ADVISORY COMMITTEE ON

TAX EXEMPT AND GOVERNMENT ENTITIES

(ACT)

INTERNATIONAL PENSION ISSUES IN A GLOBAL ECONOMY: A SURVEY AND ASSESSMENT OF IRS' ROLE IN BREAKING DOWN THE BARRIERS

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I. EXECUTIVE SUMMARY

A. Overview of Report

The focus of the Employee Plans subcommittee of the ACT for the year 2008-2009 was to survey and assess the most important federal tax issues affecting retirement plans of employers involved in cross-border transactions and the Internal Revenue Service ("IRS") Employee Plans Division's role in addressing those issues and providing education and outreach.

The ACT began their project by creating an inventory of international issues developed from the experiences of the ACT Employee Plans members along with an outline of the various aspects of retirement plans affected by a globalized workforce, spanning from federal tax compliance in plan design, to meeting coverage requirements, to tax reporting and withholding on retirement plan distributions.

During the year, the ACT met with or had telephone conference with representatives of the Treasury and IRS, including the Tax Exempt and Government Entities Division (TE/GE), and the Large and Mid-Size Business Division (LMSB), and IRS office located in other U.S. possessions, as well as several external stakeholders.

The results of the survey and assessment extend into areas not within the scope of TE/GE's jurisdiction; however, the ACT determined that inclusion was necessary to fully represent its findings.

It is the ACT's hope that this report will spur the IRS to begin to address these international pension issues as "one" IRS, while keeping in mind the goal…

> *…to break down the barriers and impediments to U.S. employers desiring to provide pensions to nonresident aliens working in the United States and to U.S. citizens and resident aliens transferred to affiliates of U.S. employers outside the United States.*

B. Principles

In developing its recommendations, the ACT was guided by the following principles:

1. The ACT's due diligence process should solicit the views of the IRS, practitioners, and stakeholders who are confronted with international pension issues on a regular basis.

2. The ACT should determine the level of coordination between the IRS divisions and identify gaps in services in their efforts to address international pension issues for both employers and employees, including tax withholding and reporting by administrators of pension plans and

payers currently faced with distributions to nonresident aliens and expatriates.

3. The ACT should identify applicable law, regulations, treaty or other legal guidance that present impediments to providing international pensions and suggest proposed solutions or clarifications.

4. The recommendations of the ACT should include a component addressing the need for educating the pension community on the most common international pension issues faced by employers, employees, and the IRS.

5. Tools should be provided to assist the IRS in its education and outreach efforts on international pension issues.

C. Recommendations

The ACT's recommendations can be classified into three (3) categories as follows:

1. "One IRS" on International Pension Issues

a. Create an IRS "International Focus Team"

- Create an "International Focus Team" consisting of representatives of each of the IRS Divisions: TE/GE, LMSB, W&I, and SBSE, with the goal of addressing the issues raised in this report, as well as other issues identified by the Team, in part through education and outreach (see below).

b. Formalize an Internal Working Group for Treaty Negotiations

- Formalize an internal working group between Treasury, Chief Counsel, IRS TE/GE Employee Plans, and LMSB to address treaty issues and to provide input regarding treaty negotiations. Clarification is needed as to where jurisdiction resides with respect to treaty issues that impact multiple business units within IRS and Treasury. Some of the issues to be reconciled by this working group are included in this report.

2. Internal Revenue Code Issues

The IRS is requested to issue guidance or work with Treasury and other agencies to obtain guidance regarding retirement plan related international pension issues. This section also includes requests for new provisions and treaty-related guidance.

The categories and sections of the Internal Revenue Code ("Code")[1] for which guidance is requested include:

a. <u>Pension Contributions and Benefits</u>

- Code §§ 83, 404, and 404A with regard to how contribution deductions are allocated between U.S. and foreign employers since the Pension Protection Act of 2006[2].
- Code § 404 with regard to deductions by a U.S. employer for contributions made by a foreign affiliate with respect to foreign compensation includible under Code § 404.
- Code § 415 with regard to the inclusion of an employee's foreign compensation as compensation for purposes of employer nonelective contributions to a 403(b) plan.
- Code §§ 415 and 985 with regard to foreign exchange issues.
- Multiemployer Plans - Canada - enter negotiations to allow U.S. multiemployer contributions to follow a temporary U.S. worker back to Canada.
- The definition of "comparable plans" for treaty purposes and whether nonqualified wrap and restoration plans are included, perhaps using the Code § 409A definition of a "broad-based foreign retirement plan" for this purpose.
- The treatment of contributions and dividends to foreign trusts for U.S. tax purposes.
- The treatment of contributions to IRAs and rollovers under treaties.
- Taxation of U.S. citizens on accruals and earnings in other countries.
- Reconciliation of the timing of determinations regarding treaty coverage and the filing tax returns.
- The requirements for a Taxpayer Identification Number when no tax revenues are involved.
- The idea of and need for a Global Retirement Plan.

1 References to the "Internal Revenue Code" and the "Code" are to the Internal Revenue Code of 1986, as amended.

2 P.L. 109-28 (August 17, 2006).

b. <u>Pension Distributions</u>

- Code § 864 with regard to the determination of the portion of a pension distribution to a nonresident alien that constitutes ECI (income effectively connected with the United States).

- Code § 871(f) with regard to the need for an exclusion from nonresident alien income of lump sums on the same basis as the current exclusion for payment of annuities.

- Code § 402(f) with regard to inclusion in the Direct Rollover Notice of special rules for pension distributions to nonresident aliens.

- Evaluating the flat withholding rates (0%-30% rate) to determine if another rate or series of rates would more closely relate the rate to the actual taxed owed by the nonresident alien.

- The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act")[3] with respect to reporting issues for nonresident aliens, including clarification as to the types of plan distributions that will be subject to the new HEART Act tax on expatriates' deferred compensation and whether there are differences between the treatment of distributions from qualified retirement plans, non-qualified plans and IRAs.

- Guidance to address the coding and other issues related to reporting nonresident alien distributions from qualified retirement plans and IRAs on IRS Form 1042-S with input from the IRS Information Reporting Program Advisory Counsel ("IRPAC").

- ERISA[4] 1022(i) plans covering Puerto Rico residents with regard to the transition rules on rollovers, investment of plan assets, and coverage issues.

- Asset pooling issues under Revenue Ruling 81-100 regarding participation by Puerto Rico–only qualified plans in U.S. group trusts.

- Special issues for Guam and Mariana Islands plans with regard to withholding and reporting of pension distributions, investment by a Guam plan in U.S. stocks, and estate taxes relating to pension plans or IRAs with U.S. assets.

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3 P.L. 110-245, 122 Stat. 1624 (June 17, 2008).
4 Employee Retirement Income Security Act of 1974, P.L. 93-406, 88 Stat. 829 (September 2, 1974).

- Allow rollovers to U.S. plans and IRAs of eligible distributions from approved "broad-based foreign retirement plans" meeting the Code § 409A definition.

- Multiple spouses for purposes of meeting spousal consent and other spouse benefit rights.

c. Non-qualified Deferred Compensation

- Code § 402(b)(4) with regard to taxation of foreign deferred compensation pans.

3. Education and Outreach on International Pension Issues

Provide education and outreach to employers and payers with regard to rules for taxation and rollovers of pension distributions to nonresident aliens and U.S. citizens working abroad. The recommendations include:

a. Revised and New IRS Publications

- Revising and updating specific existing IRS Publications to correct or add needed information on international pension issues.

- Using the sample tools provided in Exhibits to this report as the basis for creating new publications on international pension issues, which include the following:

  (i) FAQs (frequently asked questions with answers) covering certain pension tax matters involving U.S. possessions;

  (ii) A summary of the reporting and withholding rules applicable to pension and IRA distributions to non-resident aliens; and

  (iii) A Primer on international pension rules that could be issued by the IRS as a single publication or in a series of newsletters or articles distributed to taxpayers, plan sponsors and payers, and posted on the international pensions website (see below).

b. IRS Website Improvements

- Establishing a dedicated IRS website to international pension issues that contains information from all IRS Divisions.

- Assigning a dedicated IRS email address for questions and comments about international pension issues.

- Adding a link to this Report with a request for input from the public for more information about the issues facing employers, payers, and taxpayers and recommendations for guidance or change.

- Include links to all international pension publications, including those listed in Exhibit A to this report.

c. Expanded IRS Seminars

- Coordination between the IRS Divisions, especially TE/GE, LMSB, and W&I, to give joint presentations at tax conferences and in other public forums on reporting and withholding on pension distributions.

II. INTRODUCTION

A. Today's World – The Global Workplace

The financial events of the past year have provided a vivid reminder of how globally connected our marketplace has become. In the employee benefits area, the increasing globalization of U.S. business operations has resulted in the cross-border transfer of employees as U.S. companies strive to ensure that the necessary talent and expertise is in place wherever they do business. These cross-border transfers necessarily impact employee benefits and deferred compensation of all types—pension, welfare, and fringe benefits, as well as stock-based and deferred compensation plans and programs.

In April 2008, IRS Commissioner Douglas Shulman addressed the Tax Executives Institute meeting in Washington, DC, about "the challenges of tax administration in a global economy." Noting that it "is an area where there are a number of vexing issues without easy answers," he asked for cooperation from practitioners and experts to work with the IRS to provide these answers.

In remarks presented to the Tax Analysts Conference in 2008 on the IRS Restructuring and Reform Act of 1998 (the "Restructuring and Reform Act")[5], Commissioner Shulman discussed the impact of international tax issues on the restructured IRS[6], noting that while the current IRS structure focuses on taxpayer (or customer) segments, issues involving global workforces cross IRS Division lines and require inter-Division coordination. Given this fact, Commissioner Shulman said, "I believe we need to reinforce the notion of 'One IRS.'" This idea of "One IRS" is particularly necessary when dealing with international pension issues.

To support Commissioner Shulman's objectives, Steven T. Miller, Commissioner of the Tax-Exempt and Government Entities Division (TE/GE), communicated to his Directors the need for an "International Environmental Scan," with the long-term objective of "developing a solid understanding of the most important federal tax administration issues implicated by the intersection between the globalization movement and our communities and customers, including . . . employee plans . . . in order to align TE/GE's service and enforcement efforts with the Servicewide approach to international tax administration." Mr. Miller added a short-term task of "working with external stakeholders to conduct an environmental scan of . . . employee plans and their sponsors regarding these plans, . . . regarding [international] [cross-border] activities and issues." The ACT was identified as one of the external stakeholders asked to participate in this environmental scan.

5 IRS Newswire, IR-2008-090 (July 18, 2008).

6 As a result of restructuring under the Restructuring and Reform Act, the four primary divisions of the IRS are Wage and Investment (W&I), Large and Mid-Size Business (LMSB), Small Business/Self-Employed (SBSE) and Tax-Exempt and Government Entities (TE/GE).

B. Concerns and Challenges

Employees, whether U.S. citizens transferred to work abroad or foreign nationals assigned to work in the United States, naturally are concerned about the impact of their home country's tax rules and those of the country of relocation on their compensation and benefits.

Employers engaging in cross-border employee transfers must consider which benefit plans will cover transferred employees, as well as the impact their participation will have on the tax qualification of those plans. Employers also need to understand the tax impact on the transferred workers to determine whether reimbursements or other compensation is desirable to compensate the transferred employee for any lost tax advantages or adverse tax consequences.

In carrying out their respective analyses of the corporate and benefit aspects of cross-border employment transfers, employees and employers face a bewildering array of issues involving U.S. and foreign tax and benefit law, including the added layer of complexity presented by tax treaty issues if the employment transfer involves work in countries with which the United States has entered into such a treaty.

In these difficult economic times, it should be noted that the burdens of compliance with increasingly complex requirements of the Internal Revenue Code (the "Code") and regulations with respect to U.S. taxpayers' participation in foreign compensation arrangements when working abroad (e.g., §§ 409A and 457A) may provide an impetus for U.S. and especially foreign employers to hire non-U.S. employees to fill jobs at all levels of the organization.

The globalization of businesses and workforces makes this topic of "international benefits" a timely one and of significant concern for the IRS in its efforts to encourage tax compliance by employees and employers and to support employers in their efforts to provide tax-favored benefits and properly report taxable distributions from qualified retirement plans to nonresident aliens and expatriates.

Recent surveys of multinational employers consistently indicated that a vast majority of multinational employers depend on a decentralized approach to benefit plan design and tax compliance. That is, most are compelled to allow local managers and consultants to have oversight of their local populations' benefit programs. The primary reason given for this decentralized practice is due to concerns about company headquarters' inability to stay in compliance with laws and regulations in foreign labor markets. Consequently, less than 25% of surveyed multinational employers indicated that they have a global benefits manager who oversees all of their foreign and domestic employee benefit plans.[7]

Most multinational companies provide their expatriate employees with employee benefit programs, according to a 2005 survey by Mercer Human Resources

[7] *Global Benefits Strategies Survey* (ASINTA, November 2003, at 10).

Consulting. The survey found that 75% of the respondents had policies in place to offer employee benefits to employees posted overseas, while the remaining 25% either did not offer employee benefits to expatriates or did offer benefits on an ad hoc basis. Only 23% of respondents to the survey maintain an international retirement plan (i.e., a retirement plan exclusively designed for globally mobile employees and financed via a trust or insurance contract in an offshore tax-sheltered organization). "That figure is low because, according to the survey, respondents said it is typically expensive to administer such plans and challenging for the companies to comply with many different international regulations."[8]

C. Purpose and Structure of Report

Unlike other areas of tax and benefit law, there is no "ready resource" to which employers and employees can turn in order to work through international pension and benefit issues. Indeed, practitioners with expertise in this area are few and far between. The report identifies the gap in services provided to employers on international tax matters and suggests ways to address certain problems generated by the failure of the Code to recognize, in some areas, the global activities of U.S. businesses.

This report represents what might best be called a "survey of international pension issues." The focus is thus on issue identification. Although recommendations are made for the potential resolution of some issues, these recommendations have not been fully vetted with Treasury and IRS personnel or with international pension stakeholders. The ACT believes that such vetting must and no doubt will occur. With that caveat, however, it is anticipated that this report will provide a useful starting point for establishing priorities about the issues presented and the ultimate resolution of these issues.

The report identifies issues that are global in nature (i.e., those common to international pensions generally), issues that are specific to U.S. territories and possessions, and issues applicable to certain specific countries.

As the ACT met with representatives from various interested parties, the dramatic lack of resources available to U.S. and foreign employers and workers regarding international pension issues became apparent. Therefore, the report concludes with a discussion and recommendations regarding education and outreach opportunities to make meaningful information accessible to stakeholders to assist them in their international pension planning and compliance.

It is also important to consider what this report does not do. It does not purport to cover every potential international pension issue. It does not cover important pension issues that fall under the jurisdiction of other federal agencies (e.g., the U.S. Department of Labor). It does not focus on certain compensation and benefit issues that do not fall within TE/GE's jurisdiction (e.g., international issues involving

[8] Barbara Cockburn, *Mercer survey examines expatriate benefits*, http://www.businessinsurance.com/cgi-bin/news.pl?newsId=6906 (December 2005).

employer stock option programs). The international pension community is encouraged to respond with suggestions for topics and issues not identified in the report that TE/GE should also consider.

The report includes some issues that require legislative rather than regulatory resolution. While the ACT recognizes that the IRS cannot take independent action with respect to such issues, it is important that the issues be identified to provide Commissioner Shulman and others with as complete a picture as possible of the challenges facing U.S. companies operating in today's global business environment. This will enable Treasury to educate Congress about international pension problems over which the IRS does not currently have regulatory or enforcement jurisdiction.

The ACT has spent the last year gathering information to prepare this report. It is intended to provide a framework and foundation for TE/GE, in concert with the other IRS Divisions, to begin to address international pension issues for the benefit of employers and individuals, in furtherance of Commissioner Shulman's laudable goal to become "One IRS" and to break down the barriers to providing benefits in this global economy.

III. BACKGROUND

A. Overview

What was most striking in the preparation of the report has been the difficulty in finding one IRS resource that could provide the information sought by the ACT. The ACT learned that while there are significant IRS resources and efforts focused on assistance and guidance for individual taxpayer employees as to compensation and wages earned abroad and for nonresident aliens working in the United States, little attention has been paid to providing resources for the employers of these individuals particularly in regard to the retirement plans maintained by U.S. and foreign employers on their behalf. What follows in this Part of the report is an overview of the efforts IRS has made on international pension issues, and some general information about the U.S. taxation of worldwide income and the federal income tax withholding rules for pension distributions to nonresident aliens. This background information provides a frame of reference for what follows in this report.

B. IRS Efforts on International Pension Issues

Some of the projects undertaken and guidance provided by the IRS in connection with international pensions is listed below. It is by no means an exhaustive list, but it recognizes some areas of focus by the IRS.

1. Employee Plans Exams International Focus Team

This team was formed to enhance compliance through audits and outreach in Puerto Rico and other U.S. possessions.

One initiative of the team is the "Hacienda Project", an effort to coordinate between the IRS and the Hacienda (formally the "Departamento de Hacienda" - Puerto Rico's equivalent of the IRS). Among the team's goals are to facilitate cross-referrals, help the Hacienda create a voluntary correction program similar to EPCRS[9] for Puerto Rico-only qualified plans and provide audit training for dual-qualified plans (plans qualified in both the United States and Puerto Rico). The team has already conducted some audits and training has been provided for IRS agents on dual-qualified plans with a view towards training Hacienda agents on both dual-qualified and Puerto Rico—only qualified plans. A Memorandum of Understanding between the IRS and the Hacienda was signed in August 2006 and provides the basis for information sharing between the two agencies.

Cases for audit have also been chosen in the U.S. Virgin Islands, and audits will begin once a Memorandum of Understanding has been entered into with

[9] EPCRS is the Employee Plans Compliance Resolution System; *See* IRS Revenue Procedure 2008-50, 2008-35 I.R.B. 464 (September 2, 2008).

the U.S. Virgin Islands Bureau of Internal Revenue that will clarify IRS jurisdiction and disclosure procedures between the two tax authorities.

Audits in other U.S. territories are anticipated.

2. The U.S. Model Income Tax Convention and Treaty Efforts

The Model Income Tax Convention of November 15, 2006, provides a template for bilateral treaty negotiations between the U.S. government and other nations for the purpose of avoiding double taxation and preventing fiscal evasion with respect to taxes on income. Based on information provided to the ACT, there are 59 U.S. income tax treaties in force covering 67 countries (the difference caused by the treaty with the USSR which still covers former members of the Soviet Union that have not entered into new treaties with the United States).

The IRS Office of Associate Counsel, International, interprets treaties and is responsible for cross-border pension plans. Treasury negotiates treaties but the negotiating team typically includes two IRS representatives, one from IRS Chief Counsel's office and one from the IRS competent authority's office. Treaty negotiations are ongoing and it can take years to finalize a treaty. See the discussion of treaty issues in Part V of this report.

3. IRS Website Information

Using the search terms "IRS Publications International" on the IRS website (www.irs.gov) produces a list of publications and information that currently exists for taxpayers on international tax matters. Exhibit A attached to this report lists some of the materials identified by this search.

4. IRS Large and Mid-Size Business Division (LMSB)

Kathy Robbins, Field Operations Director for LMSB, spoke at the October 17, 2008, Executive Enterprise Institute conference in Arlington, Virginia. Ms. Robbins discussed information reporting and the significant increase in cases concerning international issues. The IRS is reviewing information reporting issues with respect to IRS Form W-8 in recognition of the different terminology used by foreign companies. In addition, the IRS is increasing training and efforts to modernize its information reporting systems to better obtain and utilize information involving cross-border transactions and international businesses. LMSB provides a number of links on its website (www.irs.gov/businesses/international) to general tax information for international businesses, some of which are also referenced on Exhibit A of this report.

The ACT understands that a Servicewide International Planning & Operations Council was established in 2007 by the Deputy Commissioner, International (LMSB) with representation from each of the IRS business units. The primary focus of the Council has been preparing a Servicewide Budget Proposal for FY2010, preparing annual Priorities for the Servicewide Approach to Tax Administration, monitoring planned activities in support of the Servicewide Approach, and coordinating collaboration among business units to improve customer service and enforcement efforts.

There are currently five locations around the world where U.S. citizens (including expatriates) are being serviced - London, Paris, Frankfort, Beijing and Florida (which services the Caribbean and South America). The IRS is currently considering what guidance is needed with respect to these U.S. citizens living outside of the United States and certain nonresidents. The following topics have been identified for review:

- Income reporting;
- Filing requirements;
- "Accidental Americans" – i.e., those born in the United States but who moved abroad when very young and are unaware of dual citizenship and U.S. tax filing requirements; and
- The need for coordination on international tax issues among the IRS business units.

To improve taxpayer service and achieve the overall IRS objectives, the senior IRS officials (called Tax Attaches) serving in these overseas locations maintain relationships and coordinate with the IRS business units, Treasury, Treaty partners, taxpayers, business organizations and the practitioner community. In addition, the overseas posts promote the IRS presence to address the need to encourage and facilitate voluntary compliance of a growing U.S. population overseas and a growing nonresident alien population with U.S. tax obligations.

In 2004, LMSB established a Voluntary Compliance Program (VCP) for payers who did not withhold and/or report taxes correctly under Code § 1441 with respect to distributions to nonresident and resident aliens.[10]

The LMSB International Compliance Strategy and Policy unit has announced that it will be focusing on ensuring compliance by U.S. withholding agents. LMSB has assumed that large employers hire tax professionals and consultants to assist with their international tax reporting and withholding issues.

[10] Section 1441 Voluntary Compliance Program (the "Section 1441 VCP"), Rev. Proc. 2004-59, 2004-42 I.R.B. 678, effective September 29, 2004, until December 31,2005, (later extended to March 31, 2006, by Rev. Proc. 2005-71, 2005-2 C.B. 985).

5. IRS Wage & Investment Division (W&I)

The W&I Division is charged with answering international tax law questions about reporting and withholding. A survey is being conducted of the expatriate community to determine how they obtain information and what taxpayer services they require. Although customer service representatives are directing taxpayers to the IRS website (www.irs.gov) and to its "frequently asked questions" (FAQs) pages for information, it appears that in some regions, such as the Middle East, Africa and parts of Asia, certain taxpayers may have difficulty accessing the Internet.

C. U.S. Taxation of Worldwide Income

Unlike most foreign jurisdictions that impose tax only on residents, U.S. federal income tax law imposes taxes under Code §§ 1 and 61 on U.S. citizens, permanent resident aliens (individuals holding a green card) and certain other resident aliens (individuals who meet the substantial presence test under Code § 7701(b)(1)(A)(ii)). Some foreign jurisdictions tax their residents only on domestic sourced income and not on income earned off-shore. The United States taxes citizens and resident aliens both on their U.S. source income and their off-shore or worldwide income ("U.S. Persons"). Although the Code provides tax credits to taxpayers who pay taxes to foreign jurisdictions[11] and certain exclusions for U.S. Persons working abroad[12], a U.S. Person must recognize a larger percentage of gross income than might be included by a non-U.S. Person who earns the same salary, but whose employer provides an off-shore trust to fund bonus or equity compensation. For U.S. Persons working abroad or for foreign persons working in the United States, treaties preventing double taxation offer some relief.

D. Federal Income Tax Withholding Rules on Pension Distributions to Nonresident Aliens

On October 6, 1997, the IRS issued final regulations under Code §1441, which deal with income tax withholding on certain payments of U.S. source income delivered outside of the United States to non-U.S. Persons, generally referred to as nonresident aliens.

A nonresident alien is an individual who is neither a U.S. citizen or resident nor a resident alien. IRS Publication 519 provides more information on resident and nonresident alien status, the tests for residence, and the exceptions to them.

The Code § 1441 regulations became effective generally with respect to payments made on or after January 1, 2000.[13] These regulations have caused significant confusion because pension and IRA distribution withholding is generally governed under Code § 3405.

[11] Code §§ 901-906.
[12] Code § 911.
[13] IRS Notice 98-16, 1998-15, I.R.B. 12 (April 13,1998).

Distributions from a U.S. retirement plan to a nonresident alien outside of the United States may be subject to higher income tax withholding at the rate of 30% under Code § 1441, instead of the normal withholding rates described under Code § 3405. In the case of an IRA distribution, the rate would be 10%. For qualified retirement plans and 403(b) plans, the rate depends upon whether the distribution is periodic or nonperiodic.

For additional details, see Exhibit B of this Report (Summary of General Rules for Federal Income Tax Withholding and Reporting on Distributions from Qualified Pension Plans and IRAs to Nonresident Aliens).

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IV. DUE DILIGENCE PROCESS

A. Information Gathering

As part of the ACT's information gathering process for this report, the members interviewed various IRS and Treasury officials, along with international benefits practitioners and consultants. The ACT wishes to thank all of these individuals who generously gave of their time to the ACT for their valuable contributions to this report. Attached, as Exhibit C, is a list of the individuals who provided input for this report.

A survey prepared by the ACT was posted on BenefitsLink, www.benefitslink.com, which is an informational website for employee benefit professionals. A copy of the survey is attached as Exhibit D. The survey yielded very limited results - only one person formally responded to it.

The ACT would particularly like to thank representatives of the American Benefits Council (ABC) who provided valuable input for the report. The ABC is an advocate for employer-sponsored benefit programs. Its membership consists of companies, many of whose business focus is global. Discussions centered on impediments to doing business globally with respect to retirement benefits. The following issues, among others, emerged from these discussions:

- Deduction issues related to coverage of employees working abroad in U.S. plans;
- Administering "orphan" plans of U.S. affiliates;
- Dealing with tax issues related to foreign citizens working in the United States;
- Coverage issues presented by foreign affiliates;
- The need for a "multinational" plan for a company's foreign workers;
- The need for clear guidance on reporting and withholding rules;
- Lack of knowledge by foreign employers that certain programs are subject to U.S. laws (e.g., Code § 409A); and
- Problems identifying U.S. citizen-employees of acquired foreign companies.

B. Observations Gleaned from the Information Gathering Process

The following observations emerged from the ACT's information gathering process:

- There are many IRS rules with which even skilled practitioners are not familiar concerning retirement plans that cover employees in a global workforce.

- Corporations utilizing foreign national workers often do not know where these individuals are employed, hindering determinations of which country's tax and benefit rules apply.
- Foreign parents and subsidiaries of U.S.-based companies are reluctant to and, in some jurisdictions, by law cannot share information with their U.S. affiliates, especially with regard to compensation paid to and benefits provided for employees employed outside of the United States (in many instances due to local data privacy laws).
- Human resource and tax departments of U.S. companies often do not know that a U.S. citizen is working outside of the United States as a result of (i) a special assignment (secondment) by management; some of which are temporary or short-term, while others may be more permanent assignments or (ii) due to local hires of U.S. Persons where the local employer does not request or maintain information on employee's citizenship, residency or tax status.
- Within the IRS, various teams have emerged to work on international pension issues, but there is no formal coordination among the teams or within the IRS business units.
- Tax withholding and reporting errors occur due to the complexity of the applicable rules, not only with respect to the applicable withholding rate, but also with respect to the allocation of distributions among U.S. and foreign companies and the determination of where to send withheld taxes. Double taxation concerns also exist.
- Plans that are dual-qualified in the U.S. and Puerto Rico provide additional complications by having to comply with two sets of qualified plan rules and ERISA. Puerto Rico-only qualified plans are also subject to many provisions of ERISA.
- U.S. businesses that discontinue foreign operations want to administer orphan plans in the U.S. without impacting their other U.S. qualified plans.
- There is an increasing need for multinational pension plans providing greater mobility and portability.
- Foreign employers that cover U.S. Persons in their pension plans, especially under nonqualified deferred compensation arrangements, are often unaware that they may have reporting and withholding requirements due to their plans being subject to Code § 409A.
- Foreign employers acquiring other foreign employers often do not know that the presence of U.S. Persons in their workforce could subject the foreign employer to U.S. tax requirements.

V. SURVEY OF INTERNATIONAL PENSION ISSUES AND RECOMMENDATIONS

A. Overview and Global Recommendation

This section of the report discusses a variety of issues and provides recommendations concerning international pension matters. It is organized by topic and identifies the agency or division that would have primary responsibility for the implementation of the recommendations. While the ACT was asked to prioritize the recommendations and identify whether the recommendations involved an issue within or outside the United States, there was no consensus on the priorities due to the varied interests of the different stakeholders and the issues could not be easily categorized that way. Furthermore, the priorities may be more appropriately based upon IRS resources to effect the changes requested and should be determined in conjunction with future discussions with stakeholders. [14]

Successful implementation of the recommendations will depend in large part upon whether there is a commitment to ensure that TE/GE – Employee Plans not only is involved, but is a proactive participant in a coordinated effort among the various business units within IRS and Treasury in the implementation process. As with other coordinated efforts, a joint understanding of the process and formalization of the procedures for developing and implementing solutions to these international pension tax matters is essential.

B. Pension Contributions and Benefits

1. Deduction for Certain Foreign Deferred Compensation Plans Under Code § 404A Responsibility – IRS Counsel and Treasury

Background

A number of issues have arisen under Code §§ 83 (Property Transferred in Connection with Performance of Services), 404 (Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation under a Deferred-Payment Plan), and 404A (Deduction for Certain Foreign Deferred Compensation Plans)[15] after the Pension Protection Act of 2006

[14] In addition, the ACT members have relied on input from TE/GE in identifying the primary responsible parties and acknowledges that the IRS Commissioner may wish to consider a different assignment of responsibility in responding to this report and implementing the recommendations.

[15] While the ACT has not addressed other issues under Code § 404A, it learned that proposed regulations § 1.671-1(g) and (h) and § 1.671-2, which were published in the Federal Register on September 27, 1996, and address the application of the grantor trust rules to nonexempt employees' trusts in response to questions that arose in connection with Code § 404A regulations proposed in 1993, cannot be finalized until the grantor trust issues are resolved. It should be a priority to commit the resources from the various business units to finalize these regulations.

and FASB's Interpretation No. 48 (FIN 48).[16] There are no clear rules for allocating deductions as there are under the sourcing rules for inclusion of income.

Issues

The issues are best illustrated by the following example.

An executive accrues a pension under a U.K. parent's plan while working for 3 years in the United States for a U.S. subsidiary of the U.K. parent, is transferred to Switzerland where he works for a number of years for a Swiss subsidiary of the U.K. parent, and later receives a distribution from the U.K. parent's pension plan. The sourcing rules provide guidance on how much the executive should include as income for U.S. federal income taxes. Although the U.S. subsidiary should be able to take a deduction for the contributions made on behalf of the executive while he worked in the United States, it is unclear whether the entire deduction can be allocated to the United States subsidiary or whether some proration is required.

Recommendation

Treasury should issue guidance under Code §§ 83, 404, and 404A on how deductions are allocated between U.S. and foreign employers.

2. Deduction Under Code § 404 for Contributions for Nonresident Aliens Allowed Based on Foreign Compensation under Code § 415

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

As mentioned above, the LMSB is providing services to U.S. Persons in five locations around the world and intends to provide guidance on a number of issues. However, there does not appear to be recognition that employers in these locations also need guidance on how to report U.S. taxable income and under what circumstances a deduction is available.

Recently published Treas. Reg. § 1.415(c)-2(g)(5)(ii)[17] allows a plan to exclude foreign compensation (i.e., compensation for services performed outside of the United States) for Code § 415 purposes if (1) it is paid to nonresident aliens working outside the United States who do not participate in the plan, and (2) the foreign compensation exclusion applies on a uniform

[16] Financial Accounting Standards Board (FASB) Interpretation No. 48 *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

[17] 72 Fed. Reg. 16878, 16918-16919 (April 5, 2007).

basis to all nonresident aliens. The preamble to the regulations indicates that this foreign compensation exclusion is relevant in determining who is a highly compensated employee under Code § 414(q)[18] or a key employee for top-heavy purposes under Code § 416.

Treasury Regulation § 1.415(c)-2(g)(5)(i) clarifies that foreign compensation paid to a worker, including a nonresident alien, can be included as compensation for Code § 415 purposes, even though the foreign compensation is not included in the worker's U.S. gross income on account of the location of the services or on account of Code §§ 872, 893, 894, 911 and 933. According to the preamble[19] to the regulations, the foreign compensation clarification means nonresident aliens working outside of the United States are not prevented from participating in a U.S. qualified plan on account of the Code § 415 compensation rules.

Issues

While the Code § 415 regulations generally accommodate foreign compensation for most tax-qualified plans, they do not authorize salary reduction contributions for purposes of Code §§ 401(k) or 403(b) by the foreign employer.[20] Thus, a 401(k) or 403(b) plan sponsor would have to make contributions on behalf of the U.S. citizens, resident aliens or nonresident aliens working for a foreign employer. However, the preamble to the Code § 415 regulations explains that the regulations do not modify the rules relating to the entity that is properly entitled to a deduction for contributions made to the plan on account of an employee's participation.[21] The preamble appears to be referring to the general rule that an employer cannot deduct compensation paid on behalf of an employee of another employer, even if both employers are members of the same controlled group.[22]

Recommendations

Treasury should recommend that Code § 404 be amended to allow a U.S. employer to deduct contributions to its U.S. qualified plans made on behalf

[18] Code § 414(q)(8) states that nonresident aliens working outside the United States are not treated as employees.

[19] 72 Fed. Reg. 16878, 16899 (April 5, 2007).

[20] The current Code § 415 regulations effectively prevent nonresident aliens working in the United States from participating in a 403(b) plan. However, nonresident aliens working outside the United States can participate in 403(b) plans, although salary reduction contributions by these nonresident aliens remain problematic because the home country may not recognize or may penalize the deferred compensation. Also, see discussion in paragraph 3 below.

[21] A deduction will not be an issue for tax-exempt employers contributing to a 403(b) plan.

[22] *See Transamerica Corp. v. United States*, 187 Ct. Cl. 119 (1984) (parent corporation could not deduct stock option compensation paid to an employee of its subsidiary); *Young & Rubicam, Inc. v. U.S.*, 187 Ct. Cl. 635 (1969) (employer could not deduct salaries and other related compensation, such as profit sharing plan contributions, paid for workers temporarily transferred to its foreign subsidiaries). Code §§ 406 and 407 provide limited exceptions to the general rule.

of participating U.S. citizens, resident aliens or nonresident aliens working for a foreign employer which is a member of the same controlled group of trades or businesses.

3. Foreign Compensation under Code § 415 for Purposes of 403(b) Plan Participation

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

A 403(b) plan can cover nonresident aliens. In some cases these individuals may have no taxable compensation in the United States because of treaty provisions. In some cases the employee will make a treaty election by filing a W-8BEN, but in others the employee will make the election by filing for a refund of U.S. taxes with IRS Form 1040 which makes it difficult for an employer to know if the individual has taxable U.S. compensation.

Code § 415(c)(3)(E) limits a participant's compensation under a 403(b) program to the participant's "includible compensation" under Code § 403(b)(3).[23]

Issues

While Treasury Regulation § 1.415(c)-2(g)(5) appears to provide for a broad inclusion of foreign compensation for 401(a) and 401(k) plans, § 1.415(c)-2(g)(1) provides that the inclusion provisions do not apply to 403(b) plans. The result is that nonresident aliens working in the U.S. are ineligible for both elective and non-elective contributions under a 403(b) plan. While not being permitted to make pre-tax deferrals from foreign compensation that is not taxed in the United States is not a problem, the provision does put the employer in the position of having to create a 401(k) plan in order to provide employer contributions for nonresident aliens, which seems to be a form over substance requirement.

Recommendations

Amend the Code § 415 regulations to provide that foreign compensation can be considered for purposes of nonelective contributions to a 403(b) plan. To the extent that this change is determined not to be within the regulatory authority of the Treasury Department, Treasury should recommend that Code § 403(b) be amended as necessary to provide the parity between 403(b) plans and 401(k) plans that was intended by the elimination of the exclusion allowance in favor of the 415 restrictions.

[23] Code § 403(b)(3); Treas. Reg. § 1.415(c)-2(g)(1).

4. Foreign Exchange Issues

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Plan participants are often paid in whole or in part in foreign currencies. Plan benefit formulae and contributions are typically determined in U.S. dollars.

Issues

If a U.S. Person working for an employer in a foreign country is paid in that country's currency, the timing of conversion of the compensation to U.S. dollars is an issue under the plan and under Code § 415. The current Code § 415 regulations do not address currency conversion.

As a practical matter, the plan document should provide that the currency conversion will be as of a specified date during the year in which the compensation is earned (e.g., December 31), not when contributions are made to a defined contribution plan or when pensions are calculated under a defined benefit plan. The issue is whether such a practical plan provision would comply with Code § 985,[24] which defines "functional currency" and specifies conversion rules for transactions conducted in a foreign currency.

According to IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*,[25] the following rules generally apply (emphasis added):

> Your functional currency generally is the U.S. dollar unless you are required to use the currency of a foreign country. . . . The U.S. dollar is the functional currency for all taxpayers except some qualified business units.
>
> ***If your functional currency is the U.S. dollar, you must immediately translate into dollars all items of income, expense, etc. (including taxes), that you receive, pay, or accrue in a foreign currency*** and that will affect computation of your income tax. Use the exchange rate prevailing when you receive, pay, or accrue the item. . .
>
> ***If your functional currency is not the U.S. dollar,*** make all income tax determinations in your functional currency***. At the end of the year, translate the results, such as income or loss, into U.S. dollars to report on your income tax return.***

[24] Code § 985 and the related Code §§ 986-989 were enacted by § 1261(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

[25] IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (November 2008) at 5, available at http://www.irs.gov/publications/p54.

[Emphasis Added].

While IRS Publication 54 is directed at individuals, not plan sponsors, Treasury Regulations for employers funding foreign plans rely on Code § 985.[26]

Recommendations

The regulations under Code § 415 or Code § 985 need to include guidance regarding foreign currency provisions of U.S. qualified plans and reference the other Code sections to which the currency conversion rules apply. The guidance to employer/plan sponsors should be consistent with the guidance to individual taxpayers provided in IRS Publication 54.

5. Multiemployer Plans – Canada

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

Within Canada, worker mobility from one province to another is facilitated, in part, by plans similar to what are referred to in Canada as "multiemployer plans." In general, these are plans which are collectively bargained, but may be sponsored and maintained by employers and/or by a union. Because each Canadian province has its own pension rules, these multiemployer plans are essential to Canadian businesses where the employer transfers employees from a workplace in one province to an affiliate located in another province and to ensure the mobility of skilled labor to where it is needed most.

Canadian multiemployer plans typically provide a cents or dollar per hour pension, rather than a compensation or service-based pension. The Canadian plans typically have reciprocal agreements among them that allow contributions for a worker to be made to the worker's "home" plan. Such plans are particularly important in the construction and entertainment industries. For example, a Canadian entertainer may have several short-term jobs in different provinces in Canada; these agreements would permit benefit accruals or contributions under a qualified Canadian plan to be consolidated into one plan, regardless of where the individual works. However, if a Canadian resident-entertainer works both in the United States and in Canada in a given year, there is limited ability to provide coverage under a Canadian plan relating to the compensation for services rendered in

[26] Proposed Treas. Reg. § 1.404A-4, United States and Foreign Law Limitations on Amounts Taken into Account for Qualified Foreign Plans, 58 Fed. Reg. 27219 (May 7, 1993), ("For taxable years beginning after December 31, 1986, the cumulative United States amount, the cumulative foreign amount, and the aggregate amount must be computed in the employer's functional currency. See generally § 964 and §§ 985 through 989 for rules applicable to determining and translating into dollars the amount of income or loss of foreign branches and earnings and profits (or deficits in earnings and profits) of foreign corporations.").

the United States. Similarly, Canadian construction workers may work on both United States and Canadian projects each year.

Article 13 of the Fifth Protocol to the United States-Canada 1980 Income Tax Treaty (the "Canadian Protocol") provides for a deduction or exclusion from income in the Contracting State in which the individual is working and covered by a qualifying retirement plan in the other Contracting State provided the individual is not a resident in the other State, but only for certain temporary periods and subject to certain requirements.

Issues

While the multiemployer plan concept is helpful within Canada, challenges arise when workers cross the border to work in the United States or when U.S. residents and workers cross the border to work in Canada. Cross-border work problems include the following:

- Canadians who work in their industry in Canada and then accept temporary assignments in the United States cannot have the U.S. employer's contributions made to the workers' "home" plan in Canada because of United States tax rules, unless the individual can claim benefits under the Canadian Protocol for years beginning on or after January 1, 2009.[27]

- U.S. employees who temporarily work in Canada cannot have retirement contributions of Canadian employers made to the U.S. employees' "home" plan, unless the Canadian Ministry of Finance approves the U.S. plan, or unless the individual can claim benefits under the Canadian Protocol for years beginning on or after January 1, 2009.

- Vesting schedules differ between Canada (2 years) and the United States (typically 5 or 6 years). This could mean that pensions may be forfeited with respect to work in the United States when those pensions would not be forfeited if the work were performed in Canada.

- It is not easy to provide a Canadian who transfers to a U.S. location with a Canadian pension and a U.S. pension that would add up to the pension that would be earned for employment exclusively in Canada. Further, the plan benefits cannot be transferred from a U.S. qualified plan to a Canadian qualified plan, or vice versa, without tax consequences to the participant and possible disqualification of one or both plans.

- Qualification of a U.S. pension plan is required by Canadian law for workers in Canada to remain in a U.S. pension plan, unless the individual can claim benefits under the Canadian Protocol for years beginning on or

[27] There are some plans that are dual-qualified in both Canada and the United States, _e.g.,_ the National Hockey League Pension Plan.

after January 1, 2009. This is somewhat similar to dual-qualified plans in Puerto Rico—however, there are stricter pension accrual limits in Canada[28] than under the U.S. qualified plan rules, and Canadian plans are not subject to ERISA as are Puerto Rico plans.

- Canadians can accumulate pensions in U.S. plans that meet the requirements of a "Foreign Registered Plan." This is an exception to the dual qualification requirement, but requires application to the Canada Revenue Agency.

- Canadian tax issues arise if a deferred compensation plan is either unfunded or if an annuity is purchased. There are Canadian law compliance issues if the compensation is pre-funded.

Recommendations

The United States should consider entering into negotiations to allow employer retirement contributions to "follow" a worker. For example, a Canadian working temporarily in Michigan should be permitted to have retirement contributions by the Michigan employer transferred to the worker's home plan in Canada when the transferred employee returns to Canada.

6. Treaty Issues

Responsibility – IRS LMSB, TE/GE, and Counsel, and Treasury

Background

Other than the minority of instances where alternative provisions are specifically adopted, most pension/annuity articles of bilateral tax treaties with the United States provide that the country of residence (as determined under the treaty's residency article which contains tie breaker rules when more than one residency is established) may tax a person's pension or annuity under its domestic laws. Some treaties provide that the country of residence may not tax amounts that would not have been taxable by the other country if the person were a resident of that country. In some cases, government pensions/annuities or social security system payments may be taxable by the government making the payments. There also may be special rules for lump sum distributions. Thus, it is necessary to review each tax treaty independently in order to determine the applicable rules.[29]

Although many of the bilateral tax treaties address the taxation of distributions from employer pensions/annuities, there are only ten treaties

[28] There is a maximum benefit accrual rate of 2% under Canada tax pension rules.

[29] *See* IRS, International Tax Gap Series, *The Taxation of Foreign Pension and Annuity Distributions* (October 2008) available at www.irs.gov/businesses/article/0,,id=187083,00.html.

and two protocols that address the taxation of contributions to employer pensions/annuities.[30]

The 1996 Model Income Tax Treaty included pension contribution provisions as does the 2006 Model Income Tax Treaty.[31] The 1996 Model provided that contributions would be deductible (or excludible) for purposes of determining an employee's tax liability in the host country and required that (1) the employee must have been contributing to the home country plan before beginning to work in the host country, (2) the plan must be similar to one for which the home country would provide such a deduction (or exclusion), and (3) the deduction (or exclusion) is limited to the amount that would be allowed for such a plan. It also provided for a deduction to the contributing employer against its taxable income in the host country.[32] The 2006 Model also requires that the competent authority of the host State determine that the pension fund to which the contribution is made in the other (residency) State generally corresponds to the plan in the host State.[33] It also provides U.S. tax treatment for certain contributions by or on behalf of U.S. citizens who are residents in another State to pension funds established in that other State that is comparable to the treatment that would be provided for contributions to U.S. pension funds. This tax benefit is limited to the lesser of the amount of relief allowed for contributions and benefits under a pension fund established in the other State and the amount of relief that would be allowed for contributions and benefits under a generally corresponding pension fund established in the United States.[34]

Each of the bilateral treaties is negotiated between the United States and the other contracting state and results in various permutations. For example, the treaties with Switzerland (1996) and Ireland (1997) impose a five-year limit on how long an employee may qualify for benefits under the provisions. The treaty with the United Kingdom (2001) has special rules for U.S. citizens who live in the U.K. and participate in a U.K. pension scheme. A special commuter provision is included in the Canadian Protocol, which permits

[30] These include U.S. treaties with France, The Netherlands, Sweden, Austria, Switzerland, Ireland, the United Kingdom and Belgium, and protocols with Germany and Canada. There is also a pending treaty with Italy. *See,* Fleeman, M. Grace, *Cross-Border Pension Contributions,* The Tax Journal, June 23, 2008, at 11-12.

[31] United States Model Income Convention of November 15, 2006, (the "2006 Model Income Tax Treaty"), Article 17 ("Pensions, Social Security, Annuities, Alimony, and Child Support"), Article 18 ("Pension Funds").

[32] Fleeman, *supra* note 30, at 12.

[33] The Model Income Convention of September 20, 1996, (the "1996 Model Income Tax Treaty") also contained this requirement in Article 18, paragraph 6(d)(ii).

[34] 2006 Model Income Tax Treaty, Article 18; United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, 56-58.

cross-border workers to deduct contributions made to a pension plan or other employment-related retirement plan in the country of employment.[35]

Many treaties provide relief where the competent authority has determined the types of plans that are covered by the treaty provisions. This requires the U.S. competent authority to agree that the foreign plan generally corresponds to a plan recognized for tax purposes in the United States. In the earlier treaties, each individual desiring to take advantage of the treaty provision (or the plan sponsor) needed to obtain a ruling that the foreign plan generally corresponded to a plan recognized for tax purposes in the United States, requiring submission of all the plan documents (translated into English, if necessary).

The IRS has begun to enter into competent authority agreements with the other contracting state that lists the types of plans in each country that are understood to generally correspond to plans recognized for tax purposes in the other country.[36] In some cases these plans are actually listed in the Treaty, the Protocol or the Exchange of Notes relating to the treaty.[37]

Issues

Not every country that has entered into a bilateral treaty with the United States has compiled an agreed upon list of the approved plans to be covered by the treaty ("comparable plans").

Treaties are robust on protecting "qualified" or "approved" retirement plan accumulations, but do not provide similar protection for non-qualified plans

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35 Department of Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as amended by the Protocols Done on June 14, 1983, March 28, 1984, March 17, 1995, and July 28, 1997, ("Technical Explanation of the U.S.-Canada Protocol") (2008), available at http://www.treas.gov/press/releases/reports/tecanada08.pdf. Note, although Roth IRAs are treated as retirement plans under the taxation of distributions from pension plans provision of the U.S.-Canada Protocol, Roth IRAs do not receive the same treatment under the contribution provisions of the Protocol and are treated as taxable contributions to a savings account.

36 Such agreements have been entered into with The Netherlands (2000 and 2007) and Switzerland (2004).

37 *See,* Protocol Amending the Convention Between the United States of American and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, August 29, 1989, (the "German Protocol") and the United States response to United Kingdom Note regarding the U.S – U.K. Double Taxation Convention, July 24, 2001, (the "U.K. Exchange of Notes). The hierarchy of authority is as follows (in order of importance):

- Treaty
- Protocol
- Exchange of Notes
- Technical Explanation – (either a Treasury unilateral document or the product of negotiation (e.g., Canada))

where they are designed to work with the base retirement plan ("restoration" type plans).

IRAs are not specifically addressed in most treaties[38] and need to be contemplated or additional guidance provided. The ACT acknowledges that there is a significant difference of opinion between the US and other countries with whom pension provisions have been negotiated on the characterization of IRAs. The US considers IRAs to be pension plans; other countries consider IRAs to be savings plans in most part due to their "demand account" status. The ACT understands that this may provide a barrier in providing additional guidance in the area.

There are some procedural problems with complying with treaty requirements for filing forms claiming treaty protection. For example, most foreign plans are funded on a monthly or quarterly basis. Thus, where a bilateral treaty has a provision stating that a U.S. Person working in the other country would not have to recognize the contribution to or accrual under a U.S. plan with respect to tax liability in the foreign country, the individual is required to complete and deliver Form W-8BEN to the U.S. payer to take advantage of this treaty provision.

Another procedural problem is presented by the situation in which an employee lives in the United States and receives a pension/annuity from a foreign country. In this situation, the individual must claim the desired treaty withholding exemption on the form and in the manner specified by the foreign government. If the foreign government and/or the foreign withholding agent refuse to honor the treaty claim, the individual may make the treaty claim on his personal income tax return, or other prescribed form, filed with the foreign country. Additionally, a foreign tax credit on the individual's U.S. federal income tax return may be available for any foreign income tax withheld from the foreign pension or annuity.[39]

Recommendations

a. Although some bilateral treaties specify the home country pension plans/schemes that are deemed to be comparable,[40] a number of other treaties do not contain such specificity. Guidance containing general principles that could be applied to determine comparability would be helpful. Perhaps for countries that have an employer-based private pension system, the Code § 409A definition of "broad-based foreign retirement plan" could be used.

[38] *But, see,* Canadian Protocol, Article 13, amending Paragraphs 3 and 4 of Article XVIII of the Treaty.

[39] *See* footnote 12 and accompanying text, *supra*.

[40] *See* for example, the Technical Explanation to the 2001 U.S. – U.K. Treaty (2003), Art. 3, Par. (o) for a list of the U.S. and U.K. plans that are deemed to be comparable.

b. An internal working group between Treasury, Chief Counsel, IRS TE/GE Employee Plans, and LMSB should be formalized to address treaty issues and to provide input regarding treaty negotiations. Clarification is needed as to where jurisdiction resides with respect to treaty issues that impact multiple business units within IRS and Treasury. Some of the issues to be reconciled by this working group include the following:

   - what constitutes a comparable plan[41] and whether the U.S. and foreign competent authorities can enter into agreements to list comparable plans when the treaty does not contain a list;
   - what constitutes a pension fund in another country (e.g., must the pension fund be a funded plan, must the pension fund meet foreign local requirements, are grantor trusts treated as funded plans in a foreign country);
   - how contributions and dividends to foreign trusts are taxed;
   - what is the permissibility and appropriate treatment of IRAs and rollovers[42];
   - whether non-qualified "wrap" or restoration plans can be included as comparable plans; and
   - whether U.S. citizens are taxed on accruals and earnings in other countries.

c. The IRS should recognize the disconnect between the time at which a determination is made regarding treaty coverage and the time for filing returns required to take advantage of treaty provisions, which is usually after the end of the taxpayer's tax year, and provide some flexibility as to the time for filing the required forms.

d. Reconsider the necessity of having nonresident aliens participating in U.S. plans obtain a TIN to be used on required filings to claim treaty relief when no tax revenues are involved.

e. Treaty negotiators should take into account that retirement income comes from more than one source. Mobile workforces typically need non-qualified benefits to make them whole as they move from country to country.

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[41] For example, in France it is difficult to distinguish between the social security system and a pension plan.

[42] Rollover provisions were not included in the 2006 Model Income Tax Treaty (see footnote 31, *supra*) because of problems with the rollover provisions in the 1996 Model Income Tax Treaty (which were used in the treaty with South Africa).

7. Global Retirement Plans

Responsibility – Treasury and Congress

Background

Many large multinational companies would like to have one retirement plan cover their global workforce, including their U.S. workforce. Such a plan would create economies of scale and administrative consistency.

Issues

Rules such as Code § 409A (Inclusion in Gross Income of Deferred Compensation under Nonqualified Deferred Compensation Plans), nondiscrimination rules under Code § 402(b), and U.S. Department of Labor (DOL) regulations limiting individuals who may be covered by unfunded non-qualified arrangements make the creation of a global retirement plan extremely difficult to achieve on a tax-effective basis.

If all employees are covered under a U.S. 401(k) plan, pre-tax contributions by payroll deductions would be required, but this is difficult administratively, as most off-shore employees are paid through separate payrolls. There is also the issue of compliance with the DOL's requirement on the timing of transferring employee contributions to the trust.

Recommendations

One suggestion is to permit a U.S. parent or affiliate to make contributions on behalf of all employees and matching contributions for all of the participating employers. It is recognized that the impact of other U.S. and foreign laws would have to be considered as well. Similar to other recommendations, the principle underlying this recommendation is that there should be a mechanism to recognize the portability and mobility of employees among U.S. employers with foreign affiliates and foreign employers with U.S. affiliates.

C. Pension Distributions

1. Taxation of Pension Distributions to Nonresident Aliens – Effectively Connected Income under Code § 864

Responsibility – IRS Chief Counsel and Treasury

Background

Code § 864(c)(6), which was enacted in 1986 and is effective for tax years beginning after 1986, provides that income paid in one year for services performed in another year will be treated as income effectively-connected with the United States ("ECI") in the year of payment if it would have been treated as ECI if it had been taken into account in the year the services were performed. Read literally, the rule would not apply if the individual was a

U.S. resident alien or otherwise subject to U.S. taxes in the year the services were performed (because the ECI rules apply only to nonresident aliens).

Issues

Whether the literal reading of the ECI provision articulated above is a correct reading of the rule so as to exclude its application to individuals who were U.S. Persons in the year the services were performed.

Whether the earnings and accretions portion of the distribution from a U.S. pension plan would always be fixed, determinable, annual, periodic (FDAP) income or whether they would be ECI if the contributions are ECI.

Finally, a question arises about the effective date of the provision, namely whether it applies to payments made after 1986 for services performed before 1987.

Recommendations

Guidance is needed with regard to the determination of the portion of a pension distribution to a nonresident alien that constitutes ECI. In addition, the effective date provisions should be clarified.

2. Taxation of Annuities to Nonresident Aliens under Code § 871(f)

Responsibility – Treasury and Congress

Background

Code § 871(f), enacted in 1966, applies when there are a small number of nonresident aliens in a U.S. plan and they leave the United States. If they are paid in the form of an annuity, the distribution is excludable from income.

Issues

Most U.S. employers now provide defined contribution plans or cash balance plans that permit lump sum distributions, which do not qualify for this favorable tax treatment.

Recommendations

Code § 871(f) should be amended to also exclude from income lump sum distributions from qualified trusts and annuities.

3. Direct Rollovers – 402(f) Notice

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

A participant in a U.S. qualified retirement plan in receipt of an eligible rollover distribution under Code §§ 402(c), 403(a)(4), 403(b)(8)(A), and

457(e)(16) must receive a written explanation under Code § 402(f) that describes the tax, rollover options, and withholding applicable to the distribution. The notice requirement is typically satisfied by using a model issued by the IRS[43]. The IRS model notice is in the process of being modified to reflect recent changes in the tax rules.

Issues

The IRS model 402(f) notice does not reflect the special rules applicable to eligible rollover distributions to nonresident aliens that are not subject to the withholding rules of Code § 3405. The eligible rollover distributions to nonresident aliens that are not rolled over to an eligible retirement plan (including an IRA) may be subject to the withholding rules under Code § 1441 if the distribution is the only U.S. source income, rather than the Code § 3405 rules, which include the 20% mandatory withholding on distributions subject to the direct rollover rules. The withholding under Code § 1441 for distributions not rolled over will result in a withholding rate of 0% to 30% depending on applicable Treaty rates.

Recommendations

The IRS model 402(f) notice should be revised to include language to address the withholding rules under § 1441 that apply instead of the mandatory withholding rules under Code § 3405, for eligible rollover distributions to nonresident aliens not rolled over to an eligible retirement plans (including an IRA).

4. Withholding and Reporting on Pension Distributions to Nonresident Aliens and Certain Expatriates

Responsibility – IRS TE/GE, W&I and Counsel, and Treasury

Background

Exhibit B to this report summarizes the general rules on withholding and reporting pension distributions to nonresident aliens.

Issues

There is a mismatch between amounts withheld and the tax actually owed by a nonresident alien receiving a distribution from a qualified plan, 403(b) plan or IRA that is attributable to effectively-connected income (ECI). Although the individual is taxed at graduated rates on the income, withholding is either automatic at a 30% rate for IRAs or a lesser amount, if the treaty permits, for qualified plan and 403(b) plan distributions. This results in the recipient either having to file and pay estimated taxes if the flat 30% rate (or treaty rate) is too little or having to file for a refund if the 30% rate is too high.

[43] IRS Notice 2002-3, 2002-2 I.R.B. 289 (January 14, 2002).

Section 301, Title III, of the HEART Act further compounds the problem. While this tax is aimed at high net-worth individuals who permanently expatriate (by giving up U.S. citizenship or U.S. residency after the date of enactment), it affects the timing and taxation of world-wide assets immediately before expatriation relating to services performed in the United States. Section 301 requires 30% withholding on certain "eligible deferred compensation items," which include distributions from qualified plans, 403(b) and 457(b) plans and other benefit distributions as well as certain transfers of property under Code § 83 . The HEART ACT dictates when the 30% withholding requirements apply without regard to lower treaty rates. The obligations of payers of pension distributions are not clear with respect to withholding from affected expatriates.

There are many complex issues relating to tax reporting rules for distributions to nonresident aliens, but they are beyond the scope of this report. One illustrative example is that excess contributions to an IRA or 401(k) plan are reported on IRS Form 1042-S, not on Form 1099-R. The Form 1042-S does not contain a coding system, like that applicable to the 1099-R to indicate to the IRS that a correction of an excess contribution is being made from the payee's account.

Recommendations

a. An evaluation of the flat 30% rate should be made to determine if another rate or series of rates could be applied so as to more closely relate the flat rate (or the treaty rate) to the actual taxed owed by the nonresident alien.

b. Guidance should be issued to clarify the new deferred compensation tax under the HEART Act. Guidance is still needed with respect to reporting issues for nonresident aliens, including clarification as to the types of plan distributions that will be subject to this new tax, and whether there are differences between the treatment of distributions from qualified plans, non-qualified plans and IRAs.

c. Additional guidance and recommendations should be considered by an IRS team, with input from IRPAC, to address the coding and other issues related to reporting nonresident alien distributions from qualified retirement plans and IRAs on IRS Form 1042-S.

5. Puerto Rico

a. ERISA § 1022(i)(1) Plans Covering Puerto Rico Residents

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Revenue Ruling 2008-40[44] addresses whether a distribution from a trust under a plan qualified under Code § 401(a) to a non-qualified foreign trust is treated as a distribution. It also addresses whether the result is different if the transferee plan trust satisfies the requirements of § 1165(a) of the Puerto Rico Internal Revenue Code ("PR Code") and is described in § 1022(i)(1) of ERISA (a "1022(i)(1) Transferee Plan"). The ruling concluded that, in both instances, the transfer of amounts from the U.S. qualified trust is treated as a taxable distribution from the transferor plan. The Ruling also provides limited transition relief for a transfer prior to January 1, 2011, to a 1022(i)(1) Transferee Plan that would satisfy the requirements of Code § 414(l) but for the fact that the transferee trust is not a qualified trust within the meaning of § 401(a).[45]

The transition relief provides that (1) the portion of each distribution from a 1022(i)(1) Transferee Plan that is attributable to amounts that were transferred from a U.S. qualified plan before January 1, 2011, will be treated as income from sources within Puerto Rico and (2) employees participating under a 1022(i)(1) Transferee Plan may be treated as excludable employees for purposes of applying Code § 410(b) with respect to the U.S. transferor plan for plan years beginning prior to January 1, 2011, if either (a) the U.S. plan would satisfy the requirements of Code § 410(b) if the U.S. plan and the 1022(i)(1) Transferee Plan were aggregated for testing purposes, and the U.S. plan by itself would satisfy the average deferral percentage test of Code § 401(k)(3) (disregarding Code § 401(k)(3)(A)(i)) and the average contribution test of Code § 401(m), if applicable; or (b) in the case of a defined contribution plan that provides for contributions other than elective contributions for employees benefiting under the 1022(i)(1) Transferee Plan, the rate of such contributions following the transfer date is not reduced from the rate under the U.S. plan prior to the transfer date.

Issues

Although Rev. Rul. 2008-40 addressed and answered a number of issues that arise with respect to spinning off a portion of a plan qualified both under Code § 401(a) and § 1065(a) of the PR Code (a dual-qualified plan), it did not address a number of issues that are still outstanding, including whether

[44] Rev. Rul. 2008-40, 2008-30 I.R.B. 166 (July 28, 2008).

[45] Even more limited transition relief was provided for a transfer to a qualified funded plan under Code § 404A(f)(1) where the employer elects to have Code § 404A apply to the plan. In that case the holdings of Rev. Rul. 2008-40 do not apply if the transfer was made before October 1, 2008.

the assets of a 1022(i)(1) Transferee Plan may be co-invested with qualified plan assets in a group trust under Rev. Rul. 81-100[46] or in the U.S. master trust of a controlled group member.

Beginning in 2011 when the transition relief relating to Code § 410(b) testing for U.S. qualified defined contribution plans is no longer available, employees resident in Puerto Rico who participate in a 1022(i)(1) Transferee Plan and are employed by a plan sponsor (or by a member of the same controlled group, within the meaning of Code § 414(b) and (c), as a plan sponsor) of one or more U.S. qualified plans will be required to be taken into account for purposes of applying Code § 410(b) to the transferor plan and other U.S. qualified plans maintained by members of the controlled group. Because the benefits provided under the 1022(i)(1) Transferee Plan are not counted under Code § 410(b), it will be more difficult to pass these nondiscrimination tests.

Recommendations

Although Rev. Rul. 2008-40 provides transition relief, the underlying analysis and conclusion that transfers of assets from a qualified plan to a 1022(i)(1) Transferee Plan will disqualify the qualified pension plan should be reconsidered, and the transition rule made permanent, for the following reasons:

- There may well be situations after 2010 in which an employer who established a separate 1022(i)(1) Transferee Plan or initially established a Puerto Rico-only qualified plan for employees resident in Puerto Rico acquires a company with a dual-qualified plan. The successor employer will no longer be able to divide the plans and transfer the assets for the Puerto Rico employees from the newly acquired entity's dual-qualified plan to a 1022(i)(1) Transferee Plan without disqualifying the transferor U.S. qualified plan;

- The PR Code contains different definitions of highly compensated employees, different limits on covered compensation and different ADP and ACP testing;

- Further, recent amendments to the PR Code relating to the taxation of distributions from plans qualified under Section 1165 of the PR Code provide more beneficial tax results than can be provided to dual-qualified plans,[47] which make it administratively more difficult to maintain dual-qualified plans;

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[46] *See* Groom Law Group Letter to Treasury Department on Group Trust Arrangements, dated December 4, 2008.

[47] *See* Puerto Rico Act 181, December 10, 2007, ("Act 181"). Act 181 amended PR Code § 1165, retroactive to January 30, 2006, to reduce to 10% the capital gains rate applicable to lump sum distributions if certain requirements are satisfied. However, the general 20% income tax and

- 1022(i)(1) Transferee Plans are subject to ERISA, cover U.S. citizens and are subject to similar (although not exactly the same) broad coverage and nondiscrimination requirements as U.S. qualified plans; and

- Under the Rev. Rul. 2008-40 transition relief, employees covered by a 1022(i)(1) Transferee Plan may be excluded from the application of Code § 410(b) when testing the coverage and benefits of employees remaining in the transferor plan (assuming the other requirements of the relief are met). However, this will become a testing issue beginning in 2011 and may already be one for Puerto Rico plans that were initially established as 1022(i)(1) Transferee Plans. Although these plans are not subject to the nondiscrimination requirements of Code § 401(a), by law they do need to meet the requirements of § 1165(a) of the PR Code. Consideration should be given to amending the requirements under the qualified separate line of business (QSLOB) regulations[48] to automatically treat 1022(i)(1) Transferee Plans as meeting the QSLOB requirements. If such a change is made, the employees covered by a 1022(i)(1) Transferee Plan could continue to be excluded from testing under Code § 410(b) of U.S. qualified plans maintained by another member of the same controlled group

b. Asset Pooling – Revenue Ruling 81-100[49]

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Revenue Ruling 81-100, as clarified and modified by Rev. Rul. 2004-67[50], provides that if certain criteria are satisfied, a trust that is part of a qualified retirement plan, an individual retirement account exempt from tax under Code § 408(e) or an eligible governmental plan under Code § 457(b) may pool its assets in a group trust without adversely affecting the tax status of any of the separate trusts or the group trust.

Issues

It is not clear under current law whether a group trust must satisfy the requirements of Rev. Rul. 81-100 if all of the participating plans are maintained by entities within the same controlled group and invest directly in the group trust rather than through separate trusts. Code § 401(a) provides that a trust is a qualified trust if, among other things, (1) it is part of a pension or profit sharing plan and (2) it, and the plan of which it is a part, satisfy the

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withholding rate applies to lump sum distributions paid from a U.S. situs trust with no Puerto Rico co-trustee acting as paying agent.

48 Treas. Reg. § 1.414(r).

49 Rev. Rul. 81-100, 1981-1 C.B 326 (January 1981).

50 Rev. Rul. 2004-67, 2004-28 I.R.B. 28 (July 12. 2004).

requirements of Code § 401(a).[51] No additional requirements are imposed on a trust merely because it takes the form of a sub-account in a group trust. Revenue Ruling 81-100 by its terms applies only to group trusts in which there are separate "participating trusts."[52]

Master trusts also satisfy all of the requirements of Rev. Rul. 81-100. The second requirement of Revenue Ruling 81-100 could be affected by the inclusion of an ERISA § 1022(i)(1) plan trust, namely that the group trust instrument expressly limit participation to, among other things, pension, profit sharing and stock bonus trusts or custodial accounts qualifying under Code § 401(a) that are exempt under Code § 501(a). For purposes of Code § 501(a), an ERISA § 1022(i)(1) plan is treated as an organization described in Code § 401(a), provided such plan is exempt from taxation under the PR Code.

Recommendations

Issue guidance clarifying that an ERISA § 1022(i)(1) plan trust is permitted to co-invest in a qualified group trust under Rev. Rul. 81-100.

6. Special Tax Issues for Guam and Mariana Islands[53]

a. Taxation of Distributions to Guam Residents

Responsibility – IRS TE/GE, LMSB, and Counsel, and Treasury

Background

Many issues are faced in connection with the taxation of distributions to Guam residents participating in U.S. pension plans and the treatment of pension plans maintained by Guam employers. Guam has adopted a mirror image of the Code.

With regard to taxation of distributions to Guam residents who have worked for part of their service in Guam and part in the United States, the issue of allocating the taxes and remitting them to Guam and the United States has been a continuing problem. The Guam resident is subject to Guam income tax on distributions of the employer contributions and employee contributions to the plan made while working in Guam and the remainder is subject to tax

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51 *See also* Treas. Reg. § 1.401-1(a)(3)(ii) (July 1989).

52 *Cf.* Rev. Rul. 69-421, Part 2(e), 1969-2 C.B. 59 (citing Rev. Rul. 56-267, 1956-1 C.B. 206 (January 1956), the predecessor to Rev. Rul. 81-100, in its description of rules for plans and trusts of multiple employers).

53 Similar issues may also exist with respect to employees in the U.S. Virgin Islands and American Samoa, but the ACT did not uncover specific issues in the due diligence process. The ACT did learn that there may be IRS authority providing for payers of U.S. pension plan distributions to certain American Samoans to forward taxes withheld from those distributions directly to the American Samoa tax authorities rather than to the IRS, but the ACT was unable to locate this authority.

in the United States. The entire earnings portion is sourced based on where the trust is located.[54]

Issues

If a pension plan is a U.S. qualified plan, the tax withholding rules of Code § 3405 apply and all withholding is to be remitted to the United States. There is no provision for submitting part of the withholding to possessions treated as foreign, such as Guam, which therefore must issue a Form 1042-S rather than a 1099-R.

Recommendations

The ACT considered the following possible solutions but determined that each has its own problems:

1. Use the address of the participant when the distribution is made to determine the tax authority to receive withholding. Thus, if the participant has a Guam address, then the withholding would be paid to Guam. If the participant has a U.S. address (or address outside of the U.S. but not in Guam), the withholding would be paid to the IRS.

2. Track the earnings of the individual based on service in Guam and service in the United States. Some employers may maintain this information but the technology necessary to maintain these records is not available to the vast majority of plan trustees and third-party administrators. Even if this alternative could be implemented, the plan trustee would pay withholding to two places, Guam and the IRS, but would issue only one 1099-R/1042-S. The 1099-R/1042-S should contain boxes for allocation of the income to another U.S territory or possession.

3. Use the place of business of the plan trustee to determine whether the tax should be paid to the IRS or Guam. If the place of business of the trustee is in Guam, then the withholding would be paid to Guam. If the place of business is in the United States, then the withholding would be paid to the IRS.

The problem with all three approaches is that the withholding agent may not be told where the recipient works or how services should be allocated between the United States and Guam. In addition, amounts withheld may not be paid to the tax authority that has the authority to tax the distribution.

It would make little difference which tax authority received the withholding if the participant has the information required to determine the amount of the distribution that should be taxed by each jurisdiction and the jurisdictions

54 *See* Rev. Rul. 2008-40, 2008-30, I.R.B. 166 (July 1, 2008), Rev. Rul. 79-388, 1979-2, C.B. 270 (July 1979), and Rev. Proc. 2004-37, 2004-26 I.R.B. 1099 (June 28, 2004).

have a mechanism to transfer the withholding and other tax payments to match the tax liability.

Therefore, the recommendation is that guidance be issued indicating that all withholding is required to be remitted to the IRS, unless the affected taxpayer takes the initiative of prorating plan contributions between the United States and the territories and informs the withholding agent of the allocation. In addition, a Memorandum of Understanding (or other appropriate agreement) should be entered into with the affected territories to provide for remittance of a certain percentage of collected withholdings, based on a rational basis related to the likely amount that would have been remitted to such authorities had the actual amounts due been remitted directly to the affected tax authorities using an average for a specified period of years.

The ACT understands that LMSB is dealing with similar issues with foreign governments pursuant to Code § 932 (Coordination of United States and Virgin Island income taxes), and recommends coordination with LMSB in implementing a solution with respect to Guam and Mariana Islands residents.

b. Treatment of Pension Plans Maintained in Guam

Responsibility – Treasury and Congress

Background

A pension plan maintained in Guam that invests in shares of stock of a U.S. corporation or other funds maintained in the United States is not considered to be maintaining a foreign grantor trust under Code §§ 404(a)(4) and 402(c) and (d), but is treated as a tax-exempt trust under Code § 501(a). Specifically, Code § 402(c) precludes treatment of the trust as a grantor trust.

Issues

Even though the Guam plan trust is treated as tax exempt under Code § 501(a) for purposes of allowing deductions for contributions, taxation of distributions and allowing rollovers to an IRA or another qualified plan under Code §§ 402 and 404, the trust is a foreign trust subject to mandatory withholding on dividends paid by U.S. corporations to the plan's trust under Code § 1441. The trust is not given full status of a tax-exempt trust under § 501(a) but merely treated as tax exempt for limited purposes.

Recommendations

Treat a Guam plan trust exempt from tax under Code § 501(a) as also exempt from the withholding requirements of Code § 1441.

c. Estate Tax on Organic Act Citizens

Responsibility – Treasury and Congress

Background

Certain residents of Guam who are citizens of the United States by reason of their Guam residency are treated as nonresidents (i.e., not citizens) under Code § 2209. These residents are commonly known as "Organic Act Citizens."

The estates of Organic Act Citizens are not subject to the U.S. federal estate tax with respect to assets outside of the 50 states. However, their estates are subject to the federal estate tax on securities issued by the United States and U.S. corporations and real property located in the 50 states.

An Organic Act Citizen may be a participant in a qualified plan or own an IRA that invests in U.S. securities and real property located in the 50 states ("U.S. Assets").

Issues

Whether plan benefits or IRA assets, to the extent that they are U.S. Assets, are subject to U.S. federal estate tax.

Recommendations

To the extent that a participant (or beneficiary) of a qualified plan is not entitled to a distribution of the plan assets in kind, the investment by the plan in U.S. Assets should not cause any portion of the pension to be considered a U.S. Asset subject to the estate tax upon the death of an Organic Act Citizen. It would be desirable to treat IRAs the same way to the extent that it could be shown that the IRA assets could not or would not be distributed in kind.

7. Rollovers from Foreign Plans to U.S. Plans and IRAs (U.K. Example)

Responsibility – IRS TE/GE and Counsel, Treasury and Congress

Background

For a number of years there has been much confusion over the tax treatment of impermissible rollovers from foreign-based retirement plans to U.S. qualified retirement plans. To add to this confusion, many websites, including those of the foreign-based plans, are not only informing participants in the foreign plans that such rollovers are permitted, but are also providing names of U.S. investment companies that will accept such rollovers to an IRA.

The issue has been further complicated by plans that are offered to employees of companies that are located in a U.S. possession (such as Puerto Rico) where the question has also been raised as to whether terminating participants may roll over distributions to a U.S.-based IRA or qualified retirement plan.

In August 2008, an IRS Memorandum issued by the Associate Chief Counsel (International) to Michael Julianelle, Director of Employee Plans (TE/GE)[55] examined a rollover issue related to a very specific transaction under the U.K. pension scheme rules. The issue addressed was whether an individual who is a resident of the U.S. may rely on the parenthetical language in Article 18(1) of the U.S.-U.K. income tax treaty to make a tax-deferred rollover distribution from a U.K. pension scheme to a U.S. retirement plan where the distribution would not qualify as an "eligible rollover distribution" within the meaning of Code § 402(c)(4). The Memorandum stated that there was nothing under Article 18 of the U.S.-U.K. treaty that would permit such a tax-deferred rollover to be recognized.

Issues

Additional questions arising under other treaties have not been specifically addressed, nor has the situation been addressed with respect to rollovers from pension plans of U.S. possessions. Although the Memorandum referred to above may not be cited as precedent, and does not provide guidance with respect to all of the rollover scenarios, it can be assumed from the authority cited that these transactions, unless treated otherwise in future guidance, cannot be made under the current structure of Code § 402.

Recommendations

Acknowledging that that there would be a tax cost, rollovers to U.S. qualified plans or IRAs should be permitted from approved "broad-based foreign retirement plans" meeting the Code § 409A definition.[56] This result would provide more flexibility for cross-border mobile employees. The European Union has already approved this concept.

8. The Rights of Multiple Spouses

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Qualified plans may cover participants who under local law have more than one legal spouse. For example, in many Middle Eastern countries, local law recognizes that a man may have more than one wife. In other countries, a woman may have more than one husband.

[55] Memorandum from Associate Chief Counsel (International) to Michael Julianelle (Director Employee Plans TE/GE), Memorandum No. AM2008-009 (August 21, 2008).

[56] *See* Treas. Reg. § 1.409A-1(a)(3)(v).

Issues

Where a participant with multiple spouses participates in a U.S. qualified plan, the following issues need to be addressed:

a. What law controls the definition of marriage and legal spouse?

b. If the plan is required to provide a qualified joint and survivor annuity, would only the first spouse be entitled to such coverage or would each spouse be entitled to an allocable share? With respect to qualified optional survivor annuities, do all of the spouses have to agree on the same form of annuity?

c. With respect to waiver of the qualified joint and survivor annuity or a death benefit in a defined contribution plan, do all of the spouses have to agree?

d. With respect to QDROs, what court's decision controls? What if local law does not require a court order?

Recommendations

The IRS should consider these issues and provide appropriate guidance for plan administrators. Plan administrators would prefer a requirement that the participant name one spouse to receive the protections under U.S. laws. Clarification is needed as to how the federal Defense of Marriage Act[57] ("DOMA") would apply in these circumstances.

D. NON-QUALIFIED DEFERRED COMPENSATION

1. Taxation of Funded Foreign Deferred Compensation Plan under Code § 402(b)(4)

Responsibility – IRS Counsel, Treasury, and Congress

Background

Many foreign deferred compensation plans are exempt from the requirements of Code § 409A, but U.S. Persons who participate in funded, non-U.S. retirement plans may be subject to taxation under Code § 402(b) (Taxability of Beneficiary of Nonexempt Trust).

Regulations under 409A exclude from the definition of "non-qualified deferred compensation" certain foreign plans where (1) there is an

[57] P.L. 104-199 (September 21, 1996), 110 Stat. 2419 (codified at 1 U.S.C. § 7 and 28 U.S.C. § 1738C). Under DOMA, the term "marriage" means only a legal union between one man and one woman as husband and wife, and the term "spouse" refers only to a person of the opposite sex who is a husband or wife, for purposes of determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the Untied States.

applicable treaty, (2) the plan is a "broad-based foreign retirement plan" under 409A, or (3) the plan is subject to a totalization agreement.[58] However, if the foreign plan is funded, unless there is treaty relief, a U.S. Person must include in income an amount calculated under Code § 402(b)(4). This rule applies for purposes of determining the amount that highly compensated employees must recognize when one of the reasons the plan is not exempt under Code § 501(a) is its failure to satisfy the coverage testing under Code §§ 401(a)(26) or 410(b). But, a failure to satisfy the coverage testing may be attributable to the requirement to ignore coverage of nonresident aliens who participate in the plan along with U.S. expatriates.

Issues

Even though a foreign plan is in fact broad-based, the IRS treats all amounts accrued as discriminatory, since the nonresident aliens actually participating in the foreign plan are not taken into account.

This causes the U.S. participants to be subject to the relatively less favorable rules of Code § 402(b)(4), which taxes the employee on his entire vested accrued benefit in the trust at the close of the taxable year of the trust in which it was not exempt under Code § 501(a) rather than the rules of Code § 402(b)(1), which taxes the employee on the employer's contributions to the trust during the employer's applicable taxable year for which the trust is not exempt, to the extent the employee's interest in the trust is vested.

Recommendations

a. As under the 409A regulations, the IRS should adopt similar exclusions for purposes of Code § 402(b) for foreign broad-based plans by (1) permitting the rules under Code § 402(b)(1) to apply and (b) allowing nonresident aliens who are actually participating in the plan to be taken into account to determine whether the plan meets the Code § 410(b) coverage rules solely for purposes of applying Code § 402(b).

b. Provide for a transition rule to allow non-compliant plans to become compliant after communicating the rules in connection with the foregoing recommendation.

c. Code § 402(b)(4) requires a taxpayer who is a highly-compensated employee to declare as income his accrued benefit at the end of the year less any amounts previously declared and recognized. To encourage compliance, a transition rule should be adopted in the first year the taxpayer makes the declaration.

[58] Treas. Reg. § 1.409A-1(a)(3). A totalization agreement is an international Social Security Agreement, which eliminates an individual having to pay taxes to two Social Security Systems (U.S. and foreign country) and attempts to make the individual whole with regard to Social Security benefits when splitting a career between the U.S. and a foreign country.

d. It is the ACT's understanding that Code § 402(b)(4) was never intended to apply to foreign pension plans that were established as non-qualified plans. This is confirmed by the legislative history which shows that Code § 402(b)(4) was intended to apply to previously qualified plans that become disqualified due to discrimination testing under the tighter rules after 1986. Clarifying guidance on this point should be issued.

e. If Code § 402(b)(1) can be used to determine the includable amount (based on the changes suggested above), there also should be a rule adopted for administrative ease under which the actuary of the foreign plan certifies that a specific approved actuarial method is being used and the contribution to be made for the year on an aggregate basis is a percentage of covered compensation. This will solve the problem created by the fact that, in many situations, there are more than one or two U.S. Persons in the foreign plan, and it is difficult and expensive to have the actuary provide individual calculations.[59]

[59] *See, e.g.*, Rev. Rul. 2004-3, 2004 -7 I.R.B. 486 (February 17, 2004), addressing allocation of U.S. income under the U.S./German Treaty to a nonresident alien partner when the partnership has a U.S. office.

VI. EDUCATION AND OUTREACH ON INTERNATIONAL PENSION ISSUES

Responsibility – IRS TE/GE, LMSB, SBSE, and W&I

This section of the report highlights areas for which education and outreach could lead to greater compliance with pension plan qualification rules, as well as with the rules applicable to reporting and withholding on distributions to U.S. Persons working abroad and to nonresident aliens working in the United States. Special consideration should be given to education and outreach with regard to compliance with rules involving participants in pension plans maintained in U.S. possessions and territories and for those residents who participate in U.S. pension plans.

A. Summary of Tax Rules for Reporting and Withholding on Pension and IRA Distributions to Nonresident Aliens

Exhibit B of this report sets forth some general information on reporting and withholding on distributions to nonresident aliens and expatriates from U.S. qualified retirement plans and IRAs as an informational piece that could form the basis for an article or other educational piece for the IRS website and other outreach and educational efforts. Since the rules are set forth in various Code sections and there is not a single IRS source for this type of information, it would be helpful to have a general guide like this as a useful tool to employers, withholding agents and taxpayers. Exhibit B also contains a sample worksheet as well as a flowchart describing the presumption rules. With many penalties being assessed by LMSB (more recently a financial organization was charged $780 million for improper withholding and reporting), it is clearly evident that education materials and assistance to payers is needed.

B. Proposed New Publication – U.S. Qualified Retirement Plans: Cross-Border Transactions

There is a notable lack of guidance directed toward U.S. employers who sponsor qualified plans covering an international workforce. The IRS has issued many publications on cross-border tax issues. However, these publications focus on individuals,[60] not employers or plan sponsors. The only IRS publication addressing some of the cross-border tax issues

[60] IRS Publication 593, *Tax Highlights for U.S. Citizens and Residents Going Abroad* (December 2008), identifies three other useful publications that provide greater details on foreign income, foreign tax credit and general tax treaty benefits; IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (November 2008); IRS Publication 514, *Foreign Tax Credit for Individuals* (March 2007); and IRS Publication 901, *U.S. Tax Treaties* (April 2009). Other IRS publications addressing cross-border tax issues for individuals include IRS Publication 4732, *Federal Information for U.S. Taxpayers Living Abroad* (January 2009); IRS Publication 516, *U.S. Government Civilian Employees Stationed Abroad*(January 2009); IRS Publication 4588, *Basic Tax for Green Card Holders* (October 2006); IRS Publication 513, *Tax Information for Visitors to the United States* (March 2009); IRS Publication 519, *U.S. Tax Guide for Aliens* (April 2008); and IRS Publication 678-FS, *Foreign Student and Scholar Text* (2007).

addressed in this report is Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Exhibit E of this report is a draft of a proposed new publication addressing the U.S. income tax consequences for (1) U.S. Persons who remain covered under a U.S. qualified plan even though they have been transferred to work in another country ("outbound workers") and (2) nonresident aliens transferred from another country to work in the United States that are covered by a U.S. qualified plan ("inbound workers"). The targeted audience for the publication is an employer that sponsors a U.S. qualified plan.

The IRS should review this draft publication and consider issuing it in full or in part initially as informational material on its website, with the view towards having it ultimately be reviewed and edited to become an IRS Publication.[61]

C. Proposed Frequently Asked Questions Regarding Taxation of Distributions to Guam residents from U.S and Guam Plans

Part V of this report includes a discussion of special issues relating to the taxation of pension distributions to residents of Guam and Mariana Islands who participate in plans sponsored by U.S. or Guam employers.

Attached as Exhibit F to this report are sample questions and answers that the IRS might consider as the starting point for Frequently Asked Questions to be published on the IRS website as part of its education and outreach efforts. The questions and answers use some examples to address some general rules regarding the proper tax treatment of distributions from either U.S. based plans or plans maintained in Guam.

D. Revisions to Existing IRS Publications

Exhibit A of this report lists 15 different IRS Publications primarily dealing with the income taxation of individuals who are U.S. taxpayers going abroad or foreign citizens working in the United States. The ACT understands that each IRS Publication has an owner. It is recommended that an International Publications task force be formed, consisting of the owners of the IRS Publications addressing foreign pension issues.

Noticeably absent is an IRS Publication for employers regarding qualified and non-qualified retirement plans and IRAs. Consideration should be given to the development of such a Publication or a single source that identifies the various publications and the issues they address.

[61] The IRS might also consider expanding the publication (or issuing a separate publication) to address the U.S. income tax consequences when a U.S. employer sponsors a non-qualified deferred compensation plan that covers outbound and inbound workers.

In addition, the following is a list of suggested revisions to the existing publications.

1. **Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities***

   The IRS should consider updating this publication's treaty provisions to specifically address whether or not the treaties cover IRAs.

2. **Publication 593 (December 2008), *Tax Highlights for U.S. Citizens and Residents Going Abroad***

   While Publication 593[62] provides a summary of many cross-border tax issues for U.S. Persons going abroad, it omits one significant issue—contributions or accruals under retirement or deferred compensation plans – which applies whether these U.S. Persons participate in a foreign plan or a U.S. plan.

   U.S. Persons working in a foreign country but covered under a U.S. qualified plan will not be currently taxed in the United States on contributions under a defined contribution plan or on accruals under a defined benefit plan. However, the foreign country may impose income taxes[63] on these workers for such contributions or accruals.

   Similarly, U.S. Persons working in a foreign country and covered under a foreign plan may not be currently taxed in the foreign country on contributions or accruals under the foreign plan. However, the U.S. may impose income taxes on these U.S. Persons for such contributions or accruals.

   Some U.S. bilateral income tax treaties with foreign countries provide relief for U.S. Persons working in a foreign country and covered by a U.S. or a foreign retirement plan.

   Code § 409A (Non-Qualified Deferred Compensation) also could apply when a U.S. Person is covered under a foreign plan. However, the Code § 409A regulations[64] exclude deferrals under a foreign plan if:

   - The deferrals of foreign earned income are excludable for U.S. income tax purposes under an applicable income tax treaty;

[62] Available at http://www.irs.gov/pub/irs-pdf/p593.pdf.
[63] The foreign taxation of U.S. Persons going abroad is beyond the scope of IRS Publication 593.
[64] Treas. Reg. §§ 1.409A-1(a)(3), (b)(8).

- The plan is broad-based, the U.S. Person is not eligible to participate in a U.S. qualified plan, and the nonelective deferrals of foreign earned income do not exceed the Code § 415 limits that would apply if the plan were a U.S. qualified plan; or

- The deferrals would be excluded as foreign earned income under Code § 911 if the amounts had been paid, instead of deferred, when earned.

Publication 593 need not thoroughly explore the income taxation of contributions or accruals for U.S. Persons going abroad who participate in a foreign plan or a U.S. qualified or non-qualified retirement plan. However, Publication 593 should make a U.S. Person aware that those contributions or accruals could create an income tax issue under foreign and U.S. law if the United States has not entered a bilateral income tax treaty with the foreign county related to those contributions or accruals.

E. Education and Outreach on Coverage, Nondiscrimination Testing, and Controlled Group/QSLOB Rules

Treasury Regulations require that plan sponsors satisfy myriad minimum benefit, participation and coverage standards. These standards require the performance of tests (most required on an annual basis) that involve the collection and organization of detailed employee census data (including compensation, birth dates, service dates, job classification, ownership percentages, etc.). Further, this data must be collected and organized from all members of the plan sponsor's controlled group and employers under common control with the sponsor, as determined under Code §§ 414 and 1563. (For the remainder of this Section E, the term "Controlled Group" includes all the entities required to be considered as a single employer under the applicable Code sections.) Members of a Controlled Group are determined without regard to whether the plan sponsor and its affiliated companies are foreign-based or foreign-owned.

Following are some particular areas where education and outreach is necessary to improve compliance while recognizing the challenges employers face in gathering the information needed to meet the various coverage and nondiscrimination requirements on a controlled group basis.

1. Controlled Groups

Members of the same Controlled Group must be aggregated for coverage and other testing purposes. The determination of who is a member of a Controlled Group is determined on the basis of common ownership among the employers being considered. Many U.S.-based plan sponsors who are subsidiaries of a foreign entity or a joint venture between two or more foreign entities, or a joint venture between a U.S.-based company and a foreign entity, are unable to obtain enough information about the ownership interest of the foreign entity(ies) to determine if they are a part of a Controlled Group with other U.S.-based subsidiaries who share ownership with the plan sponsor. Thus, Controlled Group status is often undetermined and can go undetected, meaning coverage and other qualification requirements are not being satisfied. Furthermore, plan sponsors are often confused about the treatment of employees who transfer to another member of the Controlled Group, particularly when the transfer is to or from a foreign entity within the Controlled Group. For example, is a distribution permitted in the case of such a transfer, and is prior service with the foreign entity credited for eligibility, vesting and benefit accrual purposes?

2. Qualified Separate Line of Business (QSLOB)

The QSLOB rules under Code § 414(r) may be used to determine whether a business meets the requirements of Code § 401(a)(26) and Code § 410(b). Employers who are members of the same Controlled Group may apply to the IRS for a determination as to whether or not the Controlled Group operates as two or more QSLOBs.[65] If the Controlled Group can satisfy the QSLOB requirements, the plan sponsor is able to meet the various qualification requirements and perform certain tests as if each QSLOB is a stand-alone entity, thus disregarding other members of the Controlled Group for coverage and nondiscrimination testing purposes. Difficulties arise in filing for a QSLOB determination with the IRS in determining who is considered the "employer" for purposes of filing the required Notice and submitting to the IRS a request for determination to satisfy administrative scrutiny. For example, if the parent company is a foreign entity, is it considered the employer and is it required to make the QSLOB application and filings?

3. Data Privacy Issues

As mentioned above, the coverage, participation and other qualification testing under the Code requires extensive employee data for all members of the Controlled Group (regardless of whether the employees are receiving U.S.-source income). When the Controlled Group includes foreign entities, this presents difficulties due to foreign rules, regulations, and customs concerning what data may be disseminated and to whom. Thus, even when U.S.-based plans are sponsored by members of a known Controlled Group, the required testing can be difficult to perform.

[65] If the Controlled Group members qualify under the statutory or regulatory safe harbors, an individual determination by the IRS is not necessary.

4. Employee Transfers

An increasing number of employees are being asked to take assignments overseas, and more U.S. citizens are being employed by foreign entities. Plan sponsors should be able to adopt a benefits strategy that does not economically disadvantage plan participants by the accrual of benefits or allocation of contributions merely due to the ownership structure of their employer and its related entities or as a consequence of their transfer of employment to a related foreign entity. However, the rules and regulations concerning such situations are confusing to plan sponsors and employers or fail to provide adequate guidance, resulting in a lack of coordination of benefit plans or, worse, disqualification.

5. IRS Presentations on Reporting and Withholding Requirements

TE/GE should coordinate with LMSB to expand its existing withholding and reporting presentations to reflect international pensions for the benefit community.

Education and outreach efforts should be designed to:

a. Increase awareness among plan sponsors of the necessity to take into consideration all members of the Controlled Group to which they belong, including foreign parent companies and any subsidiaries in the Controlled Group.

b. Increase awareness among foreign corporations that pay U.S.-based income of the necessity to make Controlled Group determinations and QSLOB applications.

c. Provide guidance on international and cross-border retirement plan issues to allow plan sponsors to adapt to and plan for an increasingly global economy and work force.

d. Make plan sponsors and employers aware of the potential consequences of transferring to a foreign entity within their employer's Controlled Group to enable them to adopt benefit plan strategies that keep employees from suffering financial harm with respect to their benefits.

F. IRS Website

The ACT suggests the following recommendations regarding the IRS website to further promote education and outreach to the various stakeholders and practitioners with respect to international pension issues:

a. Create and maintain a dedicated section of the IRS website for international pensions and include a link to that site on the general retirement plans website as well as on LMSB, W&I, and SBSE websites.

b. Create and maintain a dedicated email address for comments and questions to be submitted regarding all facets of international pensions, and post FAQs with answers.

c. Post this ACT report on the IRS retirement plans website and on any international pensions website (recommended above), along with a request for information to be submitted via the international pensions email address (recommended above) to assist IRS with its efforts in learning more about the issues raised in this report and to obtain more anecdotal examples of the problems, assistance with prioritizing the needs and additional ideas as to how needed changes can be implemented by IRS or otherwise.

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VII. CONCLUSION

There is a substantial gap in the level of assistance the IRS provides to employers compared to the level of assistance it provides to individual taxpayers regarding international pension/tax matters. This can be remedied, in part, by a unified team approach, which should include representatives of each of the IRS business units, including TE/GE Employee Plans, and representatives from the Department of Treasury.

Addressing the issues raised in this report regarding problematic sections of the Internal Revenue Code, Treasury regulations, and treaty provisions can remove impediments and improve the provision of retirement benefits by employers to a mobile and globalized workforce.

Education and outreach is critical to improving compliance in the international retirement plans arena. A task force consisting of the "owners" of the various IRS publications on international pension and tax issues should undertake a project to centralize the materials on a single IRS website, perhaps containing fewer, more topic-oriented and comprehensive publications, to replace the various materials from a variety of business units.

As with other efforts to promote tax compliance, education and outreach, and "soft contact compliance checks" should be undertaken before any significant audit projects begin with respect to international pension compliance.

This report can be utilized as a checklist, with the implementation of recommended changes serving as further steps towards fulfillment of the IRS' role in breaking down the barriers that employers and employees face in providing, administering, and reporting international pensions in compliance with U.S. tax law.

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EXHIBIT A. Information Obtained from Keyword Search - "IRS Publications International" - on IRS Website at www.irs.gov

1. International Taxpayer

This page, which can be found at www.irs.gov/businesses/small/international/index.html contains a list of IRS materials focused primarily on the individual international taxpayer. Among the items referenced on this page are the following notable links:

a. Servicewide Approach to International Tax Administration[66]

This page outlines the IRS' initiative to improve taxpayer services, enhance enforcement of tax laws, and modernize the IRS through its people, processes, and technology. The initiative appears to be geared primarily toward taxpayer services for individuals.

b. Alien Taxation – Certain Essential Concepts[67]

This page is under SBSE and provides general information about the U.S. taxation of aliens.

c. Help With Tax Questions – International Taxpayers[68]

International taxpayers are directed to this page of the IRS website to ask questions via the internet or to call a special phone number for taxpayer assistance. This web page appears to be geared primarily to individual taxpayers, not to employers or service providers who issue tax reports to the taxpayer.

d. The Internal Tax Gap Series[69]

This page contains links to monthly articles addressing the gap in the amount of tax that international taxpayers should pay as against the amount of taxes actually paid, highlighting areas of noncompliance. An article from October 2008 addresses the taxation of international pensions and annuities.

[66] Servicewide Approach to International Tax Administration (last reviewed or updated October 17, 2007) at www.irs.gov/businesses/international/article/0,,id=174834,00.html.
[67] Alien Taxation – Certain Essential Concepts (last reviewed or updated November 3. 2008) at www.irs.gov/businesses/small/international/article/0,,id=96414,00.html.
[68] Help With Tax Questions – International (last reviewed or updated November 12, 2008) at www.irs.gov/help/page/0,,id=133197,00.html.
[69] The International Tax Gap Series (last reviewed or updated April 1, 2009), at www.irs.gov/businesses/article/0,,id=180259,00.html.

2. IRS Publications

Pub. 54	Tax Guide for U.S. Citizens and Resident Aliens Abroad
Pub. 80	Circular SS - Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
Pub. 513	Tax Information for Visitors to the United States
Pub. 514	Foreign Tax Credit for Individuals
Pub. 515	Withholding of Tax on Nonresident Aliens and Foreign Entities
Pub. 516	U.S. Government Civilian Employees Stationed Abroad
Pub. 519	U.S. Tax Guide for Aliens
Pub. 570	Tax Guide for Individuals with Income from U.S. Possessions
Pub. 593	Tax Highlights for U.S. Citizens and Residents Going Abroad
Pub. 678-FS	Foreign Student and Scholar Text (2007)
Pub. 901	U.S. Tax Treaties
Pub. 1187	Specifications for Filing Form 1042-S, Foreign Persons U.S. Source Income Subject to Withholding, Electronically
Pub. 1321	Special Instructions for Bona Fide Residents of Puerto Rico Who Must File a U.S. Individual Income Tax Return (Form 1040 or 1040A) (2007)
Pub. 4732	Federal Tax Information for U.S. Taxpayers Living Abroad
Pub. 4588	Basic Tax for Green Card Holders: Understanding Your U.S. Tax Obligations

EXHIBIT B. Summary of General Rules for Federal Income Tax Withholding and Reporting on Distributions to Nonresident Aliens from Qualified Pension Plans and IRAs

The nonresident alien withholding and reporting requirements, which generally are summarized below, depend upon a number of factors: the nature and source of the payment; the status of the payee – U.S. or foreign, beneficial owner or intermediary; where the payment is made (in or outside of the United States); and where the account is held (on-shore or off-shore).

A withholding agent, such as a financial institution that makes a payment of U.S. source income (which includes U.S. qualified retirement plan and IRA distributions) to a nonresident alien, is liable to the U.S. government for the amount of tax that should have been withheld, unless an exception to withholding exists.

I. Withholding from Periodic and Nonperiodic Distributions Under Code § 3405

Unless the nonresident alien is eligible for and elects no withholding under Code § 3405, the distribution is treated for federal income tax purposes as any other retirement plan distribution and withholding applies according to the type of plan (IRA, qualified retirement plan or 403(b) plan). For IRAs, withholding is at the standard 10% rate; for qualified retirement plans, the rate is either based on the nonperiodic withholding rate of 10% or the periodic withholding tables contained in Publication 15 (including the amendments reflected in Publication 15-A under the Stimulus Act of 2009). In this case, the distribution and tax withholding is reported on IRS Form 1099-R. If a distribution is made to a U.S. Person and it is an eligible rollover distribution, the taxable portion of the distribution from a qualified retirement plan or 403(b) plan is subject to 20% mandatory withholding.

II. Electing Out of Nonresident Alien Withholding under Code § 3405

A. If a distribution is made to a nonresident alien, an election to waive the normal withholding is made by (1) filing Form W-8BEN with the payer (see "The W-8 Family of Forms" below) and (2) signing a written certification, under penalty of perjury, with the payer that the individual is not a U.S. citizen or resident alien, and is not an expatriate of the United States (one who expatriates for the principal purpose of avoiding U.S. taxes).[70]

[70] Code § 3405(e)(13)(B)(i).

B. A nonresident alien who elects out of Code § 3405 withholding is subject to withholding under Code § 1441, usually at the treaty rate or in the case of an IRA distribution normally at the rate of 30%. The distribution is reported on IRS Forms 1042-S and 1042. IRS Publication 515 (Withholding of Tax on Nonresident Aliens and Foreign Entities) contains more information about the various types of income, including retirement income, which are subject to tax withholding and explains when exemptions or reduced withholding rates apply to certain types of income.

III. Lower Treaty Rates

If a nonresident alien elects no withholding under Code § 3405 by filing Form W-8BEN and providing the statement described above, the recipient may be able to claim the treaty benefits under the country's income tax treaty with the United States. If any lower treaty rate applies (including 0%), the payments are still reportable on IRS Form 1042-S and 1042. Using the lower treaty rate is not automatic for IRAs.[71]

IV. The "W-8 Family of Forms"

Without proper documentation (the appropriate and valid applicable Form W-8), the 30% withholding rate applies. The IRS has issued the following withholding certificates referred to as the "W-8 Family of Forms":

Form Number	Name of Form	Information about the Form
W-8BEN	Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding	When this form is filed with the payer, the individual is claiming to be a foreign person and is also claiming whether or not treaty benefits apply.
W-8ECI	Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States	In general, foreign persons are subject to U.S. tax at a 30% rate on income they receive from U.S. sources. However, no withholding is required on income that is, or is deemed to be, effectively connected with the conduct of a trade or business within the United States. and is includible in the beneficial owner's gross income for the tax year.
W-8EXP	Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding	A withholding agent may treat a payee as an international organization without requiring a Form W-8EXP if the name of the payee is one designated as an international organization by Executive Order and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is an international organization.

71 *See* Part V.B.6. of this report for a discussion of treaty issues.

Form Number	Name of Form	Information about the Form
W-8IMY	Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding	A qualified intermediary, withholding foreign partnership, or a withholding foreign trust must provide the EIN that was issued to the entity in such capacity (such as its "QI-EIN", "WP-EIN" or "WT-EIN"), or otherwise the Form W-8IMY it submits is not valid.
W-8CE	Notice of Expatriation and Waiver of Treaty Benefits	To be completed by a "covered expatriate individual" as notification to the payer that special tax rates apply. The form is required if the individual has any deferred compensation accounts.

V. Duration of Form W-8BEN Validity

A Form W-8BEN provided without a Taxpayer Identification Number (TIN) remains in effect for a period that begins on the date the form is signed and ends on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. For example, a Form W-8BEN signed on September 30, 2004, remains valid through December 31, 2007.

A Form W-8BEN furnished with a TIN will remain in effect until the status of the person whose name is on the form changes, or a change in circumstances makes any information on the form incorrect, provided that the withholding agent reports on Form 1042-S at least one payment annually. Thus, a Form W-8BEN containing a TIN remains valid for as long as the filer's status and the information relevant to the filer's certification on the form remains unchanged.

A TIN is either a U.S. Social Security Number (SSN) or an Individual Tax Identification Number (ITIN). An ITIN can be obtained by a nonresident alien who either does not have or is not entitled to a SSN.

The validation process of the Form W-8BEN requires establishing foreign status (using the pension presumption rules); establishing a claim for treaty benefits; and that the form is signed and dated.

VI. Claim by Nonresident Alien for a Refund of Tax Withheld

Whether the payer withholds under Code § 3405 and files Form 1099-R reporting the retirement distribution or withholds under Code § 1441 and files Form 1042-S reporting the retirement distribution, the nonresident alien can file Form 1040-NR in order to claim a refund of taxes.

VII. IRS Amends Final Nonresident Alien Regulations to Include IRAs

On May 16, 2000, the IRS published amendments[72] to the final regulations[73] on the income tax withholding requirements on payments made to nonresident aliens. These amendments extended the "presumption rules" applicable to qualified retirement plans and 403(b) plans to IRAs described under Code § 408. Code § 408 includes traditional IRAs, SEP IRAs, and SIMPLE IRAs, but does not include Roth IRAs that are governed under Code § 408A. Although Code § 408 IRAs are now mentioned in the nonresident alien regulations, this does not necessarily change the resulting withholding on payments to a nonresident alien.

VIII. Presumption of Payment to a U.S. Person

Payments from a qualified plan, a 403(b) account, or a Code § 408 IRA that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. Person **only if**: the payee has a SSN (not just an ITIN) **and** a mailing address in the United States, or in a foreign country with which the United States has an income tax treaty in effect providing that a payee who is an individual resident in that country would be entitled to an exemption from U.S. tax on retirement plan payments. In such cases, income tax is withheld at the appropriate rate under Code § 3405, depending upon the type of plan and frequency of payments, and payments are reported on IRS Form 1099-R. Any payment that does not meet the above requirements can be presumed to be made to a foreign person, in which case income tax is withheld under Code § 1441 at the treaty rate or, if none can be identified, at a rate of 30%, and the payments are reported on IRS Form 1042-S.

For purposes of the retirement plan and IRA presumption rules, a participant with an address in one of the U.S. possessions (which include American Samoa, Guam, Northern Mariana Islands, Puerto Rico and the U.S. Virgin Islands) is treated as foreign and withholding is required at the statutory 30% NRA rate.

IX. Presumption of Foreign Status by Filing Form W-8BEN

If the payer receives from the payee a completed Form W-8BEN, the withholding agent can usually presume the payee is foreign, unless the withholding agent has reason to believe that the payee is a U.S. Person. When a Form W-8BEN is received, the withholding agent applies the 30% withholding rate. However, if the payment is from a qualified plan or a 403(b) account **and** the payee either has a SSN an ITIN, the withholding agent can apply the lower treaty rate (if any) found in the tables in IRS Publication 515 (Withholding of Tax on Nonresident Aliens and Foreign Entities).

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72 T.D. 8881, 65 Fed. Reg. 32152 (May 22, 2000), 2000-23 I.R.B. 1158.
73 T.D. 8734, 62 Fed. Reg. 53387 (October 14, 1997); 1997 I.R.B. 5.

X. Lower Treaty Rates are NOT Automatic for IRAs

Unlike distributions from qualified retirement plans or 403(b) plans, in order to apply any lower treaty rates for payments from an IRA, the treaty must specifically state that IRAs are treated as "pension income." Payers refer to IRAs being "treaty specific" for purposes of withholding under Code § 1441. Thus, If a treaty does not specifically so state or if the treaty is silent, the 30% withholding rate **cannot be reduced**, even if the payee has a SSN or ITIN. Since the payer is "responsible for the withholding," if the withholding is incorrect, the payer - not the plan - is subject to penalties, and thus most IRA payers default to the 30% withholding rate.

XI. Glossary of Terms

A. Nonresident Alien

A nonresident alien is an individual who is not a U.S. citizen or resident. A nonresident alien is not a "resident alien."

B. Resident Alien

A resident alien is an alien who meets either the green card test or the substantial presence test for the calendar year. IRS Publication 519 provides more information on resident and nonresident alien status, the tests for residence and the exceptions to them.

C. Individual Tax Identification Numbers

A Tax Identification Number (TIN) is either a U.S. Social Security Number or an Individual Tax Identification Number (ITIN). An ITIN can be obtained by a nonresident alien who either does not have or is not entitled to a U.S. Social Security Number.

D. Periodic Distributions

Periodic distributions are annuity-type payments scheduled over a period longer than one year, including installment payments, made from a qualified retirement plan, 403(b) plan or 457(b) plan. Periodic distributions (not subject to Code § 1441 of the Code) are subject to withholding as if such payments were wages, depending on the payment frequency (*i.e.*, monthly, quarterly, semi-annually or annually). Therefore, the normal wage withholding tables found in Circular E are used to determine the amount to be withheld from each plan annuity or installment payment.

The individual may indicate marital status and the number of exemptions for purposes of determining the withholding amount. If the individual fails to make such indication, the payer withholds as if the individual were married and claiming three withholding allowances.[74]

If the recipient does not provide a Social Security Number or the IRS notifies the payer (before any distribution is made) that the payee's Social Security Number is incorrect, the payer must withhold as if the payee were single and claiming no withholding allowances.

E. Nonperiodic Distributions

Nonperiodic distributions are distributions that are not periodic and are made from a qualified retirement plan, 403(b) plan, 457(b) plan or IRA. Nonperiodic distributions are subject to a flat withholding rate of 10%. All distributions from IRAs are considered to be nonperiodic. The recipient may elect to have more than 10% withheld from a nonperiodic distribution.[75]

F. Payments made Outside of the United States

Treasury Regulation § 1.1441-1(b)(3)(iii)(C) provides that for payments made outside of the United States from a qualified retirement plan, 403(b) plan, 457(b) plan or IRA for which a withholding agent (the payer) cannot reliably associate with documentation may be presumed to be made to a U.S. Person only if the withholding agent has a record of a SSN for the payee and relies on a qualifying mailing address. A qualifying mailing address is an address used for purposes of information reporting or otherwise communicating with the payee and is located (1) in the United States or (2) in a foreign country with which the United States has an income tax treaty in effect that provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts received from a retirement qualified plan.

If the payer can presume that the recipient is a U.S. Person, withholding is made in accordance with Code § 3405. Thus, if the payment is an eligible rollover distribution (as defined under Code § 402(c)(4)), mandatory withholding applies at the rate of 20%. If the payment is not an eligible rollover distribution, the voluntary withholding rules apply (10% or the rate determined by the wage tables), including the recipient's right to waive the withholding requirement. However, pursuant to Code § 3405(e)(13)(A), the recipient is not permitted to elect no withholding if the person's address is outside of the United States or is in any U.S. possession. For payments made to a nonresident alien where the payer is withholding under Code § 3405, withholding is made as if the recipient were single and claiming one withholding allowance.

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[74] Treas. Reg. § 35.3405-1, Q&A B-4.
[75] IRS Form W-4P.

Any payment from a qualified retirement plan or 403(b) plan that is not presumed made to a U.S. Person is presumed made to a foreign person. A withholding agent making a payment to a person presumed to be a foreign person may not reduce the 30% amount of withholding required under Code § 1441 on such payment unless it receives a withholding certificate.

G. Withholding Agents

A withholding agent is a person, U.S. or foreign, that has control, receipt or custody of an amount subject to withholding or who can disburse or make payments of an amount subject to withholding. A Withholding agent can be an individual, corporation, partnership, trust, association, or any other entity, including but not limited to any foreign intermediary, foreign partnership, and U.S. branches of certain foreign banks and insurance companies. In general, the person who pays (or causes to be paid) the amount subject to withholding to the foreign person (or to its agent) must withhold.

XII. Sample W-8BEN Checklist

Form W-8BEN Checklist for Pension Payments
(Use for Form Validation and Determining Presumption Rules)

Presumption Rules (Determine whether Payee is U.S. or Foreign)

Presume U.S. if both of the following are valid; otherwise presume foreign.

☐ Valid U.S. SSN

Note: Treat the following as invalid SSNs – Begins with "000," contains all zeros, ones, twos, etc., begins with a "plan number," contains alpha characters, or begins with an "8" (an SSN cannot begin with an "8" but check EINs. If an entity is a beneficiary then EIN may begin with an "8").

Also check for beneficiary status or QDRO account; the SSN may belong to another person or entity.

☐ U.S. Residence Address

Includes an address in the United States or an address in a foreign country that has an income tax treaty with the United States in effect that exempts that type of payment from U.S. tax. Refer to Presumption Rule Chart for Private and Government Plans. Does not include addresses in one of the U.S. possessions; treat these as foreign and withhold based on the appropriate treaty rate, or 30% if an IRA or treaty rate cannot be determined.

Withholding and Reporting

If both boxes are checked, this is a distribution being made to a U.S. Person and the normal pension withholding rules apply pursuant to Code §3405 and reporting is done on form 1099-R. **STOP, no further determination is required.**

If both boxes are not checked then the NRA withholding rules apply under Code §1441 and reporting is done on Form 1042-S.

Validation of Form W-8BEN

Part I of Form W-8BEN (Establish Foreign Status)

☐ Full name is indicated on Line 1 and matches the name under the pension plan.
☐ The "individual" box is checked, or if payment is made to a beneficiary the "complex trust" or "estate" box may be checked.
☐ Name and entity box information matches.
☐ The permanent address does not include a P.O. box or "in care of" address.
☐ The permanent address is a foreign address, or the permanent address is a U.S. Address but there is additional documentary evidence (written explanation is provided by payee) that would presume that the person is foreign.
☐ The mailing address is foreign (or the plan has a written foreign address), or the mailing address is a U.S. address but there is additional documentary evidence **and** a written explanation is provided by payee that would presume that the person is foreign.
☐ The distribution paperwork has a foreign address, or the distribution paperwork has a U.S. address but there is additional documentary evidence **and** a written explanation is provided by payee that would presume that the person is foreign.
☐ The country entered on the form must be spelled out and not abbreviated.

Part I Determination is ☐ U.S. ☐ Foreign

Part II – Establish Claim for Treaty Benefits

(Completed by NRA claiming Treaty Benefits)

- ☐ Box 9a is checked and a treaty county is listed. The treaty country must be spelled out not abbreviated.
- ☐ Permanent residence country is the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ Mailing address is in the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ Address on file for plan is in the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ If there are instructions in the plan file to pay amounts to an address outside the treaty country there is a written explanation provided by the payee.
- ☐ Box 9b is checked if a reduced rate of withholding under a treaty benefit is claimed.
- ☐ If required (check the most recent instructions for the list of countries that require line 10), line 10 is completed with the Treaty Article number, reduced treaty rate, identification of the income for which treaty benefits are being claimed (e.g., pension income), and an explanation of the reason the NRA meets the terms of the treaty article.
- ☐ Review and verify the Treaty Article cited. Payer is not required to verify if the "person" is entitled to this provision, only that the Treaty Article cited and the tax rate is correct.

Part II – Treaty Claim Country _________________; Rate: __________%

Part III - Does not apply to Pension Payments

Part IV – Signatures

- ☐ The form is signed and dated. The validity period is measured from the date entered.
- ☐ The form contains no additions, deletions or alterations. The capacity line is completed. If the capacity line indicates an agent, a Form 2848 or copy of another document authorizing the agent must be attached to this form. If neither is attached the form, the form is not valid.
- ☐ The form must be an original. No copies, faxes or substitute versions of Form W-8BEN may be used.
- ☐ The form is the most recent version of the Form W-8BEN.
- ☐ If form is not valid, determine status under the presumption rules. If there is any doubt, withhold at 30% and report on the Form 1042-S, not on a Form 1099-R.

Part IV - ☐ Completed properly and completely; ☐ Not completed properly and completely.

XIII. Sample Flowchart for Withholding and Reporting Determinations Under Presumption Rules for Foreign Persons and U.S. Persons

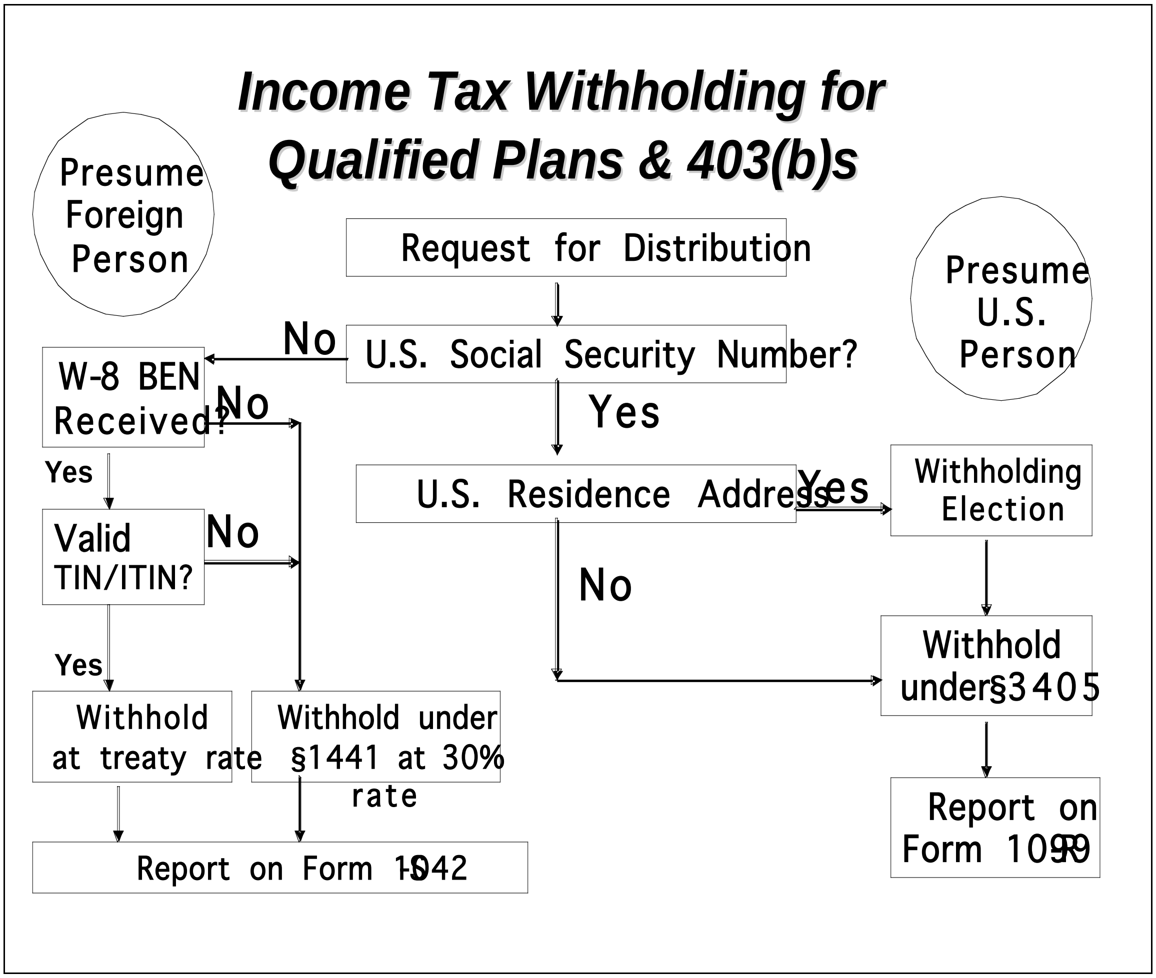

EXHIBIT C. Individuals Who Provided Input for This ACT Report

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2. Alan Tawshunsky – Deputy Division Counsel/Deputy Associate Chief Counsel (TE/GE)
3. Linda S. Marshall – Senior Technical Reviewer

B. IRS Office of Associate Chief Counsel (International)

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E. Treasury

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F. The Hacienda Project Team

1. Verina M. Sanchez – Group Manager, EP Exam, Group 7651
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G. Stakeholders

1. BenefitsLink – Dave Baker,
2. American Benefits Council
   Jan M. Jacobsen – Senior Counsel, Retirement Policy
   Carl Lerner – Retired from Pfizer
   David Powell, Esquire – Groom Law Group
   Ken Porter – was with DuPont and now is the head of the American Benefits Council new International Committee formed in 2007
3. Consultants
   James Klein of Deloitte and Touche
   Russ Hall of Towers Perrin
4. Benefits Counsel
   Michael Mazzuca – Canadian attorney
   James Starshak – Carlsmith Ball, LLP, Honolulu, HI
   Dennis R. Bonessa – Reed Smith, LLP, Pittsburgh, PA

EXHIBIT D. BenefitsLink Survey

Survey of Employee Benefits Issues in a Global Economy; September 30, 2008, Response Date

The IRS Advisory Committee on Tax Exempt and Government Entities (TE/GE) (the "ACT") is undertaking a study to identify international and cross-border activities, issues, challenges, impediments and barriers in connection with the design, coverage, portability, and tax administration of U.S. employee retirement (qualified and non-qualified) and fringe benefit plans.

As part of this effort, the ACT is particularly interested in the views of stakeholders, such as employers, administrators, trustees, custodians, practitioners and consultants regarding these issues.

While all input is welcome, the ACT is particularly interested in the challenges, barriers, and concerns, in connection with the following categories:

(1) U.S. employee benefit plans covering employees working outside of the United States, whether expatriates, seconded employees, leased employees, non-resident aliens or others with U.S. and/or foreign compensation.

(2) U.S. employee benefit plans covering foreign nationals, green card holders, resident aliens, or others on temporary visas or assignments (such as clergy, ambassadors, speakers) working in the United States.

(3) Coverage issues, such as controlled groups and separate lines of business, compensation definitions and discrimination testing, involving U.S. subsidiaries with foreign parents or U.S. companies with foreign operations.

(4) Reporting, withholding and other special issues relating to Puerto Rico and other U.S. possessions and territories, after Rev. Rul. 2008-40.

(5) Reporting and withholding on contributions and distributions, double taxation, treaties, rollovers and other tax related issues.

To shape the direction of the ACT's further analysis and recommendations, we would appreciate your input by September 30, 2008. In the space provided below, please enter all information that you feel would be helpful. If you would be willing to participate in further discussion by conference call or attend a stakeholders' meeting in Washington, DC, in October 2008 or January 2009, please indicate your interest and provide contact information.

After you have entered your comments below (in this Microsoft Word document), please send the revised document to the ACT ***on or before October 22, 2008,*** by emailing it to actsurvey@penserv.com

As members of the ACT, we greatly appreciate your assistance with this project.

Susan D. Diehl	*(215) 444-9812*
Dodi Walker Gross	*(412) 288-4132*
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Michael M. Spickard	(330) 644-2044; ext 201
Marcia S. Wagner	(617) 357-5200

Please enter comments below – no limit as to length; include as many pages as you'd like -- and send the revised document to 4 or before October 22, 2008. Thank you!

EXHIBIT E. Specimen for IRS Publication and/or Posting on IRS Website

U.S. Tax-Qualified Retirement Plans: Cross-Border Transactions

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U.S. Tax-Qualified Retirement Plans: Cross-Border Transactions

I. Introduction

This primer addresses the U.S. income tax consequences for (1) U.S. citizens or resident aliens who remain covered under a U.S. tax-qualified retirement plan ("U.S. qualified plan") even though they have been transferred to work in another country ("outbound workers") and (2) nonresident aliens who are transferred from another country to work in the United States and are covered by a U.S. qualified plan ("inbound workers").[76] For purposes of this discussion, all employer plans are included (Code § 401(a) qualified plans, 403(b) plans and 457(b) plans) in the reference to U.S. qualified plans.

After discussing the eligibility of these workers to participate in a U.S. qualified plan, other issues are presented based on the plan's four basic income tax advantages:

- The employer can currently deduct contributions to the plan;
- The workers are not currently taxed on the contributions to the plan or, in the case of defined benefit plans, benefits that accrued under the plan;
- The trust or other funding vehicle (e.g., group annuity contract) is not taxed on investment earnings that accumulate under the plan; and
- The workers are generally taxed when they receive distributions from the plan, although the distributions may be entitled to further favorable income tax treatment (e.g., tax-free rollover to an IRA (individual retirement arrangement)).

Each of these four tax advantages are conditioned upon the U.S. qualified plan's compliance with numerous requirements in the Internal Revenue Code of 1986, as amended (the "Code"). However, this primer focuses on those U.S. requirements that apply to cross-border transactions involving outbound and inbound workers, including illustrations of the requirements under bilateral income tax treaties with foreign countries.

Although the focus is on U.S. requirements, the primer also discusses conceptually similar foreign law requirements that might apply to outbound and inbound workers covered by U.S. qualified plans.

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[76] For a more detailed analysis of these and other international transactions (*e.g.*, covering outbound workers in a foreign retirement plan), see Hall, Woyke & Klein, *International Pension Planning* (2003) (Tax Management Portfolios 320-2nd).

II. Outbound Workers

A. Eligibility to Participate

1. Exclusive Benefit Rule

A U.S. qualified plan must be maintained for the exclusive benefit of employees of the employer sponsoring the plan.[77] Thus, it would initially appear that a U.S. qualified plan could not cover an employee transferred to a foreign country to work for an affiliated employer without including all employees of such affiliate. Of course, the exclusive benefit rule would not create a problem if the employer sponsoring the plan merely opens a branch—in contrast to creating a subsidiary or other separate business entity—in the foreign country.

2. Code §§ 406 and 407 – Foreign Affiliates and Domestic Subsidiaries

Prior to ERISA and the addition of Code §§ 414(b) and (c), the problem created by the exclusive benefit rule was initially addressed by Code §§ 406 and 407, which were added to the Code in 1963. Code § 406 enables an American employer[78] to treat U.S. citizens or resident aliens employed by its foreign affiliate[79] as its employees for tax-qualification purposes if certain conditions are met. Similarly, Code § 407 enables a parent corporation with a domestic subsidiary[80] doing business outside the United States to treat U.S. citizens or resident aliens employed by its domestic subsidiary as its employees if certain conditions are met.

Code § 406 Conditions. Code § 406 imposes the following conditions:

- The U.S. qualified plan document must expressly cover U.S. citizens or resident aliens working for a foreign affiliate.
- Contributions cannot be made to another funded plan for these workers, even if it is not a U.S. qualified plan, with respect to their compensation from the foreign affiliate.

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77 Code § 401(a).

78 Code § 406 defines an "American employer" by reference to Code § 3121(h). For a corporation, it means being organized under the laws of the United States or of any state. See discussion of Code §§ 414(b) and (c) under II.A.3.

79 A "foreign affiliate" is a foreign entity in which the American employer owns a 10% or more interest. Code § 406 incorporates this definition by reference to Code § 3121(l)(6). Code § 406 would be available to a U.S. subsidiary of a foreign parent corporation only in the highly unlikely event that the U.S subsidiary owned a 10% or more interest in the foreign parent corporation.

80 Code § 407(a)(2) requires a U.S. parent corporation to own at least 80% of the domestic subsidiary's voting stock. Also, at least 95% of the domestic subsidiary's gross income over a three-year period must be derived from sources outside the United States.

- A Code § 3121(l) Social Security agreement must cover the U.S. citizens or resident aliens working for the foreign affiliate.[81]

- The U.S. qualified plan must cover all the U.S. citizens and resident aliens covered under the Social Security agreement.

Under a Social Security coverage agreement, an American employer can agree to cover U.S. citizens and resident aliens under Social Security, even if they are working for a foreign affiliated employer in a foreign country. With respect to each foreign affiliate, however, the American employer can choose only to cover either none or all of these workers under a Social Security coverage agreement.[82] As a result, Code § 406 does not allow an American employer to select which U.S. citizens or resident aliens to cover under its U.S. qualified plan. If the foreign affiliate is covered under a Social Security coverage agreement, then § 406 requires the U.S. qualified plan to cover all of its U.S. citizens and resident aliens.

Code § 407 Conditions. Code § 407 imposes the following conditions:

- The U.S. qualified plan must expressly cover U.S. citizens or resident aliens working for the domestic subsidiary doing business in a foreign country;

- Contributions cannot be made to another funded plan for these workers, even if it is not a U.S. qualified plan, with respect to their compensation from the domestic subsidiary; and

- The U.S. qualified plan must cover all the U.S. citizens or resident aliens working for each domestic subsidiary.

The Code § 407 regulations explicitly require that the U.S. qualified plan apply to every domestic subsidiary of the U.S. parent.[83] Thus, Code § 407 does not allow the U.S. parent corporation to select the U.S. citizens or resident aliens working for domestic subsidiaries who will be covered under its U.S. tax qualified retirement plan.

Because of the Code §§ 406 and 407 restrictive conditions, many employers comply with the exclusive benefit rule by relying on the controlled group rules under Code §§ 414(b) and (c), which do not impose similar conditions.

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81 If the United States has a Social Security totalization agreement with the foreign country where the foreign affiliate is doing business, Social Security taxes are paid only to one country.

82 A Social Security coverage agreement is filed using IRS Form 2032.

83 Treas. Reg. 1.407-1(b)(1)(i).

3. Code §§ 414(b) and (c) – Controlled Group Rules

Code §§ 414(b) and (c) controlled group rules were enacted in 1974 primarily to supplement the nondiscrimination rules for U.S. qualified plans. Nevertheless, Code § 414 became another solution to the exclusive benefit rule because:

- Code §§ 414(b) and (c) treat all employees of the members of a controlled group as if they were employed by a single employer when applying the nondiscrimination rules and certain other tax-qualification rules, including the exclusive benefit rule.[84]
- Foreign members can be part of an employer's controlled group.[85]

Relying on Code §§ 414(b) and (c), instead of Code §§ 406 or 407, enables a U.S. qualified plan to selectively cover U.S. citizens or resident aliens working in a foreign country as long as the selective coverage does not violate the nondiscrimination rules or applicable minimum standards (e.g., minimum participation standard under Code § 401(a)(26)). However, the nondiscrimination rules and minimum standards apply on a controlled group basis (i.e., all employees of the controlled group are treated as employed by a single employer). Thus, if a U.S. qualified plan would otherwise satisfy these requirements on a controlled group basis, the plan will continue to satisfy these requirements in the vast majority of cases, even if U.S. citizens or resident aliens working in a foreign country are selectively covered.

As suggested by the plan document requirement under Code §§ 406 and 407, the plan document for a U.S. qualified plan relying on the controlled group rules to satisfy the exclusive benefit rule must accurately describe the U.S. citizens or resident aliens working in a foreign country who are covered by the plan. Otherwise, the plan will fail the most basic tax-qualification requirement—it must be administered in accordance with the terms of the plan document.

4. Code § 414(n) – Leased Employees

Another solution to the exclusive benefit rule is a leasing arrangement under which the U.S. citizens or resident aliens working in a foreign country remain employees of the U.S. employer but are leased to the employer in the foreign country.

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84 In Private Letter Ruling 8228116 (April 19, 1982), the IRS ruled that a parent corporation's U.S qualified plan could cover nonresident aliens employed by one of its foreign subsidiaries that was part of the parent corporation's controlled group. In Private Letter Ruling 8144028 (August 4, 1981), the IRS ruled that a U.S. qualified plan could selectively cover certain highly compensated nonresident alien employees not earning U.S. source income.

85 In *Fujinon Optical, Inc. v. Commissioner*, 76 T.C. 499 (1981), the U.S. Tax Court ruled that a U.S. subsidiary's qualified plan discriminated in favor of highly compensated employees, even though it covered all employees satisfying the plan's minimum age and service requirements, because employees of other U.S. subsidiaries of the same foreign parent were excluded from the plan.

Technically, Code § 414(n) would require the foreign employer to treat these workers as employees not only of the U.S. employer but also of the foreign employer in determining whether the foreign employer's U.S. qualified plan, if any, discriminates in favor of its highly compensated employees. Because the foreign employer is highly unlikely to sponsor a U.S. qualified plan, however, the foreign employer's treatment of the leased workers as employees for tax-qualification purposes is almost irrelevant. The important point is that the leased worker remains an employee of the U.S. employer for exclusive benefit rule purposes.

Under Code § 414(n), a worker would be a leased employee of the foreign employer if the worker is not a common law employee of the foreign employer and all three parts of the following test are satisfied:[86]

- The worker performs services for the foreign employer pursuant to an agreement between the foreign employer and the U.S. employer;
- The worker performs services for the foreign employer on a substantially full-time basis for at least one year; and
- The worker is subject to the primary direction or control of the foreign employer.

A worker would be treated as a common law employee of the foreign employer if the foreign employer has the right to direct and control the worker's activities.[87] Thus, the U.S. employer must retain in the leasing agreement the right to discharge the worker and the right to direct and control the worker's activities, subject to the foreign employer's contractual right under the leasing agreement to direct and control the worker's activities.

It should be noted, however, that a leasing arrangement could create a foreign law compliance problem if the foreign country where the leased worker is performing the services determines that the U.S. employer is doing business in the foreign country. Thus, a leasing arrangement might require the U.S. employer to comply with the foreign country's rules for doing business in the country.

5. Definition of "Compensation"

When a U.S. qualified plan is amended to address the eligibility of U.S. citizens and resident aliens working for an employer in a foreign country to participate in the plan, the plan document should also address the compensation of these workers that will be taken into account in operating the plan. Recently published regulations under Code § 415 clarify that compensation paid to a worker for services performed outside the United States can be compensation for Code § 415 purposes, even though the

[86] Code § 414(n)(2).
[87] Rev. Rul. 87-41, 1987-1 C.B. 296 (January 1987).

compensation is not included in the worker's U.S. gross income on account of the location of the services.[88]

The critical issue is how the U.S. qualified plan defines compensation for benefit calculation purposes. The definition of compensation could take into account foreign housing subsidies, cost of living allowance or similar compensation elements. The question is whether the plan's compensation definition should include all or any of these compensation elements.

If the U.S. citizens or resident aliens working for an employer in a foreign country are paid in that country's currency, then the timing of conversion of the compensation to U.S. dollars is also an issue. The plan document should specify that the currency conversion will be as of a specified date during the year in which the compensation is earned (e.g., December 31), not when contributions are made to a defined contribution plan or when benefits are calculated under a defined benefit plan.

B. Employer Tax Deduction

Several methods are available for a U.S. qualified plan to cover U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring the plan. However, whether employer contributions to these employee plans can be deducted and which entity is entitled to the deduction are issues separate from the issue of whether these workers are eligible to participate in the U.S. qualified plan.

As a general rule, an employer cannot deduct compensation paid on behalf of an employee of another employer, even if both employers are members of the same controlled group.[89] The following discussion explains the conditions imposed on the exceptions to the general rule.[90]

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88 Treas. Reg. § 1.415(c)-2(g)(5) Foreign Compensation, published at 72 Fed. Reg. 16877, 16918-16919 (April 5, 2007). However, the Code § 415 regulations do not authorize salary reduction for Code § 401(k) purposes. Thus, a 401(k) plan sponsor would have to make contributions on behalf of the U.S. citizens or resident aliens working for a foreign employer. Also, 415 compensation for 403(b) plan purposes is limited to includible compensation under Code § 403(b).

89 In *Transamerica Corp. v. United States*, 7 Cl. Ct. 119 (1984), the U.S. Court of Claims held that a parent corporation could not deduct stock option compensation paid to an employee of its subsidiary. In *Young & Rubicam, Inc. v. United States*, 187 Cl. Ct. 635 (1969), the court held that an employer could not deduct salaries and other related compensation (*e.g.*, profit sharing plan contributions) paid for workers temporarily transferred to its foreign subsidiaries for six months to two years.

90 If the U.S. citizens or resident aliens working in a foreign country are leased to the employer in the foreign country but remain employees of the U.S. employer, then the U.S. employer is permitted to deduct contributions made on behalf of the leased employees.

1. Code § 406 – Foreign Affiliates

Code § 406(d) allows the foreign affiliate, not the U.S. employer, to deduct the contributions made on behalf of the U.S. citizen or resident employees working for the foreign affiliate, even though the U.S. employer actually makes the contribution to the U.S. qualified plan. Thus, the deduction is valuable only if the foreign affiliate is subject to U.S. income taxes (e.g., because it has U.S. source income).

2. Code § 407 – Domestic Subsidiaries

Code § 407(d) also allows the domestic subsidiary doing business in a foreign country, rather than the U.S. employer, to deduct the contributions made on behalf of U.S. citizen or resident aliens working for the domestic subsidiary, even though the U.S. employer actually makes the contribution to the U.S. qualified plan. Unlike the § 406 deduction, however, the domestic subsidiary can apply the deduction, regardless of its source of income.

3. Code § 414(b) and (c) – Controlled Group Rules

The controlled group rules under Code § 414(b) and (c) do not allow one member of a controlled group to deduct contributions to U.S. qualified plan made on behalf of another member of the controlled group.[91] The controlled group principle that treats all employees of the members of a controlled group as if they were employed by a single employer does not apply to the deductibility of plan contributions.

The Code § 406 regulations suggest that the contributing parent corporation making the nondeductible contribution can treat the plan contribution as a contribution to capital to the extent those plan contributions are not reimbursed.[92] If the parent corporation is reimbursed by the subsidiary employing the workers on whose behalf the plan contributions are made, then the parent corporation has no income tax consequences. The subsidiary generally is permitted to deduct the reimbursement to the contributing employer as a compensation expense.[93]

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91 Code §§ 414(b) and (c) specifically exclude their applicability to Code § 404. Code § 404(a)(3)(B) does allow a member of an affiliated group to deduct contributions on behalf of an unprofitable member of the affiliated group, if that member's contributions are contingent upon current or accumulated profits. This minor exception proves the general rule.

92 Treas. Reg. § 1.406-1(e)(3) ("[A]n unreimbursed contribution by the domestic corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.").

93 Rev. Rul. 84-68, 1984-1 C.B. 3 (January 1984) ("Because the parent's payment of cash bonuses to its subsidiary's employees is treated as a contribution to the subsidiary's capital accompanied by constructive payment by the subsidiary of the cash bonuses to its employees, the cash bonuses may be deducted by the subsidiary under section 162 of the

4. Excise Tax on Nondeductible Contributions

Code § 4972 imposes a 10% excise tax on an employer making contributions in excess of the amount allowable as a deductible contribution to a U.S. qualified plan. However, the IRS has ruled that this 10% excise tax does not automatically apply to employers making nondeductible contributions to a U.S. qualified plan for U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring the plan.[94] According to the ruling, the 10% excise tax is focused not on nondeductible contributions but on contributions exceeding the deductible limit (i.e., the amount allowable as a deduction). Thus, if the nondeductible contributions do not exceed the deductible limit (assuming the nondeductible contributions were deductible), then the 10% excise tax does not apply.

C. Employee Taxation on Contributions or Accruals

U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring a U.S. qualified plan, but covered by a U.S. affiliate's qualified plan, will not be currently taxed in the United States on contributions under a defined contribution plan or on accruals under a defined benefit plan. However, the foreign country may impose income taxes on these workers for the contributions or accruals under the U.S. qualified plan.

Some U.S. bilateral income tax treaties with foreign countries provide relief for these workers from foreign income taxes on contributions and accruals under the U.S. qualified plan. For example, the 2004 U.S.-France Income Tax Treaty[95] provides that contributions or accruals under the U.S. qualified plan are not taxable to the employee in France. However, the income tax relief in France is limited to the amount that could be contributed under a "generally corresponding" French retirement plan. The relief is also conditioned upon the employee participating in the U.S. qualified plan before working in France. Article 19 of the 2006 Model Income Tax Treaty has similar provisions.[96]

Code . . . ."). Revenue Ruling 84-68 relies on *Anderson v. Commissioner*, 67 T.C. 522 (1976), *aff'd* 583 F.2d 953 (7th Cir. 1978).

[94] Private Letter Ruling 200211050 (December 19, 2001).

[95] *See* Paragraph 2 of revised Article 18 as stated in the Protocol Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital ("2004 U.S.-France Tax Treaty"), Article III (restating Article 18 of the 1994 U.S.-France Income Tax Treaty in its entirety). The 1994 U.S.-France Income Tax Treaty, the 2004 U.S.-France Tax Treaty, and their technical explanations are available at http://www.irs.gov/businesses/international/article/0,,id=169505,00.html.

[96] United States Model Income Tax Convention of November 15, 2006 ("2006 Model Income Tax Treaty").The model treaty and its technical explanation are available at http://www.irs.gov/businesses/small/international/article/0,,id=164686,00.html.

D. Tax-Free Investment Earnings for Trusts

1. Domestic Trusts

Code § 401(a) requires that the trust for a U.S. qualified plan be maintained in the United States as a domestic trust.[97] In order to be considered a domestic trust, Code § 7701(a)(30)(E)—defining a domestic trust—requires that a U.S. court have jurisdiction over the trust.

The status of a trust as domestic or foreign becomes an issue when a trust has individuals as trustees and one or more of them are not U.S. citizens, or where one or more fiduciaries with control over the appointment of an institutional trustee, such as members of the plan sponsor's board of directors, are not U.S. citizens. In these situations, the "control" test in Code § 7701(a)(30)(E) may not be met because the U.S. trustees may not be able to "control all substantial decisions" of the trust.[98]

2. Investment Earnings of Domestic Trusts

The tax-free treatment of investment earnings on plan assets held in trust for a U.S. qualified plan is not affected by covering U.S. citizens or resident aliens working in a foreign country for an affiliated employer not sponsoring the plan but covered by a U.S. affiliate's qualified plan. As explained below, however, the U.S. income tax treatment of those investment earnings when distributed will vary depending on where the U.S. citizen or resident alien resides when the U.S. qualified plan makes a distribution.

3. Foreign Country Taxation

A separate issue is whether the foreign country will impose income tax on the U.S. citizens or resident aliens for their share of the U.S. qualified plan's investment earnings. For example, the 2004 U.S.-France income tax treaty provides relief in France only for U.S. citizens or resident aliens working in France that do not obtain citizenship or immigrant status in France.[99]

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97 *See also* Treas. Reg. § 1.401-1(a)(3)(i) ("a qualified trust under section 401(a) . . . must be created or organized in the United States . . . and it must be maintained at all times as a domestic trust in the United States . . . ").

98 Treas. Reg. § 301.7701-7(d)(1)(iv) ("[T]he trusts . . . are deemed to satisfy the control test . . . provided that United States trustees control all of the substantial decisions made by the trustees of the trust . . . .").

99 *See* Department of the Treasury Technical Explanation of the Protocol Between the United States of America and the French Republic Signed at Washington on December 8, 2004, available at http://www.irs.gov/businesses/international/article/0,,id=169505,00.html. The Technical Explanation describes Article 18's relationship to other articles and provides an example going in the other direction: "[A] U.S. resident (who is not a citizen or a green card holder) who is a beneficiary of a French pension plan will not be subject to tax in the United States on the earnings and accretions of, or the contributions made to, a French exempt pension trust with respect to that U.S. resident.."

E. Employee Taxation on Distributions

1. Background

If U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring a U.S. qualified plan, but covered by a U.S. affiliate's qualified plan, return to the United States before the plan makes distributions to them, no special issues arise regarding the income tax treatment of their distributions. However, if they are residing in a foreign country when the distributions are made, special rules apply.[100]

Regardless of where they reside, U.S. citizens and resident aliens are generally taxed in the United States on their worldwide income (i.e., regardless of whether the source of the income is within or outside the United States). Thus, qualified plan distributions to U.S. citizens and resident aliens are potentially subject to double taxation—in the United States and in the foreign country of residence at the time of the distribution.

2. Treaties

Some U.S. bilateral income tax treaties with foreign countries provide relief from foreign income taxes. For example, the 2004 U.S.-France income tax treaty[101] provides that distributions from a U.S. qualified plan are taxable only in the United States. This relief applies to both periodic and lump sum payments. On the other hand, many other income tax treaties provide relief from double income taxation by allowing only the foreign country where such U.S. citizens or resident aliens reside to impose the income tax.[102]

3. Withholding

Code § 3405(a)(2) generally allows U.S. citizens and resident aliens to elect out of withholding on retirement plan distributions. However, Code § 3405(e)(13) specifically bars the election for any distribution delivered outside the United States. The bar is lifted only if the recipient of the distribution certifies to the payer that (a) the recipient is not a U.S. citizen or is not a resident alien of the United States or (b) the recipient is not a nonresident alien expatriated from the United States to avoid taxes as described in Code § 877.

Consistent with Code § 3405(a)(2), Form W-4P[103] allows U.S. citizens, resident aliens, or their estates who are recipients of retirement plan distributions to elect out of withholding or to specify the amount of withholding. The Form W-4P

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[100] These special rules will also apply if these U.S citizens or resident aliens never left the United States until they moved to another country and then begin receiving distributions from the plan.

[101] *See* Article 18, Paragraph 1, as amended and restated in the 2004 U.S.-France Income Tax Treaty, Article 3, Paragraph 1.

[102] *See* 2006 Model Income Tax Treaty, Article 17, Paragraph 1.

[103] Withholding Certificate for Pension or Annuity Payments.

instructions[104] reflect the Code § 3405(e)(13) bar on distributions delivered outside the United States and the treatment of nonresident aliens:

> Unless you are a nonresident alien, withholding (in the manner described above) is required on any periodic or nonperiodic payments that are delivered to you outside the United States or its possessions. . . A foreign person should submit Form W-8BEN, Certificate of Foreign Status of Beneficiary Owner for United States Tax Withholding, to the payer before receiving any payments.

As explained below, nonresident aliens are subject to the Code § 1441 withholding rules, not the Code § 3405 withholding rules. Nonresident aliens would file the Form W-8BEN[105] or Form 8233[106] to claim relief from the Code § 1441 withholding rules, for example, if a tax treaty exempts their retirement plan distributions from income and withholding taxes.[107]

III. Inbound Workers

A. Eligibility to Participate, Employer Tax Deduction, Employee Taxation on Contributions or Accruals, and Tax-Free Investment Earnings for Trust

The host of issues identified in the previous section for outbound workers do not generally apply to inbound workers because they are employees of the employer sponsoring the U.S. qualified plan, even though they are foreign nationals instead of U.S. citizens or resident aliens. For example, their eligibility to participate[108] in a U.S. qualified plan and their employer's ability to deduct contributions to the plan generally will not create issues. The foreign nationals also need not be concerned about U.S. income taxes either on (1) the contributions to a defined contribution plan or accruals under a defined benefit plan or (2) the plan's investment earnings.

Foreign nationals potentially have a concern about their foreign country imposing income taxes on their contributions or accruals or their share of the plan's investment earnings. However, the foreign nationals may be eligible for income

[104] See Page 4 of 2009 Form W-4P.

[105] Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding.

[106] Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.

[107] The Form W-4P instructions suggest that the recipient of a retirement plan distribution who files a Form W-8BEN would be certifying that the recipient is not a U.S. citizen or is not a resident alien of the United States. The Form W-4P instructions do not address the other certification available under the statute (i.e., the recipient is not a nonresident alien expatriated from the United States to avoid taxes as described in Code § 877). The Form W-4P instructions seem to make the prior guidance in Notice 87-7, 1987-C.B. 420, obsolete.

[108] Without any adverse effect under the nondiscrimination rules, Code § 410(b)(3)(C) allows a U.S. qualified plan to exclude nonresident aliens working outside the United States. The plan's eligibility provisions should be reviewed to ensure that nonresident aliens working in the United States are not also excluded.

tax relief in their foreign country under an income tax treaty with the United States. This would be the reciprocal income tax relief under the same treaty provisions explained above for outbound workers.

B. Employee Taxation on Distributions

The employee tax treatment for distributions from a U.S. qualified plan to foreign nationals is different and more complex than distributions to U.S. citizens or resident aliens. When foreign nationals return to their foreign country, they become nonresident aliens from the U.S. point of view (unless they continue to hold a green card). The following discussion addresses the issues raised by distributions to these nonresident aliens.

1. U.S. Source Income

Code § 861(a)(3) states that compensation earned by a nonresident alien while working within the United States is U.S. source income.[109] Based on Code § 861(a)(3), the IRS has ruled that the portion of a plan distribution attributable to employer contributions earned by a nonresident alien while working within the United States is U.S. source income.[110] The IRS has also ruled that the portion of a plan distribution representing investment earnings is U.S. source income, even if the entire plan distribution is attributable to employer contributions earned by the nonresident while working outside the United States.[111]

2. Effectively Connected Income

The portion of a distribution attributable to employer contributions is "effectively connected" to the United States and, therefore, is generally subject to the Code § 1 graduated income tax rates, as provided in Code § 871(b). However, the portion of the distribution attributable to investment earnings is "not effectively connected" to the United States and, thus, is generally subject to the Code § 871(a) 30% flat rate tax.[112]

Code § 864(c)(6) states that income is effectively connected to the United States in the year that it is received if it would have been effectively connected to the United States in the year to which it is attributable. Thus, a plan distribution received by a nonresident alien that is attributable to employer contributions earned for services he performed within the United States is effectively connected in the year received. This rule applies even if the nonresident alien is no longer performing services in the United States.[113]

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[109] Conversely, Code § 862(a)(3) states that compensation earned by a nonresident alien working outside the United States is not U.S. source income.
[110] Rev. Rul. 56-82, 1956-1 C.B. 59 (January 1956).
[111] Rev. Rul. 56-125, 1956-1 C.B. 627 (January 1956); Rev. Rul. 79-388, 1979-2 C.B. 270 (July 1979); Rev. Rul. 79-389, 1979-2 C.B. 281 (July 1979).
[112] Private Letter Ruling 8904035 (October 31, 1988).
[113] *Id.*

3. Sourcing Rule for Defined Benefit Plan Distributions

Revenue Procedure 2004-37 provides guidance on determining the source of a defined benefit plan distribution to a nonresident alien.[114] First, the guidance describes how to determine the total amount of employer contributions deemed to have been made on behalf of a plan participant. It then describes how to apportion those contributions to services performed outside the United States. Finally, it states that the distribution is U.S. source income to the extent the amount is not attributable to employer contributions for services performed outside of the United States.[115]

The total amount of contributions is based primarily on the number of years that a nonresident has participated in the plan and the present value of the plan participant's pension on the annuity starting date. If the pension is paid as a lump sum, the present value is the lump sum amount. If the pension is paid in the form of a straight life annuity, a table is used to determine the present value. If the pension is not paid as a lump sum or straight life annuity, the present value is determined on the annuity starting date based on a 7% interest rate and the mortality rate in Revenue Ruling 2001-62.

Once total employer contributions have been determined, the procedure apportions the contributions to service performed outside of the United States based on the ratio of the number of months credited under the plan for services performed outside of the United States to the total number of months of credited service under the plan. A special adjustment applies to distributions from defined benefit plans that are partially funded with after-tax employee contributions.

Conspicuous by its absence from the procedure is guidance for determining the portion of a distribution that is effectively connected with the United States. By failing to provide this guidance, the IRS is effectively requiring withholding[116] at the 30% flat rate for both employer contributions for services performed within the United States and the investment earnings, rather than allowing withholding at the graduated income tax rates for the portion of the distribution constituting effectively connected income because it is attributable to employer contributions for service within the United States

[114] Rev. Proc. 2004-37, 2004-26 I.R.B. 1099 (June 28, 2004).

[115] The IRS has not published guidance for defined contribution plans, presumably because tracing the sources (*i.e.*, investment earnings and contributions for resources within and outside the United States) is more administratively practicable for a defined contribution plan than for a defined benefit plan.

[116] The withholding rules for distributions to nonresident aliens are discussed below.

4. Annuity Distributions

If a nonresident alien receives a distribution from a U.S. qualified plan in the form of an annuity, Code § 871(f) states the distribution to a nonresident alien is excludable from gross income if:

- 90% or more of the employees under the plan are U.S. citizens or residents at the time the distribution begins, and

- The benefits are attributable to services that were either:

    - performed outside the United States by a nonresident alien, or

    - performed within the United States for a foreign employer by a nonresident alien who was temporarily present in the United States for a period (or periods) not exceeding 90 days during the taxable year and whose compensation for such services did not exceed $3,000.

5. Income Tax Treaty Relief

Many U.S. bilateral income tax treaties provide relief from double income taxation by allowing only the foreign country where the nonresident alien resides to impose an income tax on distributions from U.S. qualified plans.[117] Thus, nonresident aliens returning to their foreign country with such a treaty would not be subject to U.S. income tax on their U.S. qualified plan distributions.

6. Withholding and Rollovers

Code § 1441 generally requires payers to withhold the 30% (or the treaty rate, if less) of income payable to nonresident aliens. As a result, distributions from U.S. qualified plans are subject to withholding under Code § 1441.[118] Indeed, the Code § 1441 regulations[119] explicitly state that Code § 3405 does not apply to any distribution subject to withholding under Code § 1441.

The entire distribution from a U.S. qualified plan to a nonresident alien is subject to 30% (or the treaty rate, if less) withholding, even if a portion of the distribution is attributable to employer contributions for services within the United States and, thus, effectively connected to the United States and subject to U.S. graduated income tax rates. As result, if a nonresident alien's graduated income tax rate is

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[117] *See* 2006 Model Income Tax Treaty, Article 17, Paragraph 1.

[118] Pursuant to Code § 1441(c)(4), IRS regulations exempt from 30% withholding compensation for services that is "effectively connected" to the U.S. In addition, regulations that applied prior to 2001 allowed a nonresident alien to elect withholding under the graduated income tax rates to avoid the 30% flat tax rate withholding, even though only the portion of the distribution attributable to employer contributions for services within the United States was effectively connected to the United States. *See* Preamble to Proposed Treas. Reg. § 1.1441-4, 61 Fed. Reg. 17614 (April 22, 1996) (discussing Treas. Reg. § 1.1441-4T(b)(ii)).

[119] Treas. Reg. § 1.1441-4(b)(1)(ii).

lower (or higher) than the 30% flat withholding rate, the nonresident alien must file Form 1040 NR[120] to claim a refund (or pay additional tax).

If a nonresident alien qualifies for U.S. income tax relief, or a reduced U.S. income tax rate, under a treaty, then the nonresident alien must file Form 8233[121] with the plan administrator to claim an exemption from U.S. income tax withholding. If the nonresident alien is claiming an annuity distribution is exempt from U.S. income tax under Code § 871(f), the nonresident alien must file Form W-8BEN[122] with the plan administrator. Form W-8BEN should also be filed instead of Form 8233 when a distribution is subject to U.S. income tax solely because of the investment earnings (i.e., no portion of the distribution is attributable to employer contributions for services within the United States).

A distribution from a U.S. qualified plan is subject to the 30% flat withholding rate if the recipient does not have a U.S. social security number for the recipient or if the recipient's address is in a foreign country without an income tax treaty that would exempt the distribution from U.S. income tax.[123]

Nonresident aliens can elect to rollover eligible distributions to an IRA and avoid income taxation and the 30% withholding under Code §§ 3405 and 1441 if certain requirements are met. The rationale for the ruling is:

> The primary reason for imposing withholding tax at the source on distributions to NRAs and U.S. citizens abroad is that it may be difficult or impossible to collect the tax once the income is out of the United States. This concern is addressed, however, if a qualified plan distribution is rolled over to an IRA. An IRA must be established in the United States and must have a United States trustee. Thus, withholding tax should be imposed later, as the IRA proceeds are distributed.[124]

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[120] U.S. Nonresident Alien Income Tax Return.
[121] Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.
[122] Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding.
[123] Treas. Reg. § 1.1441-1(b)(3)(iii)(C).
[124] Private Letter Ruling 9206015 (November 7, 1991).

EXHIBIT F. Sample of Frequently Asked Questions on Taxation of Distributions from U.S. and Guam Pension Plans covering Guam and Mariana Islands Residents

Background

There are many complex issues facing pension plans and taxpayers based in or doing business in Guam. The following examples of typical problematic scenarios and proposed questions and answers are intended to assist the IRS in creating an educational posting on its website.

Example 1 – U.S. Plans with Participants in Guam

Company X, a U.S. domestic corporation, sponsors a 401(k) profit sharing plan. Bank and Trust, a U.S. Bank serves as Trustee for the 401(k) profit sharing plan. Company X opened an office in Guam and transferred employee Manager to Guam. The 401(k) profit sharing plan allows the employees of Company X based in Guam to participate in the 401(k) profit sharing plan. Manager participates in the 401(k) profit sharing plan. Bank and Trust does not do business in Guam.

Manager retires and moves to Hawaii. After relocating to Hawaii, he takes a lump sum distribution from the 401(k) profit sharing plan and does not roll the distribution over to an IRA or other qualified plan. The distribution is subject to the mandatory 20% withholding under Code § 3405.

Q1. What portion of the distribution is subject to the Guam income tax?

A1. The amount subject to the Guam income tax is the amount of elective deferrals made by Manager while working in Guam and the amount of Company X profit sharing contributions made on behalf of Manager while working in Guam. See Rev. Rul. 2008-40; Rev. Rul. 79-388; Rev. Proc. 2004-37.

Q2. What portion of the distribution is subject to U.S. income taxes?

A2. All of the distribution not subject to Guam income tax will be subject to U.S. income tax. See Rev. Rul. 2008-40; Rev. Rul. 79-388; Rev. Proc. 2004-37.

Q3. Does Bank and Trust pay any portion of the withholding on the distribution to Guam?

A3. Pursuant to Code § 3405(d), the withholding should be paid to the IRS. The plan was qualified with the IRS. The Internal Revenue Code applies. There is no provision to pay the withholding to any agency other than the IRS.

Q4. How does Manager report the income subject to the Guam income tax when he files his U.S. income tax return?

A4. Manager should file IRS Form 5704 with his tax return. This return allocates the 401(k) profit sharing plan distributions between the U.S. and Guam. It is the responsibility of Manager to maintain records to determine the amount of the plan distribution that is subject to Guam income tax and U.S. income tax.

Q5. May Manager directly transfer or roll over the distribution to an IRA (including the portion subject to Guam income tax)?

A5. The amount that would be subject to U.S. income taxes may be rolled over to an IRA. The portion of the distribution subject to Guam income tax may also be rolled over to an IRA. See Code § 402(c) and (d).

Example 2 – Guam Plans

Company Y maintains a plan in Guam. The plan participants reside in Guam. The plan investments include shares of stock in U.S. corporations.

Q1. Is the trust that holds the plan assets a foreign grantor trust?

A1. No. Code §§ 404(a)(4) and 402(c) and (d) treat the trust for the Guam plan as a tax-exempt trust under Code § 501(a). Specifically, Code § 402(c) precludes treatment of the trust as a grantor trust.

Q2. As a foreign trust, are the dividends payable to the trust by the U.S. corporation subject to mandatory withholding under § 1441?

A2. Even though the Guam plan trust is treated as tax exempt under Code § 501(a) for purposes of allowing deductions for contributions, taxation of distributions and allowing rollovers to an IRA or another qualified plan under Code §§ 402 and 404, the trust is a foreign trust for withholding on dividends paid by U.S. corporations to the plan's trust. The trust is not given the status of a tax-exempt trust under § 501(a) but is merely treated as tax exempt for limited purposes.