A Proposal for Fair U.S. Tax Treatment of Foreign Pensions

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In this article, Bugnion and Singer highlight the negative consequences of U.S. current taxation of foreign pensions and recommend that Congress pass legislation to allow foreign pensions to be taxed on the same basis as U.S. qualified pensions.

The U.S. State Department estimates that between 7 million and 8 million U.S. citizens reside outside the United States. An untold number of U.S. lawful permanent residents (green card holders) reside abroad. American citizens and green card holders who reside abroad remain subject to U.S. income tax on their worldwide income (citizenship-based taxation).[1] Americans abroad may also be taxed on their worldwide income by the country where they reside (residence-based taxation). Surveys have shown that 70 to 80 percent of Americans abroad define themselves as residing outside the United States indefinitely or permanently,[2] primarily because of employment with a foreign employer or marriage to a foreign national. Most of those Americans will continue to reside abroad after they retire.

Congress rarely considers how U.S. tax legislation applies to U.S. citizens and green card holders who reside outside the United States (collectively, Americans abroad) unless the legislation is specifically directed toward them. As a result, Americans abroad are discriminated against by the U.S. tax code in numerous ways. The U.S. taxation of Americans abroad who are participants in foreign pension plans[3] is the most unfair.

U.S. Taxation of Foreign Pension Plan Accounts

Under U.S. citizenship-based taxation, foreign pension funds of Americans abroad are subject to U.S. taxation as follows:

- **U.S Taxation of Contributions.** Unlike the rules for contributions to U.S. qualified plans, employee contributions to a foreign pension fund do not reduce an employee's U.S. taxable income, and employer contributions to a foreign pension fund increase an employee's U.S. taxable income.
- **U.S. Taxation of Pension Fund Income.** Unlike the income of U.S. qualified plans, which accrues tax free, the income of an employee's foreign pension fund is treated as income of the participant subject to U.S. tax each year. If a foreign plan fund invests in foreign mutual funds or exchange-traded funds, all classified by the IRS as passive foreign investment companies, the result can be particularly punitive — negative investment returns in the foreign pension account.
- **Double Taxation of Distributions.** Distributions from foreign pension funds to Americans abroad are taxed by both the country of residence and the United States. Individuals subject to double taxation may, however, avoid double taxation by claiming a foreign tax credit

[1]Green card holders who meet the treaty residency tie-breaker rule criterion of an applicable income tax treaty may elect to be treated as nonresidents of the United States for tax treaty purposes. The election does not necessarily allow the individual to escape U.S. disclosure reporting requirements. Many green card holders choose not to elect nonresidency treatment because it may jeopardize their green card status.

[2]*See* Overseas Vote Foundation and U.S. Vote Foundation, "OVF and U.S. Vote 2012 Post-Election Survey Report," at 9, *available at* https://www.usvotefoundation.org/sites/default/files/OVF_ElectionReport_2012_web.pdf.

(Footnote continued in next column.)

[3]For more detail on the U.S. taxation of foreign pension plans, see http://www.andersentax.com/publications/newsletter/march-2013/participation-in-a-foreign-pension-plan; http://www.expatattorneycpa.com/id70.html; and http://intltax.typepad.com/intltax_blog/2014/06/pfic-attribution-through-foreign-pensions.html.

on a Form 1116, ''Foreign Tax Credit (Individual, Estate, or Trust),'' not a simple form.[4]

Bottom line: Under current U.S. law, Americans abroad pay U.S. taxes twice on their foreign pension accounts — when they accrue, and when they are paid out.

The addition of employer contributions to U.S. taxable income and the disallowance of a reduction in income for the employee's contribution, when combined with the annual taxation of the accrued income in pension accounts, can inflate participants' U.S. taxable income by more than 10 percent, pushing some into a higher U.S. tax bracket.

When the time value of money is considered, this treatment of foreign pension funds denies Americans abroad the possibilities and advantages of saving for retirement that are available to U.S. residents.

Additional Reporting Requirements

In addition to reporting on their U.S. tax returns employer contributions to foreign pensions and income earned from those pensions, U.S. participants in foreign pension plans may also have additional tax reporting costs for annual submissions of forms related to their foreign pension funds[5]:

- Form 3520, ''Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts'';
- Form 3520A, ''Annual Information Return of Foreign Trust with a U.S. Owner'';
- Form 8621, ''Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund'' if PFIC rules apply;
- Form 8938, ''Statement of Foreign Financial Assets''; and
- Financial Crimes Enforcement Network Form 114, ''Report of Foreign Bank and Financial Accounts.''

The IRS's aggressive compliance enforcement of the new rules and regulations under the Foreign Accounts Tax Compliance Act targeting accounts of U.S. persons in foreign financial institutions, the monitoring of foreign investments and foreign trusts, and enforcement of the new PFIC reporting rules seriously affect Americans abroad. Even when a foreign pension fund is classified as comparable to a U.S. pension fund under FATCA (discussed below), a U.S. taxpayer must still list the pension fund among foreign financial assets on IRS Form 8938 and FinCEN Form 114.

That asset reporting requirement, the uncertainty in valuing pension funds, and the confusion and complications related to possible U.S. taxation of the annual increase in pension value cause significant concern among American taxpayers overseas, not only because of the additional cost of compliance but also the heavy penalties for inaccurate reporting on Form 8938 and Form 114.

U.S. Income Tax Treaty Exceptions

There is an exception for Americans abroad who are tax residents of a country with an income tax treaty with the United States that includes provisions related to foreign pension plans of U.S. participants. Such language is included in the recently finalized 2016 U.S. Model Income Tax Treaty.[6] Under the provisions:

- Contributions to foreign pension funds by Americans abroad are treated the same way as contributions to U.S. pension plans by American residents. An employee's contributions are excludable for U.S. tax purposes, and his employer's contributions to the foreign pension plan are not added to the taxable income of the U.S. taxpayer.[7]
- Income accrued in a foreign pension fund is exempt from current U.S. income tax as long as it is not distributed to the beneficiary.
- The provisions related to foreign pension funds require the competent authority, that is, the U.S. Treasury, to have agreed that a designated foreign pension plan generally corresponds to a pension plan established in the United States.

Under this language, the U.S. Treasury allows foreign pensions to be considered comparable to U.S. pensions and treated the same way as U.S. domestic pensions for U.S. tax purposes.

Although similar language was included in the 2006 Model Income Tax Treaty, this language has only been integrated into the tax treaties with

[4]IRS Publication 514, ''Foreign Tax Credits for Individuals'' is 30 pages long. Instructions for Form 1116 are 23 pages long. However, FTCs may be used to offset only U.S. taxes attributable to foreign income. A participant in a foreign pension plan who traveled to the U.S. periodically for work must allocate their pension distributions between U.S. and foreign-source income based on where their services were performed.

[5]Beneficiaries and annuitants of Canadian retirement plans are exempt from the Form 3520 and Form 3520A reporting requirement, however. *See* Rev. Proc. 2014-55, section 5.01. The pension fund is not required to be included on Form 8938 or FinCEN Form 114 if the fund is considered comparable to a U.S. pension fund under an applicable U.S. income tax treaty.

[6]The 2016 United States Model Income Tax Convention is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf.

[7]These provisions apply as well to foreign nationals who remain covered by their foreign pension plan while working in the United States.

Belgium, Canada, and the United Kingdom.[8] The United States has more than 50 current income tax treaties.[9] Older treaties include such language only when the existing treaty is amended by a protocol or when the treaty is replaced by a new income tax treaty. Unfortunately, most of the treaties and protocols ratified since the 2006 Model Tax Treaty was introduced did not include this new pension fund language. None of the tax treaties and protocols awaiting ratification by the U.S. Senate[10] include this language. Thus, Americans abroad who reside in countries covered by treaties without this foreign pension fund language or in countries without an income tax treaty with the United States are unfairly discriminated against regarding their foreign pensions.

The discrimination is caused by the ''savings clause'' in all U.S. tax treaties.[11] The savings clause allows the United States to tax its citizens and residents[12] according to its domestic laws under citizenship-based taxation as if the treaty had not come into effect. In other words, the savings clause allows the U.S. government to discriminate against its own citizens and green card holders at the expense of reciprocity. The savings clause of the Model Tax Treaties of 2006 and 2016 and of existing treaties provide an exception to the savings clause regarding distributions from private pensions, but only for participants who are neither U.S. citizens nor green card holders. Thus, distributions to Americans abroad are subject to U.S. taxation regardless of whether the special foreign pension language is in the treaty. When a treaty does not include the special foreign pension language for Americans abroad, contributions and accrued income are taxed by the United States as well. That is the case even if the treaty includes a provision specifically exempting contributions and accrued income from taxation. The exceptions to the savings clause for these provisions only apply when the participant is neither a U.S. citizen nor a green card holder.

Based on the experience with new treaties and protocols over the past 10 years, this unfair U.S. tax treatment of U.S. participants in foreign pension plans will never be resolved by tax treaties.

The Only Fair Solution: Congressional Action

To end this unfair tax treatment of all Americans abroad regarding their foreign pension plan income and contributions requires action by Congress. This can be accomplished by amending the U.S. tax code to include the 2016 U.S. Model Treaty language regarding foreign pensions,[13] as proposed in Exhibit A: *An Act for Fair U.S. Tax Treatment of Foreign Pensions*.

The proposed tax law allows for uniform application of fair tax treatment by the United States of foreign pension and retirement funds. As such, it applies to all Americans abroad, not just Americans residing in foreign countries with a U.S. tax treaty. The change has no effect on the reciprocity provisions in treaties affecting foreign nationals who are not green card holders with regard to their foreign pensions.[14] The legislation would be applicable worldwide on a unilateral basis, regardless of whether a tax treaty exists between a foreign country and the United States. The legislation proposed affects only the citizenship-based taxation of U.S. citizens and green card holders. It imposes no constraints on the benefits to foreign countries provided by the U.S. treaty network. It simplifies the U.S. tax code, tax administration, and enforcement by automatically allowing uniform treatment of foreign pension funds. It provides the additional benefits of reducing compliance costs and valuation uncertainties for U.S taxpayers.

Foreign Pension Funds Comparable to U.S. Pension Funds

The 2016 U.S. Model Tax Treaty language requires Treasury to agree that designated foreign pension funds generally correspond to pension funds established in the United States. Treasury has already gone through the exercise of defining foreign pension and retirement funds that are comparable to U.S. funds and of establishing a country-by-country list of funds meeting the criteria. This was done to establish intergovernmental agreements for the purposes of FATCA. Annex II of the

[8]Article 17, Article 18, and Article 19, respectively.

[9]The former USSR treaty covers the nine Newly Independent States that have yet to enter into their own treaty with the United States.

[10]A new treaty with Chile, replacement treaties for Hungary and Poland, and protocols for the treaties with Japan, Luxembourg, Spain, and Switzerland. Senate ratification of all tax treaties and protocols has been put on hold by Sen. Rand Paul, R-Ky., since 2010.

[11]The saving clause is included in article 1 of new treaties. *See* article 1(4) and (5) of the 2016 Model Treaty. The saving clause of some older treaties may be found in miscellaneous provisions near the end of the treaty, e.g., article 29(2) and (3) of the treaty with France.

[12]The term ''residents'' includes foreign nationals who meet one of the two residency tests for tax purposes — the green card test or the substantial presence test. The saving clause in the treaties with the former USSR and the People's Republic of China applies only to U.S. citizens.

[13]Article 17, paragraph 2(b), and Article 18, paragraph 3(a), (b), (c), and (d)

[14]For example, the 2016 Model Treaty reciprocal provisions allowing pension fund payments made to individuals to be taxed only by the country of residence remain unchanged.

Model 1 IGA provides the definition of foreign pension funds that are determined to be nonreporting financial institutions for purposes of sections 1471 and 1472 of the code, that is, comparable to U.S. funds. The definition states that the funds must:

- be established to provide retirement, disability, or death benefits to beneficiaries that are current or former employees of one or more employers;
- be subject to government regulations and provide annual information reporting about its beneficiaries to the relevant tax authorities of the country;
- be generally exempt from tax in the foreign country on investment income under the laws of the country due to the status of retirement or pension plans; and
- receive at least 50 percent of their contributions from sponsoring employers.

Also, distributions or withdrawals from the funds must only be allowed upon the occurrence of specified events related to retirement, disability, or death.[15]

Funds that are judged as being comparable to U.S. pension plans for exemption from FATCA reporting by the foreign financial institutions should also be sufficiently comparable to U.S. pension funds to be taxed on the same basis as U.S. pension funds.

Conclusion

The U.S. taxation of foreign pension funds denies Americans abroad the possibilities and advantages of saving for retirement that are provided U.S. citizens and green card holders residing in the United States. The increased awareness among Americans abroad of the U.S. tax treatment of their foreign pension and retirement plans and the inability to save effectively for retirement are important factors driving the mounting wave of renunciations of U.S. citizenship.

At a minimum, Congress owes Americans abroad a treatment of foreign pensions and retirement funds equivalent to that allowed for U.S. pension and retirement funds. The 2016 Model Tax Treaty confirms the intent of the government to do so. But tax treaties are not the solution; only congressional action can provide a solution for all Americans abroad. The principal work in identifying foreign pension funds that qualify as comparable to U.S. funds has already been done through Treasury's work in implementing IGAs for FATCA compliance. All that is needed now is for Congress to pass a law that treats these comparable foreign pension and retirement funds like U.S. qualified plans for U.S. income tax purposes.

Exhibit A: An Act of Fair U.S. Tax Treatment of Foreign Pension

A Proposed Addition to the U.S. Tax Code

Paragraph 1. Income Earned by Foreign Pension Funds

When a U.S. citizen or lawful permanent resident (green card holder) who is a resident of a foreign country is a member or beneficiary of, or participant in, a pension fund established in that foreign country, the income earned by the pension fund is not income of the individual unless, and then only to the extent that, it is paid to, or for the benefit of, that individual from the pension fund (and not transferred to another pension fund established in that foreign country in a transfer that qualifies as a tax-deferred transfer under the laws of the foreign country).

Paragraph 2. Employer and Employee Contributions and Accrued Income on Foreign Pension Funds

a. When a citizen or green card holder of the United States who is a resident of a foreign country exercises an employment in that same foreign country, the income from which is taxable in that foreign country, the contribution is borne by an employer who is a resident of that foreign country or by a permanent establishment situated in that foreign country, and the individual is a member or beneficiary of, or participant in, a pension fund established in that foreign country,

i. contributions paid by or on behalf of that individual to the pension fund during the period that the individual exercises the employment in that foreign country, and that are attributable to the employment, shall be deductible (or excludible) in computing the individual's taxable income in the United States; and

ii. any benefits accrued under the pension fund, or contributions made to the pension fund by or on behalf of the individual's employer, during that period, and that are attributable to the employment,

[15]*See* Annex II to FATCA Model 1 Intergovernmental Agreements, *available at* https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Annex-II-to-Model-1-Agreement-11-4-13.pdf. For a list of the foreign pension funds by country that meet these criteria, see Groom Law Group Chtd., ''Cumulative List of Non-U.S. Pension Funds Exempted by FATCA Intergovernmental Agreements,'' March 27, 2015, *available at* http://www.groom.com/media/publication/1224_IGA_Cumulative_List_Alpha_03272015.pdf.

shall not be included in computing the employee's taxable income in the United States.

b. The provisions under paragraph 1 and paragraph 2(a), (a)(i), and (a)(ii) also apply to citizens and green card holders working in a foreign country neighboring their foreign country of residence, when the individual pays income taxes in the country of residence, but the pension fund is established in the country where the individual is employed.

c. The relief available under paragraph 2(a) and (b) shall not exceed the lesser of:

i. the relief that would be allowed by the United States to its residents for contributions to, or benefits accrued under, a generally corresponding pension fund established in the United States; and

ii. the amount of contributions or benefits that qualify for tax relief in the specified foreign country.

d. For purposes of determining an individual's eligibility to participate in and receive tax benefits on a pension fund established in the United States, contributions made to, or benefits accrued under, a pension fund established in the foreign country shall be treated as contributions or benefits under a generally corresponding pension fund established in the United States to the extent relief is available to the individual under this paragraph.

e. This paragraph shall not apply unless the Department of the Treasury of the United States has agreed that the pension fund generally corresponds to a pension fund established in the United States.

f. The U.S. Department of the Treasury is charged to make such determination under paragraph 2(e) for all countries within one year after passage of this law, and beyond the first year to include rapidly any new foreign pension fund plans which subsequently come into being and which Treasury deems to correspond to a pension fund established in the United States.

Paragraph 3. U.S. citizens and green card holders who meet the conditions of paragraphs 1 and 2 will have their foreign pension plans treated on the same basis as U.S. domestic pension plans for U.S. tax purposes.