

US citizens living in Australia – US tax filing obligations

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On July 4, 2015, The Sydney Morning Herald ran an article entitled [“Why Australia is now home to the sixth largest American population in the world.”](#) The article discusses the dramatic increase in US citizens who have recently chosen to make Australia their home. According to the article, and the Australian Bureau of Statistics, the number of US citizens living in Australia has increased to 90,000 from 60,000 from 2001 to 2011. Economist Lyman Stone has published even more statistical information on the [American diaspora in Australia](#).

Regardless of the reasons US citizens immigrate to Australia, they all share one thing in common: the requirement to file US tax returns. The unfortunate news is that US tax law is agonizingly complex, and the worse news is that this complexity increases exponentially when applied to an individual who is subject to both US and Australian tax law.

For US citizens in Australia, the tax and filing obligations continue throughout the individual's life and even upon death. The only way to end the tax liability and filing obligations is to renounce US citizenship, which comes with its own set of filings and traps for the unwary. Renouncing US citizenship will be the subject of a subsequent article (however, you may [click here](#) for additional articles on the topic).

In this article, I identify many of the US tax forms that are typically required to be filed by US citizens living in Australia. There are a lot of them, they are complex, and penalties for non-compliance are shockingly high, but there are administrative programs through which an individual can get caught up with the tax filings and avoid penalties.

National Taxpayer Advocate Report

The unenviable predicament faced by US citizens living in Australia (and elsewhere abroad) has not gone unnoticed in Washington D.C. The National Taxpayer Advocate 2011 Annual Report to Congress was very critical of the current compliance burden of US citizens residing abroad. In its introduction to this issue, the report states:

The complexity of international tax law, combined with the administrative burden placed on these taxpayers, creates an environment where taxpayers who are trying their best to comply simply cannot. For some, this means paying more US tax than is legally required, while others may be subject to steep civil and criminal penalties. For some U.S taxpayers abroad, the tax requirements are so confusing and the compliance burden so great that they give up their US citizenship.^[1]

The report continues to address more specific areas that are particularly challenging for these taxpayers:

- The overwhelming complexity of international law;
- The complexity and administrative detail of often duplicative international reporting requirements;
- Steep penalties that may be disproportionate to tax liability;

- The IRS's focus on international tax enforcement without adequate coordination or a corresponding increase in service; and
- The lack of targeted taxpayer service for each of the four groups of international taxpayers, which leads to confusion, errors, and higher compliance costs for this population.^[2]

While the IRS's National Taxpayer Advocate (which is an independent branch of the IRS itself) does not draft policy or enforce the law, it can (and has) affect change through its annual reports. Misery loves company, but what it loves more is recognition. If nothing else, the reports recognize the plight of US citizens living in Australia.

Common US tax filing obligations for US citizens in Australia

In applying US tax law, we do so through the lens of the Internal Revenue Code, which is to say that common Australian income tax planning, estate planning, and so forth needs to be analyzed under US tax law. Unfortunately, common savings, retirement, and educational planning in Australia does not lend itself well to US tax analysis and, as a result, there can be significant complexity. Most of these filing obligations do not affect the individual's US tax liability, however, there can be significant penalties for the failure to file the requisite returns on time.

In the discussion that follows, I identify many of these filing obligations and the penalties for failing to timely file. It is important to note, however, that nearly all of the penalties are subject to the statutory defense of "reasonable cause". In addition, the IRS has several programs and procedures under which an individual can get caught up with his tax filing obligations and avoid the application of the penalties. IRS has recently updated its [website](#) to make the rules of these procedures easier to find and follow. Further, our firm has written several articles on this topic (which you may find by clicking [here](#) and [here](#)).

The Paperwork Reduction Act of 1980^[3] was enacted in order to identify and reduce the burden imposed by federal filing obligations. To that end, the IRS is obligated to collect data on the time required to complete various tax forms. The estimate of time is typically located on the back page of the instructions for the appropriate form and is reproduced in the discussion below.

1. Australian Superannuation fund

Without a doubt the most common and difficult to analyze planning scheme faced by US citizens in Australia is the superannuation fund. In March of 2016, my colleague Marsha Dungog and I wrote an extensive paper on this topic and were invited to present it to representatives of IRS, US Treasury, and the US Congress. A summary of the paper is available [here](#).

Suffice to say that this area is nearly impenetrable in its complexity and there are no clear answers as to how superannuation funds should be reported and taxed for US purposes. Shortly we will publish another article on this topic, however until we do so I am compelled to offer the following advice: **beware of anyone who claims to have a simple or straightforward answer to the US taxation of Australian superannuation funds.** Until the law is changed or guidance is provided, those who claim to have "the answer" are simply uninformed.

2. US individual with an income tax filing obligation

The most common situation that will cause a filing obligation is when the individual has an income of a sufficient amount or of a particular type that will trigger the obligation to file the US Individual Income Tax

Return (Form 1040).

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|---|--|
| 1040 | <p>Failure to file penalty is 5% of the amount shown on the return per month not to exceed 25%.</p> <p>IRC section 6651(a)(1)</p> <p>Failure to Pay Penalty is 5% of the amount shown on the return per month not to exceed 25%</p> <p>IRC section 6651(a)(2)</p> <p>Accuracy Penalty depending on understatement is 20%-40% of the amount shown on the return</p> <p>IRC section 6662</p> | 13:00 hours |

While an individual may not have income sufficient to trigger a filing obligation, if the individual owns or has signatory authority over a foreign bank account, the individual must file the Schedule B regardless of the balance in the account.^[4] Since the Schedule B cannot be filed without the form 1040, an individual with a foreign account must file the form 1040.^[5]

3. US individual who owns or has signatory authority over non-US accounts with an aggregate value in excess of \$10,000

Because it comes with the threat of criminal sanctions for not filing, the form that has caused the most commotion in Australia is the FinCen 114 (commonly referred as the foreign bank account report or FBAR). Under the Bank Secrecy Act^[6], a resident or citizen of the US must file an FBAR in certain

circumstances.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|--------------------------|--|--|
| FinCen 114 (FBAR) | Non-willful penalty is \$10,000 per year per account Willful penalty is: <ul style="list-style-type: none">• Greater of 50% of the account or \$100,000• Not more than 5 years in prison | 0:45 hours |

31 USC. 5321(a)(5)

4. US individual resides in Australia and owns or has signatory authority over non-US financial interests with aggregate year-end value in excess of \$200,000 (\$600,000 for joint filers)

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|---|--|
| 8938 | Failure to file penalty is \$10,000 if form is not "accurate and complete." If account is disclosed and tax is unreported on the account, penalty is 40% of the tax owed | 2:52 hours |

IRC section 6038D

5. US individual transfers money or other property to an Australian trust (education savings plans)

In Australia, education savings plans (ESPs) are a tax-efficient way to save for a child's tertiary education. However, that can have onerous tax and reporting consequences to US taxpayers if they are classified under US law as foreign trusts. While IRS has not ruled on the classification of education savings plans (ESPs) the conservative approach is to treat both of these vehicles as foreign trusts and report them on both the Form 3520 and 3520-A.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|--|--|
| 3520 | Failure to file penalty is 35% of the value of the property transferred | 6:40 hours |

IRC section 6048

6. US individual receives a distribution from an Australian trust (including education savings plans)

Since ESPs are likely considered foreign trusts, distributions from them are subject to the same reporting obligations as are any other foreign trust.

| Form | Failure to File Penalty | IRS Estimate of time required to |
|-------------|--------------------------------|---|
|-------------|--------------------------------|---|

prepare return

3520 **Failure to file penalty** is 35% of the value of the property transferred 6:40 hours

IRC section 6048

7. US owners of ESPs or US individual is a trustee of a non-US trust

US individuals who are deemed to be owners of foreign trusts must report these interests on an annual basis. The form 3520-A provides information about the foreign trust its beneficiaries, and US persons who are treated as an owner.^[7]

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|---------------|--|--|
| 3520-A | Failure to file penalty is greater of \$10,000 or 5% of the amount "owned" by person. | 3:24 hours |

IRC section 6677(b)

Criminal Penalties may apply for failure to file if fraudulent or willful

IRC sections 7203, 7206, 7207

8. US individual receives a gift from a non-US person or a distribution from a non-US estate

US individuals are required to report gifts from non-US persons and gifts from foreign entities (including foreign estates). These filing obligations are frequently overlooked.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|---|--|
| 3520 | Failure to file penalty is 5% of the amount of the gift or distribution, not to exceed 25% | 6:40 hours |

IRC section 6039F

9. US individual is a shareholder, officer, or director of certain Australian corporations

Generally, the form 5471 must be filed if the individual has an interest in a controlled foreign corporation (CFC).^[8] However, even if the corporation does not meet the definition of a CFC, a shareholder, officer, or director may, nonetheless, have a filing obligation.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|---|--|
| 5471 | Failure to file penalty is \$10,000 and reduction of foreign tax credits | 24:17 hours |

IRC sections 6035, 6038, and 6048

10. US corporation has 25 per cent or more ownership by non-US persons

Foreign-owned US corporations or foreign corporations engaged in US trade or business are typically required to report transactions between 25 per cent foreign-owned domestic corporations and the foreign parent.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|--|--|
| 5472 | Failure to file penalty is \$10,000 | 3:30 hours |

IRC sections 2038A and 2038C

11. US individual transfers property (including money) to certain Australian corporations

US individuals are required to report transfers of property to CFCs and other information. Just as with the reporting obligations under the form 5471, even if the corporation is not a CFC, the form 926 may still be required.

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|--|--|
| 926 | Failure to file penalty is 10% of the value transferred with a maximum of \$100,000 | 14:51 hours |

IRC section 6038B

12. US individual owns certain Australian partnerships or sells interest in Australian partnerships

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|--|--|
| 8865 | Failure to file penalty is \$10,000 | 36:05 hours |

IRC sections 6038, and 6046A

13. US individual transfers property (including money) to Australian partnerships

| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
|-------------|--|--|
| 8865 | Failure to file penalty is 10% of the value transferred with a maximum of \$100,000 | 36:05 hours |

IRC sections 6038B

14. Person owns an Australian insurance policy on a US individual

There is a one per cent excise tax on insurance premiums for policies issued on US individuals. This is one of the most overlooked filing obligations for US individuals residing in Australia. At this time there is no penalty for filing the form 720 and the liability for the tax is joint and several with the owner, broker, and issuer.

| Form | Failure to File Penalty | IRS Estimate of |
|-------------|--------------------------------|------------------------|
|-------------|--------------------------------|------------------------|

| | | |
|------------|-----------------------------------|--|
| 720 | No failure to file penalty | time required to prepare return 1:58 hours |
|------------|-----------------------------------|--|

- Excise tax of 1% on premiums

- Tax is joint and several with owner, broker and issuer

IRC section 4371

15. US individual owns an interest in an Australian mutual fund

In 2010, IRS released a memorandum that concluded an unidentified Canadian mutual fund was classified as a corporation for US tax purposes.^[9] The consequence of IRS's position is that the mutual fund trust in question would also be classified as a passive foreign investment company (PFIC) and as a result, subject to the PFIC reporting requirements on form 8621.^[10]

| | | |
|-------------|-----------------------------------|--|
| Form | Failure to File Penalty | IRS Estimate of time required to prepare return |
| 8621 | No failure to file penalty | 20:34 hours |

Conclusion

The US is the only industrialized country that taxes its citizens on their worldwide income regardless of where they reside. (However, there are some in the UK that believe their tax system should revert to a US style system to prevent "tax dodging"). In the past, the filing obligations that accompany US citizenship were far less onerous than they are now because in the olden days the penalties for not filing the right form at the right time were typically a percentage of the US taxes owed. Since the US allows a credit against US tax liability for the taxes paid in Australia (and elsewhere) there was typically no additional US tax owed. No filing, no tax owed, no penalties, no problems!

Under current law, however, the penalties for not filing the appropriate returns when due can be financially ruinous. The penalties can be waived by either participating in one of the IRS's catch-up compliance programs or establishing "reasonable cause" for not having filed.

The IRS's National Taxpayer Advocate is aware of the unenviable situation faced by US citizens in Australia and elsewhere abroad. And the recognition that there is a problem is, of course, the first step in correcting the problem.

For more information on US/Australia tax considerations, visit our [microsite](#).

[1] National Taxpayer Advocate 2011 Annual Report to Congress at 129. Citing Memorandum for Secretary Geithner from J. Russell George, Treasury Inspector General for Tax Administration, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* 13 (Oct. 15, 2010).

[2] *Id.* at 130.

[3] Pub. L. No 96-511, 94 Stat. 2812, codified at 44 USC. 3501-3521.

[4] Question 7a on the Schedule B to the form 1040 and 1040A states: "At any time during [the year] did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country?"

[5] Failure to check "Foreign Account" box on Schedule B can result in criminal penalties. IRC section 6662.

[6] 31 USC. 5311-5330 and 31 C.F.R. Pt. 103.

[7] See, IRC section 678 for the determination of ownership status.

[8] See, IRC section 957 for the definition of Controlled Foreign Corporation.

[9] Chief Counsel Memorandum 201003013.

[10] IRC section 1298(f).