

U.S. Tax Laws Governing Foreign Pensions

by Christopher Callahan



The importance of the U.S. tax treatment of foreign pensions and some similarly treated retirement accounts and social security programs is growing rapidly as the IRS receives more information about offshore plans and seeks to bring taxpayers into compliance. In many ways, the U.S. taxation and information reporting of foreign pensions (and similar plans) is at an inflection point — much as foreign bank accounts and the related foreign bank account report were a mere decade ago. In that regard, overlooked foreign pension classification and reporting missteps are being swept up in the fervor for consistency and accuracy in foreign asset reporting.

Further, the lack of guidance in this area of tax law has led to negative taxpayer outcomes, with many taxpayers overreporting the tax owed and filing information returns that may not be required. Other taxpayers still fail to report their offshore plans altogether (perhaps because of opacity of the rules discussed herein). As a result, U.S. citizens and income tax residents working abroad, as well as foreign nationals who have moved to the United States and retain an interest

in a foreign plan, are at risk of paying more U.S. tax, interest, and penalties than they may have to under the law.

There are various U.S. tax and reporting obligations a U.S. person must comply with in connection with her interest in a foreign pension, retirement account, or some social security program accounts. Although potentially modified by income tax treaties and social security totalization agreements, the U.S. statutory framework alone provides a mazelike experience for taxpayers trying to determine the proper way to report their interests in those foreign plans.

To provide a more focused discussion, this article describes tax and reporting issues for foreign-defined contribution plans of active companies with numerous employees. Much of the discussion may also apply to defined benefit plans, IRAs, some social security program accounts, and other similar plans organized to help people save for retirement and other important financial moments. Not all types of plans that may require similar analysis are discussed.

I. Nonqualified Plans and Their Classification

When analyzing the U.S. tax and reporting obligations of a foreign pension plan, the first essential determination is whether the plan should be treated as qualified for U.S. tax purposes under section 401. Generally, a pension plan must be created or organized in the United States to be a qualified plan, so foreign pension plans generally will not qualify.

In limited circumstances, if a foreign plan meets the requirements to be a qualified plan other than having been created or organized in the United States, preferable tax treatment may still be available for U.S. plan participants under section

402(d).¹ In practice, however, foreign plans rarely satisfy the requirements unless formed with U.S. persons in mind. Thus, despite the potential exception, few foreign pension plans may be treated as qualified.

This discussion assumes that the foreign plans considered are not treated as qualified from a U.S. tax perspective under section 401(a) and do not meet the section 402(d) exception. That assumption results in many complexities, as well as disparate treatment of U.S. persons with U.S. plans and those with foreign plans. The level of disparity often hinges on factors outside the U.S. person's control; however, with proper information and advance planning, those issues might be mitigated. In that regard, a nonqualified foreign plan will generally be treated as a foreign trust — the question is what kind. As discussed below, practitioners generally interpret section 402(b) as governing foreign plans and treating them as nonexempt employees' trusts. However, other practitioners have treated some plans as foreign grantor trusts under sections 671-679.²

A U.S. person participating in a foreign nonqualified plan may be treated for U.S. tax purposes as a beneficiary of: a nonexempt employees' trust under section 402(b); a grantor trust under sections 671-679; or a bifurcated trust partly taxable as an employee grantor trust under reg. section 1.402(b)-1(b)(6) and partly as a nonexempt employees' trust.³

To determine which of those reporting positions is proper, a taxpayer should evaluate who made the contributions to the plan. That can often be accomplished by asking the pension administrator for copies of the contribution reports, which delineate which contributions were made by the employer and which were made by the employee. If all contributions to the plan are considered employee contributions, grantor trust treatment may be applicable. In contrast, if the employer contributions are equal

to or greater than the employee contributions, the entirety of the plan may be treated as a nonexempt employees' trust under section 402(b).⁴ Finally, a U.S. person participant may be deemed the beneficiary of a bifurcated trust when both the employer and employee are treated as having contributed to the plan and the employee contributions are not incidental when compared with the employer contributions.⁵ In a bifurcated trust scenario, the taxpayer may be treated differently for separate portions of the plan assets — the not incidental contributions being treated as contributions to and subsequently as assets of a grantor trust,⁶ and the remaining contributions being treated as contributions to, and subsequently as assets of, a nonexempt employees' trust.

The challenge of applying a taxpayer's facts to that analysis becomes even more daunting when one considers the lack of guidance on what constitutes an employee, employer, or non-incidental contribution under section 402(b) and its regulations. The lack of guidance results in confusion over how to apply the relevant rules, as well as disparate reporting and tax treatment among similarly situated taxpayers.⁷

Given that lack of guidance, taxpayers — and, perhaps more commonly, their tax advisers — often rely on a superficial analysis (for example, the proverbial “if it looks like a duck test”) to determine whether a contribution should be treated under reg. section 1.402(b)-1(b)(6) as an employee or employer contribution. Unfortunately, that surface-level inquiry often fails to consider various nuances intrinsic to this niche of U.S. tax law. Instead, and somewhat counterintuitively, there are numerous situations when contributions that appear on their face to have been made by one party may more properly

⁴ *Id.*

⁵ An employee's total contributions are not incidental if, as of a specific date, they are greater than the employer contributions. See examples in reg. section 1.402(b)-1(b)(6) and (7).

⁶ That portion of the bifurcated trust may be referred to as an employee grantor trust under reg. section 1.402(b)-1(b)(6). See Berg and Dungog, *supra* note 2.

⁷ *Id.*

¹ If that exception applies, distributions from specified foreign plans may be treated for U.S. tax purposes as if they were organized in the United States. See reg. section 1.402(c)-1.

² See Roy Berg and Marsha-Laine Dungog, “U.S. Income Tax Treatment of Australian Superannuation Funds,” *Tax Notes Int'l*, Oct. 10, 2016, p. 177.

³ *Id.*

be classified as having been made by the other party.⁸ The most common resulting reporting error that I have seen in practice is taxpayers reporting their entire interest in the foreign pension as being an interest in a grantor trust. Although that generally IRS-friendly reporting position might minimize the risk of challenge on audit,⁹ it might also be inconsistent with the relevant laws and result in tax deferral loss, foreign tax credit timing issues, overtaxation, and unnecessary information reporting.¹⁰ Instead, it may be more accurate (and potentially taxpayer friendly) for a taxpayer to report his interest in the plan as being an interest in a nonexempt employees' trust.

II. Taxing Foreign Pensions

As discussed above, a foreign plan's classification for U.S. tax purposes could have a significant impact on the related tax and information reporting at the participant level.

A. Taxing Plan Contributions

Employer contributions to a nonexempt employees' trust are generally included in the employee's gross income once vested in accordance with section 83.¹¹ Property is substantially non-vested under that section when it is subject to a substantial risk of forfeiture under section 83(c)(1) and reg. section 1.83-3(c), and is nontransferable under section 83(c)(2) and reg. section 1.83-3(d).¹² The converse of that statement is that some employer contributions may be includable in gross income when they are either transferable or not subject to a substantial risk of forfeiture.

⁸ For example, the elective deferral rules in section 401(k) and the legislative history of section 402(b) indicate that some pretax employee contributions could be treated as employer contributions under reg. section 1.402(b)-1(b)(6). See Veena K. Murthy, "Selected Cross-Border Equity and Deferred Compensation Issues With Funded Foreign Plans," 42 *Compensation Plan. J.* 67 (2014).

⁹ It is likely the IRS would avoid challenging a position that is generally IRS friendly, or at least IRS friendly in the context of the specific audit.

¹⁰ That can result in increased annual compliance costs and late-filing penalty exposure.

¹¹ See also section 402(b)(1); reg. section 1.402(b)-1(a)(1) and -1(a)(2)(i); reg. section 1.61-2(d)(1); and reg. section 1.83-8(a)(4).

¹² See also reg. section 1.83-3(b).

Also, employer and employee contributions may be taxable in the year they are made under the constructive receipt doctrine, the economic benefit rule of section 402(b), or the employee grantor trust rules in reg. section 1.402-1(b)(6).¹³ If a portion or all of the contributions are treated as non-incident employee contributions, they may be considered immediately taxable income and noncompensatory.¹⁴ Thus, once again, who made the contributions might affect the U.S. participant's tax result — in this case, it could affect whether the taxpayer can defer inclusion in his gross income of the employee contributions. Includable contributions (whether made by the employer or employee) are generally subject to FICA and FUTA;¹⁵ however, the earnings and growth within the plan may escape FICA and FUTA taxation, even once distributed.¹⁶ The obligation to withhold FICA and FUTA taxes might fall on the employer for contributions vested when made and on the trustee when contributions vest after being made.¹⁷

Taxpayers may often find it difficult to support the position that some foreign plan contributions should not be included in gross income in the year contributed. That said, if a plan's assets are not protected from the claims of creditors of the employer and related entities, the plan may be unfunded, and the related contributions could avoid inclusion in gross income under section 83.¹⁸ Unfortunately, contributions to an unfunded plan might instead be subject to the potentially more punitive rules of section 409A if the plan also fails to comply with the requirements of that section. As a result, U.S. person participants might need to engage in a substantially complicated analysis to avoid including in their U.S. taxable income plan contributions under section 83 or 409A.

When the contributions are less significant, taxpayers might find it difficult to justify the

¹³ See Berg and Dungog, *supra* note 2, citing various Tax Court cases.

¹⁴ See reg. section 1.402(b)-1(b)(6); and Murthy, *supra* note 8.

¹⁵ See reg. section 31.3121(a)-2(a); reg. section 31.3102-1(a); and Rev. Rul. 2007-48, 2007-30 IRB 129.

¹⁶ See Murthy, *supra* note 8.

¹⁷ See Mary R. Jones, "Sec. 402(b) and Foreign Pension Plans," *The Tax Advisor*, Mar. 1, 2012.

¹⁸ Compare Murthy, *supra* note 8, with Rev. Rul. 57-528, 1957-2 C.B. 263, and Rev. Rul. 57-37, 1957-1 C.B. 18.

professional fees that may be incurred to determine whether some contributions (other than perhaps incidental employee contributions) should avoid immediate taxation. When the contribution amounts are larger, there might be a greater incentive for a taxpayer to hire a tax adviser to perform further analysis. Further, in many cases, all or a portion of the plan contributions may be tax deferred in the relevant foreign jurisdiction. That potential tax deferral in the foreign country combined with immediate U.S. taxation commonly results in FTC timing issues — another potential incentive to seek deferral under U.S. law.

B. Taxing Plan Growth and Reporting Concerns

Perhaps the most substantial U.S. tax and reporting differences among the various foreign plan classifications is how the earnings of and growth within the plans are taxed. For a nonexempt employees' trust, earnings are generally includable in income when distributed or made available.¹⁹ That can be deemed the "preferred result" because it defers U.S. tax on the plan's earnings and allows them to grow tax free until distributed. Further, those kinds of pension plans will be considered treated as nondiscriminatory employees' trusts.

In contrast, a highly compensated employee (HCE)²⁰ of a discriminatory employees' trust might have to annually include in gross income an amount equal to the vested accrued benefit under the trust in excess of the employee's investment in the contract — that is, the tax basis — to the extent not previously includable as determined under section 72.²¹ The value of that vested accrued benefit includes plan contributions, earnings, and growth. As a result, an HCE participant of a discriminatory employees' trust essentially loses the earnings tax deferral advantage potentially available to nondiscriminatory employees' trust participants

and may be subject to an annual mark-to-market regime for the plan's growth.²² To make matters worse, there is no guidance on point to indicate whether a loss can be taken by an HCE of a discriminatory employees' trust if the plan's value decreases during the tax year.²³ Moreover, the discriminatory employees' trust participants may lose the benefit of tax deferral for some incidental employee contributions that may be available to nondiscriminatory employees' trust participants.²⁴

Based on the above, when a taxpayer is determined to be an HCE participant of a plan treated as an employees' trust, the analysis of whether the plan is discriminatory becomes of the utmost importance for determining the participant's tax and reporting obligations. The plan may be discriminatory if it fails to meet the requirements of section 401(a)(26), which generally applies solely to defined benefit plans, or section 410(b), which generally governs whether defined contribution plans are discriminatory. The coverage tests of section 410(b) typically seek to determine whether a "significant enough" number of non-HCE employees are eligible to benefit from the plan the HCEs enjoy.²⁵ Those tests generally exclude nonresident alien employees with no U.S.-earned income, regardless of whether they are participants. Thus, in many situations, a vast majority of a foreign employer's workforce will not be includable in the analysis — sometimes simplifying the related mathematical calculation and increasing the odds that the plan will be nondiscriminatory.

In contrast to the tax results described above, U.S. person participants in plans taxed under the grantor trust rules may need to annually include in gross income any realized income of the plan.²⁶

¹⁹ See section 402(b)(2).

²⁰ An HCE is broadly defined under section 414(q) as an employee who was a 5 percent owner of the employer at any time during the current or preceding tax year, or an employee who for the preceding tax year met an indexed compensation limit and, if applicable, whose pay is in the company's top 20 percent of compensation. See section 402(b)(4)(C).

²¹ See section 402(b)(4).

²² *Id.*

²³ See Murthy, *supra* note 8 (citing sections 402(b), the regulations thereunder, and Rev. Rul. 2007-48).

²⁴ See section 402(b)(4).

²⁵ To qualify under one of the three tests, the plan must generally: (1) benefit at least 70 percent of employees who are not HCEs; (2) benefit a percentage of employees who are not highly compensated employees, which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) satisfy the average benefit test in section 410(b)(2).

²⁶ See Berg and Dungog, *supra* note 2; and sections 671-679.

That said, it is often difficult for taxpayers to obtain the financial records needed to determine what percentage of a plan's growth relates to realized income. Thus, many taxpayers reporting their interest in plans as interests in grantor trusts simply report the plan's entire growth as resulting from realized income, thus essentially mimicking the vested accrued benefit regime applicable to discriminatory employees' trusts. Second, participants in grantor trust plans may be treated as indirect owners of passive foreign investment company interests held through the pension plan.²⁷ That can result in additional reporting obligations and significant tax implications.²⁸ Third, participants in grantor trust plans may be required to annually file forms 3520 and 3520-A, unless they qualify for relief under Rev. Proc. 2020-17, 2020-12 IRB 539.²⁹ Thus, U.S. persons who may have previously failed to properly report their interest in a foreign pension may be substantially motivated to evaluate whether their plan qualifies as an employees' trust because a finding of an employees' trust classification may significantly reduce taxable income and penalty exposure.

C. Taxing Distributions

The U.S. taxation of distributions from a foreign pension plan that is treated as an employees' trust are governed by sections 72 and 402(b). Amounts distributed are includable in gross income and are taxable unless they represent an investment in the contract — that is, the employee's basis.³⁰ An employee's basis in a plan includes amounts contributed by the employer that were includable in the employee's gross income under subtitle A (or prior income tax laws), or would not have been includable in

the employee's gross income (under the law applicable at the time of contribution) if paid directly to the employee (as long as the exclusion would not have been because of the application of the foreign earned income exclusion under section 911).³¹ Similarly, employee contributions to, earnings of, and the growth within the plan includable in the employee's gross income could also result in a corresponding basis increase.³² Moreover, the employee's plan basis may be increased by any amounts included in the employee's gross income under reg. section 1.402(b)-1(b) when an employee's rights under a nonexempt employees' trust change from non-vested to vested.

Consistent with the central theme of this article, a foreign plan's classification as a discriminatory employees' trust, a nondiscriminatory employees' trust, a grantor trust, or a bifurcated trust could have a major impact on how a taxpayer's basis in his foreign pension is calculated. Each classification category has unique income inclusion rules for contributions to, earnings of, and growth within the plan that might affect the taxpayer's plan basis, and thus the taxation of any eventual distributions received from the plan. That could further encourage taxpayers to seek clarification from their tax advisers of the proper classification of their foreign plans for U.S. tax purposes.

The foreign pension basis rules of section 72(w) may be even more complex for foreign nationals who become U.S. persons. Contributions made to a plan or income earned in a plan when the taxpayer was not a U.S. person might not increase the taxpayer's basis in the plan if they are deemed applicable nontaxable contributions or earnings. An applicable nontaxable contribution is any contribution (either by the employer or employee) made for compensation for services performed by an employee while she was a nonresident for U.S. income tax purposes that is foreign-source income and was not subject to income tax under the laws of the United States or any foreign country (but would have been subject to income tax if paid as

²⁷ See reg. section 1.402(b)-1(b)(6).

²⁸ See, e.g., sections 1291 and 1298(f).

²⁹ Rev. Proc. 2020-17 provides that a taxpayer may be exempt from filing forms 3520 and 3520-A on her interest in a foreign pension plan if six criteria are met. That analysis can be cumbersome, and it is often difficult to obtain all the information needed to properly advise a taxpayer on whether the relief applies to her situation. As such, Rev. Proc. 2020-17 remains a valuable arrow in the taxpayer's foreign pension quiver but may have limited practical value. However, the number of requirements (and perhaps the difficulty of meeting some of them) should be reduced, which should increase the number of taxpayers eligible for relief.

³⁰ See sections 61, 402(b)(2), 72(c)(1)(A), and 72(e)(6); see also reg. sections 1.61-2(d)(1) and 1.402(b)-1(c)(1).

³¹ Section 72(f) provides special rules for computing employees' contributions.

³² See reg. section 1.402(b)-(1)(b)(6); and sections 671-679 and 1014.

cash compensation when the services were rendered). Similarly, applicable nontaxable earnings includes earnings paid or accrued in the foreign plan while the employee was a nonresident for U.S. income tax purposes that were not subject to income tax under the laws of the United States or any foreign country. As a result, foreign nationals who have a pension overseas that has not previously been subject to tax could be subject to U.S. income tax on the contributions and earnings of the plan paid or accrued while the taxpayer was a nonresident alien when the plan proceeds are distributed to (or constructively received by) her. In some cases, FTCs may be available to minimize the U.S. tax burden on those distributions; however, if the relevant foreign jurisdiction does not tax the entire distribution or imposes lower rates than the United States, FTCs might not eliminate the U.S. tax on the amounts earned before becoming a U.S. person. That potential outcome could give foreign individuals pause in deciding whether to become a U.S. person. Thus, it is important to discuss with pre-immigration clients whether they have any foreign pensions.

III. Conclusion

The failure of most foreign plans to be qualified under section 401 and instead generally be governed under section 402(b) creates a level of tax complexity that could arise only from the intersection of U.S. pension tax law and U.S. cross-border tax law. Whether Congress intended that outcome in enacting section 402(b) may be relevant for some academic pursuits, including seeking additional government guidance or legislation on the subject. However, in practice, tax practitioners that help taxpayers comply with their U.S. tax and information reporting obligations must continue to educate themselves on the issues discussed here.

Importantly, while this article discusses some of the rules applicable to defined contribution plans organized by active companies with numerous employees, it covers perhaps 5 percent of the relevant rules and issues that arise with foreign pensions. There are countless other plans that may be treated differently from or similarly to the plans discussed here.

If a taxpayer relies on U.S. income tax treaties or social security totalization agreements to remedy the inequitable treatment of U.S. persons with interests in foreign pensions, retirement plans, and social security programs, he might be disappointed when he discovers that those instruments often fail to provide sufficient relief. As a result, the U.S. government should enact new legislation to address the massively disparate tax and reporting obligations applicable for U.S. persons who have offshore pension plans as a result of having worked offshore for a legitimate employer and those who have U.S.-based pension plans because they have worked only in the United States.³³ ■

³³ This article is intended for general information purposes only and does not constitute legal advice. The reader should consult with knowledgeable legal counsel to determine how applicable laws apply to specific facts and situations. This article is based on the most current information at the time it was written. Because it is possible that the laws or other circumstances may have changed since publication, please call your tax adviser to discuss any action you may be considering as a result of reading this article.