LAW OFFICES OF
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July 5, 2024

VIA REGULATIONS.GOV PORTAL

Internal Revenue Service
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Transactions With Foreign Trusts and Information Reporting on Transactions With Foreign Trusts and Large Foreign Gifts Proposed Regulations (REG-124850-08)

Dear IRS, Chief Counsel, and Treasury Personnel:

We appreciate the opportunity to provide comments pursuant to the IRS' request for comments on the proposed foreign trust and foreign gift regulations. We commend the IRS for finally proposing regulations under §§ 6048, 6677, and 6039F. We provide various comments on the proposed regulations including important suggestions relating to retirement, pension, and tax-favored plans and several issues relating to large foreign gift and inheritance reporting. We also provide additional suggestions sparked by the failure of the IRS to fairly administer penalties relating to international information returns.

Background

The founder of Law Offices of Daniel N. Price, PLLC, Dan Price, spent nearly twenty years as an attorney for the Office of Chief Counsel of the Internal Revenue Service. Much of Dan's career with the Office of Chief Counsel focused on international tax enforcement. Among other responsibilities Dan helped draft, implement, and oversee the 2014 Offshore Voluntary Disclosure Program and the Streamlined Filing Compliance Procedures. Dan assisted with revising and overseeing the Voluntary Disclosure Practice under I.R.M. 9.5.11.9 and served as counsel on several LB&I Compliance Campaigns focused on international compliance issues. Dan also served as an official spokesperson for the IRS and the Office of Chief Counsel concerning international tax and FBAR enforcement. In private practice, Dan's practice includes international compliance issues. Dan's experience with the Office of Chief Counsel and his private practice experience gives him a unique and well-rounded perspective on the issues of international tax enforcement and the reporting burdens placed on taxpayers.

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Comments

1. Expand reporting exceptions for foreign retirement, pension, and tax-favored plans

We praise the IRS for the administrative relief from reporting under Rev. Proc. 2020-17 that was largely incorporated into the draft regulations. Nonetheless, we request expanding the exceptions to I.R.C. § 6048 reporting for foreign retirement, pension, and tax-favored plans in Treasury Regulations. We strongly urge broader administrative relief from reporting beyond the very limited parameters in the proposed regulations. We also recommend more guidance from the IRS relating to when foreign pensions and pension-type arrangements may or may not be reportable as foreign grantor trusts. No other portion of the Proposed Regulations affects more taxpayers, and importantly no other portion of the Proposed Regulations affects as many middle-class taxpayers. We strongly urge Treasury and the IRS to consider reducing foreign trust reporting for foreign retirement, pension, and tax-favored plans to reduce the compliance burdens on middle-class taxpayers.

Specifically, we recommend expanding the reporting exceptions under § 1.6048-5(b). We recommend eliminating the requirement that "only contributions with respect to income earned from the performance of personal services are permitted." Proposed Reg. § 1.6048-5(b)(2)(iii). From our review of various foreign private pensions, most do not contain an explicit limitation on the source of contributions either in the plan documents or under local law. For example, we have seen a Turkish private pension where parents may contribute to an individual's private pension.[1] In Germany, South Africa, and other countries, various private pensions do not contain any explicit limitations on the source of contributions; we surmise that no explicit limitations on the source of contributions is provided under local law because typically working class taxpayers make contributions from their earned income from performing personal services.

Also, many private pensions and state-sponsored pensions do not have an explicit cap on lifetime contributions. In many countries, the prevailing wages for workers or annual contribution limitations provide for a de facto limit on lifetime contributions. We recommend eliminating the lifetime limit on contributions under Proposed Reg. § 1.6048-5(b)(2). In the alternative, we recommend increasing the contribution limits to an annual limit of $200,000 and a lifetime limit of $3,000,000. We similarly recommend increasing the "value threshold" under Proposed Reg. § 1.6048-5(b)(2)(iv)(1) to $3,000,000.

[1] Whether a pension contribution originates from an individual's performance of personal services, the individual's investment income, or from a gift from a family member does not change the overall bona fides of a private pension.

We also recommend clarifying whether the contribution limitations under Proposed Reg. § 1.6048-5(b)(2)(iv)(1) apply to general plan limitations or look through to individual circumstances. *See* Andrew Velarde, IRS Urged to Make Trust Reporting Changes for Retirement Accounts, TAX NOTES (July 8, 2024). That article discusses the proposed regulations. In the context of Proposed Reg. § 1.6048-5(b)(2)(iv)(1), it was reported that IRS personnel said "that the relief conditions were on an individual level and not account wide." Based on this statement, it appears that the IRS does not intend § 6048 reporting if a retirement or pension plan allowed more than the specified limits for annual or lifetime contributions, if the individual's annual or lifetime contributions were actually below the thresholds provided in the proposed regulations. We urge the IRS and Treasury to make explicit in the final regulations that the limits are based on individual circumstances and not general pension and retirement plan limits.

Further, to reduce the compliance burden on middle class taxpayers, we recommend exempting from reporting under § 6048 all foreign pension and retirement plans that are afforded beneficial treatment under income tax treaties (*e.g.*, treaty provides a tax exemption or a tax deferral with respect to gross income). For example, although the U.S.-U.K. income tax treaty provides certain benefits for retirement plans, the onerous and costly information reporting regime under § 6048 still applies to many U.K. retirement and pension plans even if income from a foreign pension is not treated as taxable income in the U.S. This regulatory mismatch only harms middle class taxpayers by creating traps for the unwary. And for those taxpayers that are aware of the reporting requirements because they have competent professionals, the regulatory mismatch imposes heavy compliance costs.

We encourage Treasury and the IRS to consider the body of scholarly and practitioner writing discussing some of the very real reporting complexities for foreign pension and retirement plans requesting regulatory reporting exceptions. *See, e.g.*, Roy A. Berg and Marsha-Laine Dungog, U.S. Income Tax Treatment of Australian Superannuation Funds, TAX NOTES INT'L, October 10, 2016 (among other things requesting that the regulations under § 6048 be amended to clarify that Australian superannuation arrangements be excluded from reporting on Forms 3520 and 3520-A). *See also*, Marsha-Laine Dungog and Jennifer S. Silvius, Bringing Home the (Canadian) Bacon: U.S. Tax and Canadian Retirement Plans, TAX NOTES, October 17, 2022 (among other things requesting that Canadian Tax Free Savings Accounts or TFSAs be exempted from foreign trust reporting under § 6048). *See also*, Andrew Velarde, Detailed Foreign Trust, Gift Regs Address Reporting, Penalties, TAX NOTES, May 8, 2024. Among others, we recommend exempting from § 6048 reporting U.K. Self-Invested Personal Pensions or SIPPs, Canadian Tax Free Savings Accounts or TFSAs, Australian Superannuation Funds, German Riester and Rürup private pensions, and a host of other private pension plans across the world intended to benefit working and middle class taxpayers saving for retirement.

Finally, from a tax enforcement perspective, requiring § 6048 reporting for foreign pension, retirement, and other tax-favored plans currently provides little or no enforcement utility to the IRS. In general, foreign pension, retirement, and other tax-favored plans are not used to further offshore tax evasion;[2] those plans are often very regulated under local law of the foreign country. The onerous reporting mandated under § 6048 provides limited utility to the IRS in combating offshore tax evasion. Further, FBAR reporting and Form 8938 reporting for foreign pension, retirement, and other tax-favored plans provide sufficient information to the IRS on such foreign financial assets. So, exempting foreign pension, retirement, and other tax-favored plans from § 6048 reporting would not impede IRS data-mining and tax enforcement efforts. Further, because the IRS has refused to allow efiling of Forms 3520 and 3520-A, the enforcement utility of such forms is automatically hindered as opposed to FBAR data which is mandated to be efiled and routinely data-mined by the IRS.

In sum, the narrow reporting exceptions under § 6048 for foreign retirement, pension, and tax-favored plans overly burden middle-class U.S. persons with expensive compliance costs and creates penalty traps for the unwary. Concerning penalties, *see infra* item 11. We urge that the final regulations provide broader reporting exceptions for foreign retirement, pension, and tax-favored plans.

2. Eliminate the proposal for joint and several liability for § 6677 penalties

We recommend eliminating Proposed Reg. § 1.6677-1(f)(2) proposing to impose joint and several liability for § 6677 penalties for married taxpayers. This proposal exceeds statutory authority to impose joint and several liability. *See* § 6013. Further, if Treasury and the IRS proceed with the *ultra vires* proposed regulation, then innocent spouse provisions must be incorporated into the regulations to protect married spouses unaware of § 6048 reporting issues.

3. Harmonize filing deadlines

We recommend harmonizing income tax return deadlines and Form 3520 deadlines for U.S. persons residing abroad. Taxpayers residing abroad have a June 15 deadline for filing income tax returns. Treas. Reg. § 1.6081-5(a)(6). We recommend an explicit June 15 deadline for Forms 3520 for taxpayers residing abroad. Additionally, taxpayers residing abroad may extend their income tax return filings to December 15. We recommend that if a taxpayer residing abroad receives an extension to file an income tax return to December 15 that the Form 3520 deadline be similarly extended. Also, for those

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[2] The IRS views some Malta pension plans as "dirty" and "abusive." We recommend that the IRS recognize that the drafting of the U.S.-Malta income tax treaty gave rise to the transactions which the IRS now views as abusive. Hence, we recommend distinguishing Malta pension plans on the basis of treaty drafting and generally provide broad relief from § 6048 reporting for foreign pensions and retirement plans.

taxpayers residing abroad who qualify for the foreign earned income exclusion under I.R.C. § 911 under the bona fide foreign residence test can receive an extension of time to file to January 30, 45 days after the otherwise available December 15 extended deadline.[3] We recommend explicitly harmonizing the Form 3520 deadlines to consider these extended due dates.[4]

4. Increase thresholds for large foreign gift and inheritance reporting under § 6039F

We recommend expanding reporting exceptions including (1) increase reporting thresholds for large foreign gifts and inheritances from individuals to $1,000,000 and (2) except all reporting of large foreign gifts between spouses.

The current proposed regulations at § 1.6039F-1(c)(2) provide for reporting large foreign gifts and inheritances from individuals more than $100,000 with that threshold indexed for inflation. We applaud indexing the threshold for inflation, however it should first be adjusted upward. The $100,000 threshold was adopted 26 years ago in Notice 97-34. We recommend adjusting the reporting threshold to $1,000,000 and indexing that amount for inflation.

Further, we recommend excepting from reporting gifts and inheritances between spouses. Transfers from a nonresident alien spouse to a U.S.-person spouse should be completely excluded from the section 6039F reporting regime. Requiring reporting between married spouses is an unnecessary invasion of familial and marital privacy. Additionally, information concerning spousal transfers would likely provide no useful information to the IRS. In the context of spousal transfers, especially *inter vivos* transfers between spouses, the IRS would gain no useful information in its fight against tax evasion to close the tax gap. In many cases, transfers between spouses constitute routine support, which does not fit into the dichotomy of gift or income provided in the proposed regulations.

5. Eliminate the proposed anti-avoidance rule

We recommend eliminating the proposed anti-avoidance rule under Proposed Reg. § 1.6039F-1(b)(2). The proposed anti-avoidance is completely unnecessary and will only create additional traps for the unwary to incur penalties. *See infra* recommendation 11. Especially in the context of loan agreements among family members, which sometimes are handled informally, the IRS may misconstrue bone fide loans among family members

[3] *See* Form 2350 Instructions.
[4] We also recommend a similar harmonizing of filing deadlines for U.S. persons residing abroad for the FinCEN Form 114 or FBAR.

as gifts and improperly impose § 6039F reporting penalties. Hence, we recommend eliminating the proposed anti-avoidance rule.

6. Clarify the standard for reasonable cause

We recommend clarifying the reasonable cause standard under Proposed Reg. § 1.6039F-1(e)(2). As drafted the proposed regulation references the principles in §1.6664-4 and § 301.6651-1(c). First and most importantly, we recommend explicitly providing that reasonable cause be applied liberally in this context. *See* Treas. Reg. § 1.6038A-4(b)(2)(ii) (providing for liberal application of reasonable cause for "small corporations" that failed to timely file Forms 5472). We recommend that the proposed regulations include a statement such as: "The Commissioner and his delegates shall apply the reasonable cause exception liberally in all cases where the taxpayer had no knowledge of the requirements imposed by § 6039F."

Second, we recommend clarifying that the guiding principles in §1.6664-4 and § 301.6651-1(c) shall provide taxpayers maximum flexibility in showing reasonable cause. Please make clear that referencing the guiding principles is not intended to create a new, higher standard for reasonable cause in the arena of § 6039F.[5]

7. Eliminate identification of transferors

Proposed Reg. § 1.6039F-1(c)(2)(B) mandates providing identifying information relating to transferors. We recommend eliminating this proposed rule. Mandating that the U.S. recipient of a foreign gift or inheritance provide the identifying information of the transferor is unduly invasive and unnecessary. Additionally, mandating identifying information will almost certainly lead to unnecessary controversies. It is not uncommon for IRS personnel at IRS campuses to assert reporting penalties for immaterial, minor foot-faults on forms. Mandating the identifying information of the transferor will almost certainly lead to more penalty assessments during processing of Forms 3520 at IRS campuses. The IRS should focus on reducing taxpayer burden and avoiding unnecessary penalty disputes.

8. Create a form for reporting large foreign gifts and inheritances and provide warning on Schedule B

We recommend creating a standalone form with instructions for reporting large foreign gifts and inheritances with a cross-reference to that form on Schedule B, Part III in sequence with the FBAR and foreign trust questions. Historically taxpayers and the tax return preparation community have been ignorant of the requirement to report large

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[5] As a practical matter, the IRS and the Independent Office of Appeals have been applying an elevated, super-standard for reasonable cause in the context of requests to abate § 6039F penalties.

foreign gifts and inheritances on Form 3520. Foreign gift and inheritance reporting has proven to be a trap for the unwary. Innocent taxpayers who reasonably relied on uninformed tax professionals have been severely penalized by the IRS and have even been forced to litigate IRS obstinance concerning reasonable cause. *See generally Wrzesinski v. United States*, docket no. 22-cv-03568, U.S.D.C. W.D. Pen. (government conceded § 6039F penalty without filing a responsive pleading). And many taxpayers that self-prepare their income tax returns are never alerted to the requirement to report large foreign gifts and inheritances. A standalone form for reporting large foreign gifts and inheritances and a Schedule B, Part III question will enhance public awareness of § 6039F and compliance with reporting requirements.

9. Provide guidance on reporting of partial or incomplete foreign gifts under § 6039F

At times foreign gifts may consist of partial interests in property, for example property subject to usufructs. *See generally* PLR 201032021. Further, at times foreign gifts may involve transfers that are incomplete given the operation of foreign law. We recommend clarifying in the regulations how to value completed gifts of partial interests in property and whether reporting is necessary for incomplete gifts which may be undone or reversed by the foreign transferor. For example, under German law, certain gifts may be fully revoked by the transferor within a specified number of years.

10. Provide an additional example under Proposed Reg. § 1.6039F-1(g)

We appreciate the examples provided under Proposed Reg. § 1.6039F-1(g). Example 3 illustrates the reporting required when a U.S. person receives a gift from a dual resident taxpayer. We recommend an additional example relating to dual resident taxpayers. Specifically, we recommend an additional example where a dual resident taxpayer *receives* a large gift from a foreign person. We recommend including such an example to illustrate that a large gift to a dual resident taxpayer would not trigger a § 6039F reporting obligation.

11. Reform IRS penalty administration for § 6677 and § 6039F

IRS penalty administration relating to § 6677 and § 6039F is failing U.S. taxpayers.[6] We recommend that the proposed regulations take into account the IRS'

[6] For example, the high abatement rates relating to penalties assessed under § 6039F quantify the IRS' failure in penalty administration. The National Taxpayer Advocate published that the "IRS abates these penalties [§ 6039F] at rates often exceeding 50 percent… ." https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf Abatement rates often exceeding 50 percent demonstrate that the IRS is failing in its mission which includes enforcing "the law with integrity and fairness to all." I.R.M. 1.1.1.2(1). It is fundamentally unfair to inappropriately penalize taxpayers that have reasonable cause and force costly battles with the IRS for abatement or refunds of those penalties.

dismal record in penalty administration and the immense burden on innocent taxpayers resulting from systemic penalty assessments relating to Forms 3520 and Forms 3520-A. Specifically, we recommend incorporating into the regulations administrative relief including (i) mandating review of reasonable cause prior to penalty assessment and (ii) First Time Abatement for §§ 6677 and 6039F penalties.

The National Taxpayer Advocate has publicly stated that international information return (IIR) penalties disproportionately impact lower and middle-income individuals and small businesses. https://www.taxpayeradvocate.irs.gov/news/nta-blog/foreign-information-penalties-provide-taxpayers-their-rights-before-assessment/2024/05/ Further, the IRS' overall high abatement rates for IIR penalties demonstrate that IRS penalty administration has failed. Because the IRS refuses to reform its punitive practice of systemically assessing IIRs for Forms 3520 and 3520-A, we recommend that the regulations provide penalty relief. Treasury and the Associate Chief Counsel International may perceive that regulations are not the appropriate method for addressing the IRS' penalty administration. But because the IRS refuses to change its punitive practices and refuses to adopt practitioner input provided through other channels, we advocate for penalty relief within the foreign trust and foreign gift/inheritance regulations.

Both §§ 6677 and 6039F contain exceptions to penalties based on reasonable cause. Arguably, the law and norms of fundamental fairness require the IRS to consider reasonable cause before assessing penalties under these Code sections. But the IRS administratively refuses to consider reasonable cause before assessing penalties under these Code sections. We request modification of the proposed regulations to require that if a reasonable cause statement is submitted with a late Form 3520 or Form 3520-A, then the IRS must consider and analyze reasonable cause before assessing penalties.

We also recommend implementing in the regulations the administrative penalty waiver known as First Time Abatement (FTA) for all international information returns, including Forms 3520 and 3520-A, for all taxpayers (individuals, estates, business entities, etc.). The Commissioner has complete and unfettered discretion in providing for administrative relief under § 7803. We urge the Commissioner to implement FTA in the proposed regulations to encourage voluntary compliance. Practitioners have commented on the impact of the IRS' practice of systemic penalty assessment on voluntary compliance. *See* Megan Brackney, The IRS's Aggressive Enforcement of Foreign Information Return Penalties Has Created Ethical Dilemmas For Practitioners (Part 2), PROCEDURALLY TAXING (December 8, 2022). We reiterate the importance of allowing

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Some taxpayers never receive any administrative consideration of their penalty matters by the IRS and must resort to litigation to resolve penalty disputes. *See, e.g.*, Andrew Velarde, Foreign Trust Penalty Complaint Dismissed After Stipulation, TAX NOTES (Oct. 13, 2023) (discussing a Form 3520-A penalty refund suit where it appeared that the IRS never considered the penalty refund claim until after the refund suit was filed).

taxpayers the opportunity to correct benign mistakes. The IRS should allow taxpayers the opportunity to file late Forms 3520 and 3520-A without any penalties when the IRS has not initiated a civil examination or criminal investigation.

Conclusion

We encourage the IRS, Chief Counsel, and Treasury personnel working on this important project to seriously consider reducing taxpayer burden wherever possible. We encourage you to read the multitude of taxpayer comments already posted about the proposed regulations as a public plea for expanding reporting exceptions and reducing taxpayer burden. This regulation project provides a unique opportunity to take into account practitioner and the general public's comments urging broader reporting exceptions from the § 6048 foreign trust reporting regime and the § 6039F foreign gift and inheritance reporting regime.

Sincerely,

Daniel N. Price
Managing Member
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Enclosures:

1. Response to request for public comments on Forms 3520 and 3520-A (OMB Number: 1545–0159) (8 pages)
2. Roy A. Berg and Marsha-Laine Dungog, U.S. Income Tax Treatment of Australian Superannuation Funds, TAX NOTES INT'L, October 10, 2016 (35 pages)
3. Marsha-Laine Dungog and Jennifer S. Silvius, Bringing Home the (Canadian) Bacon: U.S. Tax and Canadian Retirement Plans, TAX NOTES, October 17, 2022 (58 pages)

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February 9, 2023

Internal Revenue Service
Attn.: Andres Garcia
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VIA EMAIL TO pra.comments@irs.gov

RE: Response to request for public comments on Forms 3520 and 3520-A
OMB Number: 1545–0159

Dear Mr. Garcia and Other IRS and Chief Counsel Personnel:

We appreciate the opportunity to provide comments pursuant to the IRS' request for comments on Forms 3520 and 3520-A published in the Federal Register on December 16, 2022.

Overview

The request for public comments concerning Forms 3520 and 3520-A invites public comments on the following:

(a) whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;
(b) the accuracy of the agency's estimate of the burden of the collection of information;
(c) ways to enhance the quality, utility, and clarity of the information to be collected;
(d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology; and
(e) estimates of capital or start-up costs and costs of operation,

We provide comments on some of the categories listed above and also provide certain broader recommendations relating to Forms 3520 and 3520-A and administrative relief from reporting under Rev. Proc. 2020-17.

Comments

We first address two categories mentioned in the request for public comment: the accuracy of the agency's burden estimate for the collection of information on these forms and ways to enhance the quality, utility, and clarity of the information to be collected.

Burden estimate is materially understated

First, concerning the agency's burden estimate, the IRS' estimate is materially understated and contradicts publicly available data. The IRS' estimate published in the Federal Register indicates only 1,820 annual responses for Forms 3520 and 3520-A. That estimate is grossly understated and appears to be a carryover from earlier burden estimates which are publicly available and accessible at www.reginfo.gov. The IRS' supporting paperwork for the last OMB review submitted December 2019 contained that figure calculated as follows:

Authority	Description	# of Respondents	# Responses per Respondent	Annual Responses	Hours per Response	Total Burden
IRC § 671-679	Form 3520	2,000	.66	1,320	54.35	71,742
IRC § 6048(b)	Form 3520-A	500	1	500	45.59	22,795
Totals		2,500		1,820		94,537

The prior December 2016 OMB recertifications submitted the exact same data separately for the two forms (a separate OMB number previously covered Form 3520-A).

Publicly available data shows 27,431 Forms 3520 were filed in 2012. See TIGTA report "A Service-Wide Strategy Is Needed to Increase Business Tax Return Electronic Filing," September 24, 2014. See also "SOI Tax Stats - Foreign Trusts" at https://www.irs.gov/statistics/soi-tax-stats-foreign-trusts (providing some historical data including that in 2014 14,100 Forms 3520-A were filed). The extremely low estimate the IRS provided in the Federal Register for the current OMB recertification appears to be a clerical holdover from the IRS' prior OMB recertification of these forms submitted in 2019 and earlier.

Over the last decade, awareness of Forms 3520 and 3520-A has grown exponentially. A decade after the 2012 statistics in the TIGTA report, we estimate that the actual number of annual filers (respondents) of Form 3520 for tax year 2022 is probably closer to 60,000 or nearly double the 2014 statistic; we also estimate that Form 3520-A filings for tax year 2022 materially exceeds the reported 2014 data on the IRS' "SOI Tax Stats - Foreign Trusts" website.

Furthermore, the IRS' burden estimate for Form 3520 does not take into account reporting of large foreign gifts and inheritances mandated by I.R.C. § 6039F. It is clear that I.R.C. § 6039F was not included in the burden estimate because there is no mention of it in the abstract published in the Federal Register. Additionally, the burden estimates from prior submissions to OMB omit I.R.C. § 6039F. Since reporting of large foreign gifts and inheritances is much simpler than the reporting relating to foreign trusts, we recommend a separate burden estimate for the number of Forms 3520 filed solely to report large foreign gifts and inheritances. The IRS may have difficultly ascertaining the number of Forms 3520 used solely to report large foreign gifts and inheritances, and that is another reason for adopting the suggestion of creating a new, separate form to report large foreign gifts and inheritances addressed infra.

By materially understating the number of respondents, the IRS is materially understating the overall compliance burden associated with these forms. The IRS has easily accessible data in its possession and should analyze actual filing data for these forms in order to provide more accurate burden estimates to OMB. We urge the IRS to reference the most recent actual filing data in preparing burden estimates.

<u>Enhancements to quality, utility, and clarity are possible</u>

Second, we recommend that the IRS enhance the quality, utility, and clarity of the information to be collected on these forms. Form 3520 has a split personality, and we propose developing a separate form for reporting large foreign gifts and inheritances. Further, the IRS has not done enough to educate the general public and tax professionals about the requirements to report large foreign gifts and inheritances on Form 3520. Buried on page 87 of the 2022 Form 1040 instructions is a small mention of foreign gift and inheritance reporting. The 2022 Form 1040 instructions state:

> However, if you received a gift or bequest from a foreign person (including amounts from foreign corporations and foreign partnerships that you treated as gifts) totaling more than $17,339, you may have to report information about it on Form 3520, Part IV.

We recommend that the IRS create a separate form for reporting large foreign gifts and inheritances along with instructions that clearly educate the public. The IRS should include in Form 1040 instructions the actual current reporting thresholds for foreign gifts and inheritances from a nonresident alien individual or a foreign estate ($100,000) and do more to educate the public and tax professionals about the reporting requirements and penalties associated with large foreign gifts and inheritances. Additionally, we strongly recommend that the $100,000 threshold be increased to take into account inflation over the last two decades. Such an increase does not require statutory amendment. Notice 97-34 increased reporting large foreign gifts and inheritances from $10,000 to $100,000, and we recommend an increase in reporting to $500,000 through a similar notice or other agency guidance.

Most importantly, the IRS should add a checkbox to Form 1040 asking taxpayers whether they received any gifts and inheritances from sources outside of the United States. If the answer is "yes" then, the Form 1040 should direct taxpayers to the appropriate form and instructions. This suggestion naturally flows with the current Form 1040, Schedule B questions concerning foreign bank accounts and foreign trusts.

Further, we recommend that the IRS make clear to the public and tax professionals that the IRS systemically assesses maximum penalties for late and amended Forms 3520 and 3520-A. We request more transparency from the IRS about its penalty procedures and campus practices including the practice of assessing systemic penalties at maximum rates; we also urge more transparency on how IRS personnel at the Ogden Campus handle penalty assessments and requests for abatement. We also posit that systemic penalty assessments without considering reasonable cause runs contrary to the IRS' penalty policy by forcing taxpayers to engage professionals and take their penalty disputes to the Independent Office of Appeals. The IRS' Policy Statement P-20-1 addresses macro-level penalty policy and notes:

> The Service will demonstrate the fairness of the tax system to all taxpayers by:
>
> A. Providing every taxpayer against whom the Service proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply;
> B. Giving full and fair consideration to evidence in favor of not imposing the penalty, even after the Service's initial consideration supports imposition of a penalty; and
> C. Determining penalties when a full and fair consideration of the facts and the law support doing so.

IRM 1.2.1.12.1(9).

Because Ogden Campus personnel are making penalty assessments, that IRS unit needs the capability of correcting errors and considering reasonable cause in order to comply with Policy Statement P-20-1. Otherwise, the IRS is not "giving full and fair consideration to evidence in favor of not imposing the penalty." Further, when the Ogden Campus assesses systemic penalties at maximum rates and ignores reasonable cause statements submitted with late submissions, it fails to fully and fairly consider the facts and law. For example, many practitioners have submitted detailed reasonable cause statements attached to late Forms 3520 and 3520-A. In general, Ogden Campus personnel do not consider reasonable cause statements, even in cases where the facts present "textbook" reasonable cause cases where the failure to timely submit Forms 3520 and 3520-A arise from reasonable reliance on professionals.

We urge the IRS to add Forms 3520 and 3520-A to the list of forms eligible for First Time Abatement (FTA) relief. John Hinding, Director, Specialized Examination Programs & Referrals, wrote a memo dated December 7, 2022 to employees of the Independent Office of Appeals extending FTA to systemic Form 5471 and Form 5472 penalties; at this time, it appears that only business return filers are subject to systemic penalties relating to Forms 5471 and 5472. Mr. Hinding's memo is welcome news to the tax community and business filers that may be contesting systemic penalties relating to Forms 5471 and 5472. But many practitioners have expressed dismay over not including Forms 3520 and 3520 in that memo. The lack of inclusion of Forms 3520 and 3520-A ignores the many individual taxpayers contesting penalties relating to those forms, all the while business taxpayers are afforded FTA for other international information returns. It seems unfair to offer FTA to more sophisticated business taxpayers while not providing FTA to individual taxpayers. We urge an expansion of FTA to the systemic penalties imposed on Forms 3520 and 3520-A.

We strongly recommend that the IRS create a safe harbor for late filing of Forms 3520 and 3520-A where taxpayers are not under civil examination or criminal investigation and where the IRS has not already received specific information concerning the non-filing of an international information return. Conceptually, this safe harbor proposal for late filings of Forms 3520 and 3520-A could be likened to the penalty protections afforded qualified amended returns. See Treas. Reg. § 1.6664-2(c)(3). Such a safe harbor is needed because the Ogden Campus assesses maximum penalties for late and amended Forms 3520 and 3520-A without regard to the underlying facts, including reasonable cause. The Ogden Campus' procedures not only run contrary to the IRS' macro-level penalty policy but the procedures create a strong disincentive for voluntary compliance.

The strong disincentive for voluntary compliance is obvious; simply assessing maximum penalties without regard to the facts is prompting many taxpayers to elect prospective compliance rather than self-correcting past mistakes. The IRS' penalty policy begins with: "Penalties are used to enhance voluntary compliance." IRM 1.2.1.12.1(1). In the context of Form 3520 and Form 3520-A reporting, systemic penalties are actually working against voluntary compliance by creating a disincentive to self-correct past reporting mistakes. The IRS's policy of systemic penalty assessment also creates ethical issues for practitioners who counsel taxpayers on compliance matters. See Megan Brackney, The IRS's Aggressive Enforcement of Foreign Information Return Penalties Has Created Ethical Dilemmas For Practitioners (Part 2), PROCEDURALLY TAXING

(December 8, 2022) https://procedurallytaxing.com/the-irss-aggressive-enforcement-of-foreign-information-return-penalties-has-created-ethical-dilemmas-for-practitioners-part-2/.

Furthermore, the IRS may not be aware of the strong disincentive for tax professionals, specifically smaller CPA firms, to handle compliance matters relating to Forms 3520 and 3520-A because of the Ogden Campus' practice of systemic penalty assessment. Some tax professionals are no longer preparing Forms 3520 and 3520-A because of the IRS' strict liability for any and all perceived mistakes, foot faults, errors, and tardiness. The IRS' current practice of systemically assessing maximum penalties regardless of underlying facts is creating too much risk for some tax professionals especially smaller CPA firms. In many cases involving penalties assessed by the Ogden Campus, penalties far exceed malpractice insurance coverage. This is driving some CPA firms to eliminate handling Forms 3520 and 3520-A as part of their tax practices.

Broader Recommendations

Our broader recommendations focus on two main points: (1) issuing regulations or under I.R.C. § 6039F other administrative guidance to exempt certain spousal transfers from reporting and (2) providing greater administrative relief from Form 3520 and 3520-A reporting and more guidance on reporting.

Spousal Transfers

Many U.S. persons are married to non-resident aliens (NRAs). In such marriages between U.S. persons and NRAs, routine property transfers and gifts from the NRA spouse to the U.S. person spouse trigger reporting under § 6039F. It is our understanding that the IRS has generally taken the position that even transfers between spouses that under local law may be characterized as spousal support are subject to Form 3520 part IV reporting as gifts. We recommend excluding transfers from an NRA spouse to a U.S. person spouse from reporting.

Greater Administrative Relief and Guidance

We praise the IRS for the administrative relief from reporting under Rev. Proc. 2020-17. Nonetheless, we request more guidance and explicit exceptions to I.R.C. § 6048 reporting for foreign pensions and pension-type arrangements in Treasury Regulations. See, e.g., Roy A. Berg and Marsha-Laine Dungog, U.S. Income Tax Treatment of Australian Superannuation Funds, TAX NOTES INT'L, October 10, 2016 (among other things requesting that the regulations under § 6048 be amended to clarify that Australian superannuation arrangements be excluded from reporting on Forms 3520 and 3520-A). There are many gray areas relating to when foreign pensions and pension-type arrangements may or may not be reportable as foreign trusts. We recommend more guidance from the IRS on those issues, and we recommend broader administrative relief from reporting beyond Rev. Proc. 2020-17. Specifically, we recommend raising the thresholds in Rev. Proc. 2020-17 § 5.03(4) to an annual limit of $200,000 or less and a lifetime limit of $3,000,000 or less. The current limits in Rev. Proc. 2020-17 exclude too many taxpayers from the relief provided thereby creating expensive compliance burdens and traps for the unwary. Also, higher limits would also take into account potential future currency fluctuations in the event the U.S. dollar materially weakens.

The following facts are based on real life examples illustrating the need for increasing the limits provided in Rev. Proc. 2020-17:

> Mr. Smith, a UK citizen, retired a few years ago. During his working years, he had a modest pension with his employer and later moved the employer-managed pension into a self-invested personal pension (SIPP) in the UK. The balance in his SIPP is about $750,000 US, and Mr. Smith fits squarely within the definition of "middle class." Mr. Smith manages the investments in his SIPP. The U.K. SIPP just barely exceeds the limits provided for in IRS Rev. Proc. 2020-17 to avoid reporting the SIPP as a foreign trust under IRC sec. 6048. The UK sets lifetime limits for contributing to SIPPs at £1,073,100.
>
> Upon retiring, Mr. Smith began volunteering his time with a U.S. non-profit. The non-profit asked him to temporarily move to the U.S. to assist with projects. Mr. Smith arrived in the U.S. and the temporary move lasted longer than he anticipated. Mr. Smith became a U.S. person in 2018 as a result of the substantial presence test. Mr. Smith is eligible to take distributions from his SIPP based on his age, and he has taken some distributions in each year while in the U.S. for living expenses while volunteering with the non-profit.
>
> In 2018, 2019, and 2020, Mr. Smith used what he thought was a qualified and competent tax return preparer to file his Forms 1040. Mr. Smith's return preparer reported the SIPP on Forms 8938 and on FBARs but failed to identify the SIPP as a foreign grantor trust and failed to file Forms 3520 and 3520-A for Mr. Smith. Mr. Smith has not been contacted by the IRS about his filings.
>
> Mr. Smith engaged new tax professionals for in 2022 for the preparation of his 2021 income tax return, and his new professionals identified the foreign trust reporting issue relating to his U.K. SIPP.

In the vignette above, the taxpayer Mr. Smith made honest efforts to report his SIPP to the IRS and FinCEN by reporting it on Forms 8938 and on FBARs, and he relied on his tax professional to advise him of required reporting. Although of modest means, Mr. Smith does not qualify for relief under Rev. Proc. 2020-17. Since UK pension plans are covered under the U.S.-U.K. income tax treaty exempting the earnings from current U.S. taxation, Mr. Smith had no tax noncompliance.

Mr. Smith's prior reporting predicament requires choosing between two main options: (i) filing delinquent Forms 3520 and 3520-A and facing substantial systemic penalties or (ii) prospective compliance. If Mr. Smith were to file delinquent Forms 3520 and 3520-A he would face a nightmare of IRS administrative action involving penalty assessments, likely collection action leading to Collection Due Process proceedings, and a very lengthy process of requesting abatement of the penalties. Allowing Mr. Smith to file past due Forms 3520 and 3520-A without systemic penalties would demonstrate "the fairness of the tax system to compliant taxpayers." Penalty Policy 20-1 at IRM 1.2.1.12.1(3). Alternately, administrative relief by increasing the thresholds provided in Rev. Proc. 2020-17 would benefit taxpayers like Mr. Smith. We urge the IRS to consider the real world effects of its current policies and its penalty procedures at the Ogden Campus.

In conclusion, in relation to Forms 3520 and 3520-A we urge the IRS to revise the burden estimates for these forms, we urge the IRS to enhance the collection of information on these forms by creating a new form for reporting large foreign gifts and inheritances, and we urge the IRS to consider real life examples in providing broader relief to taxpayers.

Sincerely,

Daniel N. Price
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cc (via email):
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U.S. Income Tax Treatment of Australian Superannuation Funds

by Roy A. Berg and Marsha-laine Dungog

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SPECIAL REPORT

U.S. Income Tax Treatment of Australian Superannuation Funds

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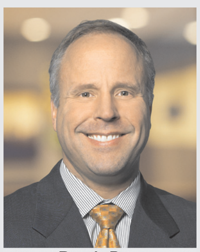

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In this article, the authors identify the U.S. federal income tax reporting and compliance uncertainties that U.S. citizens in Australia face regarding contributions and income accretions in Australian superannuation funds. Noting that those uncertainties arise from tax law incongruities not addressed in the Australia-U.S. treaty or the Australia-U.S. Social Security totalization agreement, the authors recommend that Treasury and the IRS issue clarifying guidance.

I. Summary

The U.S. tax consequences to U.S. participants in foreign social security programs generally mirror the consequences to participants in U.S. Social Security programs: Contributions and accretions are not taxed, but distributions are. When inconsistencies arise, income tax conventions and social security totalization agreements (SSTAs) generally resolve them. However, under U.S. law, when the foreign social security program is fundamentally different from the U.S. program (as is the case for Australia), the older income tax conventions and SSTAs to do not resolve the adverse U.S. tax consequences for affected individuals. This report analyzes those differences in the context of Australia's social security program and suggests ways to resolve them.

Over the past several years, the United States has considered and rejected numerous proposals to modify its Social Security programs.[1] Current Social Security programs bear the following hallmarks that are important to the analysis that follows: First, payment into the system is mandatory for all who are employed or self-employed. Second, a participant's benefits are unfunded and unsecured: They are simply a nonbinding promise by the state to pay some amount (which is subject to change) at some time (also subject to change) in the future.[2] Third, because a participant's ultimate benefit under the program is unfunded and

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[1]Congressional Budget Office, ''Social Security Privatization Experiences Abroad'' (Jan. 1999); Joint Committee on Taxation, ''Analysis of Issues Relating to Social Security Individual Private Accounts,'' JCX-14-99 (Mar. 15, 1999). *See also* Gregory N. Filosa, ''International Pension Reform: Lessons for the United States,'' 19 *Temp. Int'l & Comp. L.J.* 133 (2005).

[2]Federal courts have held that an individual claimant acquires no vested rights in gratuity-type benefits paid by the federal government to a veteran or his dependent. *See* Elmer F. Wollenberg, ''Vested Rights in Social-Security Benefits,'' 37 *Ore. L. Rev.* 360,

(Footnote continued on next page.)

unsecured, she can expect to receive her benefit (whatever that may be) whenever U.S. law entitles her to receive it. In sum, the programs are mandatory, publicly administered, unfunded, and unsecured.

Although the social security programs of many countries remain unfunded and unsecured, in the past two decades approximately 32 countries have modified their programs to provide that the mandatory withholding is deposited into a state-regulated account over which the participant has at least some investment control.[3] Australia and eight other OECD members have modified their social insurance programs in that manner.[4] In sum, those social insurance programs are mandatory, publicly regulated (although not publicly administered as in the United States), funded, and secured.

While there are many differences between the U.S. and Australian social security programs, our report focuses on the U.S. tax differences that result from the unfunded and unsecured nature of the U.S. Social Security program and the funded and secured nature of the Australian superannuation program. It identifies the overlaps and gaps between the Australia-U.S. income tax treaty[5] and SSTA[6] regarding the Australian superannuation fund[7] and provides recommendations for Treasury and the IRS to issue clarifying guidance to affected parties.[8]

304 (1957-1958); *United States v. Teller*, 107 U.S. 64, 68 (1982); and *United States v. Cook*, 257 U.S. 523, 527 (1922).

[3]Barbara E. Kritzer, ''Individual Accounts in Other Countries,'' 66 *Social Security Bull*. No. 1 (2005). The countries referenced in the bulletin include Argentina, Australia, Bolivia, Bulgaria, Chile, China, Colombia, Costa Rica, Croatia, Denmark, the Dominican Republic, El Salvador, Estonia, Hong Kong, Hungary, Italy, Kazakhstan, Kosovo, Kyrgyzstan, Latvia, Mexico, Mongolia, Nigeria, Peru, Poland, Russia, Singapore, Slovakia, Sweden, the United Kingdom, and Uruguay.

[4]The OECD member countries are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The Commission of the European Communities takes part in the work of the OECD.

[5]Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, U.S.-Australia, Aug. 6, 1982, 35 U.S.T. 1999 [hereinafter ''the tax treaty''], *as amended by* the Protocol signed on Sept. 27, 2001.

[6]Agreement between the Government of the United States of America and the Government of Australia on Social Security (Canberra, Sept. 21, 2001) (totalization agreement).

[7]*See* subsection 295-95(2) of the Australia Income Tax Assessment Act of 1997; *see also* T.R. 2008/D5 (June 4, 2008).

[8]The scope of this report is limited to identifying the U.S. income tax consequences of contributions, accretions, and distributions from an Australian superannuation fund to U.S. citizens and residents of Australia under current U.S. tax laws. It is not

(Footnote continued in next column.)

There is considerable U.S. tax uncertainty for individuals subject to both programs regarding contributions to their Australian superannuation, accretions therein, and distributions therefrom. Income tax conventions and SSTAs between the United States and other foreign countries[9] endeavor to eliminate double taxation and harmonize the qualification of individuals for benefits of both systems. However, the evolutionary patchwork of those efforts, combined with a similar patchwork of U.S. domestic law, creates a body of law that can be nearly impenetrable in its complexity and at best results in uncertain tax liability for the taxpayer, tax entitlement for the sovereign, and withholding requirements for the employer.

When analyzing the U.S. tax consequences of state-mandated social insurance programs, it is tempting to classify them as deferred compensation arrangements and analyze them with the broad brush of section 83 (property transferred in connection with performance of services), sections 401 through 436 (deferred compensation, and so forth), and sections 3101 through 3128 (FICA). However, we believe to do so (without our recommendations) would be to overlook the purpose of the SSTAs and income tax conventions. Instead, those programs should be analyzed in a manner consistent with their true nature: the equivalent to U.S. Social Security.

While we focus on Australian superannuation law, our analysis applies equally to all countries whose state-mandated social insurance programs are covered by an SSTA, regardless of the similarity or difference between those programs and U.S. Social Security.

To harmonize the U.S. tax treatment of the Australian superannuation fund (and all social insurance programs subject to an SSTA) with the U.S. tax treatment of U.S. Social Security tax, we suggest that:

1) regulations under section 402(b) should be amended to clarify that arrangements subject to an SSTA are excluded from the statute;

2) regulations under section 83 should be amended to clarify that arrangements to an SSTA are excluded from the statute;

3) 31 C.F.R. section 1010.350(c)(4) should be amended to clarify that arrangements subject to an SSTA are excluded from reporting on Financial Crimes Enforcement Network Form 114, ''Report of Foreign Bank and Financial Accounts'' (formerly TD F 90-22.1, commonly referred to as the foreign bank account report);

4) regulations under section 6048 should be amended to clarify that arrangements subject to

intended to provide a comprehensive analysis of the U.S. tax treatment of Australian superannuation schemes.

[9]The Mexico-U.S. agreement on social security was executed on June 29, 2004, but has not yet gone into effect.

an SSTA are exempt from reporting on Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,'' and Form 3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner'';

5) regulations under section 3111 should be amended to clarify that accretions of benefits under social insurance programs subject to an SSTA are excluded from an individual's income in a manner similar to the exclusion of income in section 3111(c);[10]

6) reg. section 1.1298-1T(b)(3)(ii) should be amended to clarify that passive foreign investment companies owned by an arrangement subject to an SSTA are exempt from reporting on Form 8621, ''Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund''; and

7) if the foregoing suggestions cannot be adopted, the regulations under sections 901 and 960 should be amended to allow a taxpayer beneficiary of a superannuation fund a direct or indirect foreign tax credit for the Australian taxes he paid.

We believe Treasury and the IRS could implement our suggestions in a general legal advice memorandum or memorandum of understanding between the competent authorities.[11] Doing so would give Treasury time to make the recommended changes to the regulations while providing affected U.S. persons (USP) certainty of their tax and reporting positions without the fear of civil and criminal action for failing to file the aforementioned forms.

Several areas of the code and Treasury regulations already exempt social insurance programs of foreign governments from reporting obligations or taxation.

First, the preamble to the regulations under section 6038D[12] provides that an interest in social security, social insurance, or similar program of a foreign government is not considered a specified foreign financial asset and is therefore not reportable on Form 8938, ''Statement of Specified Foreign Financial Assets.''

Further, the preamble also contains a hyperlink to a chart that compares Form 8938 filing requirements with those required by FinCEN Form 114.[13] That chart indicates that social security program benefits provided by foreign government accounts are not reportable on either the FBAR or Form 8938, although, as noted in the third suggestion above, the regulations do not reflect that conclusion.

Second, reg. section 1.1298-1T(b)(3)(ii) provides that PFICs directly or indirectly held by trusts exempt from taxation as foreign pension funds exempt from tax under an income tax treaty are likewise exempt from reporting on Form 8621.

Third, reg. section 301.6114-1(c)(1)(vii) provides that filing of Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b),'' is not required to invoke the benefits of an SSTA.

Fourth, reg. section 1.409A-1(a)(3)(iv) provides that arrangements subject to an SSTA are exempt from the application of section 409A.

Fifth, section 3111(c) exempts wages paid by employers from the tax imposed by that section when an SSTA is in place.

II. Discussion

A. Reasons for Suggested Changes

Pension reform has been an active topic of discussion in nearly all OECD countries for more than a decade. The OECD published its first comprehensive survey of pensions across the 34 member countries in 2005.[14] In that survey, the OECD separated each member country's national retirement system into three tiers and analyzed the differences across them.

First-tier pensions in a country's pension scheme are mandatory programs designed to ensure that pensioners are provided some absolute, minimum standard of living. Second-tier pensions comprise mandatory earnings-based programs designed to achieve a targeted standard of living compared with the standard of living experienced while the individual was working. Third-tier pensions are voluntary programs designed to encourage savings for retirement.

This report focuses on second-tier pensions; specifically, the U.S. tax classification of Australia's second-tier pension (the superannuation guarantee or SG).

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[10]Section 3111(c) provides: ''During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement exclusively to the laws applicable to the social security system of such foreign country.''

[11]Although several of the cited statutes do not delegate legislative rulemaking authority to Treasury, we believe the recommended clarifications are within the IRS's authority to enact interpretative regulations, subject to the notice and comment requirements of the Administrative Procedure Act, 5 U.S.C. section 553.

[12]T.D. 9706.

[13]*See* http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.

[14]OECD, ''Pensions at a Glance 2005'' (2005). *See also* OECD, ''Pensions at a Glance 2013: OECD and G20 Indicators'' (2013).

The second-tier pension scheme in the United States is publicly administered by the IRS and the Social Security Administration as an unfunded and unsecured promise to pay an undeterminable amount in the future. That is similar to the second-tier pension schemes in most OECD countries. In contrast, the second-tier pension schemes in Australia, Chile, Estonia, Israel, Mexico, Norway, the Slovak Republic, Sweden, and Russia (not an OECD member) are generally privately administered as funded and secured plans. Because social security benefits for second-tier pensions in those countries are funded, there is near certainty that adequate contributions will be made.

The United States uses two types of international agreements to coordinate various aspects of its Social Security program: the U.S. model treaty and the SSTA. Coordination between the SSTA and the U.S. model treaty is addressed either exclusively through an executive agreement or in a treaty, or simultaneously in both. That bifurcated approach results in a legal patchwork that is sometimes overlapping, sometimes fails to address important areas, and is always complex for all stakeholders to administer and comply with.[15] As mentioned, the overlap between the Australia-U.S. tax treaty and the totalization agreement comes into sharp focus in the case of the Australian superannuation fund.

As a preliminary matter, we recognize that use of the term ''superannuation fund'' to describe the various forms of superannuation schemes in Australia is most likely a misnomer. Honorable Justice Graham Hill of the Federal Court of Australia has acknowledged that the term mistakenly suggests that every superannuation scheme is actually a fund.[16] He elaborated that this impression is untrue because most superannuation schemes in Australia ''are constituted by trust deeds, and in consequence they may be properly characterized as funds in which a member might be said to have an interest (using the word 'interest' in a non technical sense).''[17]

There is much diversity in superannuation schemes in Australia. However, for purposes of this report, we have intentionally opted to use the term ''superannuation fund'' as a generic reference for all types of superannuation schemes, which include many different types of superannuation funds. Consequently, we use the terms ''Super'' or ''Australian superannuation fund'' in the same way as the Australian tax legislation, to refer to a specific type of superannuation fund, which is a regulated fund that (1) is or was established in Australia or has any asset situated in Australia; (2) has central management and control of funds ordinarily in Australia; and (3) either has no active members, or at least 50 percent of the total market value of the fund's assets attributable to superannuation interests are held by active members who are residents of Australia.[18]

The Super is a taxpayer-specific government-mandated fund for all Australian workers, which aggregates contributions from three sources: mandatory employer contributions under the SG; concessional employee pretax contributions (the voluntary employee contribution or VEC); and non-concessional employee post-tax contributions (the after-tax contributions). However, the problem with the Super is that the tax treaty and totalization agreement do not clearly address the U.S. tax consequences of contributions to, accretions in, and distributions from a Super to a USP who is a member and beneficiary or to an Australian who is working in the U.S. and required to file a U.S. income tax return.

The pension-relevant provisions of the tax treaty under article 18 have not been significantly updated since it was ratified in 1983, despite the protocol, which was signed in 2001. Consequently, it insufficiently addresses the taxation of contributions, accrued income, and distributions from a Super (implemented under the Superannuation Industry Supervision Act of 1993).

Article 18(1) of the tax treaty provides that pensions and other similar remuneration paid to a resident of Australia in consideration for past employment shall be taxable only in Australia. The term ''pensions and other similar remuneration'' under article 18(4) covers periodic payments made on retirement or death, in consideration for services rendered in connection with past employment.

Hence, one could maintain that payments from the Super would constitute distributions from a foreign pension subject to tax in Australia and not the United States. That position must be considered in light of article 1(3), under which the United States reserves its right to tax U.S. citizens on a worldwide basis as if the tax treaty were not in force (the saving clause). The saving clause does not apply to social security (as defined in the tax treaty) received by a U.S. citizen resident in Australia.[19]

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[15] Allison Christians, ''Taxing the Global Worker: Three Spheres of International Social Security Coordination,'' 26 *Va. Tax Rev*. 81, 84-85 (2006).

[16] *See* Hon. Justice Graham Hill, ''The True Nature of a Member's Interest in a Superannuation Fund,'' 5 *J. Austl. Tax'n* 1 (2002).

[17] *Id.* at 2.

[18] *See generally* Australian Tax Office, ''Income Tax: Meaning of 'Australian Superannuation Fund' in Subsection 295-95 of the Income Tax Assessment Act of 1997,'' TR 2008/9 (Dec. 2, 2008). The alternative test is that at least 50 percent of the amounts that would be payable to or for active members if they voluntarily ceased to be members is attributable to superannuation interests held by active members who are Australian residents. *See* Income Tax Assessment Act 1997, section 295-95(2)(c)(ii).

[19] *See* treaty article 1(4)(a).

The result could be that a USP who is a resident of Australia and a member and beneficiary of a Super (USP employee-beneficiary) is subject to tax in Australia and the United States on income from wages deemed constructively received from (1) SG contributions and VECs to the Super and (2) income accrued to the Super.[20] Alternatively, if the payments from the Super were classified as social security benefits, it is logical to conclude that contributions to and accretions in the Super should likewise be exempt from U.S. tax because the United States has ceded its ability to tax social security payments under article 18(2) of the tax treaty.

If analyzed under domestic U.S. tax law (without our recommended changes), contributions and accrued income in a Super would constitute part of a USP employee-beneficiary's worldwide income subject to U.S. tax while those amounts are also taxable in Australia. The basis for taxation arises because the Super represents an ''accession to wealth''[21] for the USP employee-beneficiary if the Super is classified as either a section 402(b) nonqualified retirement plan, an employee grantor trust under reg. section 1.402(b)-1(b)(6), or a foreign grantor trust under sections 671 through 679.

If the Super were analyzed as a section 402(b) plan, contributions — and in some circumstances, income accrued to the Super — would likely be subject to current income taxes, thereby resulting in substantial income tax liabilities for the USP employee-beneficiary (directly under section 402(b) or alternatively as an employee grantor trust under reg. section 1.402(b)-1(b)(6)), with no treaty relief available.

If, alternatively, the Super is treated as a foreign grantor trust under sections 671 through 679, all realized income and gains in the Super arising from superannuation assets would be attributed to the USP employee-beneficiary, resulting in income taxes and likely PFIC reporting obligations from investments held by the Super.[22] Although that option arguably results in lower current taxation to the USP employee-beneficiary up front, it effectively creates an ongoing burden in the form of more professional fees for the USP employee-beneficiary to fully comply with the complex U.S. tax reporting obligations.

We propose that if the USP employee-beneficiary of a Super ends up being double taxed by the application of section 402(b), Treasury and the IRS at the very least permit the USP to claim FTCs for Australian taxes paid by the Super under section 901 or 960 to alleviate the tax burdens incurred by the USP employee-beneficiary. If, alternatively, the USP employee-beneficiary were subject to double taxation (which could result if the Super is treated as a foreign grantor trust), we request that Treasury and the IRS clarify that the foreign taxes paid by the Super in Australia on contributions to it, and accretions on those amounts in the Super, also be creditable against U.S. income taxes of the USP employee-beneficiary.

In contrast to those two positions, we believe that SG contributions to a Super, as well as accruals and distributions therefrom, should not be analyzed as a nonexempt employees' trust, which would otherwise be subject to sections 83, 401(a), 402(b), and the like, but as consistent with the Super's true nature as a social security program.

We propose that the Super's classification relative to the SG be analyzed consistently with (and therefore be taxed similarly to) U.S. Social Security. As such, the SG contributions would fall outside the scope of section 402(b) because they do not arise from the employer-employee relationship but instead from Australia's taxing authority. Therefore, SG contributions, accruals, and distributions therefrom should not be classified as amounts transferred to the USP employee-beneficiary ''in consideration for the performance of services,'' and consequently, section 83 should not apply.

Even if section 402(b) were to apply to both the SG and employee components of the Super, which we do not believe is the correct conclusion, we maintain that contributions and accruals on a Super before distributions should be excluded from U.S. taxation as would be the case if the tax treaty were revised to incorporate article 18 of the 2006 and 2016 U.S. model treaties.

Article 18(2) and 18(4) of the 2006 model treaty and article 18(3) of the 2016 model treaty apply when the individual is a U.S. citizen and resident of the host country. They provide that contributions attributable to employment paid by or for the individual during the employment period to a pension fund are deductible or excludable in computing the individual's U.S. tax. Further, any accrued pension benefits or employer contributions attributable to employment made by the USP employer are not treated as taxable to the individual in the United States.[23] Those articles are excepted from the saving clause of both U.S. model treaties.

We also posit that the Super does not constitute a foreign grantor trust under sections 671 through 679 primarily because the USP employee-beneficiary in a Super is neither the grantor nor trustee of the Super and would not possess any discretionary powers and

[20]Under article 18 of the tax treaty, mandatory distributions from the Super that begin at the pension phase are subject to tax only in the United States and generally not in Australia.

[21]*See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[22]*See, e.g.*, reg. section 1.402(b)-1(b)(6).

[23]*See* JCT, ''Comparison of the United States Model Income Tax Convention of September 20, 1996, with the United States Model Income Tax Convention of November 15, 2006,'' JCX-27-07, at 23-24 (May 8, 2007).

control over the Super under Australian law. Consequently, Australian social security benefits attributable to Super contributions, accruals, and distributions should be treated as foreign social security benefits. Further, because foreign social security payments are already excluded from U.S. taxation under article 18(2) of the Australia-U.S. tax treaty, we recommend that the same exclusion apply to social security contributions and accruals (before distribution), which could be clarified with an MOU between the competent authorities.

B. Background

1. U.S. and Australian Pension Systems

The lack of guidance on the tax classification and treatment of Supers presents an opportunity to propose a new framework for understanding from a U.S. tax perspective what a Super is, what it is supposed to achieve for Australians, how it operates, and whether it has any similarities to retirement vehicles in the United States. Addressing those questions requires a fundamental understanding of the prevailing retirement systems in Australia and the United States.

As noted in a 2015 OECD report,[24] both the United States and Australia have three-tiered retirement systems that consist of (1) a government pension system, (2) an occupational employment-based pension system, and (3) supplemental voluntary personal savings.[25] The first tier is a public pension, while the second and third tiers typically take the form of private pensions — namely, individual retirement savings accounts in the nature of funded and secured plans.[26] In a funded and secured plan, ''the employer typically contributes a specified percentage of the worker's compensation to an individual investment account for the worker. . . . Her benefit at retirement would be based on all such contributions plus investment earnings.''[27] In contrast, benefits under an unfunded and unsecured plan may be calculated under many different methods, and distributions are typically in the form of an annuity, lump sum, or a combination of both.[28]

Some observers have noted that to be eligible for adequate retirement income from those funded and secured plans:

> Employees need to ensure that significant contributions are made to those plans (the contribution phase), that those contributions are invested well and retained until retirement (the accumulation phase), and that the accumulated retirement savings are used to provide benefits throughout retirement (the pension phase).[29]

a. United States. The U.S. retirement system consists of a universal Social Security system, a voluntary occupational pension system, and supplemental voluntary savings.[30]

The primary U.S. Social Security program is the Old Age, Survivors, and Disability Insurance program, which provides monthly benefits to retirees, their dependents, and survivors, as well as to disabled workers and their dependents.[31] An employee contributes to these programs by working in employment covered by social security and paying the applicable payroll taxes. At retirement, disability, or death, monthly Social Security benefits are paid to insured employees and their dependents or survivors.[32] The amount of benefits may be adjusted for various reasons. The primary source of funding for Social Security benefits is federal payroll taxes imposed on an employer and its employees as well as on the self-employed.[33] The taxes are deposited in two separate trust funds: the Federal Old-Age and Survivors Insurance trust fund and the Federal Disability Insurance trust fund, which are financial accounts at the U.S. Treasury.[34] Money received by the trust funds can be used only to pay benefits and operating expenses of the Social Security program. Funds not currently needed for those purposes are invested in interest-bearing securities guaranteed by the federal government.[35]

Aside from Social Security, the United States has a voluntary pension system.[36] Employers are not required to provide a voluntary pension for their employees; however, those who choose to provide one are subject to the requirements applicable to each plan under the code and, in most cases, are subject to regulation under ERISA.[37] Most contributions, earnings on contributions, and benefits are not included in gross income

[24]*See* OECD, ''Pensions at a Glance 2015: OECD and G20 Indicators,'' at 123 (2015) (2015).

[25]Jonathan Barry Forman and Gordon D. Mackenzie, ''Optimal Rules for Defined Contribution Plans: What Can We Learn From the U.S. and Australian Pension Systems?'' 66 *Tax Law.* 613, 614 (2013).

[26]*Id.*

[27]*Id.* at 615.

[28]*Id.*

[29]*Id.* at 613-614.

[30]*Id.* at 617; *see also* JCX-14-99, *supra* note 1.

[31]*See* SSA, ''Social Security Programs in the United States'' (July 1997).

[32]Forman and Mackenzie, *supra* note 25, at 617.

[33]*Id.* at 618.

[34]*See* David Pattison, ''Social Security Trust Fund Cash Flows and Reserves,'' 75 *Soc. Sec. Bull*. 1, at 2-3, 7 (2015); and Dawn Nuschler and Gary Sidor, ''Social Security: Trust Funds,'' Congressional Research Service report 7-5700 (Apr. 25, 2012).

[35]SSA, ''Summary: Financial Status of the Social Security Trust Funds,'' at 21 (July 2015).

[36]Forman and Mackenzie, *supra* note 25, at 619 (*referencing* Forman, *Making America Work* 214 (2006); and Kathryn L. Moore, ''An Overview of the U.S. Retirement Income Security System and the Principles and Values It Reflects,'' 33 *Comp. Labor L. & Pol'y J.* 5,17 (2011)).

[37]*Id. See also* JCT, ''Present Law and Background Relating to the Tax Treatment of Retirement Savings,'' JCX-32-12, at 2 (Apr.

(Footnote continued on next page.)

until amounts are distributed, even if the arrangement is funded and benefits are vested.[38] The employer is entitled to a current deduction for contributions even though they are not currently includable in the employee's income.[39] Contributions and earnings are held in a tax-exempt trust, which enables the assets to grow untaxed.[40]

b. Australia. Australia's retirement system consists of a social security program to provide for retirement, survivors, and disability benefits; the SG, a mandatory superannuation system to supplement retirement plans; and supplemental voluntary savings.[41]

The Australian social security program consists of a flat-rate benefit funded from general revenues rather than from specific payroll taxes. The benefits cover retirement, survivor, and disability benefits, which may be reduced by both an income and asset test. The retirement benefits (referred to as ''age pension'') are a means-tested income support benefit for individuals at age 65. Generally, individuals must have lived in Australia for 10 years to qualify for full age pension benefits.[42]

The Australian pension system is also referred to as superannuation.[43] Employers, employees, and self-employed persons generally contribute to employer-funded pension funds administered by trustees. Those pension funds are typically funded and secured plans, although some unfunded and unsecured plans exist.[44] Generally an individual's superannuation balance cannot be accessed until reaching the ''preservation age,''[45] death, or disability.[46] The benefits accrued in the Super can then be taken as a lump sum, pension, or combination.[47]

The SG component of the superannuation scheme consists of SG contributions to private pension funds to supplement benefits payable under the social security program.[48] Commentaries on the Australian SG scheme have noted that all contributions are fully funded and fully preserved — that is, they must be kept together with investment earnings in superannuation funds until the statutory access age is reached[49] — vested, and portable.[50] The Australian Taxation Office (ATO) provides government oversight for the SG.

2. Superannuation Fund in Australia

a. Purpose of superannuation fund. The primary purpose of the superannuation system is to deliver income to enhance the living standards of retired Australians.[51] A superannuation fund is defined as ''an indefinitely continuing fund that is a provident, benefit, superannuation or retirement fund or a public sector superannuation scheme.''[52] The sole purpose of the fund is to provide real monetary benefits, or benefits of a monetary value, to members on retirement, death, or other cessation of employment.[53] Through it, the superannuation system also seeks to achieve (1) intergenerational equity, so that ''the increased cost of an ageing population are not fully borne by the generation that will be working in several decades' time when the dependency ratio is higher,'' as well as (2) ''income smoothing — to enable individuals to smooth their income over their lifetime, and thus maintain their standard of living once they retire.''[54]

13, 2012); JCT, ''Present Law and Background Relating to Tax-Favored Retirement Saving and Certain Related Legislative Proposals,'' JCX-3-16, at 4 (Jan. 26, 2016).

[38]Forman and Mackenzie, *supra* note 25, at 619-620. Also, many distributions can be rolled over to another plan for continued income deferral.

[39]*Id.* at 620.

[40]*See* JCX-3-16, *supra* note 37, at 4.

[41]*See* SSA Program Operations Manual System (POMS) section GN 01743.010; and Forman and Mackenzie, *supra* note 25, at 623.

[42]*See* POMS sections GN 01743.010, GN 01743.015(A), GN 01743.020.

[43]Forman and Mackenzie, *supra* note 25, at 624.

[44]*See* JCX-14-99, *supra* note 1.

[45]The preservation age is the earliest that retirement benefits can be paid from a Super and still get concessional tax treatment. Forman and Mackenzie, *supra* note 25, at 627.

[46]*Id.* at 27.

[47]*Id.* at 28.

[48]*See* POMS, ''Overview of the Australian Social Security System,'' at GN 01743.010.

[49]George Kudrna, ''Does Pre-Funding of Retirement Incomes Work? The Case of Australian's Superannuation,'' in ARC Centre of Excellence in Population Ageing Research and the Research Institute for Policies on Pension and Aging, *Pre-Funded Pension Plans: Theory, Practice, and Issues Does Pre-Funding Work — Abstracts* (Oct. 2013).

[50]*See* JCX-14-99, *supra* note 1, at II. *See also* CBO, ''Social Security Privatization: Experiences Abroad,'' at 46 (Jan. 1999).

[51]*See* Australian Law Reform Commission, ''Grey Areas — Age Barriers to Work in Commonwealth Laws,'' Issues Paper 41, at paras. 68-69 (Oct. 2012). *See also* Sam Henderson, *SMSF DIY Guide* 6 (2012), noting that a superannuation fund is a low-tax structure that would encourage Australian citizens to save for retirement so there would be less strain on the government to give everyone the age pension.

[52]*See* Superannuation Industry (Supervision) Act 1993 (SISA), section 10. Superannuation is governed by several commonwealth laws, including the SISA, Income Tax Assessment Act of 1997, Corporation Act of 2001, Tax Administration Act of 1953, and a variety of case law decisions from the ATO and other tribunals.

[53]*See* ATO, *supra* note 18, at para. 113, *citing Scott v. Commissioner (No. 2)*, 40 ALJR 265, at 272 (1966) (Windeyer, J.); *Mahony v. Commissioner*, 41 ALJR 232, at 232 (1967) (Kitto, J.); and *Walstern v. Federal Commissioner of Taxation*, 9003 FCA 1428, at paras. 53-54 (2003), 138 FCR 1 at 15-16.

[54]*See* Rami Hanegbi, ''Australia's Superannuation System: A Critical Analysis,'' 25 *Australian Tax Forum* 313, 312 (2010). *See also* Australian Law Reform Commission, *supra* note 51.

There are numerous types of superannuation funds, including corporate- or employer-sponsored funds,[55] industry funds,[56] retail funds and public funds,[57] public sector funds, small Australian Prudential Regulatory Authority (APRA) funds,[58] and self-managed superannuation funds.[59] Regardless of the type of fund, most Australians have their superannuation in an accumulation fund in which a member's superannuation benefits in retirement are based on the amount contributed by her employers, the amount she voluntarily contributed, and the amount earned by the superannuation fund investing the contributions.[60]

Superannuation funds, along with other superannuation entities,[61] are regulated under the Superannuation Industry (Supervision) Act 1993 (SISA) and its Regulations (SISR) (collectively, SIS legislation).[62] SISA arises under the pension and corporation powers of the Australian constitution.[63] As a consequence, funds and trusts regulated under those powers are eligible for tax concessions if they are complying superannuation funds.[64] For a fund to constitute a complying superannuation fund under SISA, it must have (1) either a constitutional corporate trustee (the corporations route)[65] or its governing rules must provide that the sole or primary purpose of the fund is the provision of ''old age pensions''[66] (the pensions route);[67] and (2) the trustee must give APRA or the ATO an irrevocable election for the fund to become regulated under SISA.[68] A regulated superannuation fund that is at all times a ''resident regulated superannuation fund'' during the year of income is classified for Australian income tax purposes as an Australian superannuation fund (a Super) within the meaning of the Australian Income Tax Assessment Act of 1997 (ITAA97).

b. Resident Australian superannuation fund. The ATO commissioner has interpreted the definition of a Super for purposes of section 295-95(2) of ITAA97 as a regulated fund that (1) is or was established in Australia or has any asset situated in Australia; (2) has central management and control of funds ordinarily in Australia; and (3) either has no active members, or at least 50 percent of the total market value of the fund's assets attributable to superannuation interests are held by active members who are Australian residents.[69] An active

[55]Funds established for the benefit of employees of the sponsoring employers or group of related entities.

[56]Funds established generally for employees under an industrial agreement or award.

[57]Funds that offer superannuation products to the public, including master trusts (an umbrella trust or fund that uses a single trustee and a single common trust deed to operate the superannuation arrangements for unrelated individuals or companies.

[58]Funds with fewer than five members that are regulated by Australian prudential regulatory authority.

[59]Funds with fewer than five members that are regulated by the ATO.

[60]*See* Australian Securities and Investment Commission, ''Types of Superfunds,'' https://www.moneysmart.gov.au/superannuation-and-retirement/how-super-works/choosing-a-super-fund/types-of-super-funds#difference. These are also known as defined contribution funds. Most corporate or public sector funds are defined benefit funds, which are now closed to new members. The value of the retirement benefit is defined by fund rules. Compared with defined contribution funds, the employer or the fund generally takes the risk in defined benefit funds.

[61]For example, the approved deposit fund and pooled superannuation trust are superannuation entities that are also regulated under SIS legislation. However, approved deposit funds are indefinitely continuing funds maintained by a registrable superannuation entity, a licensee that is a constitutional corporation solely for approved purposes — that is, to receive rollovers of superannuation benefits. Under SISA section 10(1), a pooled superannuation trust is treated as a resident unit trust (the trustee of which is a trading or financial corporation) used for investing in specified assets under SISA section 48.

[62]SIS is administered by Australian prudential regulatory authority, the Australian Securities and Investment Commission, the commissioner of taxation, and the chief executive of Medicare. The commissioner of taxation was added as a regulator primarily for the administration of SIS legislation as it related to self-managed superannuation funds.

[63]*See generally* SISA section 3(2).

[64]*See generally* SISA sections 3(2), and 19(2) to (4).

[65]*See Superannuation in Australia* (CCH), at para. 2-170. A constitutional corporation is a trading or financial corporation (as defined under para. 51(xx) of the Australian constitution) formed within the limits of the commonwealth. Hence, a corporate trustee of a superannuation fund is a financial corporation by virtue of its activity as a trustee of the fund that is managed by its directors and officers. It is subject to all duties, obligations, and penalties under the Corporations Act of 2001 as well as SIS legislation. Alternatively, a superannuation trustee company is a company incorporated under the Corporations Act of 2001, whether its sole purpose is to act as trustee of a regulated superannuation fund. The company's constitution must have a clause prohibiting it from distributing income or property to its members. *Id.* Reasons for choosing a corporate trustee include protection from business creditors and administrative ease when trustees change. *Id.*

[66]An ''old age pension'' has the same meaning as para. 51(xxiii) of the constitution. It means a pension or annuity commencing at normal retiring age. The pension may be an allocated pension (and not a life pension) and may be payable by the fund or may be purchased from a provider using the member's benefit entitlements.

[67]Although the choice of the corporations or pensions route is optional, commentators have noted that some superannuation funds have no choice by virtue of their setup or structure because they are apparently required by SISA to have a corporate trustee in all cases (public offer superannuation fund) or a small superannuation fund with fewer than five members that is not a self-managed superannuation fund. *See Superannuation in Australia* (CCH).

[68]*See* SISA sections 19(2) to (4).

[69]*See generally* ATO, *supra* note 18. The alternative test is that at least 50 percent of the sum of amounts that would be payable to or for active members if they voluntarily ceased to be members is attributable to superannuation interests held by active

(Footnote continued on next page.)

member is a member who is a contributor to the Super or an individual on whose behalf contributions have been made.[70]

A Super is established in Australia if key elements are present: A trust deed for the Super is signed and executed,[71] and money or other property is transferred to the trustee of the Super as an initial contribution to be held in trust for the beneficiaries (members) of the Super.[72] The ATO uses principles of the general trusts law to determine when a superannuation fund was established, because most superannuation funds operate under a trust structure.[73] Indeed, the High Court of Australia has confirmed that the superannuation scheme is a ''strict trust''[74] and that a superannuation fund would not be an ''in truth discretionary trust.''[75]

The ATO determines the central management and control of a fund based on who makes the strategic and high-level decisions as well as when and where those decisions are physically made.[76] The ATO views the trustee of the Super as the party with the legal responsibility and duty for central management and control[77] because ''a trust is not a legal person but rather a collection of rights, duties and powers arising from the relationship to property held by the trustee for the benefit of beneficiaries.''[78] However, trustees of Supers are not the same as trustees selected by settlors who donate assets to a trust for trustees to administer gratuitously. Rather:

> Trustees of superannuation funds are typically corporations holding vast assets which they seek to administer in professional fashion under tight statutory regulation. The members are not volunteers or objects of bounty. Both employers and members contribute to the fund, sometimes pursuant to the contracts of employment and now, pursuant to statute law.[79]

Trustees generally derive their powers under the Super trust deed, with additional powers and duties conferred or imposed on them under SISA[80] and related legislation or state trustee laws.[81] The trustee must ensure that the Super is operated strictly in accordance with the trust deed and statutory requirements. Commentators have noted that those requirements present such a formidable task for the average Super trustee or member that in practice, most funds end up engaging specialized investment managers and tactical asset consultants for their investment activities.[82]

i. Contributions under Australian law. In a superannuation context, contribution is anything of value that increases the capital of a Super provided by a person whose purpose is to benefit particular members of the fund or all members in general.[83] Contributions include amounts such as direct cash payments by an employer or an individual to the fund; a transfer of property (or other asset) to the fund ''in specie'' by an employer or individual;[84] spouse contributions; government co-contributions; SG shortfall amounts[85] (discussed later);

members who are Australian residents. *See* Income Tax Assessment Act of 1997, section 295-95(2)(c)(ii).

[70] *See* Income Tax Assessment Act of 1997, section 295-95(3).

[71] It is not necessary that the trust deed be signed and executed in Australia if the initial contribution made to establish the fund is paid and accepted by the trustee of the fund in Australia. *See* ATO, *supra* note 18, at para. 13.

[72] *Id.* An active member of a Super is a contributor to the fund or an individual on whose behalf contributions have been made. A contributor to the fund is ''an individual who makes a contribution for the purposes of providing for future retirement or superannuation benefits.'' *See* ATO, *supra* note 18, at paras. 184-189. If a member is a contributor to the fund at a particular time, she will be an active member regardless of whether she is an Australian or foreign resident.

[73] ATO, *supra* note 18, at para. 99, citing views expressed in *JD Mahoney v. FCT*; *Western Pty Ltd. v. FCT*; and *British Insulated & Helsby Cables v. Atherton*. *See also id*. at para. 119. *See also* ATO, supra note 18, at para. 115, noting that ''as money or property is required to constitute a trust, money or other property is required to constitute a superannuation fund that is constituted as a trust consistent with the requirements of the SISA.''

[74] *See Finch v. Telstra Super Pty Ltd.*, HCA 36, at para. 66 (Oct. 20, 2010).

[75] *Id.* at para. 61.

[76] ATO, *supra* note 18, at 109-116, paras. 21-22. According to the commissioner, the everyday operational activities of the fund such as acceptance of contributions; the fulfillment of administrative duties; the investment of funds; and the preservation, payment, and portability of benefits do not constitute central management and control.

[77] *Id.* at 119, paras. 22-24.

[78] *Id.* at 119.

[79] *See Finch*, HCA 36, at para. 59.

[80] *See* SISA section 52B.

[81] The sole purpose test in SISA requires fund trustees to maintain the fund solely for the purpose of providing retirement or similar types of benefits to or for fund members. *See* ATO, *supra* note 18, at para. 112.

[82] *See Superannuation in Australia* (CCH); and *Commentary, Self-Managed Superannuation Funds Superannuation in Australia* (CCH). Members must have specific investment skills and expertise as well as awareness of SISA prudential requirements concerning investments. For example, SISA requires the fund to be maintained solely for one or more core purposes, have a properly formulated investment strategy, and comply with strict investment rules. Failure to satisfy SISA legislation may result not only in losing fund status (and tax concessions) but also in administrative and criminal penalties imposed on the trustees and anyone involved in the breach of the requirements.

[83] *See generally* ATO, *supra* note 18, at para. 1.

[84] *Id.* at para. 198, referencing section 285-5 of the Income Tax Assessment Act of 1997, stating the contributions can be or include a transfer of property.

[85] Amounts that form part of the SG charge collected by the commissioner and paid to a superannuation fund under SGAA92 when an employer fails to make sufficient superannuation contributions to a complying superannuation fund or retirement savings account. *See* ATO, *supra* note 18, at para. 198.

rollover superannuation benefits;[86] direct termination payments by employers as directed by employees;[87] and lump sum transfers from foreign superannuation schemes. However, the capital of the fund can also be increased indirectly.[88] But to be classified as a contribution, the increase must be intentional and purposeful.[89]

For the most part, a Super receives concessional and non-concessional contributions. Concessional contributions, also known as before-tax or deducted contributions, are included in the assessable income of the Super. Concessional contributions include employer contributions, both mandatory and voluntary, and most contributions made by self-employed persons.[90] Non-concessional contributions, also known as after-tax or undeducted contributions, are not included in the Super's assessable income. Non-concessional contributions include the member's personal contributions and contributions for a spouse. Another type of contribution consists of government contributions and co-contributions for low-income earners.[91] Our analysis focuses on (1) concessional employer contributions by and for an employer sponsor of the Super; (2) concessional employee contributions by or for a member of the Super; and (3) non-concessional contributions made by a member of the Super.

a. Mandatory employer contributions. Mandatory employer contributions are concessional superannuation contributions made by the employer for the employee under the SG scheme, which was introduced in 1992. The SG scheme requires employers to make contributions for their employees, equivalent to 9.5 percent of the employee's salary, which constitute ordinary time earnings.[92] Failure to make sufficient contributions by the due date and to the correct fund makes the employer liable for a nondeductible SG charge.[93]

Mandated employer contributions to the Super consist of (1) SG contributions, which are made by the employer to reduce the potential liability for the SG charge; (2) SG shortfall components, which are payments by the ATO to make up for any shortfall components of the SG charge; (3) award contributions made by the employer in satisfaction of its obligations under an industrial agreement or award; and (4) payments from Superannuation Holdings Accounts Special Account.[94] We collectively refer to the foregoing amounts as part of the SG contribution.

To be deductible to the employer,[95] SG contributions must be made to a complying Super specifically and solely for the purpose of providing superannuation benefits for the employee.[96] The following conditions must be present: (1) the contribution is made for a person who is an employee[97] and meets the employment activity condition for the employer's contribution to be deductible;[98] (2) the contribution is made to a complying Super; and (3) the contribution is made for an employee whose age is within the prescribed limit.[99]

b. Employee contributions. Employee contributions may be concessional or non-concessional. Employee concessional contributions are VECs made by the employee to the fund that constitute pretax deductions in the year they are made.[100] A deduction is allowable when the sum of assessable income, reportable fringe benefits, and reportable employer superannuation contribution to employment activities is less than 10 percent of the individual's total assessable income, total fringe benefits, and total employer superannuation contributions for the tax year.[101] Amounts attributable to employment include salary or wages, allowances, and other payments earned by an employee; commissions, director's fees, remuneration, and contract payments; employment termination payments, and worker's compensation and like payments.[102] VECs must be made to a complying superannuation fund solely for providing

[86]As defined under the Income Tax Assessment Act of 1997, section 306-10.

[87]Transitional termination payments cannot be received after July 1, 2012. *See* Income Tax Assessment Act of 1997, section 82-10F.

[88]For example, paying an amount to a third party for the benefit of the superannuation provider, forgiving debt owed by the superannuation provider, or shifting value to an asset owned by the superannuation provider. *See* ATO, *supra* note 18, at para. 11.

[89]To illustrate that, consider an increase in the fund's capital because of income, profits, and gains arising from use of the fund's existing capital. That increase will generally not be derived from someone whose purpose is to benefit particular members of the fund. *Id.* at para. 133.

[90]*See* Hanegbi, *supra* note 54, at 307 (for the proposition that the 15 percent concessional tax rate applies to most contributions by the self-employed).

[91]*See* Superannuation (Government Co-Contribution for Low Income Earners) Act of 2003 (Cth) (Austl.).

[92]*See* Robin Woellner et al., *Australian Taxation Law*, para. 23-030 (2013).

[93]*Id.* More details about the SG charge are discussed in the following sections.

[94]*Superannuation in Australia* (CCH), at paras. 39-240, 39-600, and 39-650.

[95]*See* Income Tax Assessment Act of 1997, subdivision 290-B (sections 290-60 to 290-100).

[96]*See* Income Tax Assessment Act of 1997, subdivision 290-B (section 290-10). *See also* ATO, *supra* note 18, at Part B, paras. 39 to 41. The conditions under sections 290-70, 290-75, and 290-80 must be satisfied for an employer to claim deductions for mandatory contributions made.

[97]Employee definition under common law and under the expanded definition of employee under section 12 of the SGAA.

[98]ATO, *supra* note 18, at Part B, paras. 53-56, referencing sections 290-65, 290-60(2), and 290-70.

[99]*See* Woellner et al., *supra* note 92.

[100]*See generally* Income Tax Assessment Act of 1997, subdivision 290-C for conditions that must be satisfied for deductibility.

[101]Income Tax Assessment Act of 1997, section 290-160.

[102]ATO, *supra* note 18, at paras. 62-64. *See also* Income Tax Assessment Act of 1997, sections 290-150 to 290-180.

superannuation benefits for the employee and dependents of the employee on the employee's death.[103] Self-employed individuals may, but are not required to, make personal contributions to their own superannuation fund. Those personal contributions may be deductible under some statutory conditions.[104]

Generally, employee non-concessional contributions are contributions made to the Super that are not included in the Super's assessable income. The most common type is the employee or member concessional contribution, which constitutes an after-tax voluntary personal contribution for which no income tax deduction is claimed.[105] Those include (1) contributions made for the person's spouse;[106] (2) contributions made in excess of the person's excess capital gains tax amount; (3) amounts transferred from foreign superannuation funds; (4) contributions made for the benefit of a person under 18 that are not employer contributions for that person; and (5) the person's excess concessional contributions for the year.[107]

ii. Investments under Australian law. Investment and activities engaged in by a Super are strictly regulated by an interlocking web of SIS legislation and other regulatory regimes[108] that impose ''quite rigorous regulatory standards.''[109] The High Court of Australia has commented on that aspect of the superannuation scheme, noting that because of the potentially lengthy periods over which superannuation savings are accumulated, it is ''natural that a trust mechanism would be employed and that taxation advantages of superannuation would not be enjoyed unless superannuation funds are operating efficiently and lawfully.''[110] Scholars have identified several broad investment principles that govern how funds are invested and specific prohibitions regarding fund investments.[111] For example, borrowing by the Super is strictly prohibited by SIS legislation and can be done only under specified circumstances.

Despite the variety of investment strategies available to a Super, it has been observed that most fund members do not exercise the choice to diversify and instead end up investing in default investment strategies by the fund.[112] As a result, most superannuation funds in Australia are combined in defined contribution schemes such that financial risks that include investment, longevity, and inflation risks are borne by the fund members and not covered by the Super.[113]

3. Australian taxation of superannuation fund. Although Supers are essentially trusts that hold superannuation assets, they are not taxed as trusts under Australian tax laws. A Super has special rules in place that modify general tax principles for calculating taxable income.[114] The starting point is always assessable income (excluding exempt income and non-assessable nonexempt income), from which deductions are applied to arrive at taxable income.[115] Complying Supers[116] in particular receive preferential tax treatment across three stages: contribution, accumulation, and pension. That means that not only will the Super be taxed at concessional rates but it will also be entitled to special deductions, exemptions, and other concessions.[117] In contrast, a fund that does not meet the definition of a superannuation fund will generally be assessed tax as a trust under the ordinary Australian trust tax law provisions.[118]

a. Contribution phase. The assessable income of a Super includes specific contributions.[119] During that phase, tax concessions available for contributions received by the Super include tax deductions for employer contributions and individual personal contributions; a tax offset for superannuation contributions made for the benefit of a contributor's low-income-earning spouse; and an entitlement to a government co-contribution when personal contributions are made by low-income earners.

As discussed, both SG contributions and VECs are included in the assessable income of a Super in the income year received. Those contributions are subject to a 15 percent contributions tax in the hands of the

[103]Income Tax Assessment Act of 1997, sections 290-150 to 290-180.

[104]ATO, *supra* note 18, at Part B, para. 57, referencing sections 290-150 and 290-160(1).

[105]Income Tax Assessment Act of 1997, subdivision 290-C.

[106]Spouse contributions can be made when the spouse is under 65 years old or has reached 65 but not yet 70 years and is gainfully employed part time. Income Tax Assessment Act of 1997, section 290-230.

[107]*Id.*

[108]The Australian prudential regulatory authority, chief executive Medicare, the Australian Securities and Investments Commission, the ATO, and the fair work ombudsman are regulatory agencies that share oversight of the superannuation fund industry.

[109]*Finch*, HCA 36, at para. 34.

[110]*Id.* at para. 35.

[111]*See* Forman and Mackenzie, *supra* note 25, at 42.

[112]Kudrna, *supra* note 49.

[113]*Id.*

[114]Robert L. Deutsch et al., *The Australian Tax Handbook* 1565-1566 (2014).

[115]*Id.* at 1565. The taxation of a superannuation entity is governed under division 295, Income Tax Assessment Act of 1997, which modifies general tax rules applied to a Super.

[116]*Id.* at 1566-1567. As noted, a complying Super is one that has received an unrevoked notice under SISA section 40 stating that it is a complying fund. For self-managed superannuation funds, compliance status is determined under SISA section 42.

[117]Deutsch et al., *supra* note 114, at 1566. Noncomplying Supers are taxed at 45 percent on all taxable income. *Id.* at 1568.

[118]*Id.* The governing trust tax law applied to a noncomplying Super is division 6 of Pt. III ITAA 1936, under which the Super will be taxed as a trust or a public trust (if applicable).

[119]*Id.*

Super.[120] SG contributions and VECs are subject to a yearly cap of $30,000 (or $50,000 for members age 49 or older). SG contributions in excess of the concessional contributions cap for the year are included as assessable income, which is then taxed at the employer's marginal tax rates. Concessional employee contributions that exceed the annual cap amount are included in the individual's assessable income for the year.[121]

Non-concessional employee contributions — that is, additional after-tax contributions — are generally not included in the assessable income of the Super. However, the member is liable for tax on excess non-concessional contributions that exceed annual caps, which are indexed annually. Non-concessional employee contributions are capped at six times the concessional cap for the year.[122] Amounts exceeding the cap are taxed at 49 percent (for 2016 and 2017).[123] Members can also make additional ''bring forward'' non-concessional contributions over any three-year period until they turn 63 without incurring extra tax.

b. Accumulation phase. The Super remains subject to tax while the contributions are growing in the accumulation phase. In addition to the contributions tax, a Super's taxable income[124] is taxed at 15 percent if the Super is in compliance for that year.[125] Otherwise, the highest marginal tax rate will be applied, currently 47 percent. Taxable income of a Super includes contributions, ordinary earnings, capital gains, interest, dividends, and rent.[126] However, income earned from assets held by the fund to provide pensions benefits once the income stream begins is exempt from income tax as current pension income.[127]

c. Pension phase. In the pension phase, contributions plus earnings from investing those contributions less any Super expenses are usually paid in the form of member benefits when a member reaches the preservation age[128] and meets one of the conditions of release.[129] The preservation age is the earliest age that retirement benefits can be paid from a Super with concessional tax treatment. The preservation age varies for members depending on their date of birth. In the event of death before retirement, the member benefit is paid to the member's dependents.

Some conditions of release restrict the form of the benefit or amount of benefit that can be paid (a cashing restriction).[130] For example, the payment may be an income stream (pension) or a lump sum, depending on the circumstances. Payments to members that do not meet a condition of release are not treated as Super benefits; rather, they are taxed as ordinary income at the member's marginal tax rates.[131] The ATO views those events as incidents in which a benefit has been unlawfully released, and significant penalties apply.[132]

If the Super has paid tax on contributions and earnings, benefits paid either as lump sum or pension are generally tax free for people age 60 and over. However, when the Super has not paid tax on contribution and earnings, the benefits it pays are taxed.

C. SG Scheme as Equivalent to Social Security Tax

1. SG Background

a. SG scheme. As mentioned, all employers in Australia are required to make superannuation contributions into a complying superannuation fund or retirement savings account for the benefit of their eligible employees in accordance with minimum prescribed levels. The minimum level of employer contributions is administered by the ATO under the SG scheme of the Superannuation Guarantee (Administration) Act of 1992 (SGAA), its regulations, and the Superannuation Guarantee Charge Act of 1992 (SGCA).

The superannuation system was traditionally a system of voluntary private pensions provided through employers that was expanded in the 1980s and 1990s. The first expansion, called the Award Superannuation, was sought by the labor unions spearhead by the Australian Council of Trade Unions (ACTU) seeking a universal 3 percent employer contribution to a pension fund instead of a wage increase. The central wage bargaining that took place in 1985 and 1986 resulted in an

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[120] *See* Income Tax Assessment Act of 1997, subdivision 290-C.

[121] Income Tax Assessment Act of 1997, section 291-15. Also, for years before July 1, 2014, the individual must pay an excess concessional contributions charge on the increase in the tax liability as a result of having excess concessional contributions for the relevant year. *See* Superannuation (Excess Concessional Contributions Charge) Act of 2013.

[122] Income Tax Assessment Act of 1997, section 292-85(2). For members age 65 but less than 75, the cap is $180,000 for 2015-2016. For members under age 65, the cap is $540,000 over a three-year period.

[123] Income Tax Assessment Act of 1997, sections 292-80 and 292-85(1).

[124] *I.e.*, both ordinary and statutory income derived from all sources.

[125] Deutsch et al., *supra* note 114, at 1567.

[126] *Id.* at 1570.

[127] *Id.* at 1582.

[128] Access to benefits in a Super is generally restricted to members who have reached preservation age, which ranges from ages 55 to 60.

[129] *See* Schedule 1 of the SISR for a table specifying the conditions of release and the cashing restrictions. *See also Superannuation in Australia* (CCH), at para. 8-110 et seq.

[130] *See* Schedule 1 of the Superannuation Industry (Supervision) Act of 1993 (SISR) and its regulations. There are no cashing restrictions in the event of retirement, death, terminal medical condition, or permanent incapacity, or upon reaching age 65. However, cashing restrictions apply to all other circumstances.

[131] *Superannuation in Australia* (CCH), at para. 12-500.

[132] *Id.* at para. 8-270 et seq.

agreement between employers and labor unions that has been incorporated into employment contracts since June 1986. The second expansion, called the Superannuation Guarantee (SG), took place in 1992, when the government mandated employers to provide superannuation to workers through contributions that are vested immediately and fully portable. Although the proposal originally envisioned a matching contribution from the government, this provision was replaced with a tax rebate effective in fiscal year 1999-2000.

In strict legal terms, the SGAA is structured as a piece of tax legislation, where employers who fail to make the correct amount of contributions are subject to a tax, which is imposed by the SGCA. The SGAA was structured in this way for constitutional reasons, as the Australian Constitution vests the powers that would be necessary to mandate employers to make contributions in the states rather than the federal government. In introducing the SGAA, the federal government relied on the taxing power as well as the pension power (as discussed further below).

The minimum level of SG contributions under the SG scheme is a prescribed percentage of the employee's ordinary time earnings in each quarter (charge percentage), subject to a maximum contribution base. The charge percentage is 9.5 percent until 2021. The maximum contribution base limits the employer's contributions by providing a ceiling on an employee's earnings base or salary in a quarter. For example, for 2015 and 2016, the maximum contribution base is $50,810 per quarter.

The SG contributions can be made to any complying superannuation fund or retirement savings account or to an approved clearinghouse that will forward the contributions to the appropriate fund.[133] Employers are required to offer employees their choice of fund for receiving the SG contributions or risk an additional increase in their SG charge liability as a ''choice penalty.''

An employer that fails to pay the prescribed rate of SG contribution in each quarter on a self-assessment basis is liable for the SG charge. An SG charge consists of the SG shortfall amount[134] plus interest and an administrative charge.[135] To avoid incurring the SG charge, an employer must make SG contributions by the 28th day after the end of the quarter. If there is an SG shortfall, the employer must lodge a statement with the ATO together with the SG charge payment. The SG shortfall component of the SG charge is generally paid by the ATO to a superannuation fund for the employee or the Superannuation Holding Savings Account (SHSA). An employer's failure to comply with its SG obligations may result not only in an SG charge liability also in an administrative penalty, general interest charge, or prosecution by the ATO. Unlike the SG contribution, an SG charge is not tax deductible to the employer.[136]

b. Under Australian law, the SG scheme constitutes a tax. It is undisputed that an SG contribution is a mandatory contribution by the employer of a percentage of its employee's salary to provide for the employee's own retirement.[137] The SG contribution itself, and accruals thereafter, do not constitute income to the employee in Australia,[138] even though they are paid to a Super that is intended to provide superannuation benefits for the employee in retirement. Rather, both the SG contribution amounts and accruals are taxed to the Super at a low rate of 15 percent. Distributions made by the Super during the pension phase are generally tax free to the employee.

If an employer fails to pay its required SG contributions to the Super, the difference between what is actually paid and what is owed (the SG shortfall) is charged to the employer by the commonwealth with interest and penalties — that is, the SG charge.[139] That charge is paid by the employer directly to the ATO and deposited into the Consolidated Revenue Fund and thereafter, the SG shortfall amount would be paid by the ATO to the corresponding retirement savings account, complying superannuation fund, or an approved deposit fund or SHSA for the benefit of the relevant employee in the amount of the SG shortfall.[140]

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[133] Employers with fewer than 20 employees may opt to make SG contributions through a clearinghouse.

[134] The SG shortfall amount is calculated by multiplying the employee's salary or wages for the relevant quarter by the reduced charge percentage — that is, the charge percentage less the level of superannuation support actually provided.

[135] Woellner et al., *supra* note 92, at paras. 23-810 and 23-820.

[136] *See generally* Income Tax Assessment Act of 1997, section 290-60.

[137] *Finch*, HCA 36, at para. 35. The High Court of Australia in *Finch* stated the purpose of the SG contribution as follows:

> A further factor is the public significance of superannuation. The federal government has attempted to reduce outflows by reducing the dependence of retired persons on the old-age pension funded out of general revenue. The taxation concessions now provided pursuant to Pt 3-30 of the *Income Tax Assessment Act* 1997 (Cth) are designed to encourage citizens to make provision for their retirement by investing in superannuation and to encourage their employers to create superannuation funds in their favor. The Parliament also has required employers to contribute a certain percentage of the employee's salary for these purposes.

[138] *See* ATO, *supra* note 18, at para. 104.

[139] *See* Taxation Administration Act of 1953, (Cth), Schedule 1, section 255-5(1)(a).

[140] *See* part 8 of the Superannuation Guarantee (Administration) Act of 1992 (Cth). The SG shortfall and interest component of the SG charge is paid by the ATO to the employee's superannuation fund and thus makes up for the delinquency in SG contributions of the employer.

However, SG shortfall component amounts paid by the ATO to the superannuation funds or accounts authorized by the SGAA are not actually payable to the employee until the occurrence of a pensionable event.[141] Indeed, in *Morgan v. Commissioner*, the High Court of Australia pointed out that the operative provision (section 65) of the SG scheme providing for payout of the SG Shortfall by the ATO ''does not provide for a payment of the amount of superannuation benefit directly to an employee. Rather, [section 65] provides for payment to a fund to be held against the invalidity or old age of the employee.''[142]

For those reasons, the High Court ultimately concluded that the SG charge imposed by the SGCA and SGAA is an exaction for public purposes and is therefore a valid tax imposed on employers under section 51 (xxiii) of the Commonwealth of Australia Constitution Act, otherwise known as the ''Pension Power.''[143] The SG charge is a compulsory exaction to ''encourage all Australian employers to contribute to the financial needs of all Australian employees in old age or infirmity.'' Unlike an SG contribution, an SG charge is not tax deductible to the employer.[144]

2. Role of U.S. Totalization Agreements

An SSTA is an arrangement between the United States and another country under which both countries agree on which country will be responsible for the payment of retirement benefits to recipients who earned income and paid social welfare taxes to both countries.[145] The goal of U.S. totalization agreements is to maintain the coverage of as many workers as possible under the system of the country where they are likely to have the greatest attachment both while working and after retirement.[146] To that end, U.S. totalization agreements have two features: (1) relief from double taxation for social security taxes paid on the same employment or self-employment income, such that social security tax is paid to only one of the two countries; and (2) totalization of benefits, ''such that an individual who has paid social security tax in both countries may still qualify for benefits in one or both of the countries, even if there is not enough accumulated coverage to qualify for benefits in both of the countries.''[147] In Rev. Rul. 92-9,[148] the IRS stated that totalization agreements provide for rules to maintain an employee's coverage ''under the system of the country where the work is performed and exempting the employee from coverage and taxation in the other country.''

The IRC itself provides for exemptions for FICA and the Self-Employment Contributions Act (SECA) taxes when a totalization agreement is reached between the United States and the foreign country where the USP has contacts.[149] The following provisions were added to the code by section 317(b) of the Social Security Amendments of 1977: section 1401(c) (SECA), section 3101(c) (employee's share of FICA taxes), and section 3111(c) (the employer's share of FICA taxes).

It has been observed that the United States includes fewer programs in its social security agreements than other countries.[150] In fact, the only U.S. benefit program that can be affected by a U.S. totalization agreement is OASDI, while other countries include worker's compensation, cash sickness, maternity benefits, and family allowance programs.[151] To date, the United States has 25 totalization agreements.[152]

3. Australia-U.S. Totalization Agreement

Schedule 13 to the Social Security International Agreements Act of 1999 constitutes the Australia-U.S. totalization agreement.[153] It covers contributions made under the OASDI program; acts forming the social security law of Australia;[154] and the law concerning the

[141] *See Roy Morgan Research Pty. Ltd. v. Commissioner*, HCA 35, at paras. 10-13 (Sept. 28, 2011) (interpreting section 65(1) of the SGAA).

[142] *Id.* at para. 91, explaining the effect of part 8 of the SGAA regarding section 65.

[143] *Id.* at paras. 93 to 94, concluding that the SG charge is a tax within section 51(ii) of the constitution for reasons stated in the text above.

[144] *Id.* at para. 74. The High Court of Australia stated: ''In our respectful opinion, an exaction, for the purposes of which is to encourage all Australian employers to contribute to the financial needs of all Australian employees in old age or infirmity is an exaction for public purposes.'' *Id.*

[145] These agreements are referenced as totalization agreements because they allow workers to aggregate or ''totalize'' periods of coverage to qualify for social security benefits. *See* Mickey Davis and William Streng, *Retirement Planning: Tax and Financial Strategies*, para. 21.02[2].

[146] *See* Paul Butcher and Joseph Erdos, ''International Social Security Agreements: The U.S. Experience,'' 51 *Soc. Sec. Bull*. 72 (Sept. 1999).

[147] *Id.*

[148] 1992-1 C.B. 344.

[149] Sections 1401(c) (SECA), 3101(c) (employee's share of FICA taxes), and 3111(c) (employer's share of FICA taxes) grant an exemption from the payment of Social Security taxes when a totalization agreement is in place. Those exemptions were added to the code by section 317(b) of the Social Security Amendments of 1977. *See* Rev. Proc. 80-56, 1980-2 C.B. 851, *amplified by* Rev. Proc. 84-54, 1984-2 C.B. 489.

[150] Butcher and Erdos, *supra* note 146, at 9.

[151] *Id.*, noting that section 233 of the Social Security Act allows additional provisions to be made to social security agreements that are not inconsistent with Title II (federal OASDI).

[152] *See* https://www.ssa.gov/international/agreements_overview.html.

[153] *See* Schedule 13 to Social Security (International Agreements) of 1999 — Agreement between the Government of Australia and the Government of the United States of America on Social Security, U.S.-Australia (Oct. 1, 2002).

[154] Age pension, disability support pension for the severely disabled, pensions payable to widowed persons, and career payment. *See* article 1(b)(i) of the totalization agreement.

SGAA, the SGCA, and the SGAR.[155] The Social Security Administration (SSA), Treasury, the Justice Department, and the IRS have acknowledged the need to eliminate overlapping social security coverage (dual social security coverage[156]) and double taxation of social security contributions between Australia and the United States, including the Australian SG program.[157]

a. Totalization of benefits. The provisions of the Australia-U.S. totalization agreement permit people to qualify for social security benefits based on combined U.S. and Australian coverage credits limited to the following types of benefits: U.S. retirement, survivor, and disability benefits under title II of the Social Security Act (except Medicare benefits,[158] Supplemental Security Income, or special age 72 benefits);[159] and Australian social security retirement, survivor, and disability benefits.[160] The scope of benefits under the totalization agreement is limited to OASDI benefits under U.S. law and does not cover Medicare benefits.[161]

b. Elimination of double taxation. The provisions of the Australia-U.S. totalization agreement that eliminate double taxation of salary or wages apply to U.S. Social Security taxes (including the Medicare tax portion[162]) and Australia's SG contributions.[163]

The SSA's explanatory annotations to Congress regarding article 2(b) of Part II of the Australia-U.S. totalization agreement reflect the agency's view that SG contributions are equivalent to U.S. Social Security taxes (FICA and SECA):

> For Australia, the Agreement applies to the laws on the Social Security benefits listed in Article 2.1(b) (i) and to the laws on Superannuation Guarantee (SG) in Article 2.1(b) (ii). The ''age pension'' referred to in Article 2.1(b) (i) (A) is payable at age 65 to men and age 61½ (as of 2001) to women and is referred to in these annotations as an ''old-age pension.''
>
> In accordance with Article 1.1(e), the provisions of Part II of the Agreement, which eliminate dual Social Security coverage and taxation, do not apply to the Australian benefit programs listed in Article 2.1(b) (i) since these benefits are financed entirely from general revenues and not from earmarked payroll taxes. Instead, Part II applies to the Superannuation Guarantee, which is the Government regulated program requiring employers either to pay contributions to employee retirement plans at specified minimum rates or pay a special SG Charge. As a result, when a worker is subject to U.S. laws and exempt from Australian laws in accordance with Part II, the worker's employer will be exempt from the SG requirements.[164]

The SSA's explanation provides clear guidance that under the Australia-U.S. totalization agreement, the employer and eligible employee would be exempt from making SG contributions (or their equivalent) in the

[155] *See* article 2(b)(ii) of the totalization agreement.

[156] A dual social security coverage situation occurs when a person from one country works in another country by maintaining the employee's coverage under the social security system of the country where the work is performed and exempting the employee from coverage and taxation in the other country. *See* Rev. Rul. 92-9, 1992-1 C.B. 344; *see also* ''Withholding, Social Security and Unemployment Taxes on Compensation,'' Portfolio 392, at n.330 (citing 20 CFR section 404.190(a)).

[157] *See* POMS, ''Overview of the Australian Social Security System,'' at GN 01743.001. Treasury and the IRS share the same views as the U.S. Social Security Administration concerning the general function of totalization agreements, stating: ''These agreements are intended to minimize the potential application of two different employment taxes, and correspondingly coordinate the benefits under two different social security systems.''

See T.D. 9321, 70 F.R. 57939 (Oct. 4, 2005). Indeed, Treasury and the IRS in the preamble expressed their view that amounts contributed or benefits paid under a foreign social security system by a service provider that is the subject to a totalization agreement do not constitute nonqualified deferred compensation plans that would be subject to federal income taxation under the rules of section 409A. ''Benefits and other amounts deferred under a government mandated social security system, (which a service provider is entitled to receive under the foreign jurisdiction social security system) are not subject to Section 409A.''

[158] *See* Thomas Bissell, ''International Aspects of U.S. Social Security and Unemployment Taxes,'' Portfolio 6830, at Part III.

[159] Except sections 226, 226A, and 228 of Title II of the U.S. Social Security Act (42 U.S.C. sections 401 to 433). *See* totalization agreement, article 2(1)(a).

[160] *See* POMS, ''Scope of the U.S.-Australian Agreement,'' at GN 01743.110(A).

[161] *See* Bissell, *supra* note 158.

[162] For an excellent discussion on SSTAs, *see id*. at Part III(A); *see also* ''Online Annotation to Article 2(1) of the U.S.-Australia Totalization Agreement,'' https://www.ssa.gov/international/Agreement_Texts/Australia.html#part, which states:

> For the United States, the Agreement applies to title II of the U.S. Social Security Act and the corresponding tax laws (the Federal Insurance Contributions Act and the Self-Employment Contributions Act of 1954) and any regulations pertaining to those laws. However, the Agreement does not apply to Medicare provisions (section 226 and 226A of the Social Security Act) or provisions for special payments to uninsured individuals age 72 or over under section 228 of the Social Security Act. Persons to whom the Agreement applies who qualify independently for Medicare hospital insurance or age-72 payments will be entitled to receive such benefits.

[163] *See* POMS, ''Scope of the U.S.-Australian Agreement,'' at GN 01743.110(B).

[164] *See* U.S. Social Security Administration, ''Explanatory Annotations to Congress regarding Article 2(1) of the U.S.-Australia Totalization Agreement.''

United States if the employee is working there temporarily, so long as the employer continues making SG contributions for the employee in Australia. An example from the ATO confirms that:

> Jack is an Australian resident working in Australia for an Australian employer. His employer intends to send him to the United States to work for a year. Jack's employer must make compulsory social security (including Super) contributions for him under United States law. In addition, Jack's employer also must make super contributions for him in Australia. Before Jack leaves Australia, his employer requests a Certificate of Coverage from [the ATO]. This is to check and certify that the agreement between the United States and Australia applies to his situation. Jack and his employer are exempt from making contributions under United States law. However, Super contributions must continue to be made for Jack in Australia. Similarly, if an employee in the United States is sent to work temporarily in Australia and their employer has obtained a Certificate of coverage, they are exempt from Australia's super guarantee law and the employee and their employer must continue to make social security contributions under the United States' system.[165]

The above procedures fall within the preexisting operational framework established by the IRS to implement SSTAs entered into by the United States. Rev. Proc. 80-56[166] and Rev. Proc. 84-54[167] were issued to provide guidance on procedures for implementing the amendments to sections 1401(c), 3101(c), and 3111(c). The procedures require the USP to substantiate her exemption from FICA and SECA by obtaining from the authorized official or agency of the foreign country involved an affirmative statement that there is a totalization agreement between the foreign country and the United States; and that under that agreement, wages received or paid to the employee by the employer are subject to taxes or contributions under the system of that foreign country.[168] If the SSA-equivalent agency of the foreign country does not provide that statement, the SSA itself will issue a statement that the USP earnings are not covered by the U.S. Social Security system.[169]

The above revenue procedures indicate that the IRS was cognizant that SSTAs would exclude some income earned by U.S. taxpayers overseas from U.S. Social Security taxes if an equivalent foreign tax was being paid on those same amounts. It supports our position that for the Australia-U.S. totalization agreement, the SSA, the IRS, and the ATO were aware that the SG contributions would constitute foreign taxes equivalent to U.S. Social Security taxes and therefore must be incorporated into the SSTA to prevent inadvertent double taxation of the USP overseas income.

4. U.S. Social Security Taxes and Australian SG

As mentioned, Australia's superannuation scheme includes the SG, which is a privatized mandatory savings scheme that requires a minimum amount of contributions from employers for their employees.[170] All contributions are portable, fully funded, and fully preserved — that is, they must be kept together with investment earnings in the Super until the statutory access age is reached.[171] Once received by the Super, which are generally private sector entities, contributions are placed[172] in individual accounts and invested for the employees.[173] Fund investment earnings are added to superannuation assets that may be withdrawn on reaching the statutory eligibility age[174] and also used to compute eligibility for the age pension,[175] which is intended to operate as a safety net for those who cannot provide for themselves in retirement. At the time of its implementation, the belief was that the superannuation scheme would eventually build up and reduce the age pension to a simple welfare measure by the commonwealth to pay a destitute payment or supplement only.[176] Indeed, it was anticipated that by 2005, payments from Australia's social security network would decrease substantially as payments from the Superannuation funds increased.[177]

Australia's expectation to replace the age pension with the superannuation fund to provide for retirement needs is reflected in the Social Security (International Agreements) Act of 1999 (SSIA),[178] which was enacted after the expansion of the Superannuation system in

[165]*See* ATO, ''Bilateral Agreements — What Are My Super Obligations When My Employee Is Working Overseas?''

[166]1980-2 C.B. 851.

[167]1984-2 C.B. 489.

[168]*See* section 4.0 of Rev. Proc. 80-56, *as amplified by* sections 2.02 and 4.02 of Rev. Proc. 84-54.

[169]*Id.*

[170]Kudrna, *supra* note 49.

[171]*Id.*

[172]*See* Jerry W. Markham, ''Privatizing Social Security,'' 38 *San Diego L. Rev*. 747, 813 (2001).

[173]Kudrna, *supra* note 49.

[174]*Id.*

[175]Markham has observed that unlike Social Security, the Australian age pension is viewed as a safety net for those unable to provide for themselves in retirement. Income to the recipient of an age pension or assets (excluding the pensioner's home and capital value of superannuation funds) in excess of specified levels will result in the reduction or elimination of benefits. *See* Markham, *supra* note 172, at 814, citing Centrelink, *Age Pensions: All You Need to Know* 4 (May 2000).

[176]*See* Markham, *supra* note 172, at 813, 814-819.

[177]*Id.*

[178]*See* Office of Parliamentary Counsel (Canberra), Social Security (International Agreements) Act of 1999, at Part 1(4)

(Footnote continued on next page.)

1992, which imposed mandatory employer contributions under the SGAA. The SSIA's scope references Australia's social security laws and the Australian SGAA as the two primary regimes in Australia that would be subject to an international agreement on social security with another country (a scheduled international social security agreement or totalization agreement[179]) that would override Australian Social Security law.[180]

Closer scrutiny of the SG contribution amounts payable by an Australian employer under the SG scheme provides compelling similarities to a U.S. employer's mandatory payment of FICA and SECA taxes. The similarities between the SG, FICA, and SECA taxes are explained below.

a. Rate and computation of tax. Employers in the United States and Australia are both required to pay tax measured on the amount of wages paid regarding employment. Similarly, employers in the United States are required to pay an excise tax equivalent to 6.2 percent of their employees' gross wages up to an annual cap, as compared with the 9.5 percent of the mandatory SG contributions required from employers in Australia.[181] The employer portion of the FICA tax is computed by applying the rate in effect when wages are paid. That is the same computation for the SG contribution and the SG charge.

b. Collections and liability. Employers in the United States and Australia are both required to self-assess and remit the appropriate amount of tax. In Australia, employers remit SG contributions to the Super and pay SG charges directly to the ATO, which deposits them into the Consolidated Revenue Fund, where tax collections are deposited.[182] Failure to remit the SG charge is treated as an indebtedness owed by the employer directly to the commonwealth.[183] SG charges deposited into the Consolidated Revenue Fund are then disbursed by the ATO to the extent of the SG shortfall amount as payment to the applicable superannuation fund for the benefit of the relevant employee.[184] However, SG shortfall component amounts paid by the ATO to the superannuation funds or accounts authorized by the SGAA are not actually payable to the employee until the occurrence of a pensionable event.[185]

Employers in the United States also have a duty to compute, collect, and deduct the employee portion of FICA from the gross amount of the employee's wages. The employer then remits and pays the employer and employee portions of the FICA tax directly into the general fund of the treasury, where it is then appropriated to the OASI Trust Fund and the Disability Insurance Trust Fund.[186] The employer remains liable for the employee's FICA portion if it fails to withhold from its employee's wages and remit accordingly to the IRS (even if the employer has already remitted its portion of FICA), regardless of whether the tax is collected from the employee.[187] That is because liability for the FICA payment does not arise out of the employment contract but rather is created by the federal government's taxing authority.[188]

c. Indemnification. For the employee portion of the FICA tax, the U.S. employer is indemnified against all the claims and demands of any persons for the amount deducted and paid to the federal government.[189] Similarly, the Australian employer cannot be sued directly by the Australian employee for any unpaid SG contribution amounts determined to be owed to the employee's superannuation fund.[190] The SG charge is a debt payable by an employer to the commonwealth and may be recovered by the ATO commissioner directly against the employer.[191] In some cases, even directors may be personally liable for the unpaid SG liabilities of the

(compiled Jan. 1, 2016). The SSIA was enacted in March 2000 to form part of Australia's social security law.

[179] *See id*. at parts 2(5) and 2(6).

[180] *See* SSIA part 2.6(1), which states, "The provision of a scheduled international social security agreement have effect despite anything in social security law."

[181] *See* section 3111(a). *See generally Steward Machine Co. v. Collector of Internal Revenue*, 301 U.S. 548 (1937); and *Helvering v. Davis*, 301 U.S. 619 (1937).

[182] *Roy Morgan*, HCA 35, at para. 92.

[183] *See* Taxation Administration Act of 1953, (Cth) Schedule 1, section 255-5(1)(a).

[184] *See* part 8 of the SGAA. The SG shortfall and interest component of the SG charge is paid by the ATO to the employee's superannuation fund and thus makes up for the delinquency in the employer's SG contributions.

[185] *See Roy Morgan*, HCA 35, at paras. 10-13 (interpreting SGAA section 65(1)).

[186] *See* Rev. Rul. 81-211, 1981-2 C.B. 179. *See also Steward Machine Co. v. Collector of Internal Revenue*, 301 U.S. 548, 570 (1937); *Davis*, 301 U.S. 619, cases addressing constitutionality of Titles II and IX of the Social Security Act of 1935, imposing excise tax on employers. *See also* David Pattison, "Social Security Trust Fund Cash Flows and Reserves," 75 *Soc. Sec. Bull*. 1 at 2-3, 7 (2015); and Nuschler and Sidor, *supra* note 34.

[187] *See* section 3102(b); and reg. section 31.3102-1(d).

[188] *See* Rev. Rul. 81-211, 1981-2 C.B. 179.

[189] *See* section 3509; and Rev. Rul. 86-111. *See also Navarro v. United States*, 72 A.F.T.R.2d 93-5424 (W.D. Tex. 1993) (unreported opinion); *Umland v. PLANCO Financial Services Inc.*, 542 F.3d 59 (3d Cir. 2008) (FICA does not create a private right of action for a worker against her employer for a refund of employment taxes concerning her misclassification as an independent contractor); and *McDonald v. Southern Farm Bureau Life Ins. Co.*, 291 F.3d 718 (11th Cir. 2002). *But see Ford v. Troyer*, 25 F. Supp.2d 723 (E.D. La. 1998) (an employee has a private right of action against his former employer for alleged wrongful classification as an independent contractor insofar as the claim concerns failure to withhold FICA and federal unemployment taxes but not failure to withhold income taxes).

[190] *Superannuation in Australia* (CCH) at para. 12-420 et seq.

[191] *Id.* at para. 12-390 et seq.

corporate employer,[192] similar to the trust fund liability exposure of officers of U.S. employers that do not remit their FICA and other payroll taxes to the federal government.

d. Recap. There are substantial similarities between the U.S. Social Security taxes and the SG. The similar nature of those taxes has been acknowledged and placed within the scope of coverage of the Australia-U.S. totalization agreement. Indeed, FICA and SECA do not apply, while employee wages are subject to the social security system of a foreign country under a totalization agreement between the United States and that other foreign country.[193] FICA and SECA do not apply when a USP is subject to Australia's SG scheme. The SSTA confirms that the SG is in fact equivalent to U.S. Social Security taxes.

D. Section 61 Principles

1. Section 61 Should Govern Taxation of Supers

The pressing U.S. tax question concerning the Super is whether the SG contributions and VECs paid to the Super should constitute part of the USP employee-beneficiary's worldwide taxable income. From a high-level overview of the Super, it would appear that all concessional employer and employee contributions to the Super (and income accretions therefrom) are portable, fully funded, and fully preserved from the moment of contribution for the benefit of the USP employee-beneficiary. Tax practitioners appear to have fixated on that one aspect — the employer-employee relationship — as the dispositive basis for applying section 402(b) to a Super, even though Supers are not established exclusively by private contract between employers and their employees and are not foreign tax-deferred retirement plans.[194] Most importantly, the Australian courts and tax practitioners have themselves acknowledged the folly of analyzing a member's interests in a Super within the context of contractual rights arising from an employer-employee relationship.[195] Justice Graham Hill of the Federal Court of Australia has pointed out that a member's interest in a Super is blurred by the existence of two distinct legal relationships that simultaneously overlap in the Super — the first relationship governed by a deed of trust between the trustee, the trust property, and the beneficiary; and the second relationship arising from a plan between the employer and employee that reflects the terms of their contractual relationship.[196]

We believe that section 61 provides a more comprehensive framework for determining the taxability of the Super to its UPS employee-beneficiary for U.S. tax purposes. After all, both employer and employee contributions to the Super, at first blush, reflect a ''clear accession to wealth,''[197] even though those contributions are deposited into a fund or trust. To make that determination, the Super contributions and income accretions must be examined in light of the constructive receipt doctrine and economic benefit doctrine.

a. Constructive receipt. The question that arises under section 61 is whether a USP employee-beneficiary recognizes income when concessional contributions from the employer and employee are made to the Super and income accumulations accrue to that account (the accruals), even when the USP employee-beneficiary has not actually received that money or had access to those amounts. Reg. section 1.451-2(a) states that income is constructively received by a taxpayer when it is ''credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.''[198]

For decades, U.S. courts and the IRS have applied the doctrine of constructive receipt when the taxpayer has an unqualified, vested right to receive immediate payment of income[199] and has not delayed a payment that would otherwise be due to him.[200] Application of the constructive receipt doctrine to Super contributions and income would not result in any gross income attribution to the USP employee-beneficiary. That is because the Super has satisfactory title to all assets appearing on its annual statement of financial position, and those assets are held separately from assets of the Super's members, employers, and trustees.[201]

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[192] *Id.* at para. 12-420 et seq.

[193] *See* section 3111(c), referencing section 233 of the U.S. Social Security Act. Self-employed individuals are also granted an exemption from taxes under SECA under section 1401(c). *See also* Rev. Proc. 80-56, *as amplified by* Rev. Proc. 84-54.

[194] As discussed in this report, contributions made to the Super and income accruing thereto are subject to current taxes in Australia, albeit at lower rates than ordinary income tax rates. Moreover, employer contributions paid directly to the Super as SG contributions are made under compulsion of Australian law and not voluntarily. The nature of those SG contributions is similar to U.S. Social Security, even though U.S. and Australian social security programs are administered differently.

[195] *See* Hill, *supra* note 16.

[196] *Id.* at 17.

[197] *See Commissioner v. Glenshaw Glass Co.*, 75 S. Ct. 743 (1955) (''Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion'').

[198] Reg. section 1.451-2.

[199] *See Ross v. Commissioner*, 169 F.2d 483, 490 (1st Cir. 1948).

[200] *See Gale v. Commissioner*, T.C. Memo. 2002-54. The tax court has noted that the doctrine of constructive receipt was conceived by Treasury to prevent a taxpayer from deliberately turning his back on the income and selecting a year in which to report it and reduce the same to possession. *Id.* (quoting *Hamilton National Bank v. Commissioner*, 29 B.T.A. 63, 67 (1933)).

[201] The assets of a superannuation plan may include contributions receivable, investments of the plan, cash and other monetary assets, and other assets used in the operation of the plan. See Australian Accounting Standards 25, section 27, at 16.

The Super's future obligation to fund a member's benefits on reaching preservation age is reported on its financial statements as a liability for accrued benefits.[202] Indeed, a USP employee-beneficiary has no immediate right to payment of amounts accumulated in the Super until the preservation age is reached. Once that age is attained, assets in the Super are liquidated and allocated to the member's account for distribution. The member then has an immediate right to payment of benefits from the Super, which he may opt to receive in a lump sum or periodically — at a minimum, he must withdraw at least 5 percent of the account balance yearly. Consequently, the member's right to payment of his Super benefits and control over the manner in which benefits are received at preservation age would support the assertion that the USP employee-beneficiary has actual and constructive receipt of gross income subject to U.S. taxation at his preservation age but not before that. We would argue that contributions and income accretions in the Super do not constitute gross income to the USP employee-beneficiary until those amounts constitute preserved benefits. Until then, there are several cashing restrictions that prevent the USP employee-beneficiary from obtaining unfettered access to and control over contributed amounts and income accretions in a Super. However, we are far from conceding the issue of the taxability of the Super at the pension phase. As more fully explained below, even a USP employee-beneficiary's access to the Super at the pension phase is not absolute, because there are also limits on the amount and type of benefits that can be distributed at that stage.

b. Economic benefit. The economic benefit doctrine has been called ''a limited technical device, created and advanced by the government in order to collect taxes from cash-basis taxpayers as soon as possible.''[203] Under that doctrine, a cash basis taxpayer recognizes income when he has acquired the economic benefit of money that is unconditionally and irrevocably transferred to him, although not necessarily accessible. The economic benefit doctrine is frequently applied to attribute income to a taxpayer-employee in deferred compensation arrangements when the employer has irrevocably set aside money in a trust, away from the employer's creditors, to benefit the employee.[204] In the seminal case of *Sproull v. Commissioner*,[205] the board of directors of a domestic company irrevocably transferred $10,500 to a trust to be paid out in two installments to a U.S. taxpayer who was the CEO of the company. The amount transferred constituted additional compensation to the CEO for work performed in prior years but underpaid by the company because of financial conditions. The court held that the expenditure of the $10,500 to set up the trust conferred an economic or financial benefit to the CEO in the year of transfer. The right to the trust was not contingent on any further action by the CEO, nor were there any restrictions on his right to assign or dispose of his beneficial interest in the trust. Moreover, no one else had an interest in or control over the money, except for the trustee, whose only duties were to hold, invest, accumulate, and pay out the fund and its increase to the CEO or his estate.

In determining whether an employer's SG contributions to a Super are taxable to a USP employee-beneficiary under the economic benefit doctrine, three elements must be present: (1) there must be some fund in which money or property has been placed; (2) the fund must be irrevocable and beyond the reach of the payer's creditors; and (3) the beneficiary must have vested rights in the money, with receipt conditioned only on the passage of time.[206] That means that only ministerial duties, not substantial restrictions or conditions, remain until the funds are released.[207] The third element is the most controversial for superannuation — that is, determining the nature of the beneficiary's interest in the monies contributed and accrued in the Super. The main contention is whether the USP employee-beneficiary has any vested[208] rights in the money, receipt of which is conditioned only on the passage of time as opposed to substantial restrictions or conditions.

Determining the true nature of a member's interest in Super (whether vested, contingent, or merely a right to be considered for benefits by the trustee) has perplexed Australian courts and practitioners for decades.[209] Hill has noted that the kind of superannuation scheme affects that determination.[210] For example,

[202]Financial statements of a Super are prepared as special purpose financial statements to meet the requirements of SISA and accompanying regulations.

[203]*See Thomas v. United States*, 45 F. Supp.2d 618, 625 (S.D. Ohio 1999).

[204]*See Pulsifier v. Commissioner*, 64 T.C. 245, 246 (1975) (citing *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952); and *Minor v. United States*, 772 F.2d 1472, 1474 (9th Cir. 1985) (citing Rev. Rul. 60-31, 1960-1 C.B. 174, 179)).

[205]16 T.C. 244.

[206]*See Thomas*, 45 F. Supp.2d at 620 (citing *Sproull*, 16 T.C. 244).

[207]*See Kuehner v. Commissioner*, 214 D. 2d 437, 440 (1st Cir. 1954), *aff'g* 20 T.C. 875 (1953).

[208]The term ''vested'' has different meanings depending on the context in which it is used. Vested amounts in a Super for Australian financial statement purposes are vested benefits that are not conditioned on the member's continued membership of the fund (or any factor other than resignation from the plan) and include benefits that members were entitled to receive if they terminated their fund membership at the end of the financial statement reporting period.

[209]*See* Hill, *supra* note 16.

[210]*Id.*

a member's interest in an accumulated benefits fund[211] on formation is an equitable property interest with no immediate right to payment.[212] That equitable interest is a conditional interest in the member's Super account balance under which the member has no right to the Super benefits until the conditions are met.[213] When the conditions are met, the member's interest is altered into two sub-interests: a right to immediate payment of the portion of the account balance that is not preserved, and a continuing conditional right regarding the portion of the account balance that is required to be preserved.[214] The preserved portion of the Super at the pension phase concerns specific benefits that may not be paid to the member until he retires from the workforce and attains a particular age or the benefits become payable in the event of one of the enumerated circumstances set out in the SIS regulations (for example, early retirement on grounds of incapacity, emigration from Australia, or early death before retirement).[215]

Compared to accumulated benefit funds, a member's interest in an end-benefit scheme[216] does not exist until the occurrence of the event that gives rise to the Super benefit.[217] Thus, each member's interest in the fund (regarding preserved benefits) is contingent on reaching retirement age before death.[218] The unresolved conflict with end-benefit schemes is whether trust beneficiaries, ''having more than a spec but less than an absolute interest,'' have an interest in each asset of the fund.[219]

Regardless of whether the fund is an accumulated benefits fund or an end-benefit scheme, Australian scholars have considered the true nature of a member's interest in the Super as either a contingent equitable interest that converts into a vested interest at the pension phase or a mere contractual right to Super benefits to be determined by the trustee. Arguably, neither constitutes a vested right to the Super's asset for purposes of the economic substance doctrine under U.S. tax laws, which requires a present, indefeasible right to the future receipt of property.[220] Indeed, the vesting of a Super's assets (benefits) on the USP employee-beneficiary does not depend on the making of any demand by or for the USP employee-beneficiary. That assertion is sound because a USP employee-beneficiary is not a party to the trust deed that formed the Super, and his rights as a beneficiary of the Super are not contractual in nature as others have jumped to conclude.[221] Australian courts have further elaborated on that aspect of a beneficiary's interest in a Super, noting that ''until a beneficiary under a superannuation fund becomes entitled to superannuation benefit, his or her equitable proprietary interest in the fund remains 'inchoate' and 'unchrystallised' so that neither the legal nor the beneficial owner of the amount that stands to the credit of his or her account from time to time.''[222]

Based on the above, we do not believe that a USP employee-beneficiary receives a present economic benefit when the Super is created by trust deed between the trustee and employer, or at the pension phase when the USP employee-beneficiary reaches retirable age, with only the passage of time as the sole condition left for his release. Nothing could be further from reality. There are additional conditions that may delay or hasten the release of money in a Super, particularly when amounts of money held by the Super are earmarked to be preserved unless a specific event occurs (such as death, incapacity, emigration from Australia, and other variables). Completely opposite from the foregoing is

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[211]The accumulated benefits fund is apparently the earliest and simplest superannuation scheme in Australia. Contributions are made regularly by the employer and employee, and the accounts of the fund must record the contributions received separately for each member. The trust deed requires the trustees to invest contributions in authorized investments and allocates the income from those investments yearly to the accounts of members pro rata. Gains or losses are also allocated among members. When a member retires (or is incapacitated or some other defined circumstance), she is paid out of the fund an amount equal to her interest. When the member dies, a benefit is payable to her legal personal representative or dependents, and the benefits are calculated on the same basis as if the member retired rather than died. *Id.* at 13.

[212]*Id.* at 14-15 (quoting *Caboche v. Ramsay*, 119 ALR 215 (1993)).

[213]*Id.*

[214]*Id.* at para. 48.

[215]For example, the preservation standards in the occupational superannuation standards regulations (statutory rule no. 322 of 1987). Under those standards, the effect of preservation is that benefits are payable on the retirement of the member before attaining age 55 in the form or a non-commutable pension or annuity, no benefits may be paid to a member until she retires from the workforce and attains an age of not less than 55, or the benefits become payable in one of several circumstances identified in reg. section 11(1)(a)(ii).

[216]In an end benefit scheme, the trust deed requires the employer to make contributions from time to time in accordance with actuarial advice. To fund the benefits that the deed provides for employees and dependents, benefits may be based on final end salary, average salary over a period, or some other formula. *Id.* at 15.

[217]*Id.* at 15-16.

[218]*Id.* at 16.

[219]*Id.*

[220]*See Sproull*, 16 T.C. 244; *Kuehner*, 214 F.2d at 440; and *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63, at *85. *See* Rev. Rul. 57-37, 1957-1 C.B. 18 (as modified by Rev. Rul. 57-528, 1957-2 C.B. 263); Rev. Rul. 72-25, 1972-1 C.B. 1271; and Rev. Rul. 68-99, 1968-1 C.B. 193.

[221]*See Caboche*, at paras. 62-63.

[222]*See Espasia Pty Ltd*. (ABN 74 057 517 825), in the matter of *Farm By Nature Pty Ltd*. (ABN 13 107 299 730) FCA 1552, at 229 (2009) (Gordon); *Re Coram*, 36 FCR 250, at 253-255 (1992); *Caboche*, 119 ALR 215 at 230; *Benson v. Cook*, 114 FCR 542, at 550-551, 561, 572 (2001); and *Cook v. Benson*, 214 CLR 370, at 35 (2003).

the scenario in which a USP employee-beneficiary at the pension phase is compelled to take out minimum distributions from the Super or risk incurring Australian taxes.[223] Those scenarios support the argument that a USP employee-beneficiary's interest in a Super at the pension phase remains unvested and confers no present economic benefit to the USP employee-beneficiary that would be subject to current U.S. taxation.

E. Sections 402 and 83 Regs Should Be Clarified

1. *Super Treatment Under Section 402(b)*

Under section 402(b), contributions by an employer to a nonexempt employee's trust are included in the employee's gross income when the employee's right to those contributions is no longer subject to a substantial risk of forfeiture as determined under section 83.[224] The amount includable in the employee's gross income equals the net fair market value of the employee's interest in the trust when vested.[225] Moreover, distributions received by the USP employee-beneficiary from a nonexempt employee's trust would be taxable to the USP employee-beneficiary in the year distributed or made available to that USP employee-beneficiary and limited only to the extent of that person's investment in the contract under section 72(w).[226]

As noted, we question whether section 402(b) applies at all to the Super. Section 402(b) requires an employer-employee deferred compensation arrangement — an employee's trust — to fall within its scope. Neither the IRC nor the Treasury regulations provide clear guidance on what constitutes an employee's trust.[227] Although the IRS has classified the Super as a foreign trust[228] for U.S. federal income tax purposes, whether the Super also constitutes an employee's trust for section 402(b) purposes remains unaddressed and therefore subject to interpretation.

The Super should not constitute an employee's trust and should therefore escape analysis under section 402(b) because it does not arise from a private contractual arrangement between an employer and employee like other typical (foreign and domestic) pension plans. The Super is mandated and created by Australian law, and neither the employer nor the employee can opt out of participation. The existence of the Super and SG contributions arise solely by virtue of Australia's taxing authority.

In the estate tax context, the IRS has acknowledged that accession to wealth arising from U.S. Social Security benefits should be treated differently from the accession to wealth that arises from an employment relationship. Rev. Rul. 81-182[229] states that U.S. Social Security benefits should be excluded from a decedent's estate because ''liability for payment does not arise out of the employment contract but rather is created by the Federal Government's taxing authority.'' Similarly, because the existence of the Super arises from the state's taxing authority, it should not be classified as an employee's trust.

Unlike other foreign trust arrangements in which the trustee is the legal owner of the trust assets and the employer is the settlor contributing cash or shares for employees,[230] the Super is established by executing a trust deed required under the SIS legislation along with an initial transfer of property to the trustee of the Super. Execution of the trust deed and the receipt of property give rise to the Super. The contributed property may come from the USP employee-beneficiary or other third parties, not necessarily the employer (although, in practice, the employer does contribute first). There is no mandatory or necessary employer involvement in the creation of a Super.

Even if the Super is classified as an employee's trust, one observer has noted that the legislative history of section 402(b) indicates that the statute was not intended to apply to foreign deferred compensation arrangements and instead was ''wholly focused on domestic tax qualified plans and perceived abuses with the U.S. tax-qualified plans by high ranking employees and shareholders.''[231] Indeed, in her outstanding review of the section 402(b) legislative history, Veena K. Murthy concluded:

> At no point in the history of section 402(b) has there been an indication that Congress, Treasury or the IRS intended to target and sanction foreign pension plans merely because they are funded plans that fail to satisfy sections 401(a)(26) and

[223] *See* Schedule 1 of the SISR, which sets out the conditions of release and cashing restrictions for purposes of the preservation rules. The preservation and payment rules are prescribed operating standards under SISA.

[224] Section 402(b)(1); reg section 1.402(b)-1(b)(2).

[225] Reg. section 1.402(b)-1(b)(2).

[226] Section 72 treats as nontaxable distributions amounts received by an employee that are attributable to the employee's ''investment in the contract.'' Section 72(w) provides that in determining the portion of a distribution includable in the gross income of a distributee who is a U.S. citizen or resident, the distributee's investment in the contract does not include any ''applicable nontaxable contributions'' or ''applicable nontaxable earnings.''

[227] The definition of foreign employees' trust under prop. reg. section 1.671-1(h)(2) fails to provide any definitive guidance on what constitutes an employee's trust. Indeed, the prop. reg. section 1.671-1(h)(2) definition provides a circuitous reference to sections 402(b) and 7701(a)(31).

[228] Section 7701(a)(30)(B); reg. section 301.7701-7. *See also* LTR 201538008, LTR 201538007, and LTR 201538006.

[229] 1981-1 C.B. 179.

[230] *See* Veena K. Murthy, ''Selected Cross-Border Equity and Deferred Compensation Issues with Funded Foreign Plans,'' 42 *Compensation Plan. J.* 67 (2014).

[231] *Id.*

410(b). Nor is there any indication that these legislative and regulatory bodies considered or targeted cross-border assignees . . . as persons who somehow abuse funded foreign plans to their benefit.[232]

The application of section 402(b) to foreign funded and secured pension plans is not unique to the Super. There are other non-U.S. trust arrangements potentially subject to the burdensome tax impact of section 402(b) on contributions and earnings. Those include the New Zealand superannuation plan; Dutch Stichtings; provident funds in Hong Kong Provident, Singapore, India, and Israel; Irish employee benefit trusts; U.K. employee benefit trusts; and arrangements within Swiss ''foundations.'' The main distinction, however, is that some of the countries have used totalization agreements and tax treaties to override section 402(b) consequences to a USP who has beneficial interests in a non-U.S. trust arrangement.[233]

If, despite the foregoing, the Super were to constitute an employee's trust that is subject to section 402(b), the next step of the analysis would be to determine whether the Super constitutes an exempt employee's trust under section 401(a). If the Super were classified as an exempt employee's trust, the SG contributions and VECs, as well as earnings accrued thereon, would be exempt from U.S. income taxation under section 501(a). Conversely, if the Super were classified as a nonexempt employee's trust under section 402(b)(1), the SG contributions and VECs, including earnings accrued, would be taxable to the USP employee-beneficiary as gross income if includable under reg. section 1.83-3 — that is, if those contributions are substantially vested or substantially nonvested.[234]

We acknowledge that if the Super were classified as an employee's trust to which section 402(b) applied, it would be extremely difficult or even impossible to be classified as an exempt employee's trust. Section 402(b) contains more than a few significant impediments to that classification. First is the fact that the Super is a foreign pension plan. Second is the general perception that most foreign plans are funded plans and that a funded plan has the same meaning for U.S. tax purposes as a funded plan in Australia.[235] Third is that for U.S. tax purposes, employer contributions to funded foreign pension plans constitute gross income to the employee, even though the employee's right to those contributions is deferred. Under section 402(b), the employee's right to employer contributions to the trust constitutes gross income to the employee when it is no longer subject to a substantial risk of forfeiture.

2. SG Contributions Should Be Excluded From 402(b)

The SG charge component of the Super provides further support to our suggestion that there is no employer-employee deferred arrangement subject to section 402(b). SG contributions made by the employer are compelled by statute under the SGAA. Any shortfall in SG contributions to the Super results in the SG charge — an excise tax owed by the employer to the ATO and paid directly to the collections revenue fund of the commonwealth. The ATO thereafter disburses the SG shortfall amount to the Super. There is no employee involvement with the SG contributions. It is a statutory obligation between the employer and the Australian Commonwealth, administered through the ATO. Indeed, the employee cannot bring a lawsuit against the employer for the SG shortfall amount, and the employer has no obligation to the employee regarding that amount. Rather, the SG shortfall amount results in an excise tax (the SG charge) to the employer. Based on the foregoing, it is apparent that the government (and not the employer) is the party actively involved in the contribution, investment, and distribution of the SG component to the USP employee-beneficiary.

There has been some concern among U.S. tax practitioners that the SG contributions made by the employer to the Super would constitute taxable wages to the U.S. member-beneficiary based on language found in Rev. Rul. 57-528[236] and Rev. Rul. 57-37.[237] In those revenue rulings, the IRS concluded that employer contributions to an unfunded and unsecured deferred compensation arrangement should be included in the employee's income based on the doctrine of constructive receipt.[238] As a result, the income constructively received was taxable to the employee under section 402(b) and, as a corollary, Treas. reg. section 1.402(b)-1(a)(1).[239]

One key distinction between the SG contributions and employer contributions in the above revenue rulings concerns the element of compulsion. As

[232]*Id.*

[233]*Id.*

[234]*See* reg. section 1.402(b)-1(a), (b), referencing reg. section 1.83-3(b) for the determination of whether contributions are substantially vested and substantially nonvested. *See also* T.D. 7554 (1978).

[235]Foreign pensions are perceived to be funded plans because assets are generally protected from the claims of creditors of the employer and related entities. *See* Murthy, *supra* note 230. An employee with an interest in a trust associated with a plan that is not a U.S. tax-qualified plan under section 401(a) is considered funded for U.S. tax purposes because the assets are protected from the claims of creditors and related entities. *Id.* (referencing LTR 8113107; Rev. Proc. 92-64, 1992-2 C.B. 422; and Rev. Proc. 92-65, 1992-2 C.B. 428).

[236]1957-2 C.B. 263.

[237]1957-1 C.B. 18.

[238]The employer contributions conveyed fully vested and nonforfeitable interests into a separate independently controlled trust, forming part of a plan to provide unemployment and other benefits for its employees.

[239]*See* Rev. Rul. 60-31, 1960-1 C.B. 176, *as modified by* Rev. Rul. 64-279 and Rev. Rul. 70-435.

discussed, the employer's obligations to make SG contributions to a Super do not arise because of the employer-employee relationship but from Australia's taxing authority. In *Morgan v. Commissioner*, the High Court of Australia noted that the SGAA and SGCA:

> do not operate to substitute a new statutory obligation for a pre-existing private obligation in an employer to make a payment to any employee. Rather, the legislation exacts a payment from an employer; and that payment is paid to the Consolidated Revenue Fund. While payments from the Consolidated Revenue Fund pursuant to s. 65 of the SGA Act are made by the Commissioner for the ultimate benefit of individual employees, that benefit is only received by an individual employee in the event of infirming or retirement.[240]

In short, the SG contributions and SG charge imposed by the SGCA and SGAA constitute an exaction for public purposes[241] and therefore, a valid tax imposed on employers under section 51(xxiii) of the Commonwealth of Australia Constitution Act (aka the pension power).[242] That treatment is consistent with the USP employee-beneficiary's treatment of the SG contributions and SG charge as a nonevent for purposes of her own Australian tax liability. As mentioned, the SG contribution itself, and accruals thereafter, do not constitute income to the employee in Australia.[243] Ironically, however, that same exempt amount in Australia is constructively taxed to the USP employee-beneficiary by the United States.

The IRS has already determined that a compulsory levy and contribution made by a foreign employer under its domestic law constitutes a tax. In Rev. Rul. 89-104,[244] the IRS reviewed the compulsory 13 percent contribution imposed by the Saudi Arabian government on an employer under Saudi social insurance law (of which 5 percent could be paid by the employer by withholding 5 percent from an employee's wages), which were paid to the Annuity Branch[245] of the General Organization for Social Insurance Corp. (GOSI). The inclusion of foreign workers in the Annuity Branch was terminated by the Saudi government by royal decree in 1987, and GOSI issued benefit cancellation payments in exchange for an irrevocable surrender of rights to receive GOSI benefits. The IRS ruled that the contributions made by a U.S. taxpayer under a GOSI assessment while working in Saudi Arabia constituted taxes and were not made under an employer-employee contract. Hence, the mandatory employer contributions to the Annuity Branch for the employee did not create an investment in the contract for purposes of section 72(e) or basis for purposes of section 1001. Consequently, the GOSI benefit cancellation payments received by a U.S. taxpayer from the Saudi government constituted gross income under section 61(a), even though Saudi Arabia did not tax the GOSI cancellation payment. There is no tax treaty between the United States and Saudi Arabia that would have otherwise made the cancellation payments exempt from taxation.

The SG contributions of the Super bear an interesting similarity with the GOSI Annuity Branch assessments. Both are statutory obligations of employers to make contributions to provide for the old age, retirement, and death of its employees. Both are paid directly by the employers to the state and treated as a tax. The GOSI scheme is subject to control and change at the discretion of the state, and the SG is subject to strict regulation and administration by the ATO and various regulatory agencies.

Based on the above discussion and precedents, we suggest that the SG component of the Super is properly characterized as a foreign social security tax similar to or in the same nature as U.S. Social Security taxes, which are excise taxes on the employer for U.S. tax purposes[246] and are not derived as a direct result of a contractual employment relationship.

a. SG component of the Super constitutes a separate grantor trust. Because SG contributions are the foreign equivalent of U.S. Social Security taxes, both the earnings accrued in and distributions arising from the SG contribution portion of the Super would have been taxable but for article 18(2) of the tax treaty, which exempts social security benefit payments from Australia from U.S. federal income taxation.

We acknowledge that SG contributions under the superannuation scheme are distinct from FICA and SECA under the U.S. Social Security program. SG contributions to the Super are fully funded, fully preserved, and portable from an Australian perspective and arguably funded and secured from a U.S. tax perspective, whereas FICA and SECA tax payments are made for future U.S. Social Security benefits, which are unfunded and unsecured.[247] Indeed, in *Fleming v.*

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[240] *Roy Morgan*, HCA 35, at para. 92.

[241] The SG charge was a compulsory exaction to "encourage all Australian employers to contribute to the financial needs of all Australian employees in old age or infirmity." *Id.*

[242] Commonwealth of Australia Constitution Act section 51(xxiii) (the power of the Parliament to make laws regarding invalid pensions and old age pensions).

[243] *See* ATO, *supra* note 18, at para. 104.

[244] 1989-2 C.B. 4.

[245] The Annuity Branch of the GOSI provides social insurance benefits for invalidism, old age (retirement), and death. The other branch of the GOSI, the Occupational Hazards Branch, provides insurance coverage for employment injuries and occupational diseases. *Id.*

[246] *See* section 3111(a).

[247] Indeed, federal courts have held that U.S. Social Security benefits are gratuity-type benefits paid by the government in which the individual claimant acquires "no vested rights." *See*

(Footnote continued on next page.)

Nestor,[248] the Supreme Court said the U.S. Social Security system is a form of social insurance in which the employee bears only a ''noncontractual interest'' such that the employee does not accrue property rights to Social Security benefits. It thus follows that U.S. Social Security contributions and accruals thereto are not taxed to the U.S. employee-beneficiary until those amounts are actually paid out.

We suggest that the funded and secured nature of the SG contributions in the Super does not constitute grounds for taxing contributions and accruals differently from contributions and accruals under U.S. Social Security.[249] Implicit in the SSTAs is that the foreign country's social security program is similar enough to the U.S. Social Security, and differences between the two do not justify different U.S. domestic tax treatment.

We agree with the House committee report to the Tax Reform Act of 1969, which found little practical difference between funded and unfunded deferred compensation:

> It is anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation. An employee who receives additional compensation in the form of a promise to pay him that compensation in the future made by a large, financially sound, corporation, is probably as likely to receive the compensation as an employee whose deferred compensation is placed in trust.[250]

SG contributions and accruals are preserved benefits in the Super that will not be payable to the USP employee-beneficiary until retirement age or, if earlier, until a condition of release is met. Until then, SG contributions are ''substantially nonvested.''[251] We are aware that it is likely that the nonforfeitability of the SG contributions in the trust triggers the current tax on the USP employee-beneficiary under section 402(b) because ''it embodies the taxation theory that when an employer contribution, which is placed in trust for the employee, is nonforfeitable at the time it is contributed, the employee has received an economic benefit that is taxable on a current basis.''[252]

However, we suggest that the there is no economic benefit to the USP employee-beneficiary derived from the SG contribution into the Super because it is not property of the employee until the requisite conditions of release are satisfied. Until then, SG contributions are property of the commonwealth. For example, in *Morgan v. Commissioner*, the High Court of Australia pointed out that the operative portion of the SG scheme (section 65) provides for the SG charge to be paid directly to the ATO, from which it is deposited into the government's revenue collections fund and not disbursed to the USP employee-beneficiary until specific conditions of release are satisfied:

> The SGA Act and the SGC Act do not operate to substitute a new statutory obligation for a preexisting private obligation in an employer to make a payment to any employee. Rather, the legislation exacts a payment from an employer; and that payment is paid to the Consolidated Revenue Fund. While payments from the Consolidated Revenue Fund pursuant to s. 65 of the SGA Act are made by the Commissioner for the ultimate benefit of individual employees, that benefit is only received by an individual employee in the event of infirming or retirement.[253]

We note further that if the SG contributions are currently taxable to the employee based on the economic benefit rule, the value of the USP employee-beneficiary's interest in them does not equate to the FMV of the SG contributions at the time of transfer to the Super. Australian courts have described the nature of a beneficiary's rights in a superannuation fund as

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Wollenberg, *supra* note 2, at 304; *United States v. Teller*, 107 U.S. 64, 68 (1982); and *United States v Cook*, 257 U.S. 523, 527 (1922). U.S. agencies have argued before the Supreme Court that OASDI is a gratuity, because there is no express contract of insurance between the federal government and the individual payer of Social Security benefits. *See* Wollenberg, *supra* note 2, at 300 and 306. Department of Labor and Treasury submissions have reflected that view. *Id.* at 303. *See also Fleming v. Nestor*, 363 U.S. 603 (1960). That may be the only way to explain why thousands of individuals have qualified for OASDI benefits on the basis of earnings records when no Social Security taxes were paid and even when no tax liability was incurred. *Id.*

[248] *Nestor*, 363 U.S. 603.

[249] The seminal IRS guidance on deferred compensation, which would become the cornerstone for the taxation of funded and unfunded pension plans, is Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 64-279, 1964-2 C.B. 121; and Rev. Rul. 70-435, 1970-2 C.B. 100. For insightful legal commentaries on the origins of the taxation of deferred compensation and legislative initiatives to abolish section 402(b)'s distinction between funded pension plans (current income inclusion) versus unfunded pension plans (no current income inclusion), see Commentary, ''Implementing Policy Objectives in the Taxation of Deferred Compensation Arrangements,'' 1978 *Duke L.J.* 1460 (1978); David R. Goode, ''Deferred Compensation Under the Tax Reform Act of 1969,'' 5 *U. Rich. L. Rev*. 235 (1970-1971); Ralph S. Rice, ''The New Tax Policy on Deferred Compensation,'' 59 *Mich. L. Rev*. 381 (1960-1961); and Richard S. Millerick and William A. Neilson, ''Non-Qualified Deferred Compensation After Tax Reform,'' 22 *Suffolk U. L. Rev*. 43 (1988).

[250] *See* H.R. Rep. No. 91-413 (part 1), at 89-91 (1969); and Goode, *supra* note 249, at 246. The House provision was deleted by the Senate at the request of Treasury, which indicated that the matter required further study and that alternative solutions would be preferred. Commentary, *supra* note 249, at 1475, referencing S. Rep. No. 91-552 (1969).

[251] *See* reg. section 1.83-3(b).

[252] *See* Commentary, *supra* note 249, at 1468.

[253] *See Roy Morgan*, HCA 35, at para. 92.

one that is of ''inchoate nature'' as first stated by the Federal Court of Australia in *Re Coram RA: Ex Parte Official Trustee in Bankruptcy and Ors*[254]:

> Until the happening of a prescribed event that will crystalize his right into an actual entitlement, a member of a superannuation fund is neither the legal nor the beneficial owner of the amount that stands to the credit of his account from time to time.[255]

Re Coram RA consolidated judicial dicta in various cases supporting the proposition that the current right of a member of a superannuation fund is no more than an expectancy.[256] His entitlements are all in the future and all depend on the occurrence of a prescribed event, of which the most common was the attainment of an agreed retirement age.[257] Indeed, a member's inchoate interest in a Super is such that a member-beneficiary of a superannuation fund has no direct interest in the underlying assets of the trust fund.[258] The beneficiary's interest is of an ''equitable proprietary nature, albeit one which does not carry an immediate right to payment.''[259]

If the SG contributions are classified as foreign social security taxes and benefits, which we believe is the correct treatment, the SG portion should fall outside the purview of section 402(b), which applies only to funded and secured pension plans that arise from a voluntary employer-employee contractual arrangement. None of the SG contributions constitute property transferred in connection with the performance of services between an employer and employee. Rather, the SG portion of the Super constitutes a separate and independent foreign trust (the SG trust). Both the commonwealth and the employer would be considered the grantors of the SG trust; however, only the commonwealth would be treated as owner of the trust.[260] The employer would not be treated as owner of the SG trust because the SG contributions would fail to qualify as gratuitous transfers if the employer is reimbursed by the commonwealth through tax deductions equivalent to those amounts.[261] It is the commonwealth, not the employer, that indirectly transferred property to the SG trust (through the employer).

We would further suggest that the SG trust constitutes a foreign grantor trust, with the commonwealth as grantor and owner. The commonwealth exercises dominion and control over the SG trust under the principles of sections 673 through 679 such that all SG contributions and accruals are attributable to the commonwealth as the owner and not to the USP employee-beneficiary. Further, the foreign grantor trust status of the SG trust satisfies section 672(f) and Treas. reg. section 1.672(f)-3 because the commonwealth has the power to re-vest SG trust assets back to itself. Ultimately, the SG contributions, accruals, and distributions should not be taxable to the USP employee-beneficiary, because they would constitute foreign social security taxes and payments thereon exempt from U.S. tax under article 18 of the tax treaty. Further, SG contributions and accruals constitute income to the commonwealth as the grantor-owner of the SG trust and not to the USP employee-beneficiary.

3. VECs Should Be Excluded From Sections 402(b) and 83

We do not believe that the SG portion of the Super alone is distinguishable from treatment as a foreign grantor trust with the commonwealth as foreign grantor-owner for the purposes of section 402(b). We maintain that the employee portion of the Super — that is, the VEC — is also not appropriately classified under section 402(b) in the absence of any employer-employee arrangement to defer compensation. The Super's structural framework varies significantly from other non-U.S. trust arrangements[262] in which the employee's right to the trust assets may be subject to service or performance conditions that must be satisfied for the employee's right to be nonforfeitable and for the employee to receive a future distribution of cash or a transfer of legal ownership in the shares from the trustee.[263] In our opinion, there are a few compelling reasons why the Super, while generically a funded and secured trust for the benefit of the USP employee-beneficiary, is unlike other private employer-funded foreign pension plans.

a. VECs to the Super do not fall under section 402(b). We believe that VECs made by a USP employee-beneficiary to the Super (and accruals on those contributions) should not be deemed gross income to that person under the constructive receipt doctrine, or the economic benefit rule of section 402(b), or the employee grantor trust rules of reg. section 1.402-1(b)(6). As stated, an employee-beneficiary's interest in a Super has been characterized by Australian courts as merely

[254]*In re Coram* and *Ors*, FCA 425 (1992).

[255]*Id.* at paras. 13-16.

[256]*Id.*

[257]*Id. See also* Hill, *supra* note 16.

[258]*See* M. Scott Donald, ''What's in a Name? Examining Consequences of Inter-Legality in Australia's Superannuation System,'' 33 *Sydney L. Rev*. 295, 302 (2011).

[259]*See Benson v. Cook*, FCA 1684 (2001), citing *Caboche*, 119 ALR 215, at 230 (1993).

[260]*See* reg. section 1.671-2(e).

[261]*Id.*

[262]*See* Murthy, *supra* note 230. According to Murthy, non-U.S. trust arrangements include Australian and New Zealand superannuation plans, arrangements within Dutch Stichtings, Hong Kong provident funds (as well as provident funds in other countries such as Singapore, India, and Israel), Irish employee benefit trusts, arrangements within Swiss foundations, and U.K. employee benefit trusts.

[263]*See* David W. Ellis, *Structuring International Transfers of Executives*, at section 27:5.01(c); and Murthy, *supra* note 230.

incipient, undeveloped, and inchoate,[264] as well as equitable and proprietary in nature but without an immediate right to the payment of benefits. Rather, the interest is merely the expectancy of future entitlements until the prescribed event occurs.

The nature of the USP employee-beneficiary's beneficial interest in the VEC, combined with the significant cashing restrictions, investment restrictions, and borrowing restrictions on the Super under SIS legislation, give support to our contention that USP employee-beneficiary's interests in a Super is indeed one that is substantially nonvested.[265] As discussed, there are investment restrictions, cashing restrictions, and conditions of release under SIS legislation that give us reasonable grounds to assert that the beneficial interest of the USP employee-beneficiary in the employee portion of the Super is nontransferable and remains subject to a substantial risk of forfeiture.

Indeed, a USP employee-beneficiary's entitlement to preserved benefits under the Super remains subject to revisions, repeal, and amendment by the Australian Parliament.[266] For example, a beneficiary's interests in the assets of a Super can be amended by the introduction of new bankruptcy laws that gave a bankruptcy trustee power to claw back amounts contributed to a Super by a debtor,[267] as well as by provisions in bankruptcy laws that limit exemption to a bankrupt's interest in a superannuation fund to a specified amount.[268] Consequently, amounts contributed and accruing in the Super remain subject to a substantial risk of forfeiture and are not transferable to any other party at any stage, even though contributions made to the Super are deemed fully funded, fully preserved, and portable.

Our understanding of the inchoate and incipient nature of a USP employee-beneficiary's interest in Super combined with the substantial restrictions prohibiting that person from accessing funds in the Super leads us to question whether the fully funded, fully preserved, and portable nature of the VEC is at all equivalent to the U.S. tax law concept of a funded pension plan, which section 402(b) is supposed to address. Section 402(b) provides that employer contributions to a nonqualified funded plan are not includable in the employee's gross income until his rights in the trust are transferable[269] or no longer subject to a substantial risk of forfeiture.[270] The code provides that the rights of a person in property are subject to a substantial risk of forfeiture if the rights to full enjoyment of that property are "conditioned upon the future performance of substantial services by any individual."[271] That does not apply to the Super because the SG contributions and VEC are not predicated on an employer-employee relationship such that the employee's rights to the Super are conditioned on future performance of services. Indeed, the Super does not fit into a typical funded pension plan under section 402(b).

For that reason, we hesitate to dwell further on section 402(b). We are concerned that applying reg. section 1.402(b)-1(b)(6) (the employee grantor trust rules) to the SG contributions and VEC in a Super would open a can of worms for the USP employee-beneficiary, because she would be treated as (1) the substantially vested USP employee-beneficiary of a foreign employer's contributions paid to a foreign nongrantor trust (the Super), and (2) the grantor-owner of a portion of the non-incidental employee contributions in a Super with uncertain tax consequences. That regulatory exception to section 402(b)(3) undermines legislative intent to restrain the application of the grantor

[264]Rudimentary, not fully yet formed, immature, incipient interest.

[265]Reg. section 1.83-3(b) defines property as being substantially nonvested when it is subject to a substantial risk of forfeiture and it is nontransferable. Conversely, property is substantially vested of those purposes when it is either transferrable *or* not subject to a substantial risk of forfeiture. Under reg. section 1.83-3(d), property is transferable if the person receiving the property can sell, assign, or pledge (as a collateral for a loan or as security for the performance of an obligation or for any other purpose) his interest in the property to any person other than the transferor of that property and if the transferee is not required to give up the property or its value if a substantial risk of forfeiture materializes. Reg. section 1.83-3(e) defines the term "property" as including a beneficial interest in assets (including money) that are transferred or set aside from the claims of the transferor's creditors — for example, in a trust or escrow account.

[266]Most recent changes to the Super were announced by the Australian government on September 15, 2016. These changes adopt the 2016-2017 budget proposal. The government decided to amend the package to provide greater support for Australians investing in their superannuation with the primary objective of providing an income in their retirement. The three changes announced by the government on September 15 are to replace the lifetime non-concessional contributions cap with lower annual caps for non-concessional contributions, only available to people with balances less than AUD 1.6 million; defer commencement of carryforward arrangements for concessional contributions; and not proceed with measures to increase the flexibility for contributions for people aged 65-74.

[267]*See* Australia Bankruptcy Act of 1966, sections 128A through 128N, introduced in July 2006 to enable trustees to void some superannuation contributions made with the intent to defeat creditors.

[268]*See* section 116(2)(d), 116(5)-(9) of the Superannuation Industry (Supervision) Consequential Amendments Act of 1993 (Act No. 82), the relevant part of which commenced in July 1994 as discussed in Victor J. Bennetts, "Bankruptcy and Superannuation," 11 *Queensland U. Tech. L.J.* 157 (1995).

[269]One commentator has noted that the code provides a circular definition for the concept of what constitutes a nontransferable contribution to a trust, noting the "the rights of a person in property are transferrable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture." *See* Commentary, *supra* note 249, at 1467, n.44.

[270]The forfeitability requirement in section 402(b) is cross-referenced to the forfeitability requirements in section 83(a).

[271]Section 83(c)(1).

trust rules in a section 402(b) context. According to on observer, legislative history apparently indicates that section 402(b)(3) was enacted to clarify that income earned by a trust that remains undistributed to the employee would not be taxed to an employee before distribution, which ''in turn implies an intention or expectation that an employee would rarely be treated as grantor.''[272]

Further, the practical application of reg. section 1.402(b)-1(b)(6) would be extremely difficult, if not impossible, to administer for the Super regime. Reg. section 1.402(b)-1(b)(6) states:

> Where the contributions made by the employee are not incidental[273] when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employer, if the applicable requirements of such subpart E apply [meaning the grantor trust rules].

Essentially, the above regulation provides an exception to the general rule under section 402(b)(3), which provides that the beneficiary of any trust under section 402(b)(1) would not be considered the owner of any portion of that trust under subpart E of Part I of subchapter J. Reg. section 1.402(b)-1(b)(6) carves out an exception to section 402(b)(3) when a beneficiary of a section 402(b) trust would be treated as a grantor-owner of that portion of the trust attributable to contributions made by the employee. If the regulation applies, earnings on the portion of the trust attributable to the employee's contributions are considered individual income and noncompensatory, such as capital gains or interest, depending on the nature of the earnings.[274] Yet there is no clear guidance on what would constitute an employee's contribution and an employer's contribution for that regulation and, more important, on what would constitute an incidental employee contribution.[275]

Aside from the difficulty in applying the above regulation to the Super because of the dearth in guidance on what constitutes incidental employee contributions, there is also potential difficulty in implementation. The regulation implies that one Super might be treated concurrently as partially a section 402(b) nonexempt employees' trust and partially as a grantor trust according to what is considered an incidental or non-incidental employee contribution. The employer portion and the incidental employee portion would qualify as a section 402(b) employee's trust, with income inclusion to be governed by sections 72 and 83. The non-incidental employee contributions would lead to immediate income recognition with possible nightmarish PFIC tax and reporting for the underlying investments. As a practical matter, tracing specific contributions to investments that constitute PFICs would be so difficult that it would render that requirement nearly impossible to satisfy.

Because SG contributions to the Super are mandatory and all employee contributions are voluntary or elective, one employee's Super might be treated only as a section 402(b) employee's trust because no non-incidental employee contributions have been made. Meanwhile, another employee may be required to bifurcate his Super and treat the SG contribution and the incidental employee contributions (not to mention related accretion inside the Super) as a section 402(b) employee's trust and treat the non-incidental employee contribution and related accretion as a foreign grantor trust. The bottom line is that someone would have to keep track of those bifurcated contributions and balances annually because the amounts and percentages of employee contributions may well vary from one year to the next. Of course, as a practical matter, many employees might forgo voluntary contributions to avoid that morass, a tendency that runs counter to the general policy of encouraging retirement savings.

4. Direct or Deemed Paid FTC

Without the clarifications we suggest in this report, U.S. tax law could be interpreted to require a USP employee-beneficiary of a Super to include in her gross income all the SG contributions, VECs, and accruals of income within the Super because it constitutes a funded and secured pension plan that is not subject to a substantial risk of forfeiture. In that event, we suggest that the USP employee-beneficiary of the Super should be allowed to claim either a direct or deemed paid FTC against her U.S. income tax for Australian taxes paid by the Super under article 22 of the tax treaty.

Our FTC suggestion is consistent with U.S. tax law. Section 901 allows a direct credit for the amount of income, war profits, or excess profits tax paid to any foreign country. Reg. section 1.901-2(a)(2) provides:

> A foreign levy is also considered an income tax, if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. [However,] a foreign levy is not pursuant to a foreign country's authority to levy taxes to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit from the foreign country in exchange for payment pursuant to the levy.

The above regulation declares that a tax or levy in exchange for which a governmental authority confers a specific benefit will not be considered a creditable tax. That differs from the more general benefits that taxpayers expect to receive from the government when it levies the tax. It is therefore reasonable to ask whether

[272] Murthy, *supra* note 230.

[273] One may question whether the IRS would be willing to rule on what amount or percentage constitutes an incidental contribution.

[274] *See* Murthy, *supra* note 230.

[275] *Id.*

social security taxes are too directly related to the specific benefits that the employee will receive in retirement.

Reg. section 1.901-2(a)(ii)(C) clarifies that a foreign levy imposed on individuals to finance retirement, old age, death, survivor, unemployment, illness, or disability benefits or ''for some substantially similar purpose'' is not a requirement of a compulsory payment in exchange for a specific economic benefit as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies, or similar characteristics of those individuals.[276]

The foreign levy on the Super under SIS legislation is imposed on the SG contribution itself, the employee contribution, and accruals of income thereon at a rate of 15 percent on contribution and another 15 percent on accumulation. The levy is not based on the employee's age, life expectancies, or similar characteristics of individuals but on the mere fact that a contribution to the Super has been made to benefit the employee on retirement. Also, the 15 percent tax on contribution and accumulation may not be the only tax imposed if non-concessional contributions exceeding the annual cap amounts were also made that same year.

However, there are important distinctions regarding the Super taxes. First, Australia imposes the levy on the Super itself, SG contributions, employee contributions, and accrued income — not directly on the employer or the employee. Second, the SG contribution is mandatory to the employer whereas the VECs are not. The employee is not subject to a mandatory levy.

We do not believe that those distinctions, while important, are relevant to the scenario in which the USP employee-beneficiary is compelled by operation of sections 402(b) and 83 to include in her worldwide income all contributions made to the Super and accretions of income thereon. If the USP employee-beneficiary is to be taxed again by the United States for those same amounts under sections 402(b) and 83, or, in the alternative, as a grantor trust with the USP employee-beneficiary as grantor-owner under reg. section 1.402(b)-1(b)(6), it would follow that she should be able to claim either direct or indirect FTCs under section 901 or 960 against her U.S. income taxes for the Australian taxes paid by the Super on her VECs.

Our suggestion to extend an FTC to the USP employee-beneficiary for Australian taxes paid by the Super does not extend to the portion of the Super that constitutes SG contributions and accretions, because they constitute foreign social security taxes, which are not creditable under Rev. Proc. 80-54[277]:

> Section 317(b)(4) of the Social Security Amendments of 1977 provides that, notwithstanding any other provision of law, taxes paid by any individual to any foreign country with respect to a period of employment or self-employment that is covered under the social security system of such foreign country in accordance with the terms of an agreement entered into pursuant to section 233 of the Social Security Act shall not, under the income tax laws of the United States, be deductible by, or creditable against the income tax of, any such individual.

We do not anticipate contrary positions to be taken by the IRS regarding our proposal to extend FTCs to USP employee-beneficiaries of Supers for Australian taxes paid by the Super for the VECs and accruals thereto. Before the introduction of SSTA, the IRS ruled that foreign social security tax payments paid through employee contributions were generally creditable as compared with employer contributions.[278]

In 1977 Congress amended the Social Security Act to authorize the president to enter into SSTAs with foreign countries.[279] New subsections were simultaneously added to the code that deny an FTC to an individual who receives wages exempt from FICA or SECA under section 233 of the Social Security Act.[280] That disallowance has been affirmed in two cases involving the French *contribution sociale généralisée* and *contribution pour le remboursement de la dette sociale*.[281] Those tax payments were found to be social security tax payments of a foreign

[276]Reg. section 1.901-2(ii)(C).

[277]*See also* section 1401 to the Act of December 20, 1977, P.L. 95-216.

[278]*See, e.g.*, Rev. Rul. 68-411, 1968-2 C.B. 306 (Canadian social security tax payments ruled creditable); Rev. Rul. 69-338, 1969-1 C.B. 194 (Venezuelan social security tax payments ruled creditable to employees because of their compulsory nature but not on the employer's share of the payments that is not measured by the employer's income); Rev. Rul. 75-279, 1972-2 C.B. 441 (U.K. National Insurance Act taxes paid by U.S. employees ruled creditable but not the portion levied on employers). Both rulings were under section 901(a). The Supreme Court has held that the tax imposed by section 3101 was an additional income tax in cases challenging the constitutionality of federal employment and self-employment taxes. *Helvering v. Davis*, 301 U.S. 619, 635 (1937). *See also Cain v. United States*, 211 F.2d 375, 378 (5th Cir. 1954).

[279]Social Security Amendments of 1977, P.L. 95-216, section 317 (codified as section 233 of the Social Security Act, 42 U.S.C. section 433(a).

[280]P.L. 95-216, section 317(b)(2) (creating sections 3101(c), 3111(c), and 1401(c)); and P.L. 95-216, section 317(b)(4) (creating a note to section 1401, which denies the foreign tax credit). That curious approach to drafting the disallowance of the FTC was upheld in *Eshel v. Commissioner*, 142 T.C. 11 (2014), *appeal pending*; and *Erlich v. United States*, 104 Fed. Cl. 12 (2012). The purpose of those new provisions is to ensure that the U.S. employee subject to foreign social security tax is no better off than a U.S. employee subject to FICA payments. For tax payments made for U.S. Social Security, there is no credit granted against U.S. income tax. Similarly, there should be no FTC against U.S. income tax for payments for foreign social security.

[281]*Eshel*, 142 T.C. 11; *Erlich*, 104 Fed. Cl. 12.

country ''made in accordance with the terms of an agreement pursuant to section 233 of the Social Security Act.''[282]

The Australia-U.S. totalization agreement clearly identifies the SG as the other Australian social security tax that would be equivalent to U.S. Social Security taxes (FICA and SECA) in addition to the Australian social security taxes.[283] Hence, an argument could be made that the SG contributions to the Super should not be creditable to the USP employee-beneficiary. However, the Australian tax imposed on an employee's VECs or salary sacrifice is not within the scope of the totalization agreement. Therefore, the VECs (and accruals of income attributable thereto) should still be creditable for U.S. FTC purposes under either a direct or deemed paid credit mechanism, because they are exempted from U.S. Social Security taxes under sections 3101(c), 3111(c), or 1401(c). Thus, the note to section 1401 disallowing an FTC should not apply, and the older principles enunciated in the revenue rulings cited above should apply to permit a direct or deemed paid FTC for those Australian taxes if they otherwise correspond to items of income subject to current U.S. taxation.

F. U.S. Tax Law: Australian Superannuation Funds

1. Recent IRS Positions

The IRS recently published three private letter rulings concluding that a foreign trust providing superannuation benefits to its members constituted a trust for U.S. federal income tax purposes under reg. section 301.7701-4(a).[284] In all three letter rulings, the foreign social security arrangement was governed by foreign legislation and regulated by several government entities. The arrangement, which had the sole purpose of providing superannuation benefits to its members and their beneficiaries, was managed by individuals referred to in the letter rulings as trustees. All funds were derived from employer and employee contributions and from investment income. The trustees had a duty to manage funds responsibly to protect and preserve superannuation and provide an annual statement to beneficiaries stating information about the foreign trust as required by law. The trust was subject to a foreign audit by an approved auditor, and members of the trust could not unilaterally assign or transfer their benefits in the trust to another person.

A close reading of the letter rulings leads us to conjecture (without affirmation from the IRS) that they likely pertain to Australian superannuation funds. In the letter rulings, the IRS was asked to assume that the social security programs at issue were employee trusts for U.S. purposes. Therefore, it does not appear that the conclusion reached in the letter rulings depended on an analysis of whether the underlying arrangement was an employee trust. In light of our position that Australian superannuation funds should be analyzed consistently with U.S. Social Security and not as employee's trusts, we believe the rulings should be reexamined and clarified.

Reg. section 301.7701-1(a)(1) makes clear that the foreign classification of an entity does not control its classification under U.S. law.[285] In light of our suggestion that Supers are the equivalent of U.S. Social Security, we do not agree that the arrangements in the letter rulings should have been classified as foreign trusts for U.S. tax purposes, even though Australia views Supers as ''essentially trusts'' established to hold and invest in superannuation assets.[286] That is because Supers are creatures of Australian legislation and do not arise from private, contractual arrangements between an employer and employee or between a grantor trustee and beneficiary. General principles of Australian tax law were intentionally modified[287] to carve out a preferential tax scheme for Supers rather than impose ordinary trust tax law provisions applicable to ordinary and public trusts.[288]

We believe the Super's classification for U.S. tax purposes should be bifurcated into two components. The SG contribution (and accretions thereto) would constitute a foreign grantor trust (the SG trust) with the commonwealth as grantor of foreign social security taxes and benefits. The SG contributions and foreign social security taxes and accruals thereto (as social security benefits) would be exempt from U.S. income tax under treaty article 18(2).

The portion of the Super that corresponds to the VECs (and accretions thereto) would constitute a private IRA, with the USP employee-beneficiary as grantor-owner of the private IRA trust. As grantor-owner of a private IRA, contributions, accretions, and distributions would be subject to tax by the United States unless exempted under article 18 of the tax treaty. Unfortunately, the treaty does not have comprehensive pension provisions under article 18 to exempt a private IRA with a USP employee-beneficiary and grantor-owner from U.S. taxes. We would therefore

[282]Note to section 1401 under P.L. 95-216 (effective Dec. 20, 1977).

[283]*See* Australia-U.S. totalization agreement article 2: 1(b)(ii).

[284]LTR 201538008, LTR 201538007, and LTR 201538006.

[285]The regulation provides: ''The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.''

[286]Deutsch et al., *supra* note 114, at 1566.

[287]Super taxation is governed by division 295 of the Income Tax Assessment Act of 1997.

[288]Ordinary trusts and public trusts are taxed under division 6 of Part III of ITAA of 1936. *See* Deutsch et al., *supra* note 114, at 1566.

urge the IRS and Congress to fashion an administrative remedy for that problem so that only actual distributions from an Australian IRA would be taxable by the United States. That remedy could include an MOU between the competent authorities. With that remedy in place, all VEC amounts and accruals thereon would be deemed received by the USP employee-beneficiary as grantor-owner and exempted from U.S. tax, although subject to other limits such as the contribution limit found in section 415.

2. VEC Classification and Reporting: The RRSP Path

The Super is not the first pension plan to have been initially classified as a foreign nonqualified trust under section 402(b) in the absence of definitive IRS guidance. The IRS addressed the same issue with the Canadian registered retirement savings plan (RRSP), which it initially determined was equivalent to a U.S. IRA that did not meet the strict qualifications of section 408(a).[289] Indeed, the IRS views the beneficiary of a Canadian retirement plan as subject to U.S. tax on accrued yet undistributed income in the plan unless the plan constitutes an employees' trust under section 402(b) and the individual is not a highly compensated employee under section 402(b)(4)(A).[290] As a consequence, U.S. residents with contributions to, distributions from, and ownership of a Canadian trust for which an election to defer U.S. tax on accrued income under Article XVIII(7) is available would be obligated to file Form 3520 and Form 3520-A returns under section 6048.[291]

Admittedly, RRSPs do not constitute a social security program in Canada and in fact are not covered by the Canada-U.S. SSTA.[292] Despite that distinction, USP employee-beneficiaries of Canadian RRSPs and registered retirement income funds (RRIFs) have been exempted from foreign employee trust reporting requirements, while USP employee-beneficiaries of the Super do not have such clear guidance.

In Rev. Proc. 89-45,[293] the IRS described the RRSP as an IRA that meets the qualification requirements under section 408(a), with the result that earnings accrued in the plan were currently includable in the gross income of the beneficiary for U.S. tax purposes (while Canada deferred taxes on earnings until actual distribution).[294] Further, distributions received from an RRSP were also includable in gross income of the beneficiary under section 72, concurrent with Canadian taxation of the same amounts on distribution. In 2002 the IRS issued Rev. Proc. 2002-23,[295] which allowed U.S. and Canadian beneficiaries of RRSPs and RRIFs to elect to defer U.S. taxation on income accrued[296] in the RRSP until actual distribution is received. Shortly thereafter, the IRS announced a new simplified reporting regime pending design of a new form that would be more appropriate for reporting RRSP and RRIF interests.[297] That new reporting regime was in lieu of filing obligations under section 6048 (forms 3520 and 3520-A) that would otherwise apply.[298]

U.S. or Canadian beneficiaries of RRSPs or RRIFs making an election under Article XXIV(7) to defer taxation on accrued income in the RRSP or RRIF until actual distribution were not required to provide as much detailed information. According to Notice 2003-75, the new simplified reporting regime was instituted under the authority of section 6001 for tax compliance purposes and, consequently, no further reporting obligations under section 6048(d)(4) were required for RRSPs or RRIFs with beneficiaries and annuitants subject to the new simplified reporting regime.[299] No associated penalties under section 6677 were to apply to RRSPs and RRIFs, although a beneficiary or annuitant may have been subject to other penalties.[300]

Rev. Proc. 2014-55[301] introduced the most recent changes to the RRSP cross-border taxation regime by replacing all then-existing procedures that a beneficiary of a Canadian retirement plan must follow to make an election under treaty Article XVIII(7) with just two different procedures. Under the first method, an eligible

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[289] *See* Rev. Proc. 89-45, 1989-2 C.B. 596, *superseded by* Rev. Proc. 2002-23, 2002-1 C.B. 744. Rev. Proc. 89-45 provided guidance for applying former Article XXIX(5) of the Canada-U.S. treaty.

[290] Canada-U.S. treaty, Article XVIII (8). *See also* Rev. Proc. 2014-55, 2014-44 IRB 753, at section 2.01.

[291] *See* Rev. Proc. 2014-55 at section 2.04.

[292] Signed March 11, 1981.

[293] 1989-2 C.B. 596, *superseded by* Rev. Proc. 2002-23. Rev. Proc. 89-45 provided guidance for applying former Article XXIX(5) of Canada-U.S. treaty.

[294] Rev. Proc. 89-45 at section 2. Rev. Proc. 89-45 provided U.S. citizen beneficiaries of an RRSP an election to defer U.S. income taxes on the current-year undistributed earnings of the RRSP for a year if the contributions were made during the periods of Canadian residency.

[295] *See* Rev. Proc. 2002-23, providing guidance for applying new Article XVIII (7) of the Canada-U.S. treaty.

[296] Only income accrued in the RRSP was subject to deferral, not the RRSP contributions in all cases.

[297] *See* Notice 2003-75, 2003-2 C.B. 1204, *superseded by* Rev. Proc. 2014-55.

[298] We note, without confirmation or affirmation from the IRS, that the reporting obligations for Canadian RRSPs may have been excepted from the reporting obligations of foreign trusts because Article XVIII(7) and (8) of the Canada-U.S. treaty exempts contributions and earnings from taxation in the United States. If so, exemption from taxation under the appropriate income tax convention could be a condition precedent to the IRS's willingness to exempt USP employee-beneficiaries from reporting similar pensions from reporting as foreign trusts.

[299] *See* Notice 2003-75, section 3.

[300] *Id.*

[301] Rev. Proc. 2014-55, section 4.

individual[302] would elect to apply Article XVIII(7) by reporting on his Form 1040 all income recognized from the plan on receipt of distributions.[303] Under the second method, taxpayers who have previously reported all the undistributed accrued income earned in a Canadian retirement plan on their previously filed Form 1040 could make an election under Article XVIII(7) by requesting the commissioner's consent to apply Article XVIII(7).[304] Rev. Proc. 2014-55 provides that any election made thereunder is made plan by plan, regardless of whether the beneficiary was a resident of Canada when contributions were made to the plan.

Lastly, Rev. Proc. 2014-55 eliminated any further requirements for beneficiaries and annuitants of a Canadian retirement plan to report contributions to, distributions from, and ownership of Canadian retirement plans under the simplified reporting regime of Notice 2003-75 (obsoleting Form 8891) or under reporting obligations imposed by section 6048 (Form 3520). It did not, however, affect any reporting obligations for Form 8938 under section 6038D or FinCEN Form 114 imposed by 31 U.S.C. section 5314.[305]

3. Super Reporting Under Section 6048

Section 6048 imposes various reporting obligations on foreign trusts and persons making transfers to or receiving distributions from foreign trusts. A USP employee-beneficiary who is treated as an owner of any portion of a foreign trust is required to provide information regarding the trust and ensure that the trust complies with its reporting obligations.[306]

In light of the above technical concerns about the classification of the entire Super (both SG contribution and VEC portions) as a foreign trust under section 7701(a)(31) or as a funded and secured foreign pension plan under section 402(b) with an employee-grantor trust under reg. section 1.402(b)-1(b)(6), we propose that USP employee-beneficiaries of a Super be held to the same reporting obligations as beneficiaries of other foreign trusts. To do so would subject the USP employee-beneficiary, who is presumably a grantor and beneficiary of a Super, to information reporting requirements and penalties for the Super under section 6048, and, as a corollary, potentially annual PFIC reporting requirements[307] under section 1298, which may cause the taxpayer to incur significant tax compliance costs.[308]

Treasury regulations[309] under section 6048 require both grantors of foreign trusts and beneficiaries of foreign grantor trusts to file Form 3520 (for an ordinary transfer to the trust) and Form 3520-A (foreign grantors) to report their activities and interest. The regulations cover a range of activities that are likely to complicate actions conducted by or for the Super, and they will therefore cause it to file a U.S. tax form. Foreign trusts that constitute section 402(b) nonqualified deferred compensation trusts are exempted from that tax filing requirement under section 6048(3)(B)(ii) and its regulations. Those provisions state that contributions made to a nonqualified foreign trust under a plan that provides for pensions, profit-sharing, stock bonuses, sickness, accidents, unemployment welfare, and similar benefits or a combination of those contributions are not required to be reported under section 6048. Consequently, there is no affirmative obligation to file Form 3520 or Form 3520-A.

Our proposal bifurcates tax classification of the Super as a special hybrid trust entity under Australian law that comprises two independent foreign trusts: (1) the SG trust with the Australian commonwealth as grantor and owner, and trust assets composed entirely of SG contributions, accruals, and distributions equivalent to social security taxes and income that comprise social security benefits; and (2) a foreign private IRA with the USP employee-beneficiary as the grantor-owner that consists of VECs, accruals, and distributions that would be subject to special administrative reporting procedures similar to the administrative relief extended

[302] *See id.*, providing examples of what constitutes an eligible individual as a beneficiary of a Canadian retirement plan — that is, at any time he is or was a U.S. citizen or resident, has satisfied his U.S. federal income tax return filing obligations, has not reported his accrued earnings in the Canadian plan as gross income for U.S. tax purposes, and has reported all distributions received from the Canadian plan as if he had made an election under Article XVIII(7) to defer tax on accrued income in the plan until distribution.

[303] *Id.* at section 4.02. Individuals who did not make the election under Article XVIII (7) would be treated as having made it in the first year in which they would have been entitled to make the election. An election is effective for all years until a final distribution is made from the Canadian plan.

[304] *Id.* at section 4.04.

[305] *Id.* at section 5.

[306] JCT, ''General Explanation of Tax Legislation Enacted in the 111th Congress,'' JCS-2-11, at 242 (Mar. 2011).

[307] *See* H.R. Rep. No. 104-737, at 330-338 (1996); and T.D. 9650 (proposed and temporary regulations issued Dec. 31, 2013).

[308] Some U.S. expatriates in Australia have commiserated at the expensive tax compliance costs for preparing and filing Form 8621 for each foreign mutual fund held in the Super. One U.S. expatriate noted that he ended up filing 300 Forms 8621 in one year alone. If the U.S. person were to make a qualified electing fund election to report his share of the ordinary earnings or capital gains of the PFIC, perhaps to be eligible for preferential capital gains rates, it is unclear whether the necessary information would be readily available. Most commercially available foreign mutual fund investments do not qualify to allow the owner to make a QEF election because the information requirements of section 1295(a)(2)(B) cannot be satisfied. Hence, the grantor trust classification of the Super will likely lead to egregious overtaxation and burdensome and expensive tax reporting for no good policy reason.

[309] *See* reg. section 404.6048-1(a)(1); and reg. section 16.3-1(c). *See also* Notice 97-34, 1997-1 C.B. 422.

by the IRS to Canadian RRSPs. Absent that administrative relief, it would seem that the foreign private IRA would still be exempt from filing forms 3520 and 3520-A if it qualifies as a section 402(b) nonqualified trust as provided under section 6048(3)(B)(ii) and reg. section 16.3-1.

Rules that apply to Supers are needed to clarify that USP employee-beneficiaries of a Super are also not subject to section 6048 reporting requirements on income, gains, and earnings from the Super. To fail to do so would cause U.S. expatriates with Supers in Australia further aggravation arising from the requirement that they file their U.S. income returns consistently with the information received from the Super under section 6048.[310]

We recommend that regulations under section 6048 be amended to clarify that Super arrangements and other similar arrangements that are subject to an SSTA be excluded from reporting on forms 3520 and 3520-A.

G. Exclusion From FBAR

There is also confusion whether Supers constitute foreign financial accounts subject to FBAR reporting requirements.[311] There is no explicit exemption in the FBAR regulations that excludes Supers from reporting on the FBAR. We believe the IRS should amend the regulations to provide for an exemption for Supers from FBAR reporting, or, at the very least, clarify that the Super and similar arrangements subject to an SSTA do not constitute foreign financial accounts for FBAR purposes. Neither the preambles nor the text to 31 CFR section 1010.350 confirm an exemption for interests in a social security-type program such as the Super.

Despite the foregoing, the preamble[312] to section section 6038D and the IRS website[313] both exclude from the definition of foreign financial asset reporting interests in social security, social insurance, or similar programs of a foreign government. It baffles us that the Super would be treated as a foreign financial account under FBAR when it is clearly exempted as a nonfinancial foreign asset for purposes of the U.S. Foreign Account Tax Compliance Act.

In light of the foregoing, we request that Treasury amend the regulations under 31 CFR section 1010.350(c)(4) to clarify that Supers and similar arrangements subject to an SSTA are excluded from reporting on FinCEN Form 114.

H. Reporting for Social Insurance Programs

We propose to bifurcate the U.S. tax treatment of the Super into two separate trusts; namely, (1) the SG trust consisting of SG contributions to the Super as social security taxes and income accruals and distributions derived thereafter as social security benefits paid by the Australian government to a USP employee-beneficiary of a Super; and (2) a VEC trust, which would include all other contributions. Our proposal to bifurcate the classification of the Super into an exempt portion and a nonexempt portion would not create new reporting obligations or complicate existing ones.

Treasury and the IRS have already exercised their authority under section 6001 to exempt interests in Social Security, social insurance, and similar programs from affirmative tax reporting obligations in several different provisions of the code. It is within their authority to tailor new administrative procedures to remedy the U.S. income taxation and tax compliance travails faced by U.S. beneficiaries of Australian superannuation funds. We believe that Treasury and the IRS can accomplish that under the authority granted by section 6001. The following are examples of areas in which they have created similar relief.

1. Section 6038D Preamble (Form 8938)

The preamble[314] to the temporary regulations under section 6038D and instructions to Form 8938 exclude from the definition of specified foreign financial asset an ''interest in a social security, social insurance or other similar program of a foreign government,''[315] which exempts those interests from reporting. As mentioned, a chart on the IRS website[316] comparing reporting requirements between Form 8938 and the FBAR also listed those same programs as excluded from the definition of foreign financial assets under reg. section 1.6038D-3(b)(1). Consequently, there is no requirement to report the SG trust component of the Super on Form 8938 because it would not constitute a foreign financial asset under section 6038D.

Similarly, the VEC trust component of the Super should be exempted from the definition of foreign financial asset if it constitutes an indivisible component of the Super. There is a predisposition to treat the VEC trust component (as well as the SG trust component) as a foreign retirement or pension account under section 402(b), which would cause the USP employee-beneficiary to report her interest on Form 8938 as a foreign financial account under section 6038D.[317]

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[310] *See* H.R. Rep. No. 105-220, at 551 (1997).

[311] *See generally* 31 CFR section 1010.350.

[312] T.D. 9706.

[313] *See* https://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.

[314] T.D. 9567.

[315] *Id.* at Part D.

[316] *See* https://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.

[317] *See* T.D. 9706; and reg. section 1.6038D-3(b)(1). The preamble to the final regulations under section 6038D modified the definition of a financial account under the 2011 temporary regulations (which adopted the definition under chapter 4 of financial account with an exception for some retirement and pension

(Footnote continued on next page.)

2. Reg. Section 301.6114-1 (Form 8833)

Under section 6114(a), a taxpayer who asserts that a treaty overrules or modifies a provision of the code is required to disclose that position to the IRS by filing Form 8833.[318] The IRS has waived[319] that requirement for return positions that an SSTA or diplomatic or consular agreement reduces or modifies the taxation of income derived by the taxpayer.[320] Consequently, USP employee-beneficiaries of a Super should not be required to disclose the SSTA on Form 8833 to claim their totalization benefits under the SSTA. In the same vein, article 18(2) of the Australia-U.S. tax treaty exempts the SG trust from current U.S. income taxation.

3. Section 409A

In June 2009 the U.S. Advisory Committee on Tax Exempt and Government Entities released a report on international pensions that identified the U.S. taxation of foreign pension plans as an area that required clarifying guidance from the IRS.[321] Specifically, it concluded that U.S. persons who participated in funded non-U.S. retirement plans were subject to U.S. income taxation under section 402(b)(4) because the foreign plan could not constitute an exempt plan under section 401(a).[322] The committee recommended that clarifying guidance be issued to confirm that section 402(b) ''was never intended to apply to foreign plans that were established as foreign nonqualified plans.''[323] As a result, U.S. participants are subject to less favorable U.S. tax rules under section 402(b)(4), which taxes the employee on the employer's contributions to the trust during the applicable tax year for which the trust is not exempt, if the employee's interest in the trust is vested.[324]

The need to issue clarifying guidance to exempt funded foreign pension plans from inadvertent income taxation under section 402(b) is more acute with the Super because it presents a tax issue with no precedent in the IRC: Cash basis U.S. taxpayers are taxed on foreign employer contributions, which constitute Australian social security benefits that have not yet been paid or made available to them by operation of Australian law. If no clarifying guidance is provided, that fact alone arguably raises constitutional problems[325] and issues with overall tax fairness. That same problem arises regarding the section 402(b) taxation of employee contributions to the Super, which have also yet to be paid or distributed to the U.S. taxpayer.

There is precedent for the IRS and Treasury to exclude foreign retirement arrangements from the application of U.S. tax law. That happened most recently in 2007, when final regulations were issued under section 409A.[326] Those regulations contained a provision that exempted foreign nonqualified pensions from U.S. income taxation as deferred compensation under section 409A if specified conditions were met. The foreign pension plan must have an applicable tax treaty that excludes contributions made to a foreign nonqualified deferred compensation plan from U.S. federal income taxes;[327] be a broad-based foreign retirement plan under section 409A;[328] or be subject to a totalization agreement.[329] The IRS said:

> Commentators also requested that the amounts contributed or benefits paid under a foreign social security system that is the subject of a totalization agreement be exempted from coverage under section 409A. . . . The Treasury Department and

accounts) to include retirement and pension accounts as a financial account for purposes of section 6038D to require consistent reporting.

[318]Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).''

[319]*See* section 6114(b); and reg. section 301.6114-1(d).

[320]Reg. section 301.6114-1(c)(vii).

[321]*See* Advisory Committee on Tax Exempt and Government Entities, ''International Pension Issues in a Global Economy: A Survey and Assessment of IRS Role in Breaking Down the Barriers'' (June 10, 2009).

[322]According to the committee, a foreign funded pension would fail coverage testing required under section 501(a) because it would not meet section 401(a)(26) or 410(b); the plan would fail because of the requirement to ignore coverage of nonresident aliens participating in the plan with U.S. expatriates. *Id.*

[323]*Id.* at 44. *See also* comments of the American Bar Association Section of Taxation (Feb. 22, 2006) regarding nonqualified deferred compensation, focusing on foreign plan aspects under the proposed section 409A regulations (stating that foreign funded retirement plans such as U.K. and Canada registered retirement plans and like arrangements, which are already taxable under section 402(b), should be excepted from section 409A because foreign funded retirement plans ''are not the target of section 409A'').

[324]Advisory Committee on Tax Exempt and Government Entities, *supra* note 321, at 43-44.

[325]The constitutionality issue raised by Richard Skillman in his comments to Treasury regarding prop. reg. section 1.4090-4(g) was limited to the issue of income subject to income tax under the 16th Amendment. *See* Skillman comments (Aug. 6, 2010). Skillman pointed out that income must represent an ''accession to wealth'' under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), for that income to be subject to income tax under the 16th Amendment. The constitutionality issues are not limited to whether social security benefits and employee contributions to the Super, which are mere foreseeable and anticipated accessions to wealth, should constitute income subject to income tax even though those amounts remain subject to contingencies that may result in nonpayment. *See Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007). Rather, the constitutionality issues also extend to questions with the Australia-U.S. treaty, which reserves taxation of Australian social security benefits paid to a U.S. resident to the Australian government (article 18(2)), and the Australia-U.S. totalization agreement, which prevents taxation of wages subject to Australian social security taxes from concurrent taxation by the United States.

[326]*See* T.D. 9321.

[327]*See* preamble to T.D. 9321, section H(1); and reg. section 1.409A-1(a)(3)(i).

[328]*See* preamble to T.D. 9321, section H(2); and reg. section 1.409(A)-1(a)(3)(VI).

[329]*See* reg. section 1.409A-1(a)(3)(v).

the IRS believe that section 409A was not intended to apply to benefits to which the service provider is entitled under foreign jurisdiction social security system. Accordingly, these types of plans have been excluded from the definition of nonqualified deferred compensation plan for purposes of Section 409A. Similarly, for jurisdictions not covered by a totalization agreement, these regulations provide that amounts deferred under a government mandated social security system are not subject to Section 409A.[330] ◆

[330]REG-158080-04, 70 F.R. 57930, at 57939 (Oct. 4, 2005).

Bringing Home the (Canadian) Bacon: U.S. Tax and Canadian Retirement Plans

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In this article, the authors consider the use of Canadian registered plans (the Canadian tax-free savings account and the retirement compensation arrangement) by U.S. persons working in Canada and whether those plans should be treated as foreign trusts in the United States, arguing that the United States should provide clear administrative guidance on the U.S. tax treatment of such plans.

This article is one in a series of proposals sponsored by the California Lawyers Association Taxation Section and presented to various policymakers and government officials. However, the comments in it reflect the individual views of the authors who prepared them and do not represent the position of the California Lawyers Association.

Although the authors and presenters of this report might have clients affected by the rules applicable to the subject matter of this report and have advised clients on the applicable law, no participant has been specifically engaged by a client to participate in this project.

Table of Contents

The ongoing pandemic has made mobility a necessity for many families and professionals around the world. Cross-border migrations between the United States and other countries are usually wrought with tax complexities. These migrations are particularly complex when foreign retirement and savings plans are maintained by an individual relocating to the United States or by a U.S. expatriate returning home after many years. The competitive advantage of the United States regarding trade and commerce is being silently eroded by adverse U.S. tax classification and treatment of these foreign retirement, pension, and savings plans that benefit U.S. persons (USPs). Many have opted to renounce U.S. citizenship to preserve the financial wealth they have accrued abroad, and those who have achieved professional success in the United States resort to terminating their lawful U.S. permanent resident status and return to their home countries to discontinue the extraterritorial reach of U.S. tax laws after they depart the United States.

The U.S. taxation of contributions, accruals, and distributions from foreign pensions and retirement plans (collectively, foreign plans) owned by USPs remains a controversial area of U.S. tax law that requires definitive guidance as the number of USPs residing outside the United States is large and steadily increasing. Complexity arises in part because foreign plans often do not fit squarely with the types of plans available to USPs living in the United States. Until the U.S. tax classification and treatment of such foreign plans are addressed by Congress or the Department of the Treasury, annual U.S. tax reporting of foreign pensions remains fraught with proverbial "traps for the unwary." In the absence of conclusive guidance from federal tax authorities, many tax practitioners have resorted to reporting foreign plans owned by USPs (directly and beneficially) as either IRC section 402(b) nonexempt employees' trusts, which are not subject to disclosure on Form 3520 and Form 3520-A under IRC section 6048, or as foreign grantor trusts under IRC sections 671-679. These entities are also subject to reporting on the foreign bank account report as required by the Foreign Account Tax Compliance Act. This repetitive reporting increases the administrative burden on USPs living abroad and U.S. taxpayers living in the United States who have a beneficial interest in these accounts. The annual reporting, enforcement, and collection of information, taxes, and penalties on these accounts places additional strain on IRS resources with no corresponding increase in the revenue generated.

It is no secret that many U.S. executives and athletes have pursued more lucrative careers just across the border in Canada during the pandemic. Being employed in Canada means active participation in the robust Canadian retirement and savings environment that offers more opportunities for an individual to maximize retirement savings during the most profitable years of their career. However, the favorable tax treatment of Canadian retirement and savings plans do not extend beyond Canada's borders. U.S. tax laws do not provide any definitive guidance on the treatment of Canadian tax-free savings accounts (TFSAs) and retirement compensation arrangements (RCAs). As foreign trusts, TFSAs and RCAs would be subject to annual information reporting under IRC section 6048, which is made by filing Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," and Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner." However, there is no consensus among cross-border tax practitioners on whether these two plans should be subject to any foreign trust reporting. On one hand, a TFSA is functionally more similar to a Roth IRA, which is taxed under IRC section 408A, than it is to a traditional trust taxed under subchapter J of the IRC. A Roth IRA is not subject to any Canadian taxation as long as no contributions are made to the Roth IRA while the USP is a resident of Canada. On the other hand, the RCA has no direct U.S. equivalent. This type of arrangement is structured to encourage athletes and executives to work in Canada by (1) reducing the amount of Canadian-source compensation income that would be subject to Canadian ordinary tax rates; and (2) allocating a portion of such individual's Canadian-source earnings to a Canadian trust that generates no taxable income. In the rare case an RCA does generate taxable income, it will be highly taxed in Canada and consequently not subject to U.S. tax after the application of foreign tax credits for Canadian taxes paid on such amounts. Similarly, in retirement, the distributions from RCAs will be taxed in Canada at ordinary income rates, which are likely to result in no U.S. tax payable under relief that is provided under the Canada-U.S. income tax convention and protocols (the tax treaty).[1]

For Canadian tax purposes, the TFSA is a tax-deferred Canadian registered plan initially intended to provide additional retirement savings to individuals already benefiting from Canadian registered retirement plans. It is primarily a contract between a subscriber and a financial institution that will hold the TFSA on behalf of the subscriber. Under the agreement, the subscriber contributes a maximum of C $6,000 per year in after-tax dollars to the TFSA. The subscriber's contribution may earn income inside the plan without any current taxation on such accruals. Canadian income tax is also not triggered when distributions are made by the financial institution to the subscriber. The TFSA is very similar to a U.S. Roth IRA when the USP takes a qualified distribution.[2] There are some subtle differences between the two plans (there is no income threshold as a condition for eligibility to contribute to a TFSA, unused contributions may be carried forward to future years, and TFSA funds may be withdrawn without penalty); however, these differences could be mitigated by providing an exemption from trust reporting until a distribution is made under the plan.

Canadian RCAs also are intended to provide additional retirement savings for cross-border athletes and executives. It is a contract between an individual (the holder) and a participating financial institution (the custodian) under which the holder or their employer makes contributions to an RCA trust. These contributions are deductible from the income of the respective contributor, but all contributions are subject to a 50 percent refundable tax at the time of contribution. Moreover, any income earned in the RCA is also subject to a 50 percent refundable tax in the year such income is earned in the RCA. No tax is paid by the holder until benefits are received at retirement, but all such distributions are subject to tax in Canada. The refundable 50 percent tax imposed on contributions and earnings are then refunded to the RCA trust at a rate of C $1 for every C $2 distributed until the refundable tax has been entirely repaid.

Contributions to an RCA may not exceed the amount required to fund retirement benefits based on the generally accepted guidelines for pensions, equal to about 70 percent of pre-retirement income for an employee with 35 years of service for a defined benefit plan.[3] Failure to follow the generally accepted guidelines increases the risk that the Canada Revenue Agency could deem the RCA not to be an RCA but rather a salary deferral arrangement with additional substantial tax and penalties payable.[4] To ensure the RCA continues to qualify under the CRA's generally accepted guidelines, the involvement of a qualified actuary may be required. There are substantial Canadian tax compliance obligations imposed on RCAs; the custodian must apply for and obtain both a contribution account number before any contributions are made and a distribution account number before any distributions are made. The distributions are also subject to withholding by the custodian and subsequent reporting to the CRA.

Because of the absence of specific administrative guidance on the U.S. tax treatment and reporting of TFSAs and RCAs, these foreign plans have been subject to inconsistent tax treatment by tax practitioners and USPs. Many USPs and their tax advisers do not view these plans as subject to disclosure. Some view the plans as foreign employees' trusts under IRC section 402(b) that are exempt from disclosure on Form 3520 and Form 3520-A. Others report the plans as foreign grantor trusts and file forms 3520 and 3520-A each year. Because enforcement against foreign entities can be difficult, U.S. tax laws make the USP accountable for filing and liable for any taxes and/or penalties on such filings or for a failure to file. However, these penalties apply inconsistently because of divergent reporting approaches. The civil penalties imposed on inaccurate and untimely filed foreign trust reporting under IRC section 6677 are substantial. Therefore, the USP donor/contributor or USP beneficiary faces a very high risk of incurring penalties for failing to correctly report an interest in a TFSA or RCA in any given year. This issue is particularly problematic, not because of the low annual contribution limits on the TFSA, but because of the potentially substantial carryforward of unused contributions to future years.

The accurate and timely filing of forms 3520 and 3520-A was one of six additional international compliance campaigns rolled out by the Large Business and International Division[5] on May 18, 2018. Although this campaign has ended, the impact of the Form 3520/Form 3520-A campaign on USPs abroad and in the United States continues to be perpetuated with a flurry of IRS notices issued to taxpayers assessing IRC section 6677 civil penalties for failure to comply with IRC section 6048 reporting requirements regarding foreign trusts. Because the statute of limitations for assessing IRC section 6677(a) and (b) penalties ends three years after a complete and accurate Form 3520/Form 3520-A is filed, the statute of limitations may remain open indefinitely. Foreign retirement, pension, and savings accounts (including Canadian TFSAs and RCAs) are within the category of foreign trusts that are subject to Form 3520/Form 3520-A filing and therefore are subject to penalties for failure to timely file.

Treasury regulations promulgated under IRC section 6048 require grantors of foreign trusts and beneficiaries of foreign grantor trusts to file Form 3520 (in the case of an ordinary transfer to the trust) and Form 3520-A (foreign grantors) to report their activities and interest. We propose that TFSAs be exempt from annual foreign trust reporting under IRC section 6048 until withdrawals or distributions are received by a USP, similar to reporting requirements for Canadian registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs),[6] registered education savings plans (RESPs), and registered disability savings plans (RDSPs).[7]

Exempting TFSAs from annual foreign trust requirements also alleviates administrative burdens and costs for the foreign trust reporting program. TFSAs usually have small balances, but they are subject to substantial civil penalties for inaccurate or untimely filed forms 3520 and 3520-A, in addition to FBAR disclosure. However, the potential for TFSAs to carry substantial balances is far from remote because the TFSA regime provides for unused contributions to be carried forward to future years. This fact, combined with the ability of a USP taxpayer to exercise discretion and control over TFSA investments, as well as withdraw amounts from the TFSA for any reason without penalty, would support continued foreign trust reporting obligations for USP account holders of TFSAs in the year withdrawals or distributions are made.

Although more significant amounts are involved for RCAs than for TFSAs, such amounts are subject to a substantial 50 percent tax on contributions and 50 percent tax on earnings in Canada. Withdrawals and distributions can be made only after the employee reaches retirement, and such amounts would be taxed at ordinary rates. Therefore, it would be unlikely that a USP would avoid payment of U.S. taxes on RCA amounts on distribution. We believe that USPs' compliance burden and the IRS's administrative burden can be relieved if the foreign trust reporting exemption available for IRC section 402(b) plans is extended to RCAs. Foreign trusts that constitute IRC section 402(b) nonqualified deferred compensation trusts are exempted from this tax filing requirement under IRC section 6048(a)(3)(B)(ii). These provisions state that contributions made to a nonqualified foreign trust under a plan that provides for pensions, profit-sharing, stock bonus, sickness, accident, unemployment welfare, and similar benefits, or a combination of such contributions, are not required to be reported under IRC section 6048. Consequently, a USP beneficiary of a Canadian RCA should have no affirmative obligation to file Form 3520 until withdrawals or distributions are made by the RCA trust to the USP beneficiary.

We recommend that regulations under IRC section 6048 be amended, or further administrative guidance be issued, to clarify the annual foreign trust reporting requirements for Canadian TFSAs and RCAs on Form 3520 and Form 3520-A.

I. Foreign Trust Classification

Generally, U.S. citizens and U.S. lawful permanent residents (green card holders) are treated as U.S. residents for U.S. tax purposes,[8] regardless of where they live in the world. A U.S. resident is subject to U.S. federal income taxation on income from whatever source derived including, but not limited to, compensation for services, pensions, and income from an interest in a trust.[9] This general rule of worldwide taxation potentially applies to all distributions received by a U.S. resident from foreign retirement, pension, and similar deferred compensation plan arrangements unless there is a specific statutory or treaty provision that exempts such income from U.S. tax. In the absence of definitive guidance on how such foreign plans are taxed for U.S. purposes, tax practitioners have reported them as either foreign grantor trusts or foreign nonexempt employees' trusts under the IRC, which would confer an annual information reporting obligation for U.S. residents who have beneficial interests in such foreign trusts.

A. Foreign Grantor Trusts

As a preliminary matter, trusts are classified for U.S. tax purposes as either foreign or domestic trusts under IRC section 7701(a)(30)(E) and (31)(B). Under these provisions, a trust is presumed to be a foreign trust unless the following conditions are satisfied: (1) a court or courts within the United States would be able to exercise primary supervision over administration of the trust, and (2) one or more USPs have the authority to control all substantial decisions of the trust. A trust would be treated as a USP on any day that the trust meets the "court test" and the "control test."[10] Based on our understanding of Canadian RCAs and TFSAs, these likely would be classified as foreign trusts for U.S. tax purposes because (1) they are Canadian resident trusts that are controlled by Canadian resident custodians and trustees, and (2) a U.S. court would not have primary supervision over the administration of these trusts.

As foreign trusts for U.S. tax purposes, all contributions, income, and earnings of the trust potentially would be included in the gross income of their USP beneficiaries under IRC sections 671-679. This determination is made after considering the applicable U.S. tax laws and regulations below.

1. Subchapter J Taxation

Generally, subchapter J of the IRC[11] provides for taxation of trust income to the trust itself or its beneficiaries. Generally, under IRC section 641, a trust's taxable income is taxed to the trust or its beneficiaries. However, there are exceptions under IRC section 651 and section 661 that impose the tax on the beneficiaries of the trust if the income is distributed or required to be distributed to the beneficiaries. If either IRC section 651 or section 661 applies, the beneficiary is taxed on the qualifying income, and the trust receives a corresponding deduction. However, IRC section 643(a) generally provides that the deduction cannot exceed the trust's distributable net income, which is the taxable income of the trust with specified modifications.[12] If a trust's distributable net income for a tax year is not distributed to the beneficiaries,[13] it is considered undistributed net income under IRC section 665(a). Generally, no adverse consequences result from a trust declining to distribute all its distributable net income for a tax year, except that the trust (which becomes subject to the highest marginal federal income tax rate much more quickly than do individual beneficiaries) will be taxed on the undistributed net income, and the beneficiaries will not.

Because a foreign trust's income is generally not subject to taxation by the United States, if distributed net income is not distributed to its beneficiaries who are U.S. residents, taxation on this income generally will be deferred. To discourage foreign trusts from deferring distribution of distributed net income to its U.S. beneficiaries, IRC sections 665 through 668 provide that if a foreign trust makes distributions of undistributed net income (from preceding tax years) to the U.S. beneficiaries, each such distribution is classified as an accumulation distribution. The accumulation distribution is allocated to preceding years and subject to tax, including an interest charge thereon, intended generally to treat the income as if it had been taxed in the year the income was earned.[14] This interest charge, also known as the throwback tax, can result in a significant tax liability for a U.S. resident beneficiary.

IRC sections 671 through 679 (collectively, the grantor trust rules) provide an exception to the general taxation regime of subchapter J. IRC section 671 provides that where it is specified in subpart E of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits for the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the grantor trust (to the extent that such items would be taken into account under this chapter in computing the taxable income or credits against the tax of an individual). Any remaining portion of the trust shall be subject to subparts A through D of subchapter J. Hence the income, deductions, and credits of the grantor trust are included in the computation of the grantor's taxable income and not in the taxable income computation of a trust or its beneficiaries as would otherwise be required under IRC section 641. Consequently, neither the distributable net income nor undistributed net income is generally taxable to beneficiaries who are receiving distributions from a grantor trust.

The grantor trust rules potentially apply to an RCA or TFSA when a beneficiary of such trust is or becomes a U.S. resident for U.S. tax purposes (a U.S. resident beneficiary). IRC section 679(a) and related provisions provide that a USP who directly or indirectly transfers property to a foreign trust (other than to specified foreign trusts that are deferred compensation or charitable trusts as provided generally under Treas. reg. section 1.679-4(a)(2) and (3)) shall be treated as the owner of the portion of such trust attributable to such property if there is a U.S. beneficiary of the trust for that year.[15] A person treated as "the owner of any portion of a trust" by the grantor trust rules must include income from that portion of the trust's property in his or her personal income.[16]

The grantor trust rules would potentially apply to transfers of property to trusts made by the U.S. resident beneficiary within five years before attaining U.S. residency (the five-year lookback period). Under IRC section 679(a), a direct or indirect transfer of property to a foreign trust made by a noncitizen or a nonresident of the United States within five years of becoming a USP is treated "as if such individual transferred to [the foreign] trust on the [U.S.] residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer."[17] With few exceptions, the gain inherent in transferred assets is fully taxable at ordinary tax rates to a USP who transfers assets to a non-U.S. trust.[18]

If the above grantor trust rules apply to RCAs and TFSAs, a U.S. resident beneficiary would have U.S. income tax exposure from (1) contributions made to the trust upon transfer to the trust and (2) income generated by and accrued in the trust on a current basis. Our position, as discussed later in Section III, is that the grantor trust rules do not apply to an RCA because a U.S. resident beneficiary of an RCA cannot access funds contributed to such account by the Canadian employer until retirement age is reached, similar to a nonexempt employee's trust under IRC section 402(b). Moreover, amounts in an RCA are already subject to a 50 percent refundable Canadian tax on contributions and earnings, meaning that the RCA itself is not tax free. Finally, distributions received by a U.S. resident beneficiary of an RCA would be subject to tax in Canada at ordinary income tax rates and be includable in gross income for U.S. tax purposes. However, a TFSA would be subject to the grantor trust rules, so a U.S. resident beneficiary would have current U.S. income tax liability and reporting obligations as further discussed in Section IV.

B. Nonexempt Employee Trusts

Generally, IRC section 402(a) provides an exemption for amounts received by a beneficiary of an employee's trust[19] that meets the requirements of IRC section 401(a) as a qualified employee's trust and that is exempt from tax under IRC section 501(a) as an exempt employee's trust. Neither the RCA nor the TFSA would qualify as an exempt employee's trust because they are foreign trusts rather than domestic trusts as required under IRC section 401(a).[20] As a corollary, they will also fail to meet IRC section 501(a) requirements for an exempt employee's trust.

Because RCAs and TFSAs are not classified as exempt employees' trusts under IRC section 402(a), the taxability of distributions made to a U.S. resident beneficiary would fall under the parameters of IRC section 402(b), which applies to nonexempt trusts. Section 402(b) addresses the tax treatment of a beneficiary of a trust that is not exempt under IRC section 501(a).[21] Such trusts are considered funded plans for U.S. tax purposes because the assets are protected from the claims of creditors of the employer and related entities.[22] Tax practitioners have noted that IRC section 402(b) often applies to non-U.S. trust arrangements associated with foreign equity and deferred compensation plans.[23]

Foreign trusts that fall under IRC section 402(b) are typically created when an employer enters into a trust arrangement under which the trustee is the legal owner of the trust assets and the employer is the settlor, contributing cash or shares on behalf of an employee. The employee has a beneficial ownership interest in the trust. The right in this interest may be subject to service or performance conditions that must be satisfied for the employee's right to be nonforfeitable and for the employee to receive a future distribution of trust assets from the trustee. If the amounts contributed are vested[24] upon contribution, then such amounts are treated as taxable compensation income to the employee under IRC section 402(b)(1).[25] However, if the benefits vest after the contribution is made, then the employee's inclusion into income is equivalent to the fair market value of his interest in the trust as of the vesting date.[26] Eventual distributions from the trust to the employee would be taxable upon receipt under IRC section 72, which allows for the amount already taxed at the time of contribution (if applicable) to be taken into account as part of such employee's basis and therefore excluded from additional tax.

Both the RCA and TFSA must run the gauntlet of IRC section 402(b) provisions to determine the extent of potential U.S. income tax exposures arising from trust distributions to a U.S. resident beneficiary. Under IRC section 402(b)(1), employer contributions to a trust that qualifies as an IRC section 402(b) nonexempt funded plan would be includable in the current year in a U.S. resident beneficiary's gross income as compensation and subject to tax if such amounts are not subject to a substantial risk of forfeiture. As a corollary, subsequent distributions to a U.S. resident beneficiary from the trust would be taxable to such beneficiary upon receipt under IRC section 402(b)(2), except that amounts already taxed to the beneficiary at the time of contribution would be excluded from the income inclusion amount under IRC section 72(w). Moreover, if the U.S. resident beneficiary is a highly compensated employee (HCE)[27] and the RCA or TFSA fails to meet requirements of a qualified plan for broad coverage[28] and participation of employees,[29] then the U.S. resident beneficiary must include in gross income the value of the vested accrued benefit on an annual basis under IRC section 402(b)(4). The application of each of these provisions under IRC section 402(b)(2) and IRC section 402(b)(4) are discussed below.

II. IRS Guidance

The United States has not released any definitive guidance on the U.S. tax classification and treatment of Canadian TFSAs or RCAs. However, there have been opportunities over the last decade for the U.S. Treasury Department and the IRS to address the tax classification and treatment of TFSAs when the IRS issued a series of administrative notices clarifying the

U.S. tax classification and treatment of RRSPs and other Canadian registered plans such as RRIFs, RESPs, and RDSPs. Since the TFSA was introduced by the Canadian government in 2008, the IRS has released two revenue procedures addressing Canadian registered plans, which could have included guidance for TFSAs to simplify the U.S. tax reporting obligations of USPs.

In Rev. Proc. 2014-55,[30] the IRS provided guidance for applying paragraph 7 of Article XVIII (pensions and annuities) of the tax treaty. The revenue procedure eliminated previously issued information reporting requirements on USP beneficiaries[31] and annuitants[32] of a Canadian retirement plan[33] to report contributions to, distributions from, and ownership of Canadian retirement plans under the simplified reporting regime of IRS Notice 2003-75 (obsoleting as a consequence IRS Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans"[34]) or under reporting obligations imposed by IRC section 6048 (Form 3520).[35] It did not, however, affect any reporting obligations for IRS Form 8938, "Statement of Specified Foreign Financial Assets," under IRC section 6038D or Financial Crimes Enforcement Network Form 114, "Report of Foreign Bank and Financial Accounts," imposed by 31 U.S.C. section 5314.[36] Most importantly, it made clear that distributions received by any USP beneficiary or annuitant from a Canadian retirement plan must be included in the gross income of the beneficiary or annuitant for U.S. tax purposes (including the portion thereof that constitutes income accrued in the plan and not previously taxed in the United States) under IRC section 72.[37]

In Rev. Proc. 2020-17,[38] the IRS further exempted some USPs from information reporting requirements imposed by IRC section 6048 on Canadian RESPs and RDSPs,[39] to the extent such plans constituted a "tax-favored foreign retirement trust" under section 5.03 of Rev. Proc. 2020-17 or a "tax-favored foreign non-retirement savings trust" under section 5.04 of Rev. Proc. 2020-17 (collectively, applicable tax-favored foreign trusts). However, the exemption only applies to USPs who have been previously compliant regarding their income tax obligations related to such trusts.

In rendering applicable tax-favored foreign trusts exempt from the annual foreign trust reporting requirements, the IRS pointed out that IRC section 6048(d)(4) "authorizes the Secretary to suspend or modify any requirement under section 6048 if the United States has no significant tax interest in obtaining the required information."[40] The IRS stated:

> The Treasury Department and the IRS have determined that, because applicable tax-favored foreign trusts generally are subject to written restrictions, such as contribution limitations, conditions for withdrawal, and information reporting, which are imposed under the laws of the country in which the trust is established, and because U.S. individuals with an interest in these trusts may be required under section 6038D to separately report information about their interests in accounts held by, or through, these trusts, it would be appropriate to exempt U.S. individuals from the requirement to provide information about these trusts under section 6048.[41]

Based on the narrow definition of tax-favored foreign non-retirement provided in section 5.04 of Rev. Proc. 2020-17, tax practitioners were not hard-pressed to ascertain that Canadian RESPs and RDSPs would fall within the exemption from IRC section 6048 reporting because these trusts are organized in Canada exclusively for providing income for medical, disability, or educational benefits and have limited contribution amounts of $10,000 or less annually or $200,000 or less on a lifetime basis. Moreover, Canadian RESPs and RDSPs are already subject to strict conditions for withdrawal and annual information reporting by the Canadian government to maintain their status for Canadian tax purposes. The administrative burdens posed by such foreign trusts on IRS resources far outweigh the benefits generated from IRS enforcement efforts directed at delinquent foreign trust filings for USP interests in such assets. Such assets are low-balance depositary accounts that would be an unlikely offshore vehicle for U.S. tax avoidance by USPs residing in Canada.[42] However, TFSAs and RCAs are not low-value accounts, as discussed below.

III. RCAs

Professional ice hockey players on both sides of the Canada-U.S. border pursue lucrative but short careers spanning an average of 5.5 years.[43] It is therefore in the players' self-interest to carefully invest these earnings for maximum growth and minimal taxation. Canada's tax regime and rate structure make tax planning a priority for U.S. athletes playing for Canadian hockey teams. An RCA provides a way for a player to shelter income from taxes during their lucrative years playing for a Canadian team in the National Hockey

League while spreading tax liability over their post-career years when income is lower. The popularity of RCAs among hockey players is reflected by the fact that Canadian financial institutions and wealth management agencies market RCAs to players of Canadian NHL teams who are contemplating retiring outside of Canada.[44] Without an RCA in place, a professional athlete who is or becomes a USP ("USP athlete") would not be rewarded for playing for an NHL team based in Canada because income and earning potential is substantially front-loaded and subject to considerably higher taxes in Canada than the United States. Therefore, it is very likely that U.S. hockey players who are playing for, or have played for, one of these Canadian teams already have RCAs.[45]

Unlike other Canadian registered plans, an RCA allows for a funding limit that is based on the average of the player's best three years of earnings, with no maximum, as would be required in other plans.[46] Before the start of each season, the player can elect how much of their salary is allocated for RCA contributions. A player's ability to control the contribution to an RCA is no different from the ability of a U.S. employee to designate contributions to an employer-sponsored plan or 401k.

RCA contributions are made to an investment account (the RCA trust) by the team on a payroll basis. The contribution, net income earned, and gains realized are subject to a 50 percent tax. This tax is remitted to a non-interest-bearing account held by the CRA, called a refundable tax account. These funds remain assets of the RCA trust but do not earn any interest. Upon retirement, as funds are withdrawn from the RCA, the RCA trust is reimbursed from the refundable tax account, so the two accounts remain balanced.[47] All funds paid to the player from the RCA are subject to ordinary income tax rates in the year received.[48]

The prevalence of RCAs among cross-border professional athletes, as well as executives and owners of Canadian corporations, warrants definitive guidance from the U.S. Treasury Department and the IRS on the tax classification and treatment of these types of compensation arrangements. Failure to do so would perpetuate confusion and delinquency for the tax classification and treatment of these RCAs as IRC section 402(b) employees' trusts, which should be exempt from foreign trust reporting by a player who is, or becomes, a USP athlete.

A. Canadian Classification

For Canadian tax purposes, the RCA is a Canadian resident trust. It is defined under subsection 248(1) of the Income Tax Act of Canada as:

> a plan or arrangement under which contributions . . . are made by an employer or former employer of a taxpayer, or by a person with whom the employer or former employer does not deal at arm's length, to another person or partnership (in this definition and in Part XI.3 referred to as the "custodian") in connection with benefits that are to be or may be received or enjoyed by any person on, after or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer or the loss of an office or employment of the taxpayer.

The term "RCA" under subsection 248(1) of the ITA does not include a registered retirement plan, a registered pension plan, an employee trust (for life and health), a salary deferral arrangement, or a plan or arrangement established for purposes of deferring the salary or wages of a professional athlete for his services with a team that participates in a league having regularly scheduled games.

The RCA trust is a nonregistered, employer-sponsored, and employer-funded plan that is exempt from Canadian taxation under Part I of the ITA. However, it is subject to a tax under Part XI.3 (subsection 207.5), which imposes a 50 percent tax on all contributions made and a 50 percent tax on any net income earned or gains realized by the trust. The tax is payable annually, within 90 days after the end of the trust tax year, and is refundable to the trust when retirement benefits are distributed to the player. The refundable tax is collected through withholding at source upon contribution to an RCA or distribution to a player under subsections 153(1)(p) and (r) of the ITA. The refundable tax is held in a non-interest-bearing refundable tax account that is repaid to the trust custodian once benefit distributions are paid by the trust to the player (employee).

B. U.S. Classification

1. IRC Section 402(b)(2)

Under IRC section 402(b)(1), employer contributions made to a foreign nonexempt trust that constitutes a foreign funded plan would generally be fully includable in the employee's gross income in the year of contribution to the extent such amounts are not subject to a substantial risk of forfeiture. This would generally be the case if the RCA was created for a USP athlete. If the athlete was not a USP athlete at the time such amounts were contributed to the RCA trust, there is no income inclusion for the contributions made by a Canadian employer. Therefore, regarding the RCA, all the employer contributions made to the RCA trust for the benefit of the player would be fully includable in the gross income of such player if they were a USP athlete.

Under IRC section 402(b)(2), distributions received from the RCA trust would be taxable to the USP athlete in the year such distributions take place or are made available under IRC section 72 subject to some exclusions as discussed below.

2. IRC Section 72

IRC section 72(a) provides general rules for income inclusion of any amount received as an annuity. However, when an IRC section 402(b) trust is involved, principles under IRC section 72 are applied to the distribution amount received by the employee, such that only the portion of the distribution that exceeds previously taxed amounts is includable in the distributee's gross income. This applies on a pro rata basis for each distribution. IRC section 72(b)(1) provides for the exclusion from gross income of that portion of each payment that represents a return of the distributee's investment in the contract:

> Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

As provided above, the portion of the RCA trust distribution that would be includable in the USP athlete's gross income (and subject to tax) would specifically exclude amounts that constitute the USP athlete's investment in the contract. The term "investment in the contract" is defined under IRC section 72(c)(1) as:

> (A) the aggregate amount of premiums or other consideration paid for the

contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

To determine which portion of the RCA trust distributions would be taxable to the USP athlete as gross income, we would need to determine the portion of the distributions made to the USP athlete that would, if made, constitute such athlete's investment in the contract and therefore be excludable from his or her gross income.

3. Exclusion From Gross Income

IRC section 72(w) applies to nonexempt foreign trust distributions received by a U.S. resident beneficiary with previously vested contributions in such trust earned entirely while such individual was a nonresident alien performing services outside the United States. IRC section 72(w) would exclude from the USP's investment in the contract amount any portion of the trust distribution that corresponds to nontaxable contributions and nontaxable earnings. Such amounts would not be treated as part juof the USP's investment in the contract that would constitute basis, such that it would be generally taxable to the U.S. resident beneficiary. IRC section 72(w) defines nontaxable contributions and nontaxable earnings as follows:

(2) "applicable nontaxable contribution" means any employer or employee contribution —

(A) which was made with respect to compensation —

(i) for labor or personal services performed by an employee who, at the time the labor or services were performed, was a nonresident alien for purposes of the laws of the United States in effect at such time, and

(ii) which is treated as from sources without the United States, and

(B) which was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were rendered) under the laws of the United States or any foreign country.

(3) "applicable nontaxable earnings" means earnings —

(A) which are paid or accrued with respect to any employer or employee contribution which was made with respect to compensation for labor or personal services performed by an employee,

(B) with respect to which the employee was at the time the earnings were paid or accrued a nonresident alien for purposes of the laws of the United States, and

(C) which were not subject to income tax under the laws of the United States or any foreign country.

Applying IRC section 72(w)(2)(A) to the RCA of a Canadian player before he or she became a USP athlete (that is, a U.S. resident for tax purposes) is not an issue. After all, the RCA is an arrangement between the Canadian player and his or her Canadian employer regarding services performed in Canada. The primary issue that arises in this scenario is from IRC section 72(w)(2)(B)'s definition of nontaxable contributions under the IRC. As we discussed, 50 percent of the contributions made to an RCA are subject to a refundable tax amount that is remitted to the CRA. However, such amounts are ultimately refunded back to the custodian of the RCA when distributions from the RCA trust are made. Therefore, it is unclear whether the refundable tax constitutes a foreign income tax for purposes of IRC section 72(w)(2)(B) and (w)(3)(C), such that contributions and earnings accrued in the RCA trust would be classified as previously taxed contributions and earnings and constitute part of the USP athlete's investment in the contract that is not subject to tax upon distribution.[49]

Treasury has yet to promulgate regulations for guidance on what would constitute a foreign income tax under these provisions. Treasury regulations have, however, in addressing FTCs, offered guidance under Part III of subchapter N, on what would constitute a creditable income tax and when such tax is considered to have been paid for purposes of IRC section 901. Specifically, IRC section 901(b) allows a credit for any foreign "income, war profits, and excess profits taxes." According to these Treasury regulations, the predominant character of the foreign tax must be that it is consistent with an income tax in the U.S. sense of the term.[50] This requires that the foreign tax must be likely to reach net gain in the normal circumstances in which it applies.[51] Although it can be argued that the refundable tax is not an income tax in the U.S. sense of the term, it is difficult to do so with a high degree of confidence. If we assume, for sake of discussion, that it is an income tax, the next question is whether the contribution and the earnings are subject to that tax. To analyze that issue, it is important to understand how the refundable tax operates.

Part XI.3 of the ITA (subsection 207.5) requires that the employer withhold and remit 50 percent of the contribution to the RCA to the CRA.[52] This creates refundable tax.[53] The balance of the refundable tax account at the end of the year is compared to the balance at the beginning of the year. If there is an increase, additional refundable tax must be paid into the RCA.[54] If, however, there is a decrease in the balance, then the RCA may receive a refund payment from the CRA for the decrease.[55] Income received by the RCA increases the ending balance of refundable tax.[56] The calculation of refundable tax on hand at the end of the year includes a reduction for 50 percent of current distributions.[57] If, for instance, there were no contributions or income during the year and the entire RCA balance were distributed, the ending refundable tax balance would go to zero, and all refundable tax previously remitted would become refundable. The employer may claim a deduction in the year of the contribution.[58] The employee must include distributions from the RCA in his or her income.[59] When the custodian makes a distribution to the employee, it must withhold income tax at source.[60]

The phrase "subject to income tax" in IRC section 72(w) can have the broad meaning of being generally subject to the taxing power or jurisdiction of a tax regime. However, the usage in IRC section 72(w)(2) and (3) appears to have a narrower meaning, in that this IRC section also uses the phrase in saying, "would have been subject to income tax if paid as cash compensation." That phrase can be construed to mean, in the reciprocal, that if the employee received a cash payment, it would be taxable. Applying that usage to the RCA, a contribution to the RCA would be subject to tax if the RCA were taxed on the receipt of the contribution. Similarly, the income would be subject to tax if the RCA were taxed on the receipt of the income. Both the contribution and the income give rise to a payment of refundable tax.[61] However, to the extent that the tax is refundable, it will be refunded to the RCA trust one day. Once again, the Treasury regulations promulgated to address the FTC regime have contemplated the issue of a tax that is reasonably certain to be refunded and concluded that such a tax is not considered to have been paid:

> To the extent that it is reasonably certain that the amount will be refunded, rebated, abated, or forgiven. It is reasonably certain that an amount will be refunded, rebated, abated, or forgiven to the extent the amount exceeds a reasonable approximation of final foreign income tax liability to the foreign country.[62]

Based on our understanding of the RCA regime, it would appear reasonably certain that the refundable tax will be refunded no later than when all the funds of the RCA trust have been distributed to the employee and the refundable tax balance reaches zero. Moreover, the final tax liability of the RCA trust would be zero because all refundable tax will be refunded to the RCA trust eventually. It is also clear that the Canadian resident player who is the employee beneficiary of the RCA trust will ultimately bear the final tax liability because RCA trust distributions are taxable to the employee and subject to payroll withholding taxes. If a Canadian player (either a U.S. citizen who plays in Canada and returns to the U.S. or a Canadian citizen who plays in Canada and subsequently relocates to the U.S.) migrates to the United States and becomes a USP athlete, distributions from the RCA also would be subject to Canadian withholding taxes because such amounts would be paid to a nonresident of Canada at the time of distribution. Based on our review of the RCA regime and the manner in which the refundable tax is calculated, paid, and refunded, we conclude that RCA contributions earnings accrued in the trust from such contributions are both not subject to income tax in the sense in which that phrase is used in IRC section 72(w)(2) and (3) and, consequently, the RCA contributions are applicable nontaxable contributions, and the RCA earnings are applicable nontaxable earnings, under IRC section 72(w).

We further note that a USP athlete who migrates to Canada to work for a Canadian employer and establishes an RCA in the course of that employment would not be able to meet the conditions of IRC section 72(w)(2)(B) and (w)(3)(C) to include contributions and earnings in the RCA while he was a resident of Canada in his investment in the contract. This is because notwithstanding the status of the refundable tax as a foreign income tax for U.S. FTC purposes, such a USP would be subject to U.S. tax on his worldwide income (which would include the contributions and earnings in an RCA established for his benefit by the Canadian employer).

Our review of the legislative history of IRC section 72(w) supports our conclusion that both contributions and earnings accrued in the RCA trust would be subject to U.S. tax upon distribution to the formerly Canadian player if he were to become a U.S. resident for tax purposes (that is, a USP athlete) or to the USP athlete who migrates to Canada to work for a Canadian employer. The House conference report to the American Jobs Creation Act of 2004 (P.L. 108-357),[63] which codified IRC section 72(w), specifically stated that it was Congress's intent to remain consistent with U.S. model treaty provisions that provide for exclusive residence-based taxation of pension distributions to the extent such distributions were not previously included in taxable income in the other country.[64] The codified version of IRC section 72(w) would exclude from a taxpayer's basis some contributions and earnings that were not previously taxed while the taxpayer was a nonresident alien employee. The conference report states:

> The following example illustrates how the conference agreement could affect the amount of a distribution that may be taxed by the United States pursuant to a tax treaty.
>
> Assume the following facts. A, a nonresident alien individual, performs services outside the United States, in A's country of residence, country Z. A's employer makes contributions on behalf of A to a pension plan established in country Z. For U.S. tax purposes, no portion of the contributions or earnings are included in A's income (and would not be included in income if the amounts were paid as cash compensation when the services were performed) because such amounts relate to services performed without the United States. Later in time, A retires and becomes a permanent resident of the United States.
>
> Under the conference agreement, the employer contributions to the pension

> plan would not be taken into account in determining A's basis *if A was not subject to income tax on the contributions by the foreign country and the contributions would have been subject to tax by a foreign country if the contributions had been paid to A as cash compensation when the services were performed.* Thus, in those circumstances, A would be subject to U.S. tax on the distribution of all of the contributions, as such distributions are made. However, if the contributions would not have been subject to tax in the foreign country if they had been paid to A as cash compensation when the services were performed, under the conference agreement, the contributions would be included in A's basis. Earnings that accrued while A was a nonresident alien would not result in basis if not taxed under U.S. or foreign law. Earnings that accrued while A was a permanent resident of the United States would be subject to present-law rules. . . .
>
> The conference agreement authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of the conference agreement, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances. *For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the "subject to income tax" requirement.*
>
> The conference agreement also changes the rules for determining basis in property received in connection for the performance of services in the case of an individual who was a nonresident alien at the time of the performance of services, if the property is treated as income from sources outside the United States. In that case, the individual's basis in the property does not include any amount that was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were performed) under the laws of the United States or any foreign country. [Emphasis added.][65]

Based on the above passage, the concept of foreign income tax under IRC section 72(w) would exclude merely nominal tax (for example, a low- or zero-tax jurisdiction). Assuming the refundable tax was an income tax, there is an argument that the RCA trust was subject to nominal tax, if at all, because the refundable tax would be ultimately refunded back to the RCA trust when it commences trust distributions to the USP athlete.

The conference report also illustrates that the foreign country income tax on contributions and earnings in the foreign trust must have been imposed on the nonresident alien himself and not on the foreign trust entity. Based on our review of the RCA structure, the refundable tax is imposed on the RCA trust and not on the USP athlete as the beneficiary of the RCA trust. Even if the above passage from the conference report were expanded to include a foreign income tax on contributions and earnings paid by the foreign trust (instead of the nonresident individual as illustrated in the conference report), in the absence of Treasury regulations under IRC section 72(w) directly addressing this issue, we doubt that the refundable tax would constitute an income tax in the U.S. sense for reasons already discussed. Indeed, the nature of the refundable tax is closer to a deposit[66] than a tax because the 50 percent tax on contributions and accrued earnings is ultimately refunded back to the foreign trust when trust monies are distributed to the employee beneficiary (such that the beneficiary, in fact, receives the gross amount initially contributed by the employer and earnings accrued on such amounts). Further, if the contributions were made directly to the nonresident alien employee as cash compensation (rather than the foreign trust), such amounts would have been immediately subject to Canadian income tax as compensation income.

Applying the above provisions of IRC section 72(w)(2) and (w)(3) to the RCA trust, we conclude that the entire amount of the employer contributions made by a Canadian employer to an RCA trust account for the benefit of its USP athlete would constitute nontaxable contributions under IRC section 72(w)(2). We reach this conclusion because all the employer contributions into the RCA trust were subject to a 50 percent refundable tax according to Part XI.3 of the ITA (subsection 207.5). The application of the refundable tax to such contributions would not rise to the level of an income tax in the U.S. sense. As a result, the portion of the RCA trust distributions made to a USP athlete that constitutes nontaxable contributions would be subject to U.S. income tax if the USP athlete were to receive such amounts as a resident of the United States under IRC section 72(a), (c), and (w).[67]

We also conclude that a portion of the RCA trust distributions that represent earnings accrued in the RCA trust from formation date to present would also constitute applicable nontaxable earnings. Such amounts would be excluded from the USP athlete's investment in the contract amounts under IRC section 72(w)(3).[68] This is because all the accrued earnings in the RCA trust were subject to the same 50 percent refundable tax, which we do not believe would constitute an income tax in the U.S. sense. Further, a portion of these earnings would not have been subject to U.S. income tax to the extent the amounts were accruing in a foreign trust while the athlete was a nonresident alien.

In light of this analysis, distributions from the RCA trust to a USP athlete (regardless of whether or not he or she became a U.S. resident after establishment of the RCA or was already a USP player at the time of its creation) would be taxable to the individual as gross income subject to U.S. federal income taxes.[69] We also note that because the RCA trust distributions would be computed and paid to the athlete based on the Canadian dollar, the amount payable to such athlete as gross income each year will fluctuate in terms of U.S. dollars, which would be the applicable functional currency as a U.S. resident. Treas. reg. section 1.72-2(b)(3) would need to be applied to properly take into account the foreign exchange component that would be includable and excludable from such athlete's gross income for U.S. taxes.[70]

4. IRC Section 402(b)(4)

If an HCE is a member of an employee pension plan, then IRC section 402(b)(4) imposes additional hurdles to show that the plan meets the requirements of a qualified plan under IRC section 401(a)(26) (broad-based retirement plan) and section 410(b) (minimum employee participation). Otherwise, if the plan does not meet the requirements of IRC sections 401(a)(26) or 410(b), then the HCE is required to include in his gross income his vested accrued benefit (that is, the amounts in excess of his investment in the contract) in the trust as of the end of each trust year that falls within, or which ends with, the employee's tax year. If IRC section 402(b)(4) applies to the USP athlete because the RCA trust fails one of the tests outlined in IRC section 402(b)(4), then all earnings accrued in the trust will be included in the HCE's current gross income subject to U.S. tax, regardless of actual distributions.

For IRC section 402(b)(4) purposes, an HCE is defined under IRC section 414(q)[71] as an individual who was a 5 percent owner[72] of the employer at any time during the year or preceding year, or for the preceding year had compensation[73] in excess of US $80,000 as adjusted annually under IRC section 415(d) (cost of living adjustments). Employees who are nonresident aliens[74] and receive no earned income[75] that constitutes income attributable to services performed in the United States are not treated as employees for purposes of determining whether a pension plan has any HCEs.[76]

If the USP athlete was a nonresident alien when the RCA trust was funded for his or her benefit for services performed outside the United States, it would appear that the RCA trust, as a foreign nonexempt trust that is a funded plan, would have no employee that would qualify as an HCE for purposes of determining if the RCA trust constitutes a foreign funded qualified plan under IRC sections 401(a)(26) and 410(b) until sometime when such individual became a U.S. resident.

The issue that arises is that, even if the USP athlete became eligible for HCE status, he or she would no longer be an employee of the Canadian employer that established the RCA trust, nor would the USP be receiving any compensation for services provided within the United States to the Canadian employer in excess of US $80,000 (as adjusted for inflation) when he or she became a U.S. tax resident. Therefore, such a USP athlete would be ineligible to claim HCE status for his or her U.S. tax residency year under IRC section 414(q). Ultimately, the RCA trust would not have any HCE individual that would trigger the gauntlet rules of IRC section 402(b)(4) because the USP athlete would no longer be an HCE individual on which IRC section 401(a)(26) and 401(b) tests can be performed.

5. IRC Section 409A

Although it would appear that distributions received from the RCA trust would be taxable to the USP athlete under IRC section 402(b), there remains the risk that accrued earnings in the trust that remain undistributed may be taxable to the USP athlete as current income each year. This risk arises if the RCA trust constitutes a nonqualified deferred compensation plan under IRC section 409A. This statutory provision[77] provides for specified requirements that, if violated, would cause such athlete to recognize all earnings accrued in the trust, which would be currently includable in the athlete's gross income to the extent such amounts are not subject to a substantial risk of forfeiture.[78] Consequently, the USP athlete's exclusive right to receive the trust assets as the sole beneficiary of the

RCA trust (which likely constitute compensation income) may constitute deferred compensation, which will cause the athlete to recognize such accrued earnings as current gross income subject to tax.

Treasury regulations promulgated under IRC section 409(A) (the 409A regulations) define a nonqualified deferred compensation plan as including a plan under which an employee obtains a legally binding right to receive property in a future tax year when such property will be substantially vested (as defined under Treas. reg. section 1.83-3(b)).[79] There are, however, exemptions to what would be considered deferred compensation under the 409A regulations. There are two exemptions in Treas. reg. section 1.409A-1(b)(6)(i) that may apply to prevent the inclusion of accrued earnings in the RCA trust as current gross income for U.S. tax purposes:

> If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested (as defined in section 1.83-3(b)), or is includible in income solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c). In addition, for purposes of this paragraph (b), a right to compensation income that will be required to be included in income under section 402(b)(4)(A) is not a deferral of compensation.

As stated in the above Treasury regulation, a transfer of property to a trust, if such property includes a right to compensation income, is not considered a deferral of compensation for purposes of IRC section 409A if it is already subject to the income inclusion rules of IRC section 402(b)(4).[80] However, the USP athlete would be unable to claim this exemption because we think that the USP athlete would not be subject to IRC section 402(b)(4).

6. Substantially Non-Vested

The other exemption to IRC section 409A under Treas. reg. section 1.409A-1(b)(6)(i) involves the transfer of property (such as a right to compensation) to a foreign trust that is an IRC section 402(b) plan. Under Treas. reg. section 1.409A-1(b)(6)(i), amounts contributed by a Canadian employer to an RCA trust with the USP athlete as the sole beneficiary would not be treated as deferred compensation under IRC section 409A if the athlete's right to such property is substantially non-vested under Treas. reg. section 1.83-3(b).

Treas. reg. section 1.83-3(b) provides that property is substantially non-vested when it is subject to a substantial risk of forfeiture and is nontransferable. Both conditions must be satisfied to establish that the property placed in trust is substantially non-vested. A USP athlete's beneficial interest in an RCA trust would not be substantially non-vested for the following reasons.

First, the assets in the RCA trust are not subject to a substantial risk of forfeiture. Under Treas. reg. section 1.83-3(c)(1), property is subject to a substantial risk of forfeiture if the transfer has conditions directly or indirectly on the: (1) future performance (or refraining from performance) of substantial services by any person or (2) the occurrence of a condition related to the transfer, which, if not satisfied, would result in forfeiture.

In a typical arrangement, the Canadian employer would set aside monies in the RCA trust for the USP athlete's benefit upon his or her retirement or in the event of loss of employment. There are no conditions that would divest the USP athlete of his or her right to receive the property before or upon such athlete's retirement. The only implicit condition to the transfer of such property is the passage of time until the athlete's retirement or departure from the Canadian employer, and the mere passage of time does not constitute a risk of substantial forfeiture.

Second, a USP athlete's right to receive the RCA trust assets are not nontransferable because such rights can be sold, assigned, or pledged to another person (except the Canadian employer). Treas. reg. section 1.83-3(d) provides that "the rights of a person in property are transferable if such a person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture." Therefore, property is transferrable if the person receiving the property can sell, assign, or pledge (as collateral for a loan or security or any other purpose) his interest in the property to any person other than the transferor of such property. Based on this definition, a USP athlete's right to receive the RCA trust assets is transferable.

Because a USP athlete's right to receive the RCA trust assets is not substantially non-vested under IRC section 83 and its regulations, there is a risk that the RCA trust would constitute deferred compensation for IRC section 409A purposes. Consequently, the earnings accruing in the RCA trust would be currently includable in the USP athlete's gross income under IRC section 409A and subject to U.S. tax. We would, however, take the position that the accrued earnings potentially subject to U.S. tax would cover only earnings accrued in the RCA trust, starting on the date such USP athlete first departed Canada and became a U.S. resident under U.S. domestic tax laws.

C. Canada-U.S. Tax Treaty

1. Article XVIII

The tax treaty generally provides that pensions arising in Canada and paid to a resident of the United States may be taxed in the United States, but the amount of any such pension that would be excluded from taxable income in Canada if the recipient were a Canadian resident would be exempt from U.S. taxation.[81] For this purpose, the treaty defines pension as including "any payment under a superannuation, pension or other retirement arrangement."[82]

The U.S. Treasury explained that article 9 of the 1995 protocol amended Article XVIII (pensions and annuities) of the tax treaty, substituting the phrase "other retirement arrangement" for the phrase "retirement plan":

> The purpose for this change is to . . . provide that "pensions" includes, for example, Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) in Canada. The term "pension" also would include amounts paid by other retirement plans or arrangements, whether or not they are qualified plans under U.S. domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the

> Internal Revenue Code.[83]

The U.S. Joint Committee on Taxation further commented:

> The existing treaty has a provision limiting source-country taxation of pensions. Article 9(1) of the proposed protocol makes a slight change in the definition of the term "pensions." The protocol clarifies that the definition of pensions includes, for example, payments from a U.S. individual retirement account (an "IRA"), and provides that the definition of pension includes, for example, payments from a Canadian registered retirement savings plan (a "RRSP") or registered retirement income fund (a "RRIF").[84]

Because the RCA trust is a retirement arrangement that is not an RRSP, RRIF, or a qualified plan under IRC section 401(a) or IRC sections 457 or 414(d),[85] the question that arises is whether it would nonetheless constitute an "other retirement arrangement" under Article XVIII(3)(a) and therefore, a pension. We do not believe that it would qualify as an other retirement arrangement because an RCA is not considered among that class of retirement or other employee benefit arrangements favored under Canadian tax laws. Indeed, the JCT noted:

> Under present law, certain Canadian retirement plans that are qualified plans for Canadian tax purposes do not meet U.S. internal law requirements of qualification. The existing treaty, however, permits a U.S. taxpayer who is a beneficiary of an RRSP to obtain U.S. tax deferral corresponding to the deferral that the RRSP provides under Canadian tax law, to the extent that income is reasonably attributable to contributions made to the plan by the beneficiary while he was a Canadian resident (see Rev. Proc. 89-45, 1989-2 C.B. 872). *The proposed protocol expands the class of retirement or other employee benefit arrangements favored by Canadian law with respect to which the United States will grant corresponding deferral of U.S. tax, and provides that Canada will provide reciprocal treatment to a Canadian taxpayer who is a beneficiary under a pension plan or other arrangement that qualifies for deferral of U.S. tax under U.S. law.* [Emphasis added.][86]

This passage confirms that the term "pension" under Article XVIII(3)(a) was expanded to include other retirement plans or arrangements that received favorable treatment under Canadian law that would not satisfy qualified plan treatment under U.S. laws. An RCA arguably does not receive favorable tax treatment in Canada. Indeed, an RCA is omitted from the class or category of retirement plans that would be afforded qualifying plan treatment in Canada for purposes of Article XVIII.[87]

The term "qualifying plan" under paragraph 15 of Article XVIII is limited to:

> a trust, company, organization, or other arrangement that (a) is a resident of that State, generally exempt from income taxation in that State and operated primarily to provide pension or retirement benefits; (b) is not an individual arrangement in respect of which the individual's employer has no involvement; and (c) the competent authority of the other Contracting State agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. Thus, U.S. individual retirement accounts (IRAs) and Canadian registered retirement savings plans (RRSPs) are not treated as qualifying retirement plans. . . . *In addition, a Canadian retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada.* [Emphasis added.][88]

Based on the foregoing authorities, we conclude that the RCA trust, classified as an RCA under Canadian domestic law, would not qualify as a pension under Article XVIII(3)(a). This conclusion stands even if the Canadian Income Tax Conventions Interpretation Act (ITCIA) section 5 definition of pension includes an RCA.[89] It is evident from the above commentary on Article XVIII(1) and (3) that only tax-favored Canadian plans would be offered tax treaty benefits. It is also evident that the ITCIA section 5 definition of pension only applies in the absence of a treaty definition for pension. Finally, because Article XVIII(3) defines "pensions," application of ITCIA section 5 would be premature. Therefore, a USP athlete would not be able to apply the provisions of Article XVIII(1) to exclude from U.S. income taxes the accrued earnings in, and distributions received from, the RCA trust.

Articles XVIII(7), (8), (9), and (10) — all of which deal with the tax relief accorded to pension plans in Canada or the United States for the benefit of citizens and residents of the other country — would seem to apply to an RCA. The RCA may be a trust for U.S. tax purposes, but clearly it is an other arrangement that provides for pension benefits. However, these provisions all require that Canada provide tax relief to such a structure for the United States to grant similar relief, up to the limits of similar relief provided in the United States for similar U.S. pensions. Unfortunately, the RCA receives no such tax relief in Canada and indeed is taxed and withheld on in Canada to such a degree that, if credit were granted in the United States, it would be hard to think of a situation in which U.S. federal tax would be payable. It could be argued perhaps that an RCA does provide tax relief in that the income of the arrangement is not taxed in the hands of the beneficiary when earned, but it is taxed heavily in the structure. However, that relief is technical rather than effective.

2. Article XXII: Income From a Trust

Although the RCA does not technically meet the treaty definition of pension or other retirement arrangement under Article XVIII of the tax treaty, it would alternatively qualify as a Canadian resident trust under Article XXII, which states:

> 1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State, except that if such income arises in the other Contracting State it may also be taxed in that Other State.
>
> 2. To the extent that income distributed by an estate or trust is subject to the provisions of paragraph 1, then, notwithstanding such provisions, income distributed by an estate or trust which is a resident of a Contracting State to a resident of the other Contracting State who is a beneficiary of the estate or trust may be taxed in the first-mentioned State and according to the laws of that State, but the tax so charged shall not exceed 15 percent of the gross amount of the income; provided, however, that such income shall be exempt from tax in the first-mentioned State to the extent of any amount distributed out of income arising outside that State.

If the RCA trust distributions were treated as a payment out of a trust rather than a pension, and further, as income from the trust rather than capital,[90] then such amounts would be subject to 15 percent withholding tax as income distributed from a Canadian resident trust to a USP athlete (if such athlete were to become a resident of the United States), regardless of periodic or lump sum payments under Article XXII, which addresses "Other Income."[91] However, because Canadian domestic tax law does not tax distributions from an RCA (in fact, the refundable tax is paid back to the RCA trust as distributions are made), we do not think Article XXII would apply.

IV. TFSAs

The TFSA has proven to be enormously popular with Canadians. According to the latest statistics, there are over 15 million unique TFSA holders with a cumulative FMV of C $350 billion.[92] This means that about 39 percent of all Canadian residents have a TFSA.[93] Although it is a popular belief that there are over 1 million Americans living in Canada,[94] according to the U.S. government's Federal Voting Assistance Program (which conducts the Overseas Citizen Population Analysis every two years following the general election), there are only about 660,935 eligible U.S. voters living in Canada.[95] Based on the average percentage of Canadian residents owning TFSAs and the statistics available, there are perhaps as many as 390,000, but more likely closer to 260,000, USPs who have TFSAs. These TFSAs could have a market value of as much as C $7.9 billion but perhaps closer to C $5.2 billion (or about US $6 billion to US $4 billion depending on the assumptions made and the exchange rate).

Addressing the issue of exactly what are TFSAs for U.S. tax purposes and how they ought to be reported by USPs who are Canadian residents is an issue of some significance. This is particularly the case if the reporting for TFSAs is both repetitive (that is, the same account is being reported on multiple forms filed by the USP with the IRS) and the advice being given to USPs in Canada by tax professionals is inconsistent.

A. Background and Structure

The Canadian government introduced TFSAs in 2009.[96] The TFSA has been described as "a flexible, registered, general-purpose savings vehicle that allows Canadians to earn tax-free investment income to more easily meet lifetime savings needs."[97] Although the TFSA was intended to complement RRSPs and increase retirement savings,[98] a recent study shows that Canadians appear to have diverted their savings away from RRSPs and into TFSAs.[99]

Canadian TFSAs are intentionally easy to create. All that is required are two parties (a Canadian resident, as holder, and an entity, as issuer) to enter a "qualifying arrangement" that is treated as a trust.[100] The issuer must be a federally or provincially licensed trust company, a life insurance company qualified to issue annuities, or a bank or credit union that is a member of the Canadian Payments Association.[101] The agreement must be a trust agreement with a trust company, an annuity contract with a life insurance company, or a deposit agreement with a financial institution.[102] The agreement also must provide that all contributions must be made to the issuer "in consideration of, or to be used, invested or otherwise applied for the purpose of, the issuer making distributions under the arrangement to the holder."[103] Moreover, the agreement must require that the issuer will file an election to register the arrangement as a TFSA with the CRA before the end of the tax year in which the agreement is made.[104]

The terms of the agreement must also state, and the issuer must also always comply with, the following terms[105]:

1) the TFSA must be maintained for the exclusive benefit of the holder;[106]

2) while the holder is alive, only the holder or the issuer can determine the amount and timing of distributions[107] or the investing of funds;

3) no one other than the holder can make a contribution;[108]

4) distributions will reduce any tax imposed for over-contributions,[109] contributions by nonresidents,[110] or as a result of improper investments being held in the TFSA;[111]

5) the holder has the right to require the issuer to transfer the assets or the value thereof to another TFSA held by the same holder;

6) if the TFSA is a trust, the trust is prohibited from borrowing money or other

property for the purposes of the arrangement; and

7) the arrangements must comply with prescribed conditions, of which there have been no such regulations issued to date.[112]

Although the majority of TFSAs are deposit agreements with financial institutions, the terms of the agreement between the holder and the issuer are more trustlike than an ordinary account with a financial institution. The TFSA is limited, however, on the kind of investments that can be made. TFSAs are limited to specified investments similar to RRSPs, such as cash, mutual funds, securities listed on a designated stock exchange, guaranteed investment certificates, bonds, and some shares of small business corporations.[113] Because the holder retains significant control over the TFSA and has sole power to direct payments, the TFSA bears the indicia of a grantor trust for U.S. tax purposes (as discussed below) and is likely not a separate entity from the holders as others have suggested.

For 2022, a Canadian resident age 18 years and older can contribute up to C $6,000 of his or her post-tax monies to a TFSA. The cumulative total lifetime contribution cannot exceed C $81,500. Both the annual amount and the lifetime maximum amount are adjusted annually for inflation. Under current legislation, the TFSA annual contribution, if unused, can be rolled over to the succeeding year but will always be subject to the lifetime contribution limit. There is no personal deduction for contributions made to a TFSA. However, neither income earned within a TFSA nor withdrawals from it affect eligibility for Canadian federal income tested benefits, such as Old Age Security, the Guaranteed Income Supplement, and the Canada Child Tax Benefit. Moreover, an individual may provide funds to their spouse or common law partner for investment in a TFSA, with TFSA assets generally transferrable to a spouse or common law partner upon death.

B. Canadian Classification

The TFSA and the RRSP are the predominant tax-preferred savings accounts available for Canadians' personal savings, but the two are not subject to the same Canadian tax treatment. On the one hand, the RRSP is an example of a tax-deferred savings plan: Contributions are made with pretax cash, and withdrawals are generally fully taxable.[114] On the other hand, the TFSA is an example of a trust that is not taxable in Canada because it is essentially a tax-prepaid savings plan.[115] Contributions to a TFSA are made with after-tax cash,[116] and generally, there are no Canadian tax consequences when an amount is contributed to such a trust unless it carries on one or more businesses or holds one or more properties that are nonqualified investments.[117] Withdrawals from a TFSA are also tax free, and the entire amount withdrawn can be recontributed to the TFSA in future years.

With both RRSP and TFSA plans, income earned in the plan is not taxed (although, in the case of an RRSP, such income is taxed in the year of withdrawal).[118]

Because of the tax-advantaged nature of the TFSA, all contributions, accruals, and distributions are closely tracked by the CRA. First, a Canadian social insurance number must be provided by any Canadian resident opening a TFSA. Second, the issuers[119] of a TFSA are required to report all TFSAs to the CRA during the tax year in which contributions are made. Third, invalid contributions made to the TFSA during a year are subject to a monthly penalty tax that is a percentage of the highest excess contribution amount. Invalid contributions are contributions that exceed the annual contribution limit or contributions made by a non-Canadian resident. The penalty taxes can be applied concurrently if both types of invalid contributions take place. The tax is paid and reported to the CRA.[120]

In recent years, the rampant popularity of TFSAs has made it the focus of CRA attempts to curb its use by penalizing gains made through stocks held in a TFSA.[121] Such attempts, representing the CRA's effort to crack down on similar accounts throughout Canada, have uncovered C $110 million (US $83.75 million) in unpaid taxes.[122]

C. U.S. Classification

TFSAs have been excluded from all U.S. tax guidance, which has otherwise exempted USP taxpayers with interests in Canadian registered plans such as RRSPs, RRIFs, RESPs, and RDSPs from foreign trust reporting requirements. Absent clear guidance for TFSAs, there is no uniformity in the tax classification and reporting of TFSAs among tax practitioners. This breeds inadvertent noncompliance among U.S. individuals with TFSAs who rely on their U.S. and Canadian tax practitioners and return preparers to accurately report their interests in a TFSA. Cross-border tax practitioners either report the TFSA as a foreign grantor trust or not at all because of the onerous U.S. statutory filing requirements for such trusts, a situation that has been pointed out in several submissions to Treasury by different interest groups and associations over the years.[123] Regardless of whether a TFSA is considered a "foreign financial account" subject to Form 8938 or FBAR[124] disclosure or a foreign grantor trust subject to Form 3520-A, a USP who is a Canadian resident and who contributes to a TFSA is subject to income taxation on the income of such TFSA each year. Also, if the TFSA is invested in Canadian mutual funds, the USP is also subject to additional adverse passive foreign investment company taxes and information reporting requirements, including Form 8621.[125]

The TFSA is very similar to the Roth IRA in the same way that an RRSP is similar to a traditional IRA. Although Canadian scholars have noted similarities[126] between the TFSA and Roth IRA, not just in their purpose but on several key characteristics, the two are not identical:

- The TFSA and the Roth IRA are funded with post-tax monies. There is no personal tax deduction afforded to taxpayers who open accounts.
- Funds in a TFSA and Roth IRA generally grow tax free (assuming Roth IRA guidelines are followed) and are generally not subject to tax on distribution after retirement.
- Annual contribution limits to a TFSA and a Roth IRA are fixed at C $6,000 (TFSA) and US $6,000[127] (Roth IRA) for 2022;[128] however, unlike a TFSA (which has an annual contribution limit comprised of the annual contribution limit and any unused prior-year contributions), unused contribution limits in a Roth IRA cannot be carried forward to future years.
- The account holder can direct how investments in a Roth IRA or TFSA are made.
- Amounts in a Roth IRA or TFSA can be contributed by a spouse or common law partner without any earnings accrued in such contribution being attributed back to the contributor.
- There is no limit on the amount that is eligible for rollover to a Roth IRA or TFSA.
- Higher-income taxpayers have their annual contributions to a Roth IRA reduced or eliminated if their modified adjusted gross income exceeds specified thresholds[129] each year; a TFSA does not have any income threshold.
- Unlike a TFSA, from which withdrawals can be made at any time, early pre-

retirement distributions from a Roth IRA that are not "qualified distributions" are subject to a tax plus a 10 percent penalty on any portion attributable to the account earnings.[130]

D. Canada-U.S. Tax Treaty

1. Article XVIII

As discussed in Section IV.C regarding the tax treaty's application to an RCA, Article XVIII(1) also governs our analysis of the TFSA. As a refresher, Article XVIII(1) of the tax treaty generally provides that pensions arising in Canada and paid to a resident of the United States may be taxed in the United States, but the amount of any such pension that would be excluded from taxable income in Canada if the recipient were a Canadian resident would be exempt from U.S. taxation.[131] For this purpose, Article XVIII(3)(a) defines "pension" as including "any payment under a superannuation, pension or other retirement arrangement."[132]

The U.S. Treasury explained that article 9 of the 1995 protocol amended Article XVIII (Pensions and Annuities) of the tax treaty. Specifically, the current definition of pension under Article XVIII(3) was amended by substituting the phrase "other retirement arrangement" for the phrase "retirement plan." Treasury elaborated that:

> The purpose for this change is to . . . provide that "pensions" includes, for example, Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) in Canada. The term "pension" also would include amounts paid by other retirement plans or arrangements, whether or not they are qualified plans under U.S. domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the Internal Revenue Code.[133]

The JCT further commented:

> The existing treaty has a provision limiting source-country taxation of pensions. Article 9(1) of the proposed protocol makes a slight change in the definition of the term "pensions." The protocol clarifies that the definition of pensions

> includes, for example, payments from a U.S. individual retirement account (an "IRA"), and provides that the definition of pension includes, for example, payments from a Canadian registered retirement savings plan (a "RRSP") or registered retirement income fund (a "RRIF").[134]

Although a Roth IRA, which is explicitly considered a pension for purposes of the treaty under Article XVIII(3)(b), would not be subject to Canadian taxation under the treaty, this protection no longer applies when the owner of a Roth IRA migrates to Canada and becomes a Canadian tax resident. Under such circumstances, the treaty makes clear that any subsequent contributions to the Roth IRA (including conversions or rollovers from a qualified employer plan account) will cause the Roth IRA to lose its treaty protection. Thereafter, all growth accrued in the Roth IRA account would be subject to full Canadian taxation for as long as the person is a resident of Canada. Future distributions in excess of the account balance on the date of the disqualifying contribution are also subject to Canadian tax while resident in Canada. Assets in the Roth IRA are subject to Canadian deemed disposition rules when the person terminates his or her Canadian residence to the extent the appreciation in the Roth IRA related to the contribution on behalf of a resident.

Unlike a Roth IRA, a Canadian TFSA is not afforded treatment as a pension under Article XVIII(3) of the treaty. Nonetheless, to qualify as a pension under the treaty, a Canadian TFSA must constitute an other retirement arrangement under Article XVIII(3)(a) of the treaty. To do so, the TFSA must be a retirement arrangement that is not an RRSP, RRIF, or a qualified plan under IRC section 401(a) or sections 457 or 414(d) of U.S. domestic tax law.[135] We believe that a TFSA would qualify as an other retirement arrangement because, like the Roth IRA in the United States, it is considered among that class of retirement or other employee benefit arrangements favored under Canadian tax laws. Indeed, the JCT noted as follows:

> In addition, under present law, certain Canadian retirement plans that are qualified plans for Canadian tax purposes do not meet U.S. internal law requirements of qualification. The existing treaty, however, permits a U.S. taxpayer who is a beneficiary of an RRSP to obtain U.S. tax deferral corresponding to the deferral that the RRSP provides under Canadian tax law, to the extent that income is reasonably attributable to contributions made to the

> plan by the beneficiary while he was a Canadian resident (see Rev. Proc. 89-45, 1989-2 C.B. 872). *The proposed protocol expands the class of retirement or other employee benefit arrangements favored by Canadian law with respect to which the United States will grant corresponding deferral of U.S. tax and provides that Canada will provide reciprocal treatment to a Canadian taxpayer who is a beneficiary under a pension plan or other arrangement that qualifies for deferral of U.S. tax under U.S. law.* [Emphasis added.][136]

This quote confirms that the term "pension" under Article XVIII(3)(a) was expanded to include other retirement plans or arrangements that received favorable treatment under Canadian law that would not satisfy qualified plan treatment under U.S. laws. A TFSA is afforded favorable treatment under Canadian law. However, although it is essentially a trust account for retirement savings, it would not be included as part of the class or category of retirement plans that would be afforded qualifying plan treatment in Canada for purposes of Article XVIII because it can be created without any employer involvement.[137] The term "qualifying plan" under paragraph 15 of Article XVIII is limited to:

> a trust, company, organization, or other arrangement that (a) is a resident of that State, generally exempt from income taxation in that State and operated primarily to provide pension or retirement benefits; (b) is not an individual arrangement in respect of which the individual's employer has no involvement; and (c) the competent authority of the other Contracting State agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. Thus, U.S. individual retirement accounts (IRAs) and Canadian registered retirement plans (RRSPs) are not treated as qualifying retirement plans unless addressed in paragraph 10 of the General Note. . . .
>
> Paragraph 10 of the General Note provides that the types of Canadian plans that constitute qualifying retirement plans for purposes of paragraph 15 include the following and any identical or substantially similar plan . . .: registered pension plans [and] registered retirement savings plans.[138]

In light of this analysis, we would likely conclude that the TFSA would not qualify as a pension under Article XVIII(3)(a) of the tax treaty. However, we would nonetheless challenge this conclusion in light of the fact that the tax treaty treats a Roth IRA as a pension, notwithstanding that it is also an individual arrangement made without employer involvement. According to Article XVIII(3)(b):

> The term "pensions" also includes a Roth IRA, within the meaning of section 408A of the Internal Revenue Code, or a plan or arrangement created pursuant to legislation enacted by [the United States or Canada] after September 21, 2007 that the competent authorities have agreed is similar thereto. Notwithstanding the provisions of the preceding sentence, from such time that contributions have been made to the Roth IRA or similar plan or arrangement, by or for the benefit of a resident of [Canada] (other than rollover contributions from a Roth IRA or similar plan or arrangement described in the previous sentence that is a pension within the meaning of this subparagraph), to the extent of accretions from such time, such Roth IRA or similar plan or arrangement shall cease to be considered a pension for purposes of the provisions of this Article.

Roth IRAs are treated as pensions under the tax treaty, notwithstanding that they otherwise would not qualify under Article XVIII(3)(a), and payments from the United States to Canadian residents from Roth IRAs are tax free in Canada because such distributions are tax free in the United States. There is the caveat that if contributions are made to a Roth IRA for the benefit of a Canadian resident while the beneficiary is a Canadian resident, then any related amounts (distributions and income therefrom) will not be deemed to be pensions for the purposes of Article XVIII(3) and therefore may be taxed in Canada.

Because TFSAs were not introduced by Canadian legislation until after the fifth protocol was signed in 2007, it is not mentioned in Article XVIII of the tax treaty. However, it seems fairly obvious that the protocol was negotiated in light of the potential for Canada to establish a structure like a Roth IRA and for the two authorities to come to an agreement on this issue. Although there are many notable similarities between a Roth IRA and a TFSA that cannot be ignored, the two are not identical. Nonetheless, the question must be raised as to why a TFSA is not protected under the tax treaty in the same way that a Roth IRA is.

We suggest that the difference in treatment of the Roth IRA and TFSA under the tax treaty is attributable to the fact that the TFSA allows for considerably more freedom regarding withdrawals and because contributions to a TFSA are not restricted by income level. Moreover, subsection 146.2 of the ITA says a TFSA is not a retirement savings plan for Canadian tax purposes. It would therefore be somewhat inconsistent for the CRA to request the United States to recognize something as a pension for the purposes of the tax treaty when Canadian domestic law clearly states it is not.

Article XVIII(7) of the tax treaty provides an alternative basis for extending treaty protection to a TFSA:

> A natural person who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization or other arrangement that is a resident of the other Contracting State, generally exempt from income taxation in that other State and operated exclusively to provide pension or employee benefits may elect to defer taxation in the first-mentioned State, subject to rules established by the competent authority of that State, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor.

This text was originally added to the tax treaty by the third protocol in 1995 (although its language was tweaked in the fifth protocol in 2007). Before that time, the opportunity to elect to defer taxation was limited to RRSP accounts. Paragraph 7 was added to extend the scope of elective deferral to pensions and employee plans. The technical explanation to the third protocol explains the scope of the extension of treaty benefits:

> As amended, paragraph 7 applies to an individual who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization, or other arrangement that is a resident of the other Contracting State and that is both generally exempt from income taxation in its State of residence and is operated exclusively to provide pension, retirement, or employee benefits.[139]

Based on that, a USP who is a Canadian resident with a TFSA should be able to elect for a tax deferral on the income realized from TFSA asset investments if the following conditions are met:

- such individual is a beneficiary of the plan;
- the plan is exempt from income tax under Canadian law; and
- the plan is operated exclusively to provide pension, retirement, or employee benefits.

The TFSA would meet all three conditions. First, the USP (the holder of the TFSA) would be a beneficiary of the plan. Second, the TFSA investment earnings and distributions are not subject to Canadian taxation. Third, although the TFSA does not exclusively provide pension or employee benefits, it is intended to provide retirement savings because distributions would be tax free only if received by a Canadian resident individual on or after retirement age. The fact that Canadian tax law does not deem a TFSA to be a retirement plan under the ITA (but rather as a trust under subsection 146.2 of the ITA) should not deter the IRS from extending similar deferral opportunities for the TFSA for U.S. tax purposes as has been afforded to Roth IRAs for Canadian tax purposes.

2. Article XXII: Income From a Trust

Although the TFSA does not meet the tax treaty definition of pension under Article XVIII, it would alternatively qualify as a Canadian resident trust under Article XXII of the tax treaty. Article XXII(2) of the tax treaty provides:

> (1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State, except that if such income arises in the other Contracting State, it may also be taxed in that Other State.
>
> (2) To the extent that income distributed by an estate or trust is subject to the provisions of paragraph (1), then, notwithstanding such provisions, income distributed by an estate or trust which is a resident of a Contracting State to a resident of the Other Contracting State who is a beneficiary of the estate or trust may be taxed in the first-mentioned State and according to the laws of that State, but the tax so charged shall not exceed 15 percent of the gross amount of the income; provided however, that such income shall be exempt from tax in the first-mentioned State to the extent of any amount distributed out of income

arising outside that State.

If the TFSA distributions were treated as a payment out of a trust rather than a pension, and further, as income from the trust rather than capital,[140] then such amounts would be subject to 15 percent withholding tax as income distributed from a Canadian resident trust to a USP, regardless of periodic or lump sum payments under Article XXII of the tax treaty, which addresses other income.[141] However, because Canadian domestic tax law does not generally tax distributions from a TFSA, we do not think Article XXII would apply.

V. Recommendations

Based on our analysis of TFSAs and RCAs, we recommend that Treasury and the IRS provide administrative guidance instructing tax practitioners to report:

- TFSAs as foreign grantor trusts that are not subject to annual foreign trust reporting requirements because the administrative burdens posed by such foreign trusts on IRS resources far outweigh the benefits generated from IRS enforcement efforts directed at delinquent foreign trust filings regarding U.S. beneficial interests. Such assets are low-balance depositary accounts that would be an unlikely offshore vehicle for U.S. tax avoidance by USP residents in Canada, and they are already subject to government oversight and reporting requirements in Canada. However, distributions to USP resident beneficiaries of TFSAs should be subject to foreign trust reporting by filing Form 3520.
- RCAs as foreign non-grantor trusts similar to IRC section 402(b) nonexempt employees' trusts that would be exempt from Form 3520 reporting until distributions from the RCA are received by a USP who is a beneficiary of an RCA trust. Consequently, distributions from the RCA trust to the USP would be subject to U.S. tax under IRC section 72 with contributions and earnings accumulated in the RCA trust before attaining U.S. tax residency also subject to U.S. tax under IRC section 72(w)(2) and (3).

Rev. Proc. 2020-17 would not be applicable to an RCA or TFSA, and therefore, this area of cross-border tax reporting of trusts that are foreign retirement or savings plans are prone to inconsistent and incorrect foreign trust reporting. This creates complexity for U.S.

taxpayers with beneficial interests in these types of Canadian retirement and savings plans. The costly consequences of delinquent Form 3520 and Form 3520-A filings on U.S. taxpayers with beneficial interests in TFSAs and RCAs are in addition to the existing compliance burden on taxpayers subject to duplicative reporting under FBAR and FATCA for such assets. The national taxpayer advocate noted:

> The IRS has exercised its regulatory authority to eliminate duplicative reporting of assets on Form 8938 if the assets are reported or reflected on certain other timely filed international information returns (e.g., forms 3520, 3520-A, 5471, 8621, 8865, or 8891).[142]

TFSAs and RCAs are already subject to foreign financial reporting under FATCA and FBAR. There is no need to exacerbate the issues with annual international information reporting and use IRS resources by requiring that TFSAs and RCAs be subject to Form 3520 and Form 3520-A reporting as foreign trusts when no withdrawals or distributions subject to U.S. tax have been made to the U.S. beneficiary. Both types of Canadian plans are already subject to annual Canadian filings and, in the case of the RCA, substantial Canadian taxes. These are not the types of foreign trusts on which the IRS should be expending its resources.[143]

FOOTNOTES

[1] Convention between the United States and Canada with respect to Taxes on Income and Capital, signed on Sept. 26, 1980, as amended by protocols signed June 14, 1983, Mar. 28, 1984, Mar. 17, 1995, July 29, 1997, and Sept. 21, 2007.

[2] IRC section 408A(d).

[3] *See* Jack Bernstein, "RCA Planning," 6(9) *Canadian Tax Highlights* 70-71 (1998); David Harding and Kevin Dunphy, "Individual Pension Plan," 2018 *St. John's Tax Seminar* 5:1-10 (2018).

[4] We note that if this reclassification for Canada Revenue Agency purposes were to occur, there would be Canadian income tax consequences, which will have a corresponding effect on the U.S. taxable income reported by the USP taxpayer. However, this will likely be resolved through the application of FTCs.

[5] IRS, "IRS Announces the Identification and Selection of Six Large Business and International Compliance Campaigns" (May 21, 2018).

[6] *See* Rev. Proc. 89-45, 1989-2 C.B. 596, *superseded by* Rev. Proc. 2002-23, 2002-1 C.B. 744.; Rev. Proc. 2014-55, 2014-44 IRB 753, at section 2, subparagraph.01.

[7] *See* Rev. Proc. 2020-17, 2020-12 IRB 539.

[8] *See* IRC section 7701(b)(1)(A).

[9] *See* IRC section 61(a)(1), (10), (14).

[10] Treas. reg. section 301.7701-7(a)(2). Safe harbor for the court test is met if the trust instrument does not direct that the trust be administered outside the United States, the trust is in fact administered exclusively in the United States, and the trust is not subject to an automatic migration provision under Treas. reg. section 301.7701-7(c)(1)(i-iii).

[11] Subpart J of the IRC (sections 641-692) provides for the taxation of trust income.

[12] Distributable net income for a U.S. trust is taxable income plus tax exempt income but excluding capital gains and losses. *See* IRC section 643(a)(6).

[13] *See generally* IRC section 662.

[14] *See generally* IRC section 665(b).

[15] IRC section 679(a)(1).

[16] IRC section 671.

[17] IRC section 679(a)(4)(A).

[18] IRC section 684.

[19] We note that the IRC does not have a definition of what constitutes an employee's trust.

[20] IRC section 401(a) provisions only apply to "a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries."

[21] In other words, it governs the taxation of an employee with an interest in a trust associated with a plan that is not a U.S. tax-qualified plan under IRC section 401(a).

[22] *See* Veena K. Murthy, "Selected Cross-Border Equity and Deferred Compensation Issues With Funded Foreign Plans," 42 *Compensation Plan. J.* 67 (2014). In footnote 3, Murthy commented that such trusts are often referred to as secular trusts as opposed to rabbi trusts. The term "rabbi trust" is based on a private letter ruling regarding the tax treatment of assets contributed to a trust created for a rabbi by his congregation under which payments to the rabbi could occur only when his service ended. The IRS ruled that the amounts were not taxable when placed in the trust because the assets were subject to the claims of creditors of the congregation. *See* LTR 8113107; *see also* Rev. Proc. 92-64, 1992-2 C.B. 422; and Rev. Proc. 92-65, 1992-2 C.B. 428, 1992-33 I.R.B.

[23] *See* Murthy, *supra* note 22; Cynthia Blum, "U.S. Income Taxation of Cross-Border Pensions," 3(6) *Fla. Tax Rev.* 259 (1996).

[24] The term "vested" means that there is no longer a substantial risk of forfeiture as determined under IRC section 83 principles.

[25] *See also* Blum, *supra* note 23, at 306.

[26] *See* Treas. reg. section 1.402(b)-1(b)(2).

[27] IRC section 402(b)(4)(A).

[28] IRC section 401(a)(26).

[29] IRC section 410(b).

[30] Rev. Proc. 2014-55, at section 4.

31 According to section 3 of Rev. Proc. 2014-55, "the term 'beneficiary' means any individual who holds an interest in a Canadian retirement plan or plans and who would be subject to current U.S. income taxation under the domestic law of the United States on undistributed income accrued in such plan or plans."

32 "'Annuitant' means an individual who is designated pursuant to a Canadian retirement plan as an annuitant and is not also a beneficiary as defined above." *Id.*

33 "'Canadian retirement plan' means any trust, company, organization, or other arrangement that is within the scope of Article XVIII(7) of the [tax treaty]." *Id.*

34 *See id.* at section 5 ("Information Reporting With Respect to Canadian Retirement Plans)." Form 8891 was made obsolete as of December 31, 2014. *Id.* at section 5.02.

35 Indeed, Rev. Proc. 2014-55 eliminated reporting obligations of custodians of Canadian retirement plans to file a Form 3520-A. Section 5.01 of Rev. Proc. 2014-55 was made retroactive and effective for tax years beginning on or after January 1, 2003.

36 Rev. Proc. 2014-55, at section 5.

37 *See id.* at section 6 ("Distributions From Canadian Retirement Plans").

38 *Supra* note 7.

39 *See* Robert E. Ward, "IRS Provides Reporting and Penalty Relief for Canadian RESP and RDSP Arrangements, As Well as Other Foreign Retirement and Non-Retirement Plan Trusts," 49 *Tax Mgmt. Int'l J.* 5 (May 8, 2020).

40 *See* Rev. Proc. 2020-17, *supra* note 7, at section 2 ("Background").

41 *See id.* at section 3 ("Information Reporting Under Section 6048 With Respect to Applicable Tax-Favored Foreign Trusts").

42 *See* Marsha Laine Dungog and Liguo Cooper Xu, "Should Canadian RESPs and RDSPs Be Exempt From Foreign Trust Reporting?" *Tax Notes Federal*, July 22, 2019, p. 475.

[43] Fraser Lang, "Planning for the Future: The RCA and Professional Hockey Players — July 2021," GBL Insights.

[44] Matthey Bailey, "Retirement Compensation Arrangements (RCAs) for Players of Canadian NHL Teams Who Retire Outside of Canada," RBC Wealth Management (2016); *see also* Lang, *supra* note 43.

[45] For example, for the 2021-2022 National Hockey League season, about 26 percent of the active players in the league are U.S. citizens. There are seven Canadian hockey teams, all of which have U.S. citizen players. RCAs are also offered to Major League Baseball players on Canadian teams, and most of those players are USPs. For the 2022 season, about 69 percent of the players on the Toronto Blue Jays' active roster are USPs.

[46] Lang, *supra* note 43.

[47] *Id.*

[48] *Id.*

[49] We note that for a Canadian player who was not a U.S. resident (a USP athlete) at the time contributions and earnings were accruing in the RCA trust, such amounts would not have been subject to U.S. income tax.

[50] New York State Bar Association, "Report No. 1332 Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903," at 6 (Nov. 24, 2015).

[51] *See generally* Treas. reg. section 1.901-2(b). In Rev. Rul. 67-187, 1967-1 C.B. 185, the IRS ruled that the special refundable tax in effect in Canada at the time was not an income tax but rather a "compulsory loan" because it was repayable with interest within a specified time. The RCA refundable tax may be distinguished from the special refundable tax in that it does not bear interest, an important indicium of a loan, whether compulsory or otherwise, and the timing of the refund of the tax can vary according to the pattern of contributions, income, and distributions of the particular RCA. As provided by Treas. reg. section 1.901-2(b), the term "net gain," does not appear to be applicable to either contributions or distributions, which are not "net" of any expenses other than the

refundable tax itself.

52 ITA regulation 103(7).

53 ITA subsection 207.5(1) ("refundable tax").

54 ITA subsection 207.7(1).

55 ITA subsection 207.7(2).

56 ITA subsection 207.5.

57 *Id.*

58 ITA subsection 20(1)(r). The employer must file T 737-RCA to report the contribution. The RCA also reports the contribution on its T3-RCA. Distributions from the RCA are reported by the custodian on the T4A-RCA.

59 ITA subsection 56(1)(x).

60 ITA subsection 153(1)(q).

61 More precisely, as described in the preceding paragraph, RCA income goes into the overall calculation of the refundable tax balance at year-end, which may or may not require a payment of refundable tax depending on the calculation.

62 Treas. reg. section 1.901-2(e)(2).

63 *See* H.R. Rep. No. 108-755, at 790-791 (2004).

64 *Id.* at 790.

65 *Id.* at 790-791 (citations omitted).

66 The refundable tax with respect to the RCA is different from the special refundable tax, which the IRS had previously determined to be a compulsory loan, not an income tax in Rev. Rul. 67-187. *Supra* note 51.

[67] If the RCA was not subject to the refundable tax, then there would be the possibility that a portion of the employer contributions to the RCA trust may constitute nontaxable contributions to the extent that the USP athlete: (1) filed a U.S. Form 1040NR to apportion their Canadian hockey team compensation to "income from personal services performed in the United States" in the same year as such contributions, and (2) the USP athlete took a treaty-based position under Article XV(2) of the tax treaty to file such returns as a nonresident alien. IRS, "U.S. Tax Guide for Aliens," Publication 519 (2022).

[68] If the RCA was not subject to the refundable tax, then there would be the possibility that a portion of the earnings accrued in the RCA trust may constitute nontaxable earnings to the extent that the Canadian athlete: (1) filed a U.S. Form 1040NR to apportion his Canadian hockey team compensation to income from personal services performed in the United States in the same year that earnings accrued to the RCA trust, and (2) such athlete took a treaty-based position under Article XV(2) of the tax treaty to file such returns as an nonresident alien.

[69] The distribution amounts subject to tax would be equivalent to the fair market value of the RCA at the time of distribution reduced by the amount of employer contributions made.

[70] Under Treas. reg. section 1.72-2(b)(3), a specified fixed dollar amount is considered to be the amount received as an annuity and is excludable from your gross income each year. All amounts in excess of that fixed dollar amount are considered to be amounts received not as an annuity and therefore includable in your gross income. The excludable fixed dollar amount is determined by dividing the investment in the contract by the number of periodic payments anticipated using the actuarial tables of Treas. reg. section 1.72-9.

[71] IRC section 402(b)(4)(C).

[72] As defined under IRC section 416(i)(1).

[73] Compensation within the meaning of IRC section 415(c)(3).

[74] IRC section 414(q)(8), referencing "nonresident aliens" as defined in IRC section 7701(b)(1)(B).

[75] Under IRC section 911(d)(2), earned income generally includes wages, salaries, and professional fees.

[76] There is no guidance from the applicable sections of the IRC, Treasury regulations, or the IRS that a Canadian athlete would be classified as an HCE if he or she filed a U.S. Form 1040NR and took a treaty-based position for nonresident status under Article XV(2) of the tax treaty for years when such athlete earned Canadian employer compensation for services performed within the United States.

[77] American Jobs Creation Act of 2004, P.L. 108-357, section 885.

[78] *See* IRS Rev. Rul. 2007-48, 2007-30 IRB 129.

[79] Treas. reg. section 1.409A-1(b)(6)(ii).

[80] Treas. reg. section 1.402A-1(b)(6)(i).

[81] *See* tax treaty Article XVIII(1).

[82] *See* tax treaty Article XVIII(3)(a).

[83] U.S. Treasury technical explanation to the 1995 protocol.

[84] Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada," JCS-15-95 (May 23, 1995).

[85] *See also* U.S. Treasury technical explanation to the 2007 protocol, stating: "In addition, a Canadian retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada."

[86] JCT, *supra* note 84.

[87] Tax treaty Article XVIII(8)-(14) and (15).

[88] Technical explanation to the 2007 protocol, *supra* note 85.

89 As defined in ITCIA section 5, "pension" means "in respect of payments that arise in Canada, (a) if the convention does not include a definition [of] *pension*, a payment under any plan, arrangement or contract that is (i) a registered pension plan, (ii) a registered retirement savings plan, (iii) a registered retirement fund, (iv) a retirement compensation arrangement." (emphasis in original).

90 The reduced rate of 15 percent applies to income and not to the distribution of capital — that is, the employer contribution. *See* ITA subsection 212(1)(c), which also only applies to income of the trust that is income with reference to ITA subsection 104(13).

91 Canadian practitioners acknowledge that the inclusion of RCAs in "pension" under the treaty when there is no definition of pension, results in anomalous results because only periodic payments from an RCA can qualify as a pension under tax treaty Article XVIII(2), while lump sum payments do not. *See* David W. Ross, "Withholding Taxes on Retirement Compensation Arrangements," XIII(2) *Tax'n of Executive Compensation & Retirement J.* 801 (2009) (commenting on CRA Technical Interpretation 9530510).

92 *See* CRA, "Tax-Free Savings Account Statistics (2019 Tax Year)" (last accessed Sept. 28, 2022).

93 Canada's population for 2019 — the same year as the latest TFSA stats — is about 37.5 million. *See* Statistics Canada, "Population Estimates, Quarterly" (last accessed Sept. 1, 2022).

94 *See* Wikipedia, "Immigration to Canada" (last visited Sept. 1, 2022). There is no statistical proof of these 1 million Americans in Canada, but this number shows up all over the internet. Based on the number of potential registered voters, 1 million seems like a low number. For example, there are many children of USPs born in Canada, who are American citizens by virtue of their birth abroad to a U.S. citizen parent, who do not hold U.S. passports or disclose this status in the ordinary course of their day-to-day lives. Additionally, many other Canadian residents do not even know they are U.S. citizens by birth and therefore USPs for U.S. tax purposes. The authors routinely need to explain this to clients, including those who are highly sophisticated individuals. If there are half a million known U.S. citizens/voters in Canada, according to the U.S. government, we would

ballpark the actual number of U.S. citizens in Canada at well above 1 million and perhaps closer to 2 million.

[95] Kenneth Chan, "Toronto Has the World's 3rd Largest Population of Americans Living Outside of the USA," *DH News*, Oct. 10, 2016; *see also* Federal Voting Assistance Program, "State of the Overseas Voter" (last visited Sept. 1, 2022). There are more potential U.S. voters in Canada than live in the states of Alaska, Vermont, North Dakota, South Dakota, or Wyoming.

[96] Introduced as Bill C-50, The Budget Implementation Act, 2008, received Royal Assent on June 18, 2008. It became effective January 1, 2009.

[97] *See* Letter from Jim Yager, The American Chamber of Commerce in Canada, to Mark Mazur, assistant secretary (tax policy), Department of the Treasury, and Robert Stack, deputy assistant secretary (international affairs), Department of the Treasury (Mar. 4, 2016).

[98] Department of Finance Canada, "The Budget Plan 2008: Responsible Leadership," at 277 (Feb. 26, 2008).

[99] Leslie Berger, Jonathan Farrar, and Lu Zhang, "An Empirical Analysis of the Displacement Effect of TFSAs on RRSPs," 67(2) *Canadian Tax J.* 309 (2019).

[100] Para. (a) of the definition of qualifying arrangement in ITA subsection 146.2(1).

[101] Para. (b) of the definition of qualifying arrangement in ITA subsection 146.2(1).

[102] *Id.*

[103] Para. (c) of the definition of qualifying arrangement in ITA subsection 146.2(1).

[104] Para. (d) of the definition of qualifying arrangement in ITA subsection 146.2(1).

[105] Para. (e) of the definition of qualifying arrangement in ITA subsection 146.2(1) (stating that the arrangement must comply with ITA subsection 146.2(2)).

[106] *See* para. (a) of "qualifying arrangement conditions" in ITA subsection 146.2(2).

[107] Please see the definition of distribution in ITA subsection 146.2(2)(b).

[108] ITA subsection 146.2(2)(c). However, the CRA has indicated that it will allow spouses to provide gifts to each other to fund TFSAs. *See* CRA, "Tax-Free Savings Account (TFSA), Guide for Individuals," RC4466(E) Rev. 22.

[109] ITA subsection 207.02 sets the tax payable for excess contributions to a TFSA at 1 percent per month, for any month in which there is an excess amount *at any time* in the month.

[110] ITA subsection 207.03.

[111] Under ITA subsections 207.04 and 207.06, there is a tax on the FMV of prohibited or nonqualified investments acquired by trusts, equal to 50 percent of the FMV of the prohibited or nonqualified investment. This tax will be payable by the holder of a TFSA if the TFSA acquires a prohibited or nonqualified investment or an investment held by the TFSA becomes a prohibited or nonqualified investment. This tax can be recovered if the property is disposed of by the TFSA before the end of the calendar year following the calendar year in which the tax arose and only if it is not reasonable to consider that the TFSA holder knew, or ought to have known, at the time the property was acquired, that it was, or would become, a prohibited or nonqualified investment.

[112] The explanatory notes to ITA subsection 146.2(2) state that no specific conditions were anticipated and to date none have been issued. *See* Department of Finance Canada, "Tax Provisions From the 2008 Federal Budget Contained in Bill C-50 With Explanatory Notes" (2008).

[113] Government of Canada, "Types of Permitted Investments" (last updated Dec. 13, 2021).

[114] Berger, Farrar, and Zhang, *supra* note 99.

[115] *Id.*

[116] The amounts contributed to a TFSA are post-tax monies and have been subject to Canadian tax at applicable marginal federal tax rates under Canada's graduated tax rate system.

[117] *See* ITA subsection 146.2(6).

[118] Berger, Farrar, and Zhang, *supra* note 99.

[119] Issuers would include trust companies, licensed annuities providers, a person who is or would be eligible to become a member of the Canadian Payments Association, or a credit union in which an individual has a qualifying arrangement under the ITA. *See* "Tax-Free Savings Account (TFSA), Guide for Individuals," *supra* note 108.

[120] CRA, "RC243 Tax-Free Savings Account (TFSA) Return" (last updated Oct. 8, 2021).

[121] *See Canadian Western Trust Company as Trustee of the Fareed Ahamed TFSA v. The Queen*, 2019 TCC 121 (2019).

[122] *See* James Munson, "Agency Memo Focus of Canadian Tax-Free Accounts Case," BNA Daily Tax Report (last updated Oct. 27, 2020).

[123] *See, e.g.*, Yager letter, *supra* note 97.

[124] *See* Financial Crimes Enforcement Network, "BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114)" (Jan. 2017).

[125] *See* Ward, "2012 Offshore Voluntary Disclosure Program: Issues and Opportunities," 41(10) *Tax Mgmt. Int'l J.* 548 (Oct. 12, 2012).

[126] *See* Berger, Farrar, and Zhang, *supra* note 99; *see also* Yager letter, *supra* note 97; and Letter from Troy K. Lewis, AICPA, to Mark Mazur, assistant secretary (tax policy) Department of the Treasury, Robert Stack, deputy assistant secretary (international affairs) Department of the Treasury, and J. Mark Iwry, senior advisor to the secretary and deputy assistant secretary, Retirement and Health Policy Department of the Treasury (Mar. 4, 2016).

127 Individuals age 50 years or older may make catch-up contributions.

128 Also, Roth IRA contribution limits are increased for taxpayers who are at least 50 years old. For 2022, these taxpayers can contribute US $7,000.

129 For 2022, income must be below $129,000 for single filers or $204,000 for joint filers. Roth IRA contributions are entirely phased out if income reaches $144,000 for single filers and $214,000 for joint filers.

130 *See* IRS, "Distributions From Individual Retirement Accounts (IRAs)," Publication 590-B (2021).

131 *See* tax treaty Article XVIII(1).

132 *See* tax treaty Article XVIII(3)(a).

133 Technical explanation to the 1995 protocol, *supra* note 83.

134 JCT, *supra* note 84.

135 *See also* technical explanation to the 2007 protocol, *supra* note 85.

136 JCT, *supra* note 84.

137 *See* tax treaty, Article XVIII(8)-(14) and (15).

138 Technical explanation to the 2007 protocol, *supra* note 85.

139 Technical explanation to the 1995 protocol, *supra* note 83.

140 *See* ITA subsection 212(1)(c), *supra* note 90.

141 *See* Ross, *supra* note 91.

142 *See* National Taxpayer Advocate, "2022 Purple Book" (Dec. 31, 2021).

143 The views expressed herein are those of the authors and do not necessarily reflect the

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END FOOTNOTES