



CLIENT BRIEFING • INTERNATIONAL TAX

Taxation of Australian Superannuation

*Why the same account can be taxed three different ways,
and what fund structure has to do with it*

Clients relocating from Australia, or U.S. citizens and green card holders working there, typically arrive with a compulsory retirement account that Australian law treats as tax-favored and largely invisible until retirement. U.S. law has no matching category for it. Depending on how the specific fund is structured and funded, a superannuation account can be taxed as a foreign employer pension, as a trust the client is deemed to own outright, or as a foreign corporation subject to the passive foreign investment company regime — three very different answers to what looks, from the client's side, like the same account.

This briefing walks through how we sort a superannuation account into the right category, what each category means for contributions, in-fund earnings, and eventual distributions, and where the U.S.-Australia treaty does — and does not — help. It closes with the reporting checklist we confirm before signing off on a return that touches superannuation.



Why Superannuation Doesn't Map onto U.S. Retirement Law

Australian employers are required to contribute a percentage of an employee's ordinary earnings — the Superannuation Guarantee — to a fund the employee generally cannot access until preservation age, currently 60. Structurally, that resembles an ERISA pension. But superannuation funds are trusts created and governed under Australian statute, not tax-qualified U.S. plans, and the Internal Revenue Code has no provision that simply defers to a foreign retirement trust the way it defers to a section 401(k) or an IRA.

The U.S. answer instead comes from a patchwork of Code provisions written for other purposes: section 402(b) for contributions to a nonexempt employees' trust, the grantor trust rules for structures a member effectively controls, and the passive foreign investment company (PFIC) regime for foreign investment vehicles. Which provision governs a given account depends entirely on how that account is set up — there is no single answer for "superannuation."

Fund Structure Decides the Analysis

Superannuation accounts generally take one of three forms. Large Funds — retail funds run for profit by financial institutions, and industry funds run on a not-for-profit basis for a particular sector — pool contributions from many unrelated members. Self-managed superannuation funds (SMSFs) are trusts where the members are also the trustees, capped at six members. Wrap or wholesale accounts, offered through private banking platforms, sit in between: they behave like an SMSF from the member's side but remain segregated accounts within a larger institutional trust.

Each of these is a trust under Australian law, but they diverge on two facts that drive the U.S. analysis: whether an employer is currently contributing to the account, and who actually controls investment decisions — the member, or a trustee acting at its own discretion. Establishing those two facts for a specific account is the first step in every superannuation file, because the rest of the analysis follows directly from the answer.



Employer-Funded Accounts: Section 402(b)

A superannuation fund is a foreign trust that is not exempt from U.S. tax under section 501(a), so contributions to it are taxed to the member under section 402(b), which borrows its valuation approach from section 83. Ordinary employer contributions are included in the member's income as compensation in the year contributed, sourced to where the underlying services were performed.

For a member who meets the "highly compensated employee" threshold under section 414(q) — a dollar figure indexed annually — the rule changes. Instead of taxing that year's contributions, section 402(b)(4) taxes the increase in the member's vested accrued benefit for the year: the account's year-end value in U.S. dollars, less the prior year-end value, less any of the member's own contributions during the year. A highly compensated employee is therefore taxed annually on investment growth inside the fund even in a year with no new contributions, and even after leaving the employer that originally contributed.

Contributions tax and earnings tax that Australia collects from the fund itself — rather than from the member directly — are not creditable against this U.S. tax, though they are factored into the vested accrued benefit calculation as a reduction. And once a fund stops receiving employer contributions, most often after a rollover, the section 402(b) employee-trust analysis no longer applies at all; the fund has to be tested separately under the rules below.

Self-Managed Super Funds: The Grantor Trust Question

An SMSF looks, on its face, like a trust the member controls directly, which invites the grantor trust rules of sections 671 through 679. Section 402(b)(3) provides an exception: a pension trust that would otherwise be a grantor trust is instead treated as a section 402(b) pension, as long as the member's own contributions remain "incidental" to the employer's. Treasury regulations treat a member's contributions as no longer incidental once they exceed the employer's contributions as of any date.

Cross that line — a common result once a member begins making voluntary or rollover contributions without ongoing employer support — and the SMSF becomes a grantor trust: a disregarded entity whose income, deductions, and gains are attributed directly to the member every year. Australian tax paid by the fund is then available as a foreign tax credit, but Form 3520 and Form 3520-A reporting attach as well. Below that line,



the fund continues to be taxed as a pension under section 402(b), with no grantor trust filings. Because the same SMSF can cross back and forth over a member's working life as contribution patterns change, the incidental-contribution test needs to be checked for the specific year at issue, never assumed to carry forward from a prior return.

When a Fund Looks Like a Foreign Corporation: The PFIC Risk

A fund with no employer contributions cannot be classified as an employee trust, which forces a different question: is it a trust at all for U.S. purposes, or a business entity? Under the entity classification regulations, a trust with multiple, separately valued member accounts — the standard structure for retail and industry Large Funds, and for wrap accounts — is a trust with multiple classes of ownership. Where the trustee also has discretion to vary each member's investments, that structure is reclassified as a business entity and, because superannuation funds are foreign and hold predominantly passive investments, taxed as a corporation under the PFIC rules of section 1297.

A U.S. person with an interest in a PFIC files Form 8621, and because Large Funds typically invest through layers of underlying sub-funds that are themselves PFICs, the "chain of ownership" rule can require a separate Form 8621 for each fund in the chain. Because preservation-age restrictions mean most members receive no distributions for years, both the filing obligation and the underlying tax liability can sit unrecognized until a rollover or withdrawal forces the issue — which is why a mark-to-market election, taxing the annual increase in value as it accrues, is often the more manageable path once a fund is identified as a PFIC.

Taking a Distribution

Australia treats a withdrawal at or after preservation age as a tax-free event. The United States does not. Whether a distribution is taxable, and how much of it, depends on which route the account was taxed under along the way. A section 402(b) pension distribution is taxable only to the extent it exceeds contributions and vested accrued benefit already taxed in the U.S. A grantor trust distribution carries no further U.S. tax, because the member has already been taxed on the underlying income annually, though the distribution itself is reportable on Form 3520. A PFIC distribution, absent a mark-to-market election, falls under the excess distribution regime, which spreads the



gain over the fund's holding period and applies an interest charge — typically the least favorable of the three outcomes.

A client who becomes a U.S. taxpayer mid-career may also be entitled to a step-up in cost basis under section 72(w) for growth that occurred before U.S. residency began. Separately, the mandatory withholding applied when certain visa holders leave Australia and cash out their fund — the departing Australia superannuation payment — is a tax borne by the individual directly, which makes it a creditable foreign tax for U.S. purposes even though the contributions and earnings taxes the fund itself pays along the way are not.

What the Treaty Does and Doesn't Resolve

Article 18 of the U.S.-Australia income tax treaty reserves pensions, other similar remuneration, and social security payments to the recipient's country of residence, and on its face that could shield a distribution from U.S. tax. In practice it rarely does, for two reasons. First, the pension-relevant provisions of the treaty have not been substantively updated since 1983 and do not address the taxation of contributions or in-fund earnings at all — only distributions — leaving the questions addressed above entirely to domestic law. Second, and more fundamentally, the saving clause in Article 1(3) preserves the United States' right to tax its own citizens on worldwide income as if the treaty did not exist, and the pension article is not among the provisions carved out of that clause for citizens.

Whether a superannuation distribution should instead be classified as a "social security" payment — which is carved out of the saving clause — turns on the unresolved question of whether the Superannuation Guarantee is close enough in character to U.S. Social Security to qualify for that treatment. Practitioners have advanced that position, but the IRS has not confirmed it, and Treasury has not issued the clarifying guidance that commentators have repeatedly requested. Until that guidance exists, treating a distribution as treaty-exempt social security remains a considered position rather than a settled result, and it should not be taken on a return without a documented, fund-specific analysis.



Reporting Checklist

Before closing a file involving Australian superannuation, confirm the following:

CONFIRM AND DOCUMENT

- Which category the fund falls into for the year at issue — section 402(b) employee trust, grantor trust SMSF, or PFIC — and whether an SMSF has crossed the incidental-contribution line since the last return filed.
- Whether the client meets the highly compensated employee threshold under section 414(q), which shifts an employer-funded account from contribution-based to vested-accrued-benefit taxation.
- Year-end account valuations in Australian dollars, and the exchange rate applied at each valuation point, needed for the vested accrued benefit and grantor trust calculations alike.
- Whether a mark-to-market election is in place, or should be considered, for any account treated as a PFIC.
- The client's cost basis in the fund — previously taxed contributions and vested accrued benefit — before treating any distribution as taxable.
- Departing Australia superannuation payment withholding, tracked separately as a creditable tax on the individual rather than a fund-level tax.

RELATED FORMS

- FBAR (FinCEN Form 114) – required once the aggregate value of foreign financial accounts, including superannuation, exceeds \$10,000 at any point in the year.
- Form 8938 – required above filing-status-specific thresholds; the superannuation interest is a specified foreign financial asset regardless of which Code section taxes it.
- Form 3520 and Form 3520-A – required for transactions with, or ownership of, a fund treated as a foreign grantor trust.
- Form 8621 – required for any fund, or underlying sub-fund, classified as a PFIC.

This briefing is a general planning reference and does not replace a fund-specific review. Superannuation tax treatment turns on the trust deed, the contribution history, and the trustee's actual investment discretion for the account at issue, and should be confirmed against those documents before a position is taken on the return.