

Reporting Australian Superannuation Funds as Foreign Trusts for Tax Purposes

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When You Don't Have a Pair of Magical Ruby Slippers Like Dorothy^[1]

Current US tax laws do not provide any definitive guidance on the US tax classification and treatment of hybrid foreign retirement plans such as an Australian Superannuation Fund (“ASF”).^[2] In June 2015, the IRS issued a series of Private Letter Rulings (“PLRs”)^[3] to individual taxpayers holding that beneficial interests in foreign superannuation funds would be classified as foreign trusts for US tax purposes.^[4] It is no surprise that the foreign superannuation funds at issue in the PLRs were ASFs. Because the PLRs gave very little factual information about the funds at issue, and the nature of the PLRs themselves as non-precedential, one should be wary relying on these PLRs to report any ASF as a foreign trust. As with everything else involving ASFs, the devil is in the details. And with the recently-rolled out IRS compliance campaign^[5] focusing on US persons with interests in a foreign trust^[6], US expats in Australia can no longer click their heels three times (like Dorothy) and wish for their annual US tax compliance nightmares with ASFs to go away.

Opting to report an ASF as a per se foreign trust for US tax purposes is nothing new. Many US expats who are Australian residents and members of ASFs do so on an annual basis when filing their annual tax returns. However, one should be aware that doing so may entail a trip down the proverbial rabbit hole if in fact that ASF is not merely engaged in preserving assets but is actually engaged in active business operations. Why is this important? Because it will certainly impact the US tax reporting of the ASF as either an ordinary trust^[7] or a foreign corporation.^[8]

US tax laws presume that a trust is a foreign trust^[9] unless it satisfies two statutory conditions establishing it is domestic trust.^[10] If the ASF fails either of these conditions, then it would be treated as a foreign trust, but the inquiry does not end there. Just like Dorothy who had to first get on that bright yellow brick road to see the Wizard of Oz, US expats and their advisors must first ascertain whether their ASF ought to be reported as foreign ordinary trust or a business entity for US income tax purposes. But it is worth the exercise because an ASF that is reported as a foreign trust may be treated as an ordinary trust for income tax purposes,^[11] or treated, alternatively, as a business entity, which will be subject to the US income tax rules for either partnerships or corporations.^[12]

In an ordinary trust, trustees take title to the trust property with the objective of protecting and conserving it for the benefit of the trust beneficiaries.^[13] Specifically, in an ordinary trust, the beneficiaries are not associates in a joint enterprise for the conduct of business for profit.^[14] Conversely, there are other arrangements known as “trusts” but they are not classified as trusts for the purposes of the Code because they are not simply arrangements for the protection or conservation of the property for the beneficiaries.^[15] In such circumstances, if the beneficiaries or unitholders of the trust have voluntarily associated for the primary purpose of carrying on business through the trust, with the primary objective of earning profits, the trust is likely to be classified as a business trust and treated as a business entity.^[16] If it is the later, then it will be reported for US tax purposes as an association taxable as a corporation.

Translating the above US tax concepts to ASFs is not an easy endeavour, but certainly worth the effort. So a word of caution to US expats and their financial and tax advisors who default to reporting their membership interests in ASFs as a foreign trust for US tax purposes: take the time to conduct a diligent review of the ASF's structure and activities with a trusted US tax advisor who can help you navigate the complexities of reporting ASFs for US tax purposes. Because unlike Dorothy, it is unlikely that US expats with ASFs have a magical pair of ruby red shoes that can make the IRS penalties^[17] on improperly filed US tax reporting forms go away with just three clicks of their heels.

[1] See, *The Wonderful Wizard of Oz* (1939) https://en.wikipedia.org/wiki/The_Wonderful_Wizard_of_Oz. The author acknowledges that the Land of Oz is not Australia; only that Australia in short form is referenced and pronounced as "Aus".

[2] See Moodys, "US Income Tax Treatment of Australian Superannuation Funds", *Tax Notes International* vol. 84, no. 2 (October 10, 2016).

[3] A Private Letter Ruling is a ruling clarifying the IRS position on a tax issue. It is specific to the taxpayer that requested it and cannot be used or cited as precedent under §6110(k)(3). See Priv. Ltr. Ruls. 201538008, 201538007, and 201538006.

[4] 26 CFR §301.7701-4(a).

[5] <https://www.irs.gov/businesses/large-business-and-international-compliance-campaigns> (site visited 9/5/2018).

[6] <https://www.moodysgartner.com/new-irs-campaigns-on-withholding-and-international-individual-tax-compliance/> (site visited 9/5/2018).

[7] Foreign trusts are reported on IRS Form 3520 *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* and IRS Form 3520-A *Annual Information Return of Foreign Trust With a US Owner*.

[8] A foreign corporation will be reported on IRS Form 5471, *Information Return of US Persons With Respect to Certain Controlled Foreign Corporations* or IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*.

[9] 26 United States Code §7701(a)(31)(E).

[10] 26 United States Code §7701(a)(30)(E); see also, 26 C.F.R. §301.7701-7. A trust will be considered a US person (and therefore a domestic trust) if (1) a US court is able to exercise primary supervision over the trust's administration (the "Court" test), and (2) one or more US persons have authority to control all substantial decisions of the trust (the "Control" test).

[11] Subchapter J of Chapter 1 of Subtitle A of the Code.

[12] See generally, US entity classification rules (the "Check-The-Box Regulations") for foreign trusts under 26 C.F.R. §301.7701-4.

[13] 26 C.F.R. § 301.7701-4(a).

[14] *Id.*

[15] 26 C.F.R. § 301.7701-4(b).

[16] *Morrissey v. CIR*, 296 US 344 (1935).

[17] Generally, the initial penalty is the greater of USD \$10,000 or 5% of the gross value of the foreign trusts' assets under 26 USC 6677 for Form 3520s. An automatic penalty of USD \$10,000 is assessed on failure to file or timely file Form 5471.

<https://www.irs.gov/businesses/corporations/forms-5471-automatic-assessment-of-penalties-under-irc-section-6038b1>