

# U.S. Tax Treatment of Brazilian Private Pension Plans

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In this article, Callahan explains the U.S. tax treatment of Brazilian private pension plans and the analyses U.S.-resident plan participants should perform to establish how the IRS might treat their participation.

Christopher Callahan

Never has more IRS attention been focused on individual taxpayers' reporting requirements of foreign private pension plans. As a result, U.S. taxpayers with interests in those kinds of plans (particularly with those in countries that do not have income tax treaties with the United States) may be uniquely affected by the growing fervor for consistency and accuracy in foreign pension reporting and taxation.

At the time of publication, Brazil and the United States had not entered into a tax treaty. Thus, U.S. citizens and income tax residents living and working in Brazil, as well as Brazilians living and working in the United States, are at risk of paying more U.S. tax, interest, and penalties on their Brazilian pension plans than obligated to do so under U.S. law. As a result, U.S. participants in Brazilian private pension plans should insist on thorough annual analysis by their U.S. tax advisers of the tax and reporting obligations stemming from their interests in those plans.

This article overviews the Brazilian private pension system, the U.S. classification of Brazilian private pension plans for U.S. tax purposes, and the various U.S. tax and reporting obligations U.S.

persons must comply with in connection with their interest in those types of plans.<sup>1</sup>

### U.S. Statutory Framework

The first step in determining the proper U.S. tax treatment of a Brazilian private pension plan is analyzing whether the plan should be treated as qualified under IRC section 401. Generally, a pension plan must be created or organized in the United States to be a qualified plan, so Brazilian plans generally will not qualify. In limited circumstances, if a Brazilian 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).<sup>2</sup>

In practice, however, Brazilian plans rarely satisfy the requirements unless formed with U.S. persons in mind. Thus, despite the potential exception, few Brazilian pension plans may be treated as qualified. (This article assumes that the Brazilian plans it discusses will not be treated as qualified from a U.S. tax perspective under section 401(a) and do not meet the section 402(d) exception.) Instead, a nonqualified Brazilian plan will generally be treated as a foreign trust. Under that framework, and depending on who is considered to have made the contributions (employer versus employee), a U.S. person

<sup>1</sup>This article does not discuss plans or social security programs covered by the Brazil-U.S. social security totalization agreement. Various plans and programs that one might expect to be covered under the agreement are carved out — for example, Brazil's government severance indemnity fund, which is funded by mandatory employer contributions equivalent to 8 percent of an employee's salary. This article will not go into further detail on that fund, although many of the rules discussed could apply to it.

<sup>2</sup>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.

participating in a Brazilian nonqualified plan may be treated for U.S. tax purposes as a beneficiary of:

- a grantor trust under sections 671-679 (for example, when all the contributions to the plan are considered employee contributions);
- a nonexempt employee trust under section 402(b) (for example, when employer contributions are equal to or greater than employee contributions); or
- a bifurcated trust taxable partly as an employee grantor trust under U.S. Treas. reg. section 1.402(b)-1(b)(6) and partly as a nonexempt employees' trust (for example, when employee contributions are not incidental<sup>3</sup> when compared with the employer contributions).<sup>4</sup>

A U.S. participant should examine who made the contributions to the plan to determine which of the above classifications is the proper reporting position. Tax professionals might be able to obtain that valuable information by asking the pension administrator (or other parties, as discussed below) for copies of the contribution reports and other relevant information.

Taxpayers and their advisers often find it difficult to properly classify contributions because of the lack of guidance regarding what constitutes an employee contribution, employer contribution, or non-incidental contribution under section 402(b) and its regulations. There are also practical challenges in obtaining information from foreign pension administrators. As a result, contributions to Brazilian private pension plans are often misclassified as employee contributions (based on a surface-level review of the pension administrator's records), and the related pensions are misreported as grantor trusts.<sup>5</sup> That reporting misclassification could result in tax deferral loss,

foreign tax credit timing issues, overtaxation, and unnecessary information reporting.<sup>6</sup>

It therefore might be worthwhile to evaluate information in addition to the contribution reports to determine whether it may be more accurate (and potentially more taxpayer-friendly) to report the U.S. participant's interest in the plan as an interest in a nonexempt employee trust under section 402(b).

A Brazilian private pension plan's classification for U.S. tax purposes will determine the relevant U.S. tax and reporting obligations. Employer contributions to a nonexempt employee trust are generally included in the employee's gross income once vested in accordance with section 83<sup>7</sup> or 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).<sup>8</sup> Further, non-incidental employee contributions might be considered immediately taxable income and noncompensatory.<sup>9</sup>

Thus, U.S. plan participants may commonly be required to include in gross income for the current year some contributions made to a Brazilian private pension plan. As discussed herein, however, all or a portion of the plan contributions may be tax deferred in Brazil. The combination of tax deferral in Brazil and immediate U.S. taxation commonly results in FTC timing issues creating an important incentive to seek deferral under U.S. law (if applicable).

On the other hand, if a Brazilian 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.<sup>10</sup> That deferral can be ideal in many situations; however, taxpayers must query whether contributions to an unfunded plan run afoul of section 409A and, if so, what tax effect may result.

<sup>3</sup> 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).

<sup>4</sup> 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.

<sup>5</sup> For example, the section 401(k) elective deferral rules and the legislative history of section 402(b) may 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).

<sup>6</sup> These additional filing obligations, if not fulfilled in a timely manner, may result in significant late-filing penalty exposure.

<sup>7</sup> See also section 402(b)(1); reg. sections 1.402(b)-1(a)(1) and -1(a)(2)(i), 1.61-2(d)(1), and 1.83-8(a)(4).

<sup>8</sup> See Berg and Dungog, *supra* note 4, citing various U.S. Tax Court cases.

<sup>9</sup> See reg. section 1.402(b)-1(b)(6); and Murthy, *supra* note 5.

<sup>10</sup> Compare Murthy, *supra* note 5, with Rev. Rul. 57-528, 1957-2 C.B. 263, and Rev. Rul. 57-37, 1957-1 C.B. 18.

U.S. plan participants (and their tax advisers in both the United States and Brazil) should carefully analyze the relevant facts and law of both countries to determine the appropriate reporting position and its U.S. and Brazilian tax consequences.

A U.S. taxpayer must also evaluate how the earnings and growth of a Brazilian private pension plan are taxed from a U.S. perspective. For a nonexempt, nondiscriminatory<sup>11</sup> employee trust, earnings are generally includable in income when distributed or made available.<sup>12</sup> In contrast, a highly compensated employee<sup>13</sup> of a discriminatory employee trust might have to annually include in gross income an amount equal to the vested accrued plan benefit — that is, the combined plan contributions, earnings, and growth in the current year — in excess of his investment in the contract — that is, the tax basis — if not previously includable as determined under section 72. That loss of tax deferral, combined with the lack of guidance on whether a loss can be taken by a highly compensated employee of a discriminatory employee trust if the plan's value decreases during the tax year, can result in nonpreferential U.S. tax treatment for the plan participant.<sup>14</sup> Moreover, discriminatory employee trust participants may lose the benefit of tax deferral for some incidental employee contributions that may be available to nondiscriminatory employee trust participants.

In contrast to those results, U.S. persons participating in plans taxed under the grantor trust rules may need to annually include in gross income any realized plan income. Participants in grantor trust plans might be treated as indirect owners of passive foreign investment company

interests held through the plan, which can result in additional reporting obligations and significant tax consequences.<sup>15</sup>

Participants might also be required to annually file forms 3520 and 3520-A unless they qualify for relief under Rev. Proc. 2020-17, 2020-12 IRB 539. Unfortunately, in my experience, very few, if any, Brazilian plans qualify for relief under Rev. Proc. 2020-17 and its many requirements — that is, the dreaded multi-pronged “and” test.<sup>16</sup> The penalties for failing to timely file forms 3520 and 3520-A can be draconian (unless the IRS agrees there is reasonable cause for the late filing, which, because of a lack of IRS Exams resources, often requires the taxpayer to incur the expense of advocating for full or partial penalty abatement at the IRS Appeals level).<sup>17</sup>

The U.S. taxation of distributions from a Brazilian plan that is treated as an employee trust is governed by sections 72 and 402(b). Amounts distributed are includable in gross income and taxable unless they represent an investment in the contract — that is, the employee's basis, which may include some employer and employee contributions to the plan, as well as plan earnings and growth. Generally, those amounts must have been includable in the employee's gross income. Moreover, the employee's plan basis may be increased by any amounts included in his gross income under reg. section 1.402(b)-1(b) if his rights under a nonexempt employees' trust change from non-vested to vested.

Brazilian nationals who become U.S. persons face a unique challenge in determining their tax bases in Brazilian plans. Contributions to or income earned in a plan when the Brazilian national 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.

<sup>11</sup> A Brazilian plan may be discriminatory if it fails to meet the requirements of section 401(a)(26) or 410(b). The coverage tests of section 410(b) generally exclude nonresident alien employees with no U.S.-earned income, regardless of whether they are plan participants. Thus, in many situations, a vast majority of a foreign employer's workforce will not be includable in the analysis, simplifying the calculation and increasing the odds that the plan will be deemed nondiscriminatory.

<sup>12</sup> See section 402(b)(2).

<sup>13</sup> Section 414(q) broadly defines a highly compensated employee as an employee who was a 5 percent owner of the employer at any time during the current or preceding tax year or 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).

<sup>14</sup> See Murthy, *supra* note 5 (citing sections 402(b) and regulations thereunder and Rev. Rul. 2007-48, 2007-30 IRB 1).

<sup>15</sup> See, e.g., sections 1291 and 1298(f).

<sup>16</sup> Rev. Proc. 2020-17 provides that taxpayers may be exempt from filing forms 3520 and 3520-A on their interest in foreign pension plans if six criteria are met. That analysis can be cumbersome, and it is often difficult to obtain all the information needed to properly advise taxpayers on whether the relief applies to their situations. 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.

<sup>17</sup> See Benjamin M. Willis and Javier R. Chipi, “Foreign Trust Penalties: Substance Over Forms,” *Tax Notes Int'l*, Aug. 30, 2021, p. 1136; and sections 6048 and 6677.

An applicable nontaxable contribution is any contribution (by employer or employee) made as compensation for services performed by an employee while she was a nonresident for U.S. income tax purposes. The contribution must be foreign-source income that 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 cash compensation when the services were rendered. Similarly, applicable nontaxable earnings include 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, a Brazilian national with a Brazilian plan that was not previously subject to tax could be subject to U.S. income tax on plan contributions and earnings paid or accrued while she 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 Brazil 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.

### Brazilian Private Pension Plans

The Brazilian pension system is structured in three pillars: (1) a public, mandatory “pay as you go” system known as the general social security regime; (2) the pension regimes for government workers; and (3) the private pension regime (RPC) — occupational and individual plans. This article focuses on the third pillar and specific plans thereunder. As discussed below, the RPC includes funded occupational and personal pension plans privately managed by closed entities and open entities. Open and closed plans are organized as defined benefit plans, defined contribution plans, or hybrid plans. Despite being developed in 1977 (a few years before the Chilean pension reform that led to the widespread growth of private pension systems in Latin America), the RPC is still a relatively young private pension system. Yet it represents a growing industry, and, as in many OECD countries, it operates in a highly regulated environment. That regulation has led to

continued growth despite the economic challenges experienced by some countries’ pension systems.

The Brazilian Social Security Bureau, with the intermediation of the Supplementary Pension Management Council and National Superintendence for Supplementary Pensions (PREVIC), is tasked with oversight and regulation of the closed private pension entities. Open pension entities are regulated by the Brazilian Treasury, with the intermediation of the Private Insurance National Council and Superintendence of Private Insurance (SUSEP).

Legislatively, article 202 of the Federal Constitution and its Supplementary Laws 108/2001 and 109/2001 are the most influential private pension regulatory laws. Article 202 requires that private pension plans be used as a manner of saving and accumulating resources for future payment benefit, with an emphasis on providing income during the participant’s retirement.<sup>18</sup> Under article 202, a Brazilian private pension plan has a contractual nature that allows the parties (for example, the sponsors, principals, participants or beneficiaries, and pension funds) to freely design its characteristics. As a result, some plans are quite unusual.

Brazilian private pension plans are expected to operate in a nondiscriminatory manner. Although the definition of nondiscriminatory in the Brazilian pension context is slightly different (from a technical perspective) from that in the Internal Revenue Code, the overarching concept is essentially the same: If some employees are excluded or participation is limited in any way, the plan may be subject to challenge by employees and government authorities. Moreover, beneficial tax, labor, and social security exemptions granted to a Brazilian pension may be lost if the plan is not offered to all employees.

Most Brazilian private pensions comply with those rules, which, from a U.S. tax perspective, means many Brazilian plans treated as employee trusts under section 402(b) may also qualify as nondiscriminatory plans. As discussed above, that can result in U.S. tax deferral of plan income

<sup>18</sup> Cristiane Ianagui Matsumoto and Lucas Barbosa Oliveira, “First-Step Analysis: Pension & Retirement Plans in Brazil,” *Lexology*, Apr. 30, 2020.

and growth until those amounts are distributed. Thus, the value proposition for a U.S. taxpayer to engage U.S. tax counsel to evaluate the plan terms and related Brazilian rules (for example, to determine if a reasonable reporting position can be made that a plan should be treated as an employee trust rather than a grantor trust) could be significant. As in the United States and many other countries, in Brazil the main incentive to voluntarily pay into private pension plans is their status as tax-favored arrangements (relative to other investment and savings vehicles).

### Open-End Plans

As noted, Brazilian plans may be managed by open- or closed-end private pension plan entities. Open-end entities are usually managed by joint-stock companies that are operated for profit, such as insurance companies or banks, and offer individual or collective plans.<sup>19</sup> That approach is generally preferred by individuals because open plans do not have to be linked to employment, as well as small and medium-size employers. Individuals can participate in any plan offered by their employer and contract themselves for a personal pension plan. Employers have several options for private pension provision: (i) establish and sponsor an occupational pension fund; (ii) participate in an existing multi-sponsored pension fund; (iii) make eventual contributions to associative pension funds; or (iv) contract out a group or personal pension plan. The resulting competitiveness of the industry and diversity of plan options have led to preferable economic returns (mostly because of costs being driven down by market conditions) and reduced risk. As discussed above, that has helped the industry grow and led to the increased importance of understanding the U.S. tax implications for U.S. participants.

The most common open-end plans are the *plano gerador de benefícios livres* (PGBL), which has similarities to and was somewhat inspired by the U.S. 401(k) plan,<sup>20</sup> and the *vida gerador de benefícios livres* (VGBL). The PGBL offers deductible

payments at the employee level and, in some cases, at the employer level.<sup>21</sup> Employees may be entitled to deductions for up to 12 percent of some taxable income at the time of contribution; employers might be able to deduct a greater percentage.<sup>22</sup> In practice, there is deferral until withdrawal or retirement, at which time the amount is taxed at ordinary rates.<sup>23</sup> As a result, the PGBL can be classified as an EET regime (exempt contributions, exempt fund income, taxed benefits).<sup>24</sup>

Although operationally similar to the PGBL, VGBL plans are technically life insurance plans with survival coverage.<sup>25</sup> Contributions are not deductible, so they can be classified as TEE (taxed contributions, exempt fund income, exempt benefits) regimes. Unlike many other TEE regimes, however, Brazilian income tax is applied on revenue on withdrawal or retirement. Thus, VGBL plans are a particular form of TEE because they exempt withdrawals and benefits only on the premiums paid in the accumulation phase, taxing part of the income. They are designed to serve policyholders who are not covered by compulsory social security, those who always file a simplified tax return, or those who already contribute to a PGBL but want to save over 12 percent of their taxable income.<sup>26</sup> As a result of those advantages, most of the total annual funding by contributions or premiums into open plans is made into VGBL plans.<sup>27</sup>

Both the PGBL and VGBL currently exempt fund income — unlike other fixed-income non-pension funds in Brazil, there is no half-yearly tax

<sup>21</sup> Employer-level deductions are available only if the employer used the real profit method of Brazilian corporate taxation. In contrast, if the employer elects the presumed profit method, which is available to smaller businesses, the deduction is no longer available.

<sup>22</sup> See Reis and Paixao, *supra* note 20. That incentive is related to the fact that the participant also contributes to the public social security system, as provided in article 13 of Law 10887/2004. See Fábio Garrido Leal Martins and Carlos Heitor Campani, “Imposto de Renda nos planos da família PGBL e VGBL: Análise da tributação progressiva e regressiva,” 23(2) *Revista Brasileira de Gestão de Negócios* 388 (2021) (in Portuguese).

<sup>23</sup> Brazilian National Association of Pension Funds, “The Brazilian Pension System” (June 2014).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> Federação Nacional de Previdência Privada e Vida, “Caderno de Coberturas de Pessoas: Planos de Acumulação” (Mar. 16, 2020) (in Portuguese).

<sup>19</sup> *Id.*

<sup>20</sup> Adacir Reis and Leonardo Andre Paixao, “Private Pensions in Brazil,” presented in Paris to the OECD working party on private pensions (July 2004).

levied according to the quota erosion model. Therefore, the funds that would otherwise be allocated to Brazilian income tax obligations could enable those open-end plans to bring higher returns for U.S. plan participants absent a U.S. tax impact that would offset that advantage.

Since 2005, participants in both VGBL plans and the PGBL have been able to choose a regressive tax regime, with tax rates ranging from 35 to 10 percent, according to the weighted average accumulation term.<sup>28</sup> If chosen (generally at the start of the plan), the regressive regime replaces the typical progressive regime, which caps the tax rate at 27.5 percent. Although many studies have evaluated whether the PGBL or VGBL plan is economically preferable from a Brazilian financial perspective, I was unable to find any studies that cross-studied how being a dual Brazil-U.S. resident could affect the analysis. Regardless, U.S. plan participants in open-end private pension entities should consider the U.S. tax effect when deciding whether to fund PGBL or VGBL plans and whether to choose the progressive or regressive Brazilian regime for any plans.

### Closed-End Plans

Closed-end private pension entities are nonprofit organizations that offer social security benefits to organized groups, such as employees of a sponsor employer or member associations representing specific worker categories or sectors, through an employment bond or association.<sup>29</sup> Closed plans are predominantly chosen by large employers, and the plan's accumulated assets are legally separated from the sponsoring undertaking.

Most new closed-end private pension entities tend to be managed in a multi-sponsored solution, and many of Brazil's in-house plans are migrating to multi-sponsored plan solutions. As a result, more Brazilian plans than ever are "off balance sheet," thus increasing the likelihood that a plan is deemed "funded" under IRC section 83 (for determining whether contributions and other pension amounts may be immediately includable

in U.S. gross income). Many multi-sponsored plans provide better online access to information, which can be crucial for U.S. participants seeking to evaluate and properly report their interest in the plan.

Closed-end private pension entities must also annually provide accounting statements and actuarial valuations of each benefit plan (for example, defined benefit, defined contribution, and variable contribution), per legal entity or legally qualified professional, to the regulatory and overseeing body (for example, PREVIC), participants, and beneficiaries.<sup>30</sup> That information is extremely useful to U.S. participants who need to annually report the value of their pension on forms 3520-A and 8938.

U.S. plan participants who choose to delve deep into the plan terms and functionality to evaluate how to treat the plan for U.S. tax purposes are well served by the mandatory information reporting regime. Access to accounting statements and other financial documentation regarding closed plans may be more available to participants than they would be in a less regulated environment (as is the case in many countries without tax treaties with the United States).

Also, a Brazilian private pension plan should be audited annually to check the accuracy of its records and statements and verify whether it is observing corporate governance rules to preserve its solvency and performing continuous risk assessment of any potential liabilities that could affect the plan during the year.<sup>31</sup>

Pension entities that follow those guidelines should have enough data and documentation for a U.S. plan participant to evaluate whether the Brazilian plan is deemed funded under IRC section 83. The relevant documentation may be obtainable through the taxpayer's employer and outside counsel, the plan administrator, and some Brazilian agencies (for example, PREVIC and SUSEP, which have powers to request and inspect any documents and information regarding a Brazilian private plan).<sup>32</sup> As discussed above, the

<sup>28</sup> *Id.*

<sup>29</sup> See Matsumoto and Oliveira, *supra* note 18.

<sup>30</sup> *Id.* (citing article 22 of Supplementary Law 109/2001).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

section 83 analysis could provide the U.S. participant with information supporting the position that the plan is not funded, possibly making U.S. tax deferral proper for some contributions and other items. That could be a preferred reporting position for some taxpayers.

In addition to the U.S. plan participant's being able to access relevant information by requesting it, a Brazilian employer may be required to provide participants with information, such as an annual report for the prior year. Participants must also receive the following items from their employers: (1) a certificate showing the requirements to be admitted and maintained as a plan participant; (2) the requirements of eligibility and the benefits calculation formula; (3) copies of the pension bylaws and rules; and (4) a brochure with simplified information on the plan's characteristics.<sup>33</sup> That information can help U.S. participants as they prepare their U.S. tax forms. In some cases, the required information might not be furnished, or the participant discards the communication by mistake. In those instances, a

formal request by the plan participant to the employer or other relevant entity should be effective for obtaining the documents.

### Conclusion

The growing Brazilian private pension system and increasing interconnectivity between the Brazilian and U.S. economies have led to many U.S. taxpayers having to classify their Brazilian plans for U.S. tax and reporting purposes. The variety and flexibility of Brazilian plans creates a singular challenge for U.S. taxpayers and their tax advisers.

However, strong Brazilian regulations and information-gathering requirements help U.S. taxpayers obtain information to properly analyze their Brazilian plans and avoid erroneous U.S. tax classifications. As a result, U.S. participants in Brazilian private pension plans may be able to support classifying their plans for U.S. tax purposes in many ways, some of which may be tax preferred. The analysis may be daunting, but if performed correctly, it could result in significant U.S. tax and reporting benefits for the U.S. plan participant. ■

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<sup>33</sup> *Id.*