Australian Constitution was drafted at a series of constitutional conventions held in the 1890s. It was passed by the British Parliament as part of the Commonwealth of Australia Constitution Act 1900 and took effect on 1 January 1901. The Constitution is the legal framework for how Australia is governed and it can only be changed by referendum.⁶

Section 51 of the Constitution of Australia grants legislative powers to the Australian (Commonwealth) Parliament only when subject to the constitution. When the six Australian colonies joined together in Federation in 1901, they became the original States and ceded some of their powers to the new Commonwealth Parliament. There are 39 subsections to section 51, each of which describes a "head of power" under which the Parliament has the power to make laws. The Constitution also grants powers over Pensions (s51(xxiii) and s51(xxiiiA) (an amendment - see Social Services Referendum 1946).⁷

⁶ <http://www.peo.gov.au/learning/closer-look/the-australian-constitution.html>

⁷ https://en.wikipedia.org/wiki/Section_51_of_the_Constitution_of_Australia

4.1 Constitution: Pensions Power

7.11 The pensions and social security powers. The Constitution s 51(xxiii) and (xxiiiA) provide that the Parliament has power to make laws with respect to

(xxiii) Invalid and old-age pensions;

(xxiiiA) The provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental service (but not so as to authorise any form of civil conscription), benefits to students and family allowances;

7.14. Conclusion. Until the matter is settled it would be wise to regard s51(xxiii) as authorising legislation only with respect to schemes the primary purpose of which is to provide old-age pensions and which provide for the payment of lump sums only where that is incidental to the main purpose. The Review has concluded that, given the extent to which superannuation schemes provide for benefits to be taken in the form of lump sums - though there are taxation incentives to convert these lump sums into pensions - the Constitution s 51(xxiii) would not support an adequate level of regulation of superannuation funds. Some other legislative basis must be found.⁸

4.2 1946 National Welfare Fund

(Robert) Menzies was opposition leader when then Prime Minister Ben Chifley announced a National Welfare Fund to pay for pensions, unemployment relief, child endowments and even health care with a 7.5% tax increase. Menzies insisted that the Compulsory Contribution (Levy) should be kept completely separate; that it should be paid into a trust account and not mixed with general (tax) revenue. The levy and National Welfare Fund began on January 1, 1946 and contributions were shown separately on workers' personal tax assessments for 1946, 1947, 1948, 1949 and 1950 with money paid into a special fund from which claims were paid out. By 1950 the balance in the fund was almost £100,000 ... in today's money the equivalent of several trillion dollars. But the pot was too big for politicians to leave alone.

Menzies, supported by the Australian Labor Party, amended the Acts governing the fund so the compulsory contributions levy was lumped in with people's income tax and the whole lot paid straight into consolidated revenue. In 1977 Liberal PM Malcolm Fraser transferred the balance left in the welfare fund account (by then almost \$500 million, or several trillion in

⁸ [http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfsuperannuation_2/\\$file/superannuation_sub_10.pdf](http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfsuperannuation_2/$file/superannuation_sub_10.pdf)

today's terms) to consolidated revenue. Then in 1985 the Labor Government repealed Acts No. 39, 40 and 41 of 1945 (The National Welfare Fund Acts) and introduced income and asset testing, thus excluding millions of levy and taxpaying Australians from receiving the pension for which they had paid. But still the 7.5 per cent levy continued to be collected (while hidden in general income tax revenue.) But still the 7.5 per cent levy continued to be collected (while hidden in general income tax revenue.) ... and spent.⁹

4.3 Singapore Central Provident Fund

The opposite to Australia example is Singapore with its Central Provident Fund (CPF; Chinese: 公积金, Pinyin: Gōngjījīn) is a compulsory comprehensive savings plan for working Singaporeans and permanent residents primarily to fund their retirement, healthcare, and housing needs. The CPF is an employment based savings scheme with employers and employees contributing a mandated amount to the Fund. ... When the CPF was started in 1955, both employees and employers contributed 5% of an employee's pay to the scheme. The rate of contribution was progressively increased along with the growth of Singapore's economy, reaching 25% for both employers and employees in 1985 (subsequently reduced in recession periods).¹⁰ CPF membership has been increasing steadily over the years, from 3.34 million in 2010 to a total of 3.59 million in 2014. Similarly, total net balances have been rising from \$185.9 billion in 2010 to \$275.4 billion in 2014.¹¹ CPF is part of Singapore's sovereign wealth funds, which are an excellent example long duration capital formation.

4.4 Co-existence Failure between Pensions Funding & Tax Regimes

Singapore is a rare example that its national pension scheme can coexist with its taxation regime. Even though the 'Pensions Powers' exist under the Australian Constitution, a national pension scheme has failed from 1946 to coexist with its taxation regime under public sector administration. When Telstra as a public asset was listed on the Australian Securities Exchange, capital proceeds were placed in the Future Fund¹², a sovereign wealth fund with

⁹ <http://www.couriermail.com.au/news/opinion/opinion-arrogant-politicians-should-be-ready-for-a-pensioners-revolt/news-story/4d1511dbf579d8e58261d1fa4d328be5> by Brian Hale is a former business editor of The Courier-Mail and The Australian, 10 January 2017.

¹⁰ https://en.wikipedia.org/wiki/Central_Provident_Fund

¹¹ https://www.cpf.gov.sg/Assets/members/Documents/CPFTrends_Net_Balances_2015.pdf

¹² The Australian Government Future Fund is an independently managed sovereign wealth fund into which the Australian Government deposits funds to meet the government's future liabilities for the payment of superannuation to retired civil servants of the Australian Public Service. Its investment decisions are made at arm's length from the executive.[citation needed] At 30 June 2016, it was valued at A\$122.8 billion. https://en.wikipedia.org/wiki/Australian_Government_Future_Fund

the objective of covering the unfunded liabilities of the Commonwealth Public Services' superannuation schemes. The privatisation of Telstra and other public assets were not directed to the objectives of the 1946 National Welfare Fund in respect of the 'Pensions Powers' under the Australian Constitution. The Future Fund is a good example of long duration capital formation.

Clearly, Australian public sector administration has failed, given the 'Pensions Powers' under the Australian Constitution to achieve the objectives of the 1946 National Welfare Fund, where a national pension scheme cannot coexist with its taxation regime. Consequently, 1946 National Welfare Fund has failed to make adequate social protection as a 'pensions' sovereign wealth funds functioning in long duration capital formation. Therefore, the only solution looking forward is for individual tax payers to act in their private provision of pension funding formation under a preservation and portability framework in pursuit of social protection for themselves in retirement, without tax discrimination when changing jobs.

4.5 Australian Constitution 'Pensions Power' and Fiduciary Doctrine

Fiduciary doctrine seeks to enhance the likelihood that the fiduciary will properly perform his non-fiduciary duties by removing temptations, such as inconsistent interests or duties, which have a tendency to sway the fiduciary away from proper performance of those non-fiduciary duties. The removal of such influences is an essentially negative task, so that it is only natural that the fiduciary duties which are designed to achieve that result will themselves generally be proscriptive in nature: they prohibit the fiduciary from taking opportunities or from allowing his personal interest or other duties to conflict with the underlying-non-fiduciary-duties that he owes.¹³

Given the Co-Existence Conflict between taxation and the 1946 National Welfare Fund (national pensions scheme), the problem of paying Social Security old-age pensions from concurrent Government tax revenue has continued to escalate over past decades, and so has Government debt since the GFC, to compound the problem.

For this reason, the Australian Government should consider empowering its Fiduciary Doctrine with the 'Pensions Power' in the Australian Constitution by recognising that its past taxation "temptations, such as inconsistent interests or duties, which have a tendency to sway the fiduciary away from proper performance of those non-fiduciary duties" resulted in the

¹³ Conaglen, Matthew 2010, *Fiduciary Loyalty*, Hart Publishing Ltd, pp202,

termination of the national pensions scheme (non-fiduciary duty problem) and left old-age pensions – social protection in retirement – unfunded (compound problem with fiduciary duty).

Hence, Fiduciary Doctrine “the fiduciary duties which are designed to achieve that result will themselves generally be proscriptive in nature” indicates that the Australian Government has authority under the ‘Pensions Power’ in the Australian Constitution to negotiate for inclusion ‘Preservation and Portability’ Instrument into the proposed 2017 DTA with Hong Kong and China, as a contributory function towards self-funding of old-age pensions.

5. To what extent existing DTA Pensions’ provisions is insufficient?

Pre-existing Hong Kong DTA Pension Clauses with Canada and New Zealand affects employees changing jobs between jurisdictions to receive their retirement benefit¹⁴ and pay Hong Kong tax. These Pensions Clauses do not provide choice of options to either (1) personally receive lump sum less tax, or (2) to elect for preservation and portability *between* pension fund products *without tax* until retirement age.

Pre-existing Hong Kong DTA Pension Clauses with Canada and New Zealand conflict with the Australian ‘Sole Purpose Test’ in SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 - SECTION 62¹⁵. “A superannuation fund¹⁶ has as its sole purpose the provision to members on retirement or that attainment of a certain age, or the provision of benefits to dependents on the death of a member”.¹⁷ Simply, taxing DTA Pension amounts at source without preservation and portability instruments - fails Australian citizens in their ‘Sole Purpose’ need in retirement for adequate social protection.

¹⁴ Many large Hong Kong employers have 10-year vesting schedules on employer component so if employee resigns after 5 years, they lose 50% of the employer component before Hong Kong tax is applied.

¹⁵ http://www.austlii.edu.au/au/legis/cth/consol_act/sia1993473/s62.html

¹⁶ A regulated fund must have a constitutional corporation as trustee pursuant to a requirement contained in the governing rules (thereby allowing it to be regulated by the Federal Government under the Corporations power in the Australian Constitution); or the governing rules must provide that the sole or primary purpose of the fund is the provision of old-age pensions (thereby allowing it to be regulated by the Federal Government under the "Pensions Power" (Section 51xxiii) in the Australian Constitution).

<https://townsendslaw.com.au/blb-news/263/individual-trustees-and-lump-sum-benefits/>

¹⁷ Australian Taxation Office, *Income Tax: income tax deductions available to superannuation funds*, TR 93/17 17 June 1993 [13]

6. WHY SHOULD HONG KONG'S DTA PENSIONS CLAUSE BE MODERNISED?

Australian Government's SmartTraveller reports "At any one time there are about one million Australians living and working overseas."¹⁸ The Australian Consulate reported in 2015 that there were around 80,000 Australian Passport holders in Hong Kong. This trend number is increasing, not decreasing. They are not International tax evaders. But, they are most likely to seek retirement tax residency in Australia.

Hong Kong DTAs with Canada and New Zealand do not comply with the above 'Sole Purpose Test' without a preservation mechanism for existing retirement benefits between respective Common Law Jurisdictions. Preservation and Portability Instrument in a DTA would function with the scope of 'sole purpose' objective that retirement accruals would not be spent every time when changing jobs on conspicuous consumption.

7. WHAT LIMITATION IN PENSION FUNDING SHOULD CURRENTLY APPLY?

For Australian citizens working overseas, what should be their DTA cap on their 'Transfer Balance' from an overseas pension scheme after a working lifetime of employment, into an Australian taxed superannuation scheme, before they resume Australian tax residency?

Recent new Legislation provided an appropriate funding, pension model. In SUPERANNUATION (OBJECTIVE) BILL 2016 Explanatory Memorandum, states:

Chapter 3 Transfer balance cap

3.1 Schedule 1 to the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (the TLA Bill) imposes a \$1.6 million cap (the transfer balance cap) on the amount of capital that can be transferred into the retirement phase of superannuation. The transfer balance cap applies from 1 July 2017 and is intended to limit the extent to which the retirement phase interests of high wealth individuals attract an earnings tax exemption.

In accordance with the above Legislation, Australian citizens living and working overseas for period should be permitted under the Hong Kong DTA with Australia with a Preservation Portability Instrument to transfer up to AUD\$1.6 million from an overseas pension scheme into an Australian taxed superannuation scheme, that also complies with their 'Sole Purpose' need for an adequate pension in retirement.

¹⁸ <http://smartraveller.gov.au/guide/all-travellers/Pages/living-and-working-overseas.aspx>

The expected refusal by Australian Treasury is that overseas pension transfers are subject to non-concessional contributions caps. Treating an overseas pension transfer as a contribution is logically fallacious. In all honesty in logic, a transfer *between* 2 retirement schemes is logically not a contribution by a member or employer into (not between) a legally constituted, retirement scheme. I was informed several years ago, before Legislation was passed for the 1 July 2007 Treasurer Costello superannuation changes that overseas pension transfers were permitted in the draft BILL, but was crossed out when the BILL was passed. Hence, it appears that the political function made a serious error. In the interests of the one million Australians living and working overseas, this error can begin to be corrected with the advent of the DTA between Hong Kong and Australia, to preserve and transfer (portability) up to A\$1.6 million per citizen from overseas pension schemes into a taxed Australian superannuation fund.

8. DTA PENSION TAX AT SOURCE CAUSES REDUCTION IN INVESTMENT DURATION

For professional occupations, the average job duration is generally less than 7 years. Changing jobs between jurisdictions is likely to have an investment duration of around 7 years. Changing jobs will cause DTA taxed at source for a cash payout and fails in their 'Sole Purpose' longer term need for adequate benefits in retirement.

So for an employee with DTA Pensions 'Preservation and Portability' Instrument, the investment duration should range from age 20 to 80 years of age, up to 60 years. First, this should meet their 'Sole Purpose' longer term need for adequate benefits in retirement. Secondly, the DTA Instrument should significantly increase the supply of long duration capital for large scale investment projects including major mining and infrastructure financing, as well as Private Equity funds operations in venture capital start-ups and early stage commercial grow-outs¹⁹ that sponsors new jobs skills creation and new wealth economic multiplier effect.

9. HONG KONG DTA PENSIONS' PRESERVATION PORTABILITY MODEL

Currently, if a Hong Kong Pension Benefit is transferred (*between*) to a complying superannuation fund in Australia, first the benefit is taxed (15%) on release in Hong Kong as a lump sum benefit, and then it is double taxed (another 15%) on receipt by a superannuation

¹⁹ This business model takes a successful local company and scales up into a new global competitor.

fund in Australia as the transfer of an untaxed benefit from a non-complying superannuation fund. Under Australian tax rights, untaxed transfer amounts are given no prior recognition that the pension transfer amount was previously established in another Common Law taxed jurisdiction.

Australian employees in Hong Kong are faced with a tax choice of (1) receive lump sum less 15% then spend remainder on conspicuous consumption, or (2) arrange to have it transferred as an unfunded benefit into a taxed Australian super scheme and lose a total of 30% in tax. Obviously, (2) violates natural justice so normal human behaviour rejects 30% tax transferring (*between*) to a complying superannuation fund in Australia and effectively breaches their 'Sole Purpose' need for an adequate pension in retirement. If a 30% tax charge was imposed, unlike negative gearing loss, it is not recorded and carried forward, then applied to reduce pension tax liability in the future. It is simply and only a gain to general tax revenue.

The objective is to resolve the problem of double taxation of transfers of retirement benefits, in the accumulation stage before retirement. This paper proposes that the DTA Pensions Article 17 should include Preservation and Portability Instrument, with the operating mechanics in functional elements that:

1. Allows recognition of complying retirement funds in Hong Kong and Australian for the purposes of accrual of pensions' entitlements that can be accessed in retirement after 60 and after ceasing gainful employment.
2. Hong Kong does not cap the maximum benefit to fund a pension. In retirement, the Australian Legislation for a pension transfer cap of AUD\$1.6 million shall apply. Any excess can be taxed in respective jurisdiction.
3. Uses the Certificate of Compliance from an Australian resident superannuation fund as acceptable to the Hong Kong IRD - Inland Revenue Department, and for Certificate of Compliance from registered MPF and ORSO schemes in Hong Kong to be acceptable to the Australian Taxation Office;
4. On Application to the HK IRD, a DTA authorisation letter can be issued to allow for the transfer (*between*) from a Hong Kong Pension Scheme without being taxed at source and on transfer into a complying Australian superannuation fund without being taxed as an untaxed transfer;
5. On Application to the Australian Taxation Office, a DTA authorisation letter can be issued without being taxed (30%) at (by ATO) source to allow for the transfer

- (between)* from a complying Australian superannuation fund to a Hong Kong registered retirement scheme without being taxed on entry into Hong Kong;
6. Taxing pension income streams post-retirement shall be subject to the laws in respective tax jurisdiction, as currently applies in Hong Kong. In Australia, unfunded Government pensions and overseas pensions are taxed as income. This is acceptable as the ‘Sole Purpose Test’ has been funded by effective functioning of preservation and portability of accruals, protected by a DTA Pensions’ Instrument.

An effective DTA Pension’s instrument can function to set a better ‘floor plan’ that:

- (1) The benefit to Hong Kong is those employees who intend to retire in Hong Kong can transfer their retirement accumulations to Hong Kong on changing jobs. MPF and ORSO schemes are among the few investment vehicles that are administered in Hong Kong under Hong Kong Law and creates administrative employment in Hong Kong.
- (2) The benefit to the Australian Treasury is that Australians working overseas every time when they change jobs, do not have a disincentive not to transfer their pension accrual to be invested in a taxed, resident Australian superannuation schemes.
- (3) Support higher flexibility of the efficient movement of International professional labour and not have their retirement accumulations subject to tragic tax rights when there is no intent to use retirement funds for International tax evasion in all regular employment occupations.
- (4) Benefits the 80,000 Australian citizens currently living and working in Hong Kong.
- (5) Benefits China and Hong Kong citizens living and working in Australia.
- (6) There are Mainland Chinese working in Australia doing hard jobs such as fruit picking, working in meatworks abattoirs, etc., who also require a form of superannuation transfer *(between)* Australian SGC scheme and their select retirement scheme back home in China.
- (7) Superannuation funds with DTA preservation-portability instrument via Australian Primary Capital Markets does create additional local employment for greater economic efficiency and productivity that has a more effective economic multiplier effect.
- (8) If DTA preservation-portability instrument causes pensions transfer volumes to accumulate to higher levels in the Australian primary capital markets with longer duration timeframes, this should provide more ongoing tax revenue than foreigners cashing out retirement benefits in Australia when changing jobs to move back overseas.

(9) Without the DTA preservation-portability instrument, overseas pension accruals are cashed taxed out, the residual of which is often reinvested in Australian residential housing.

10.Policies Against More Residential Investment

Australian Assistant Minister of Immigration released new rules from 1 July 2015 for Significant Investor VISA migrants to Australia that restricted the amount invested into the existing stock of residential real estate.

Often when Australians overseas have an extra pension's lump sum left over every time they change employers, it is reinvested into Australian residential real estate, which only generates single digit economic returns. Often an additional investor residential mortgage is required, so big banks borrow more money from overseas for residential housing loans, which is negative for taxation revenue. APRA²⁰ is now desperately trying to limit bank's lending risk in investor residential mortgages that tightens supply and raises prices for first home buyers, who do not have the advantage of tax write-downs for investors.

11.DTA WITH INFORMATION EXCHANGE

Australian citizens working in Common Law jurisdictions should have a Legal Expectation for the DTA framework to function with information exchange for higher administrative efficiency in portability and preservation for retirement benefits between complimentary Common Law jurisdictions, because there is never intent for International tax evasion in employment, when pension cap of A\$1.6 million is applied.

²⁰ Australian Regulatory Prudential Authority

12.2009 Australian DTA With New Zealand: To what extent are existing DTA Pension Article 18 provisions insufficient?

Australia-NZ DTA (Article 18) (from 2009):

1. Pensions (including government pensions) and other similar periodic remuneration paid to a resident of a Contracting State shall be taxable only in that State. However, such income arising in the other Contracting State (other than payments of portable New Zealand superannuation or portable veteran's pension or equivalent portable payments arising in New Zealand) shall not be taxed in the first-mentioned State to the extent that such income would not be subject to tax in the other State if the recipient were a resident of that other State.
2. Lump sums arising in a Contracting State and paid to a resident of the other Contracting State under a retirement benefit scheme, or in consequence of retirement, invalidity, disability or death, or by way of compensation for injuries, shall be taxable only in the first-mentioned State.

Australia and New Zealand have formed closer economic relations, i.e., Australia-New Zealand Closer Economic Relations Trade Agreement, which is linked into their Double Taxation Agreement.

While the Pensions Clause 1 above provides for no tax out of New Zealand and no tax into Australia, the lump sums Clause 2 is not a model 'Preservation and Portability' Instrument for the transfer *between* Australian and New Zealand complying retirement schemes. Therefore, any lump sum transfers into long duration capital formation for social protection in retirement is likely to be more good luck than good management and insufficient in modern global financial requirements.

13.SUMMARY

In summary, Australian DTA Pensions Clause with Hong Kong/China should:

1. support the International Pensions' Preservation and Portability for compliance with ILO's 'Social Protection' principles in retirement;
2. support United Nations Global Compact principles concerning labour includes the elimination of tax discrimination on changing jobs before reaching retirement age;
3. constructively enhance the investment duration of pensions capital from averaging 7 years towards 60 years that creates more capital in primary capital markets for longer term investment time frames;

4. Aim to achieve the Legislative maximum of accrual of \$1.6 million by retirement age, but how that relates to an actuarial model of “a funded CPI indexed pension commencing at 66% of pre-retirement salary, which should obviate a Government’s liability in the provision of old-age pensions” is unknown? Lifestyles in the broad Australian middle class generation is directly related a measure of household income.
5. Provides a partial solution to the co-existence conflict between a national pension scheme and the tax regime, given that the Singapore CPF model is now unattainable. Australian sovereign wealth funds will provide funding for old-age pensions to retired Commonwealth Government employees, but not to former private sector employees in retirement.
6. Influences law reform in Hong Kong to increase its status as the 3rd financial capital of the world by “... Instruments (that are) part of the international effort to update international tax laws to keep pace with global and digital environment”.

Significant new supply of long duration pension transfer funds should advance the funding projects, such as:

1. China wants to build ‘One Belt – One Road’ infrastructure corridors between China and Europe.
2. Australia wants to build heavy rail corridor between the Pilbara iron ore region and the Queensland coal fields for new capacity in steel manufacture.
3. Electricity energy supply and infrastructure crisis between Australian States, including 50% expansion of Snowy River Scheme,
4. There is a proposal for high speed train service between Sydney and Melbourne,
5. More growth in long term, Private Equity funds management industry,
6. And there are many more ...

All such large-scale infrastructure developments need longer term investment time frames with supply of finance from primary capital markets.

This paper advocated that ‘Preservation and Portability’ Instrument should be included in Article 17 Pensions Clause in DTAs that preserves pension funds until retirement age, allows for the tax-free portability transactions between respective tax jurisdictions, supports adequate funding of pensions in retirement, and adds significant economic value to primary capital markets for long duration capital formation.

Appendix A - UK Overseas Pensions Transfer – International Best Practice Model

UK QROPS was introduced on 6 April 2006 as part of the 'simplification' of UK Pensions under the Finance Act 2004. A QROPS was an overseas pension scheme that met certain requirements set by HMRC which could receive transfers of UK pension benefits without incurring an unauthorised payment and scheme sanction charge.

HMRC Changes for UK Pension transfers post 9 March 2017²¹

Legislation will be introduced in Finance Bill 2017 so that:

- Transfers to QROPS requested on or after 9 March 2017 will be taxed at a rate of 25% unless at least one of the following apply:
 - i. both the individual and the QROPS are in the same country after the transfer,
 - ii. the QROPS is in one country in the EEA (an EU Member State, Norway, Iceland or Liechtenstein) and the individual is resident in another EEA country after the transfer – Gibraltar is considered to be part of the UK for this purpose.
 - iii. the QROPS is an occupational pension scheme sponsored by the individual's employer
 - iv. the QROPS is an overseas public service pension scheme as defined at regulation 3(1B) of S.I. 2006/206 and the individual is employed by one of the employer's participating in the scheme
 - v. the QROPS is a pension scheme established by an international organisation as defined at regulation 2(4) of S.I. 2006/206 to provide benefits in respect of past service and the individual is employed by that international organisation.
- UK tax charges will apply to a tax-free transfer if, within five tax years, an individual becomes resident in another country so that the exemptions would not have applied to the transfer.
- UK tax will be refunded if the individual made a taxable transfer and within five tax years one of the exemptions applies to the transfer.
- The scheme administrator of the registered pension scheme or the scheme manager of the QROPS making the transfer is jointly and severally liable to the tax charge and where there is a tax charge, they are required to deduct the tax charge and pay it to HM Revenue and Customs (HMRC).
- Payments out of funds transferred to a QROPS on or after 6 April 2017 will be subject to UK tax rules for five tax years after the date of transfer, regardless of where the individual is resident.
- Overseas residents who have transferred UK Pension monies to a third-party jurisdiction (such as Gibraltar, NZ or Malta) and those transfers were received by the third party scheme prior to 9 March 2017 are able to move those funds freely between QROPS without being subject to the new charge.
- These pre-9 March 2017 monies will be 'ring fenced transfer funds' and not subject to the new tax charge unless the member becomes a UK resident again.

²¹ https://www.ivcm.com/docs/IVCM_STATEMENT_OverseasAdvisers.pdf

Appendix B²²

Other points in support of AU-HK DTA limiting taxing rights with respect to pensions:

3. OECD Model Tax Convention (2014)

Article 18 (Pensions) of the Model Convention provides:

“Subject to the provisions of paragraph 2 of Article 19 [Government Service], pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall in taxable only in that State.”

The Commentary acknowledges that some jurisdictions are reluctant to adopt the principal of exclusive residence based taxation for pensions, noting that in some cases, mismatches between the policy adopted for the taxation of pensions by two different jurisdictions could result in a scenario where there is a risk of no tax being payable in either jurisdiction.

This can be distinguished from the present case. Based on the comments on page 5 of your paper regarding pensions transferred from HK to Australia being subject to WHT in HK @ 15% and then again subject to tax in Australia @ 15% on receipt, this is not a case of potential non-taxation. Rather, this a case where there is a risk of double taxation on the transfer of pension from HK to Australia, unless there is a DTA that limits taxing rights to one jurisdiction.

The Commentary on Article 18 of the Model Convention highlights that “various policy and administrative considerations support the principle that the taxing right with respect to [pensions paid in respect of private employment] should be left to the State of residence”.

It then goes on to outline, from paragraph 19 onwards, some of the arguments in favour of limiting taxing rights. This includes comments on removing tax obstacles to the portability of pension rights (which is one of the key issues raised in your paper):

<http://www.oecd.org/berlin/publikationen/43324465.pdf>

4. Multilateral Instrument (negotiations recently concluded between more than 100 jurisdictions)

Hong Kong and Australia have both been involved in developing the Multilateral Instrument (signing ceremony in June 2017). The Instrument is part of the international effort to update international tax laws to keep pace with global and digital environment. Multilateral Instrument operates to modify existing DTAs (subject to reservations of particular jurisdictions).

Part III of the Multilateral Instrument contains a number of Articles to address treaty abuse and includes Article 11, which is a “savings clause” that preserves the right of

²² With thanks to Zoelle Loh of KPMG who compiled the information below.

a jurisdiction to tax its own residents with the following exceptions with respect to the taxation pensions:

“pensions or other payments made under the social security legislation of the other Contracting Jurisdiction shall be taxable only in that other Contracting Jurisdiction;

pensions and similar payments, annuities, alimony payments or other maintenance payments arising in the other Contracting Jurisdiction shall be taxable only in that other Contracting Jurisdiction”

This aligns with the principle of limiting taxing rights with respect to the taxation of pensions.

5. Australia’s DTAs with neighbouring Asian countries: China (signed in 1988; in force from 1990) and Singapore (signed in 1969; in force from 1969)

To provide some examples, Australia’s DTAs with China and Singapore provides some form of limiting taxing rights with respect to pensions.

AU-SG DTA, Article 13:

“A pension or an annuity, derived from sources within one of the Contracting States by an individual who is a resident of the other Contracting State, shall be exempt from tax in the first-mentioned Contracting State.”

AU-CN DTA (Article 18):

“Subject to the provisions of paragraph (2) of Article 19, pensions paid to a resident of a Contracting State in consideration of past employment, and payments made to a resident of that State under the social security system of the other Contracting State, shall be taxable only in the first-mentioned State.”

6. Australia’s recent renegotiated DTA with Germany (signed in 2015; in force from 2016)

The majority of Australia’s DTAs were negotiated more than 15 years ago. An exception is the DTA with Germany, which was re-negotiated in 2015 (previous DTA was signed in 1975).

There is still some form of limitation with respect to taxing rights for pensions in the revised DTA. The revised DTA retains the general provision that provides for exclusive residence based taxation, and introduces some exceptions (e.g. allows source taxation of pension, subject to a limit), presumably to deal with specific concerns/policy positions. Notably, it does not go so far as to allow unfettered source taxation of pensions (unlike the HK-CAN DTA).

Revised AU-GER DTA (Article 17):

“1. Subject to the provisions of paragraph 2 of Article 18, pensions, payments made under the social security legislation and annuities paid to a resident of a Contracting State shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1 but subject to the provisions of paragraph 3, such a pension or annuity arising in a Contracting State which is attributable in whole or in part to contributions which, for more than 15 years in that State,

(a) did not form part of the taxable income from employment,

(b) were tax-deductible, or

(c) in the case of a pension or annuity arising in the Federal Republic of Germany, were afforded some other form of beneficial treatment by the Federal Republic of Germany

may also be taxed in that State provided the pension or annuity was first paid after 31 December 2016. This paragraph shall not apply if the tax relief or other form of beneficial treatment was clawed back for any reason, or if the 15 year condition is fulfilled in both Contracting States.

3. Notwithstanding the provisions of paragraphs 1 and 2, benefits paid under the social security legislation of a Contracting State may also be taxed in that State but the tax so charged shall not exceed 15 per cent of the gross amount of the benefit. However, this paragraph shall not apply if the benefits were first paid before 1 January 2017.”

Previous AU-GER (Article 18):

“Pensions and annuities paid to a resident of a Contracting State shall be taxable only in that State.”