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Cross-Border Employee Transfers—An Overview of Pension and Deferred Compensation Plan Aspects

BY EDWARD E. BINTZ

Summary

The cross-border transfer of employees can have significant employee benefit plan consequences for both employees and employers. Among the key questions that should be considered in connection with such transfers are whether and how employees will be covered by U.S.-based or foreign-based pension and other employee benefit plans. This article provides an overview of the U.S. federal income tax consequences associated with covering transferred employees under U.S.-based and foreign-based pension and deferred compensation plans.

I. Introduction

The global environment in which many businesses operate makes the cross-border transfer of employees a common aspect of business operations. A key aspect of managing cross-border employee transfers is properly structuring employees' participation in pension and deferred compensation plans. From an employee's perspective, an important consideration in deciding whether to accept a cross-border transfer is the effect that the transfer will have on the employee's pension and deferred compensation benefits. For example, whether the employee will participate in his or her home country's or the host country's pension plan may have significant tax and economic consequences to the employee. From an employer's perspective, an important consideration in deciding which plans will cover the employee and how such coverage will be provided is the continuing compliance of the employer's plans with applicable tax-qualification and other rules, as well as avoiding or minimizing any adverse plan-related consequences to the employee for which the employer often will have agreed to reimburse the employee.

This article provides an overview of the pension and deferred compensation plan aspects of cross-border employee transfers. Among the areas addressed are:

(a) whether and how coverage may be provided under U.S. tax-qualified and other pension plans when an employee is transferred from the United States to a foreign branch or affiliate or from a foreign branch or affiliate to the United States;

(b) the tax consequences of such coverage to the transferred employee; and

(c) the tax treatment of distributions where an employee has accrued pension benefits based on both domestic and foreign service.

II. U.S. Tax-Qualified Plans

A common question faced by multinational employers when transferring employees who are U.S. citizens ("U.S. employees") from a U.S. domestic employer (a "U.S. employer") to a foreign branch or affiliate is whether such employees ("outbound employees") will

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continue to be covered by one or more of the U.S. employer's tax-qualified pension plans or will instead be covered by the foreign branch's or affiliate's pension plans that may be designed to comply with local country law. Similarly, when foreign nationals are transferred to a U.S. employer from a foreign branch or affiliate (''inbound employees''), a decision must be made as to whether they will continue to be covered by the foreign branch's or affiliate's plans or will instead be covered by the U.S. employer's tax-qualified plans. As discussed below, a variety of factors influence whether outbound and inbound employees should be covered by a U.S. employer's tax-qualified plans, including how coverage can be provided consistent with the code's[1] tax-qualified plan rules, the deductibility of contributions, and the tax consequences of benefit accruals by, and distributions to, inbound or outbound employees.

A. Coverage of Outbound Employees—Tax-Qualified Plan Compliance Aspects. Under the code's tax-qualified plan rules, there are a variety of ways an outbound employee may continue to participate in the U.S. employer's tax-qualified plans. In deciding whether and how to continue coverage, a paramount consideration is the plans' continued compliance with a variety of the code's plan qualification rules, including the exclusive benefit rule under Section 401(a)(2), the nondiscrimination rules under Section 401(a)(4), the minimum participation rules under Section 401(a)(26), and the minimum coverage rules under Section 410. Whether and how these requirements may be satisfied is significantly influenced by whether the employee is transferred to an affiliate that is in the same controlled group under Section 414 as the U.S. employer (usually because the foreign affiliate has at least an 80 percent ownership link with the U.S. employer), an affiliate that is not within the same controlled group, or to a branch of the U.S. employer that is not a separate affiliate. The principal alternatives for providing coverage are discussed below.

1. Transfer to a Branch or a Foreign Affiliate That Is in the U.S. Employer's Controlled Group

From a tax-qualified plan perspective, the simplest situations in which an outbound employee's coverage in U.S. tax-qualified plans may be continued are where the employee is transferred to a foreign branch of the U.S. employer or to a foreign affiliate that is in the same controlled group as the U.S. employer. In both situations, the employee is treated as being employed by the same employer both before and after the transfer—in the case of an employee who is transferred to a foreign branch because the employee is employed by the same entity, and in the case of an employee transferred to a foreign affiliate that is in the same controlled group, because Sections 414(b) and 414(c) treat all members of a controlled group as a single employer for most plan qualification purposes.[2] As a result, in either case, no violation of the exclusive benefit rule should occur by reason of the employee's continued coverage under the plan. In addition, because Sections 401(a)(4), 401(a)(26), and 410 also apply on a controlled group basis, continued compliance with such requirements should not be adversely affected by the continued coverage of one or more U.S. employees who are transferred to a foreign branch or affiliate in the same controlled group.[3] With respect to Section 410's minimum coverage rules, the coverage of one or more U.S. employees employed by a foreign branch or a foreign affiliate does not affect the ability to exclude nonresident aliens who have no U.S. source income when testing compliance with the minimum coverage requirements.[4] In fact, the group of transferred employees who continue to be covered while on a foreign assignment may be a group that disproportionately consists of highly compensated employees (or even solely highly compensated employees), provided that the plan satisfies Section 410's coverage requirements on a controlled group basis.

It is worth noting that Section 407 provides that employees of a U.S. parent corporation's domestic subsidiary may be treated as employees of the U.S. parent for purposes of covering such employees under the U.S. parent's tax-qualified plans if, among other things, the U.S. parent owns at least 80 percent of the domestic subsidiary and substantially all of its income is foreign source. Because any subsidiary that might qualify under § 407 would also be in the same controlled group as its U.S. parent by reason of Section 407's 80 percent ownership requirement, there seem to be no situations where Section 407 would be needed in order to extend tax-qualified plan coverage to outbound employees.

2. Transfer to a Foreign Affiliate That Is Not in the U.S. Employer's Controlled Group

If a U.S. employee is transferred to a foreign affiliate that is not in the same controlled group as the U.S. employer, the continued coverage of the U.S. employee under the U.S. employer's tax-qualified plan while employed by the foreign affiliate raises more complicated issues. Because the employee is no longer employed by the same ''employer,'' continued coverage could, among other things, result in the plan violating the code's exclusive benefit rule under Section 401(a)(2). Nevertheless, as described below, there are several potential means of providing coverage, including (a) providing coverage pursuant to special statutory rules under Section 406 of the code, (b) having the foreign affiliate adopt the plan so that the plan becomes a ''multiple employer plan,'' (c) covering the U.S. employee as a ''leased'' employee, or (d) providing the employee with ''imputed'' service and compensation credit under the U.S. employer's plan.

a. Coverage Under Section 406 of the Code. In general, under Section 406, an employee of a ''foreign affiliate'' of an ''American employer'' is treated as an employee of the American employer for purposes of the code's tax-qualified plan rules if certain requirements are satisfied. The term ''American employer'' is defined to include domestic corporations and partnerships in which at least two-thirds of the partners are U.S. resi-

[1] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[2] *See* I.R.C. §§ 414(b), 414(c); PLR 200205050 (Nov. 8, 2001); PLR 8228116 (Apr. 19, 1982).

[3] *See* Treas. Regs. §§ 1.401(a)(4)-12, 1.401(a)(26)-8, 1.410(b)-1(d)(8), 1.410(b)-9.

[4] *See* Treas. Reg. §§ 1.410(b)-1(c)(3), 1.410(b)-6(c); PLR 8144028 (Aug. 4, 1981); PLR 8228116 (Apr. 19, 1982). Section 861(a)(3) allows a nonresident alien to earn up to $3,000 for services performed in the U.S. without such amount being treated as U.S. source income if certain requirements are satisfied. This amount may be increased by an applicable treaty.

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dents,[5] and a ''foreign affiliate'' of an American employer is defined as any foreign entity in which the American employer has at least a 10 percent interest.[6] Thus, in situations where a U.S. employer owns less than 80 percent of a foreign affiliate (and therefore is in a separate controlled group from the U.S. employer), Section 406 may allow employees of the affiliate to be treated as employed by the U.S. employer. Because Section 406 requires the American employer to own at least a 10 percent interest in the foreign affiliate, it does not apply in situations where an employee of a U.S. subsidiary of a foreign parent company is transferred to the foreign parent.

In general, the requirements imposed by Section 406 are as follows: (i) the American employer must enter into an agreement under Section 3121(l) to provide social security coverage with respect to employees of the foreign subsidiary who are U.S. citizens or residents; (ii) the plan must expressly provide for contributions or benefits for U.S. citizens or residents who are employees of foreign affiliates of the American employer to which a Section 3121 agreement applies; and (iii) no contributions may be made to a funded deferred compensation plan (whether or not qualified under Section 401(a)) by any other person with respect to the remuneration paid to the employee by the foreign affiliate.[7]

Employees of a foreign affiliate who are covered by an American employer's tax-qualified plan pursuant to Section 406 are treated as employees of the American employer for purposes of Section 401(a). As a result, the plan must take such employees into account for purposes of determining compliance with applicable coverage and nondiscrimination rules. For purposes of applying these rules, Section 406(b) provides that a person treated as an employee of an American employer under Section 406 is treated as a highly compensated employee of the American employer if he or she would have such status if such employee's ''total compensation'' paid by the foreign affiliate was instead paid by the American employer. Section 406 also provides special rules for purposes of applying Section 401(a)(5)'s ''permitted disparity'' rules.

An American employer is not entitled to a deduction under Section 404 for contributions made to a tax-qualified plan with respect to an employee of a foreign affiliate who is treated as an employee of the American employer under Section 406.[8] However, the foreign affiliate is entitled to a deduction equal to the amount of the deduction to which the American employer would have been entitled if the employee of the foreign affiliate were an employee of the American employer. In general, the deduction will be of value only to the extent that the affiliate has U.S. source income against which the deduction can be applied.

A principal disadvantage of relying on Section 406 to continue an outbound employee's coverage under a tax-qualified plan is that the American employer must enter into a Section 3121(1) agreement. Such agreements are irrevocable and require the American employer to pay FICA taxes (both the employer and employee portions) on behalf of all employees of the foreign affiliate who are U.S. citizens or residents. As a result, the American employer may be required to pay FICA taxes on behalf of employees as to whom it would otherwise prefer to not extend FICA coverage. In addition, Section 406 also requires that tax-qualified plans provide coverage to U.S. citizens and residents employed by all affiliates that have entered into Section 3121(l) agreements. This requirement could entail providing coverage to U.S. citizens and residents who are employees of a foreign affiliate as to which coverage would otherwise not be extended.

b. Foreign Affiliate Adopts Domestic Employer's Plan. A second possible alternative for covering employees of a foreign affiliate that is not in the same controlled group as the U.S. employer is to have the foreign affiliate adopt the plan. By adopting the plan, the plan becomes a ''multiple employer plan'' and is required to satisfy various tax-qualification requirements separately with respect to the U.S. employer's controlled group and the foreign affiliate's controlled group. For example, compliance with the nondiscrimination rules of Sections 401(a)(4) and 410(b) and the minimum participation rules of Section 401(a)(26) (if the plan is a defined benefit plan) would be determined separately with respect to employees of the two controlled groups. Having to satisfy these requirements limits the ability of a foreign affiliate to cover only selected highly compensated employees if the foreign affiliate and its controlled group also employ nonhighly compensated employees who are not excludible nonresident aliens.

c. Coverage as a Leased or Seconded Employee. Another possible alternative that may allow an outbound employee to continue to participate in a U.S. employer's tax-qualified plan(s) is to have the employee remain an employee of the U.S. employer and provide services to the foreign affiliate as a ''leased'' employee. In exchange for the leased employee's services, the foreign affiliate generally would pay a fee to the U.S. employer that would at least cover the employee's wages and benefits.

In order to avoid a leased employee arrangement causing the U.S. employer's tax-qualified plan to violate the exclusive benefit rule under Section 401(a)(2), the employee must remain a common law employee of the U.S. employer.[9] Merely retaining the employee on the U.S. employer's payroll is not, by itself, sufficient to allow the U.S. employer to continue to treat the employee as its employee. Rather, the U.S. employer must retain a sufficient role with respect to the employment of the employee to allow treatment of the employee as remaining an employee of the domestic employer. Among the factors likely to be relevant are who has the right to direct and control the employee's performance of services and who has the right to terminate the employee.[10]

Because of the potential for violations of the exclusive benefit rule, the U.S. employer's role as common law employer should be carefully structured and fully documented. In addition, as a general tax planning matter, consideration should be given to whether the leasing arrangement could result in the U.S. employer being treated as conducting a trade or business and/or

[5] I.R.C. Sections 406(a), 3121(h).
[6] I.R.C. §§ 406(a), 3121(l)(6).
[7] I.R.C. § 406(a); Treas. Reg. § 1.406-1(b)(1).
[8] I.R.C. § 406(d).
[9] *See Professional & Executive Leasing, Inc. v. Comm'r*, 89 T.C. 225, 235 (1987), *aff'd*, 862 F.2d. 751, 10 EBC 1627 (9th Cir. 1988).
[10] *See* FSA 199917010 (Apr. 30, 1999).

having a permanent establishment in the foreign jurisdiction in which the employee performs service.

d. Crediting Imputed Service and Compensation. Under so-called ''imputed'' service and compensation rules contained in the regulations under Sections 401(a)(4) and 414(s), an employee who is transferred by a U.S. employer to a foreign branch or affiliate may receive service and compensation credit under the U.S. employer's tax-qualified plan in respect of employment with the foreign affiliate in situations where the plan does not otherwise directly cover such service or compensation.[11] Under these rules, in the case of a defined benefit plan, both imputed compensation and service may be credited, while under a defined contribution plan, generally only imputed service may be credited.

In general, the following requirements must be satisfied in order for an employer's tax-qualified plan to provide ''imputed'' service and/or compensation: (a) the provisions under which imputed compensation and/or service is credited must apply to all similarly situated employees; (b) there must be a legitimate business purpose, based on all of the facts and circumstances, for providing the imputed compensation and/or service;[12] and (c) the plan provisions under which imputed compensation and/or service is credited must not by operation or design discriminate significantly in favor of highly compensated employees, based on all of the facts and circumstances.[13]

One advantage of providing continued tax-qualified plan coverage to an outbound employee by crediting imputed service and compensation is that no action is required on the part of the foreign branch or affiliate in order to provide the coverage (other than providing information as to the employee's service and compensation). In addition, because the coverage is provided by the U.S. employer for its own business reasons, it appears that, at least in some cases, the U.S. employer rather than the foreign affiliate, may be in a position to claim the federal income tax deductions associated with the continued coverage. The principal disadvantage of crediting imputed service and compensation in respect of an outbound employee's employment by a foreign branch or affiliate is that the regulations under Sections 401(a)(4) and 414(s) require that the same treatment be accorded to all similarly situated employees. The regulations do, however, allow some flexibility in determining which employees are similarly situated.

B. Coverage of Inbound Employees—Tax-Qualified Plan Compliance Aspects. In contrast to where a U.S. employee is transferred to a foreign affiliate of a U.S. employer, the tax-qualified plan compliance aspects of covering a foreign national who is transferred to a U.S. employer from a foreign branch or affiliate are relatively uncomplicated. Because the transferring employee will be employed by the U.S. employer that sponsors the plan, he or she will, in many cases, automatically be covered by the plan, or can be so covered by means of a simple plan amendment if coverage is desired. As a result, there is no need to have an affiliate adopt the plan, establish a leased employee arrangement, or provide imputed service and compensation credit with respect to the employee's U.S. employment. In addition, the coverage of a foreign national in a U.S. employer's tax-qualified plan does not affect the ability to exclude nonresident aliens who have no U.S. source income for purposes of nondiscrimination testing under Section 410.[14] Employers should be aware that if the inbound foreign national is covered by the U.S. employer's tax-qualified plans, and is being transferred from a foreign branch or a foreign affiliate that is in the same controlled group, the employee must receive credit for pre-transfer service with the foreign branch or affiliate for eligibility and vesting purposes under Sections 410 and 411.

C. Deductibility of Employer Contributions. In general, the deductibility of contributions made to tax-qualified plans, including contributions made in respect of foreign-based employment and foreign nationals, is governed by Section 404. Under Section 404, an employer is, subject to certain limits, entitled to a deduction for contributions made to a tax-qualified plan, provided that the contributions would otherwise be deductible as an ordinary and necessary business expense under Section 162.[15] Under Section 162, expenses satisfy the ordinary and necessary requirement and are deductible only if they are ''proximately connected'' to the business of the taxpayer claiming the deduction.[16]

In the case of either an inbound transfer of an employee to a U.S. employer that sponsors a tax-qualified plan or an outbound transfer to a foreign branch, the ordinary and necessary business expense requirement imposed under Section 404 should be satisfied because the employment of the transferring employee should proximately benefit the U.S. employer that sponsors the plan. Thus, assuming that the U.S. employer's overall contributions to the plan satisfy the limits imposed by Section 404, the contributions should be deductible.[17]

In the case of an outbound transfer of an employee to a foreign affiliate, the U.S. employer that sponsors the tax-qualified plan generally will not, under existing authority, be entitled to a deduction for contributions it makes to its tax-qualified plans on behalf of the employee. In general, the courts have held that the general and indirect benefit inuring to a parent corporation from the success of a subsidiary is not sufficient to satisfy the ordinary and necessary business expense requirement of Section 162.[18] Thus, where a parent corporation pays compensation to employees of a subsidiary, generally no deduction is allowed to the parent corporation. The IRS has ruled, however, that such payments by the parent corporation are treated as a contribution to the capital of the subsidiary, with the subsidiary being entitled to a deduction for the amount of the

[11] *See* Treas. Reg. §§ 1.401(a)(4)–11(d); 1.414(s)–1(f).

[12] Among the relevant facts and circumstances cited by the regulations is whether one employer has a significant ownership interest in the other employer.

[13] *See* Treas. Reg. §§ 1.401(a)(4)–11(d); 1.414(s)–1(f).

[14] *See* Treas. Reg. §§ 1.410(b)-1(c)(3), 1.410(b)-6(c); PLR 8144028 (Aug. 4, 1981); PLR 8228116 (Apr. 19, 1982).

[15] *See* I.R.C. § 404(a); TAM 8012005.

[16] *See* Young & Rubicam, Inc. v. U.S., 410 F. 2d 1233, 1237 (Ct. Cl. 1969).

[17] However, where the outbound transfer is to a foreign branch, the deduction would likely be allocable to foreign source income and would therefore reduce the U.S. employer's foreign tax credit limitation.

[18] *See* Young & Rubicam, Inc. v. U.S., *supra* note 16 at 1238; *but see* PLR 8422142 (Mar. 1, 1984).

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payment.[19] As noted above, however, where the tax-qualified plan coverage of an outbound employee is continued by means of crediting imputed service and compensation, it appears that the U.S. employer, rather than the foreign affiliate, may be in a position to claim the deduction.

Assuming that employees of a foreign affiliate are covered by the U.S. employer's tax-qualified plan and that related contributions are deductible, the question arises as to how deductions and deduction limits under Section 404 are allocated between the U.S. employer and the foreign affiliate. Section 414(b) provides that where more than one member of a controlled group has adopted a plan, the limitations imposed by Section 404(a) ''are determined as if all such employers were a single employer, and allocated in accordance with regulations prescribed by the Secretary.'' No regulations have been issued, nor has the IRS issued any guidance on the issue. It appears, however, that the IRS may accept any reasonable method, including allocating contributions and deductions based on the percentage of payroll paid by respective members of the controlled group.[20]

In Technical Advice Memorandum (TAM) 8012005, the IRS analyzed the deductibility of contributions by a U.S. parent to its tax-qualified pension plan on behalf of certain employees of its foreign subsidiaries where the plan was maintained solely by the U.S. parent. Analyzing the language of Section 414(b), the TAM states that where only one member of a controlled group adopts a plan, ''no provision is made for a section 404 deduction to that member for a contribution made on behalf of employees of other employers in the controlled group members'' and that imputation of employment under Section 414(b) for purposes of Sections 401, 410, 411, and 415 ''does not mandate imputation of employment for section 404 purposes.'' The TAM then concludes that, since Section 414(b) does not address the situation where only one controlled group member has adopted a plan, no deduction is allowed to the parent for contributions made on behalf of subsidiary employees because the contributions would not be an ordinary and necessary business expense of the U.S. parent. The TAM also states that if the plan had been adopted by the subsidiaries, pending the issuance of regulations, the same principles would apply to disallow a deduction to the parent corporation.

TAM 8012005 does not address whether a foreign subsidiary on whose behalf a U.S. parent corporation makes plan contributions is entitled to a deduction, nor whether any entitlement is dependent upon whether the foreign subsidiary has adopted the plan. It appears, however, that the subsidiary should be entitled to a deduction, whether or not the subsidiary has adopted the plan.

[19] Rev. Rul. 84-68, 1984-1 C.B. 31. *See* also Treas. Reg. § 1.406-1(e)(3) and *supra* note 8 and related text regarding the deductibility of contributions where coverage is provided pursuant to § 406.

[20] *See* 27 Tax Mgmt. Compensation Planning J. 101 (Apr. 2, 1999). In PLR 200211050 (Mar. 15, 2002), the IRS ruled that the excise tax imposed under § 4972 on nondeductible contributions made to tax-qualified plans would not apply to nondeductible plan contributions made on behalf of outbound employees who continue to be covered by a U.S employer's tax-qualified plan while employed by foreign subsidiaries that have not adopted the plan.

D. Tax Consequences of Qualified Plan Coverage to Inbound and Outbound Employees.

1. Tax Treatment of Benefit Accruals

Under the code, U.S. citizens and residents are taxable on their worldwide income without regard to whether its source is domestic-based or foreign-based. Thus, a U.S. employee who is transferred to a foreign branch or affiliate is subject to both U.S. income taxes and income taxes of the local country in which the employee is employed. Because accruals under U.S. tax-qualified plans are not income to covered employees for U.S. federal income tax purposes, continued coverage under a tax-qualified plan will not result in the current recognition of income by the employee for such purposes. However, the employee may be subject to tax on such accruals under the tax laws of the foreign jurisdiction where the employee works. Accordingly, the tax consequences of continued participation in U.S. qualified plans under local country law, including any applicable income tax treaty, should be analyzed in connection with deciding whether continued participation should be extended to the outbound employee.

In the case of a foreign national who is transferred to a U.S. employer and becomes a U.S. resident, the employee is subject to U.S. federal income taxes on his or her worldwide income as a U.S. resident and is also potentially subject to income taxes under his or her home country's tax laws. Although accruals under a U.S. tax-qualified plan are not taxable income for U.S. federal income tax purposes to a U.S. resident, they could potentially be taxable under the income tax laws of the employee's home country. Unlike the United States, however, most countries do not impose income taxes on income earned abroad by nonresident citizens. As a result, tax-qualified plan accruals will generally not be subject to income taxes under the tax laws of the inbound employee's home country.

Under the 2006 U.S. model tax treaty, benefits accrued by an employee under a ''pension fund'' that is established in one of the ''Contracting States'' (and contributions made to the pension fund by or on behalf of the employee's employer) while the employee is employed in the other Contracting State are excludible from the employee's income in the other Contracting State, subject to certain conditions and limitations.[21] A growing number of U.S. income tax treaties provide for this exclusion (subject to various conditions).[22] As an example, the U.S.-U.K. income tax treaty addresses

[21] *See* United States Model Income Tax Convention of Nov. 15, 2006 (''2006 U.S. model tax treaty''), art. 18, para. 2. The 2006 U.S. model tax treaty provides that relief available under this provision is limited to the relief that would be allowed by the other State to its own residents for contributions to and benefits accrued under a pension plan established in the other State. *Id*. In the OECD commentary published together with the 2008 OECD Model Convention with Respect to Taxes on Income and on Capital (Condensed Version 2008), the OECD Committee on Fiscal Affairs suggests a similar provision.

[22] *See* U.S.-Austria treaty, May 31, 1996; U.S.-Belgium treaty, Dec. 28, 2007; U.S.-Canada treaty, Sept. 21, 2007; U.S.-France treaty, Jan. 13, 2009; U.S.-Germany treaty, Dec. 28, 2007; U.S.-Italy treaty (signed Aug. 25, 1999; ratified but not yet effective as of July 2009); U.S.-Ireland treaty, July 28, 1997; U.S.-Netherlands treaty, Mar. 8, 2004, U.S.-South Africa treaty, Feb. 17, 1997; U.S.-Sweden treaty, Sept. 30, 2005, U.S.-Switzerland treaty, Oct. 2, 1996; U.S.-U.K. treaty, July 24, 2001.

pension accruals and earnings in a manner similar to the U.S. model income tax treaty. Under Article 18 of the U.S.-U.K. treaty, where an employee participates in a pension plan established in one of the countries (the ''home country''), benefits accrued (and contributions made) while the employee is performing services in the other country (the ''host country'') are not includible in the employee's taxable income in the host country.[23] This rule applies, however, only if: (a) contributions to the plan were made on behalf of the employee before he or she began employment in the host country, and (b) the competent authority of the host country has agreed that the plan generally corresponds to a pension plan recognized for tax purposes by the host country.[24] Thus, a U.K. citizen who is transferred to the U.S. may continue to participate in a U.K. plan without becoming subject to U.S. income taxes with respect to U.K. plan benefit accruals.[25]

2. Tax Treatment of Distributions

Where an employee has accrued benefits under a tax-qualified plan in respect of both U.S.-based and foreign-based employment, the allocation of distributions from the plan as U.S. source and foreign source income can have important income tax implications.

a. U.S. Employees Receiving Distributions Attributable to Both U.S. and Foreign Service. Under the code, U.S. citizens and residents are taxable on their worldwide income without regard to whether its source is U.S.-based or foreign-based. Thus, a U.S. citizen or resident who receives a distribution from a U.S. tax-qualified plan generally will be subject to U.S. federal income taxes on the full amount of the distribution. In some situations, however, the sourcing of the distribution income is relevant to the amount of the foreign tax credit that the employee is entitled to use.

Under Section 901, a U.S. individual may claim a tax credit for foreign income taxes paid or accrued for a taxable year.[26] In general, the amount of the credit is limited to the product of (a) the U.S. individual's total U.S. federal income tax liability and (b) a fraction, the numerator of which is the U.S. individual's foreign source taxable income, and the denominator of which is the U.S. individual's total worldwide income.[27] Foreign taxes in excess of the limitation may be carried back one year and forward 10 years.[28] Thus, if a U.S. employee has excess foreign tax credits in respect of prior foreign service or is a resident of a foreign country for the year during which a tax-qualified plan distribution is received (such that the distribution is subject to tax in the foreign country), the treatment of a portion of the distribution as foreign source income can increase the amount of foreign tax credit that the recipient is entitled to use.

Under applicable IRS rulings, a tax-qualified plan distribution that is attributable to both U.S. domestic and foreign service is divided into three components for sourcing purposes.[29] First, the portion of the distribution that represents earnings is determined. That portion is treated as U.S. source income. Then, the remaining portion of the distribution is allocated between U.S. source and foreign source income based on the contributions made with respect to U.S. employment and foreign employment. Revenue Ruling 79-389[30] contains the following example demonstrating how this allocation is made:

> A, a citizen of the United States residing abroad, received payments from a United States pension plan totaling 15x dollars for the taxable year. The portion of the 15x dollars attributable to earnings of the pension plan is 5x dollars. A's employer contributed a total of 100x dollars to the pension plan with respect to wages earned by A. Twenty dollars of this amount was contributed to the plan by the employer while A was employed outside the United States. The portion of the pension received during the taxable year that was income from sources without the United States for purposes of determining the limitation on the credit for foreign taxes paid by A pursuant to section 904(a) is 2x dollars (10x x 20x/100x).

In the case of a defined contribution plan, the amount contributed to a plan with respect of an employee for U.S. and foreign employment will generally be readily determinable since specific amounts are allocated to employees' accounts under such plans. In the case of a defined benefit plan, the determination is more complicated because contributions are actuarially determined. In Revenue Procedure 2004-37, the IRS provides a method for determining the source of pension payments made to nonresident aliens from tax-qualified defined benefit pension plans. Presumably, the same method may be used for determining the source of pension payments made to U.S. citizens and residents from tax-qualified defined benefit pension plans.

b. Nonresident Aliens Receiving Distributions Attributable to Both Domestic and Foreign Service. The U.S. income tax treatment of a distribution from a tax-qualified plan to a nonresident alien depends, in significant part, upon whether the recipient is a resident of a country with which the United States has an income tax treaty. In situations where no treaty applies, the U.S. tax treatment of a distribution to a nonresident alien depends on a determination of the portion of the distribution that is U.S. source and non-U.S. source and the extent to which the income is effectively connected with the conduct of a U.S. trade or business by the nonresident alien. In situations where a treaty applies, the distribution, if it qualifies as a ''pension,'' generally will be taxable only in the country in which the employee is resident. Both situations—where a treaty applies and where one does not—are discussed below.

[23] U.S.-U.K. treaty, *id.* at art. 18, para. 2. Earnings attributable to such accruals also are exempt. *Id.*

[24] *Id.* at art. 18, para. 3. The plans identified as corresponding plans include: (i) for the U.K., employment-related arrangements (other than a social security scheme) approved as retirement benefit schemes for purposes of Chapter I of Part XIV of the Income and Corporation Taxes Act 1988, and personal pension schemes approved under Chapter IV of Part XIV of that Act; and (ii) for the U.S., tax-qualified 401(a) plans, IRAs, SEPs, SIMPLE accounts, Roth IRAs, 403(a) annuity plans, and 403(b) plans. *See* Diplomatic Notes to the U.S.-U.K. Income Tax Treaty (Exchanged July 24, 2001).

[25] The exclusion is limited, however, to that which would be allowed by the other country to its residents. *Id.* at art. 18, para. 2 (flush language).

[26] In lieu of claiming the foreign tax credit, a U.S. individual may claim foreign income taxes as a deduction under Section 164(a)(3).

[27] I.R.C. § 904(a).

[28] I.R.C. § 904(c). The foreign tax credit is elected on a year-by-year basis.

[29] *See*, *e.g.*, Rev. Rul. 79-389, 1979-2 C.B. 281; Rev. Rul. 84-144, 1984-2 C.B. 129; *see also* Rev. Proc. 2004-37, 2004-26 I.R.B. 1099.

[30] *Id.*

(i) Treaty applies. Many U.S. income tax treaties contain provisions that address the taxation of ''pensions.'' In most cases, they provide that a pension paid in respect of past employment is taxable only in the recipient's country of residence.[31]

In general, in order for a distribution to be covered by a treaty's pension provisions, the distribution must qualify as a ''pension.'' In evaluating whether a distribution qualifies as a ''pension,'' the terms of a treaty and related reports and explanations should be reviewed. The IRS has also issued a number of private letter rulings interpreting the scope of the term ''pension'' under various treaties. For example, in Private Letter Ruling 9041041,[32] the IRS ruled that a lump-sum payment could qualify as a ''pension'' for purposes of the U.S.-Switzerland treaty then in effect, even though the treaty defined the term ''pension'' as ''periodic payments'' in consideration for services or compensation for injury.

The IRS has ruled on numerous occasions that, in order for a distribution from a tax-qualified plan to be treated as a ''pension'' for treaty purposes, a number of conditions must be satisfied.[33] Typical of such conditions are those applied in Private Letter Ruling 9644051[34] concerning the U.S.-Germany treaty. They are as follows:

(i) at the time the distribution is made, the participant must either have been employed by his employer for five years or if employed for less than five years, have been first employed by the employer (or a related employer) on or after reaching age 62;

(ii) the distribution must be (A) made on account of the participant's death or disability, (B) paid as part of a series of substantially equal payments over the participant's life or life expectancy or the joint lives (or joint life expectancies) of the participant and the participant's beneficiary, or (C) after the participant's attainment of age 55; and

(iii) the distribution must be made either after the participant has separated from service with the participant's employer or has attained age 70-1/2.[35]

If a distribution does not qualify for favorable treatment under a treaty's pension and annuity provisions, the distribution may nonetheless qualify for favorable treatment under other treaty provisions. For example, in PLR 9253049,[36] the IRS ruled that distributions from an IRA that did not qualify as a ''pension'' under the prior U.S. – U.K. treaty's Article covering pensions qualified for favorable treatment under the treaty's Article covering ''other income.''

(ii) No treaty applies. In situations where no treaty applies, a distribution from a tax-qualified plan to a nonresident alien is divided into three components for U.S. federal income tax purposes: a portion that constitutes earnings; a portion that constitutes contributions attributable to services performed in the United States; and a portion that constitutes contributions attributable to services performed outside the United States. As discussed below, in general, (A) the portion of the distribution that consists of earnings is treated as U.S. source income that is not effectively connected with a U.S. trade or business, (B) the portion of the distribution that constitutes contributions attributable to U.S. services is U.S. source income that may or may not be effectively connected, and (C) the portion of the distribution that constitutes contributions attributable to foreign service is treated as foreign source income.[37]

As noted above, the portion of a distribution received by a nonresident alien representing earnings on amounts contributed to a tax-qualified plan is classified as U.S. source income that is not effectively connected with the conduct of a trade or business by the nonresident alien.[38] Under Section 871(a), this type of income is subject to a flat 30 percent tax. The earnings component of the distribution is treated as U.S. source income regardless of whether it relates to contributions made in respect of employment within or without the United States. Thus, even if all contributions made to a plan are in respect of employment outside of the United States, the earnings component of the distribution is nonetheless treated as U.S. source income. An important exception to this rule is provided by Section 871(f), which provides a complete income exclusion for the full amount of distributions received as an annuity if (a) all services in respect of which the annuity is paid were performed outside of the United States by a person who was a nonresident alien at such time,[39] and (b) at the time of the first annuity payment, 90 percent or more of

[31] *See*, *e.g*., U.S.-Belgium treaty (Article 17); U.S.-Germany treaty (Article 18); U.S.-Spain treaty (Article 20); U.S.-Switzerland treaty (Article 18); U.S.-U.K. treaty (Article 17). The U.S.-U.K. treaty and the U.S.-Netherlands treaty contains notable exceptions. The U.S.-U.K. treaty provides that lump-sum distributions are subject to tax only in the state where the pension plan is established. *See* U.S.-U.K. treaty (Article 17). The U.S.-Netherlands treaty provides that if at any time during the five-year period preceding payment the employee was a resident of the other state, the payment may be taxed in the other state if it is paid in consideration of employment in the other state, and the payment either is paid other than as periodic payments or is paid as a lump sum in lieu of the right to receive an annuity. *See* U.S.-Netherlands treaty (Article 19). U.S. treaties contain ''savings'' clauses under which the United States retains the right to tax its citizens under its tax laws without regard to the treaty. As a result, if a U.S. citizen retires and becomes a resident of a foreign country, pension benefits paid to the U.S. citizen generally are subject to U.S. federal income taxes regardless of whether the foreign country has entered into a treaty with the United States providing that pension payments are taxable only in the recipient's country of residence.

[32] PLR 9041041 (Oct. 12, 1990). *See* also PLR 200416008 (April 16, 2004) (definition of ''pension'' as ''periodic payments'' under U.S.-Australia treaty does not preclude treatment of lump-sum distribution as a pension under the treaty).

[33] *See*, *e.g*., PLR 9806012 (Feb. 6, 1998) (U.S. – Germany treaty); PLR 9644050 (Aug. 1, 1996) (U.S. – Germany treaty); PLR 9541043 (July 6, 1995) (U.S – India treaty). Amounts distributed from an IRA that holds solely distributions that qualify as pension distributions may also qualify as a pension for treaty purposes. *See*, *e.g*., PLR 9143067 (July 31, 1991) (U.S. – U.K. treaty).

[34] PLR 9644051 (Aug. 1, 1996).

[35] *Id*.

[36] PLR 9253049 (Oct. 6, 1992).

[37] *See* Rev. Rul. 79-388, 1979-2 C.B. 270; Rev. Proc. 2004-37, 2004-26 I.R.B. 1099.

[38] *See* Rev. Rul. 79-388, 1979-2 C.B. 270; Rev. Proc. 2004-37, 2004-26 I.R.B. 1099; *see also* Clayton v. U.S., 33 Fed. Cl. 628, 652 (Ct. Cl. 1995), *aff'd without published opinion,* 91 F.3d 170 (Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996); PLR 9041041 (July 13, 1990).

[39] A limited exception is provided if the nonresident alien is present in the United States for not more than 90 days during the taxable year, his or her compensation for such services does not exceed $3,000, and certain other requirements are satisfied. I.R.C. §§ 871(f)(1)(A)(ii) and 864(b)(1).

the employees for whom contributions or benefits are provided under the plan are U.S. citizens or residents.[40]

As indicated above, the portion of a distribution made to a nonresident alien that constitutes contributions attributable to services performed within the United States is treated as U.S. source income.[41] Whether the income is treated as being effectively connected with the conduct of a trade or business within the United States (and thus subject to normal graduated tax rates (rather than the flat 30 percent tax) under Section 871) depends, in part, upon whether the relevant services were performed before 1987.

Under Section 864(c), deferred compensation paid to a nonresident alien attributable to the performance of services during years after 1986 is treated as income effectively connected with the conduct of a U.S. trade or business if the compensation would have been so treated had it been paid in the year in which the services were performed. In general, compensation for services performed in the United States is treated as income effectively connected with the conduct of a U.S. trade or business. Section 864(c)(6) does not apply to compensation deferred with respect to services performed before 1987. As a result, such deferred compensation income may be treated as being effectively connected with the conduct of a trade or business within the United States only if the nonresident alien is engaged in a U.S. trade or business in the year of receipt and the deferred income is effectively connected with that trade or business.[42]

As indicated above, the third component of a distribution to a nonresident alien—the portion that constitutes contributions attributable to foreign service—is treated as foreign source income and, as such, is not subject to U.S. federal income taxes.

For purposes of allocating a distribution to a nonresident alien among the three components described above, the amount contributed to a defined contribution plan with respect to U.S. and foreign employment will generally be readily determinable because specific amounts are allocated to employees' accounts under such plans.

In the case of a defined benefit plan, the determination is more complicated because contributions are actuarially determined. As noted above, however, in Revenue Procedure 2004-37, the IRS provided a somewhat complicated formula for allocating pension payments made to a nonresident alien from a tax-qualified defined benefit plan between U.S. and foreign source income.[43] Under the revenue procedure, the portion of each distribution attributable to contributions for services rendered outside the United States (and thus treated as foreign source income) is equal to the quotient of (i) the product of (A) the total ''deemed contributions'' (calculated as provided in the revenue procedure) and (B) a fraction, the numerator of which is the months of service credited under the plan that were rendered outside the United States and the denominator of which is the total months of service credited under the plan as of the annuity starting date, divided by (ii) the present value of the pension as of the annuity starting date (calculated as provided in the revenue procedure).[44] The remaining portion of the payment—which represents the sum of ''deemed contributions'' for services rendered in the United States plus earnings on all contributions—is treated as income from sources within the United States.[45]

III. Foreign Pension Plans

In many cases, a foreign branch or affiliate may sponsor one or more pension plans that are designed to comply with local country tax requirements. In such situations, an outbound employee could participate in the foreign branch's or affiliate's pension plans in lieu of continuing to participate in the U.S. employer's tax-qualified plans. In addition, in the case of an inbound employee who is transferred to a U.S. employer from a foreign branch or affiliate that maintains its own pension plans, the employee could remain covered by such plans rather than becoming covered by the U.S. employer's tax-qualified plans. Although in both cases such coverage might be desirable for a variety of nontax reasons, it can, as discussed below, have adverse U.S. federal income tax consequences for the transferring employee as well as the applicable plan sponsor.

A. Tax Treatment of Inbound and Outbound Employees Covered by Foreign Pension Plans.

1. Foreign Pension Plan Benefit Accruals

A foreign branch's or affiliate's pension plan will generally be designed to comply with local country law rather than the code's plan qualification rules. As a result, unless a treaty prescribes other treatment, the foreign pension plan generally will be treated as a nonqualified deferred compensation plan for U.S. federal income tax purposes, and covered employees will be subject to U.S. federal income taxes with respect to benefit accruals in accordance with the rules applicable to participation in nonqualified deferred compensation plans. Whether an employee recognizes income with respect to the accrual of vested benefits under a nonqualified deferred compensation plan will generally depend upon whether the accrued benefit is treated as ''unfunded'' and ''unsecured'' for federal income tax purposes and whether the plan complies with, or is exempt from, Section 409A.

In general, Section 409A establishes a detailed framework of rules governing nonqualified deferred compensation plans. The rules address, among other things, the

[40] *See generally* Clayton v. U.S., *supra* note 38, at 652-53 (Ct. Cl. 1995); PLR 9537028 (June 21, 1995). If the 90 percent coverage requirement is not satisfied, the annuity income may still be excluded if the recipient's country of residence grants a substantially equivalent exclusion to citizens and residents of the United States or the recipient's country of residence is a beneficiary developing country under the Trade Act of 1974. *See also* PLR 8738015 (June 17, 1987) (net unrealized appreciation on employer securities distributed to nonresident alien excluded from income).

[41] Under § 861(a)(3), compensation for personal services performed within the U.S. is U.S. source income. A limited exception is provided for a nonresident alien who is present in the U.S. for not more than 90 days during the taxable year if his or her compensation for such services does not exceed $3,000 and certain other requirements are satisfied. I.R.C. §§ 871(f)(1)(A)(ii) and 864(b)(1). See I.R.C. § 1441 and the regulations thereunder for rules relating to withholding on pension distributions made to nonresident aliens.

[42] *See* I.R.C. § 871(b); PLR 9041041 (July 13, 1990).

[43] Rev. Proc. 2004-37, 2004-26 I.R.B. 1099.

[44] *Id.*

[45] *Id.*

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timing of deferral elections, the timing of distribution elections, and permissible distribution events. Section 409A also confers adverse tax treatment on nonqualified deferred compensation plans that are funded by offshore trusts, subject to certain exceptions. Failure to comply with Section 409A results in, among other things, accelerated recognition of income under the plan and similar plans that are ''aggregated'' under Section 409A and an additional 20 percent income tax.[46]

While a full discussion of the exceptions to Section 409A available with respect to participation in foreign pension plans is beyond the scope of this article, some key exceptions include the following: (a) participation in a foreign retirement plan under which contributions, accruals and/or other amounts constituting income are excludable for federal income tax purposes under a treaty, (b) participation in a ''broad based foreign retirement plan'' by U.S. citizens and lawful permanent residents, provided that the person does not also participate in a U.S. qualified plan and the accrual does not exceed the tax qualified plan limits under Section 415, and (c) participation in a ''broad-based foreign retirement plan'' by nonresident aliens, resident aliens classified as such only under the substantial presence test of Section 7701(b)(1)(A)(ii) and bona fide residents of U.S. possessions.[47] Because of the adverse tax consequences of failing to comply with Section 409A, avoiding Section 409A violations as the result of participation in a foreign retirement plan is a paramount consideration in deciding whether to extend or continue participation in a foreign retirement plan for outbound or inbound employees.

Assuming compliance with (or an exemption from) Section 409A, if accrued benefits under a foreign pension plan are unfunded and unsecured, the employee generally will not recognize income for U.S. federal income tax purposes until actual or constructive receipt of payment of the accrued benefit.[48] In contrast, if the foreign pension plan is funded, the employee generally recognizes income with respect to his or her accrued benefit under the plan at the time the benefit becomes vested (i.e., either nonforfeitable or transferable).[49] The general rule is that the employee is required to recognize income equal to the contributions made on his or her behalf at the time of vesting. However, under Section 402(b), if one of the reasons that the trust through which benefits are funded is not tax-exempt under Section 501(a) is the failure of the related plan of which it is a part to satisfy the requirements of Sections 401(a)(26) or 410(b), an employee who is a ''highly compensated employee'' (within the meaning of Section 414(q)) is required to recognize income equal to the full amount of his or her vested accrued benefit rather than only the amount of contributions made on his or her behalf.

Section 402(b) further provides that if the sole reason a trust is not tax-exempt under Section 501(a) for a taxable year is the failure of the related plan to satisfy the requirements of Sections 401(a)(26) or 410(b), the foregoing rules do not apply to an employee who is not a highly compensated employee, with the result that a nonhighly compensated employee does not recognize income until actual or constructive receipt of a distribution.

Because a foreign pension plan is generally treated as a nonqualified plan for U.S. federal income tax purposes, in many cases it will not be desirable from a tax perspective for either (a) an outbound U.S. employee to participate in a funded foreign pension plan while on a foreign assignment or (b) an inbound foreign national to continue to participate in a funded foreign pension plan.

2. Foreign Pension Plan Distributions

a. U.S. Citizens and Residents. Because U.S. citizens and residents are taxable on their worldwide income without regard to whether its source is U.S.-based or foreign-based, distributions from a foreign pension plan to a U.S. citizen or resident will generally be subject to tax in accordance with the code's rules applicable to distributions under nonqualified retirement plans. Under these rules, if benefits under the foreign pension plan are unfunded and unsecured, the full amount of payments made to the employee under the plan are includible in the U.S. citizen's or resident's income for federal income tax purposes when received. If benefits under the foreign pension plan are funded or secured, distributions to the employee are taxable in accordance with the rules under Section 72.

Under Section 72, the portion of a distribution attributable to an employee's ''investment in the contract'' is, like ''basis,'' excluded from income for federal income tax purposes. For this purpose, an employee's investment in the contract includes (i) amounts contributed by the employee that were includible in the employee's gross income and (ii) employer contributions to the extent that the contributions were includible in the employee's income or would not have been includible in the employee's income even if paid directly to the employee.

b. Nonresident Aliens. In general, the U.S. income tax treatment of a distribution from a foreign pension plan to a nonresident alien depends, in part, upon whether the recipient is a resident of a country with which the United States has an income tax treaty. If no treaty provision applies, similar to the tax treatment of distributions to nonresident aliens from U.S. tax-qualified plans, the distribution is allocated between U.S. source income and foreign source income based on where the employee performed the services giving rise to the accrual. If the plan is funded, the distribution would be taxed in accordance with Section 72. In situations where a treaty applies, the distribution, if it qualifies as a ''pension,'' generally will be taxable only in the country in which the employee is resident.

B. Deductions and Reductions in Earnings and Profits for Contributions to Foreign Pension Plans. Ideally, contributions to a foreign pension plan by a U.S. employer conducting foreign operations through a branch would be

[46] I.R.C. § 409A(a)(1). In some cases § 457A, which imposes adverse tax treatment on nonqualified deferred compensation plans maintained by ''nonqualified entities,'' may effectively bar participation in a foreign pension plan. In general, under § 457A, a ''nonqualified entity'' is (a) any foreign corporation, unless substantially all of the corporation's income is effectively connected with a U.S. trade or business or is subject to a comprehensive foreign income tax, and (b) any partnership, unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (ii) U.S. tax-exempt organizations. I.R.C. § 457A(b).

[47] Treas. Reg. § 1.409A-1(a)(3).

[48] Rev. Rul. 60-31, 1960-1 C.B.174.

[49] *See* I.R.C. §§ 402(b) and 83.

currently deductible. Similarly, in the case of a U.S. employer that conducts its operations through a foreign affiliate, the affiliate would ideally be entitled to a current deduction for contributions to the plan (which generally will be of value only to the extent that the affiliate has U.S. source income against which the deduction can be applied) as well as a current reduction in the subsidiary's earnings and profits for purposes of the indirect foreign tax credit under Section 902. However, because foreign pension plans are not designed to comply with the code's qualification requirements, Section 404(a), which allows the current deduction of contributions to tax-qualified plans, is not available with respect to such contributions.

Although Section 404(a) does not apply with respect to contributions to foreign pension plans, Section 404A and the proposed regulations thereunder provide for a current deduction and a current reduction in earnings and profits for contributions made to a ''qualified foreign plan,'' subject to complying with a range of requirements that can be difficult to satisfy. The proposed regulations under Section 404A have generated a substantial amount of criticism, particularly with respect to the difficulty of satisfying certain Section 404A conditions and the position taken in the regulations that compliance with Section 404A is the sole means by which a foreign affiliate may obtain a current reduction in earnings and profits.[50]

A discussion of Section 404A's requirements is generally beyond the scope of this article. However, the basic requirements for qualifying as a ''qualified foreign plan'' under Section 404A are that the plan must be maintained for the exclusive benefit of the employer's employees and their beneficiaries and at least 90 percent of ''the amounts taken into account for the taxable year under the plan'' must be attributable to services performed by nonresident aliens whose compensation for such services is exempt from U.S. federal income taxes.[51] In addition, the employer must elect to have Section 404A apply. Section 404A also provides that no deduction is allowed under Section 404A to the extent that the deduction is attributable to services performed (i) by a U.S. citizen or resident who is a highly compensated employee (as defined in Section 414(q)) or (ii) in the United States if the compensation for the services is subject to U.S. federal income taxes.[52] As a result, contributions in respect of outbound employees who are highly compensated employees or inbound employees generally will not be deductible under Section 404A. In addition, coverage of a substantial number of outbound or inbound employees under a foreign pension plan can adversely affect the ability of the plan to qualify under Section 404A under the 90 percent rule noted above.

To the extent that Section 404A does not apply to a foreign pension plan, Section 404(a)(5) will generally govern the deductibility of contributions to the plan. The IRS also takes the position in the proposed regulations under Section 404A that, to the extent Section 404A does not apply to a foreign pension plan, a foreign affiliate may reduce earnings and profits only as otherwise permitted under Section 404. Under Section 404(a)(5), if accrued benefits under a foreign pension plan are unfunded and unsecured, the employer-sponsor is entitled to a deduction at the time that an employee recognizes income from the actual or constructive payment of benefits.[53] In the case of a foreign pension plan under which benefits are funded or secured, an employer is entitled to a deduction under Section 404(a)(5) for contributions to the plan in the employer's taxable year in which or with which ends the taxable year in which an amount attributable to the contribution is includible in the employee's gross income.[54] However, if the plan covers more than one employee, separate accounts must be maintained in order for the employer to be entitled to a deduction.[55] As a result of the separate account requirement, under the IRS's position in the proposed regulations, contributions to a foreign pension plan that is a defined benefit plan and that does not satisfy the requirements of Section 404A may not, at any time, be deductible or result in a reduction in earnings and profits.

C. Other Aspects of Coverage Under Foreign Pension Plans. If outbound employees are covered by a foreign pension or other employee benefit plan, consideration should be given to whether such coverage could potentially cause the plan to be covered by ERISA.[56] Under Section 4(b)(4) of ERISA, plans that are maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens are exempt from Title I of ERISA. Section 4021(b)(7) of ERISA provides a similar exemption from Title IV of ERISA, except that the plan must also be ''established'' outside the United States. Thus, if the plan covers a substantial number of U.S. citizens or residents, it could potentially become subject to ERISA.

Of note in this regard is *Pitstick v. Potash Corp. of Saskatchewan Sales Ltd.*,[57] where the court held that a severance plan maintained and operated in Canada that covered a total of 1,668 employees, less than 30 of whom were U.S. citizens and only 23 of whom were U.S. residents, was not subject to ERISA.[58] DOL has opined that a plan covering 1,330 employees of which nine were U.S. residents or citizens and a plan covering 1,564 employees, of which 117 inactive participants and 37 active participants were U.S. residents or citizens, were exempt from Title I of ERISA. It has also opined that a plan covering 25,277 employees, of which approximately 1,900 were U.S. citizens or residents, and a plan covering 110 employees of which 50 were U.S. citizens or residents, were not exempt from Title I of ERISA.[59] The Pension Benefit Guaranty Corporation (PBGC) has taken the position that a plan covering 498 employees, of which 48 were U.S. participants, and a plan covering 128 employees, of which 5 were U.S. participants, were not subject to Title IV of ERISA, pro-

[50] *See*, *e.g.*, Tax Executives Institute Comments on Proposed Regulations Under Section 404A (Jan. 6, 1994); American Institute of Certified Public Accountants Comments on Proposed Regulations Under Section 404A (Oct. 14, 1993).

[51] I.R.C. § 404A(e).

[52] I.R.C. § 404A(g).

[53] *See* Treas. Reg. § 1.404(a)-12(b)(2).

[54] *See* Treas. Reg. § 1.404(a)-12(b)(1).

[55] *See* Wigutow v. Comm'r, T.C. Memo 1983-620; Treas. Reg. § 1.404-12(b)(3).

[56] Employee Retirement Income Security Act of 1974, as amended.

[57] 698 F. Supp. 131, 10 EBC 1373 (S.D. Ohio 1988).

[58] *See also* Lefkowitz v. Arcadia Trading Co. Ltd. Benefit Pension Plan, 996 F. 2d 600, 16 EBC 2516 (2d Cir. 1993).

[59] *See* DOL Adv. Opinions 77-86A (Nov. 25, 1977), 82-38A (Aug. 2, 1982), 80-5A (Jan. 28, 1980), 78-26A (Nov. 27, 1978).

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vided that the plans were established and maintained outside of the United States.[60]

An additional factor that should be considered in deciding whether to cover a U.S. employee employed by a U.S. employer under a foreign pension plan is whether the coverage could result in the U.S. employer being required to include the foreign pension plan's trust earnings in its own income. Under Section 679, if a U.S. person directly or indirectly transfers property to a foreign trust, then, subject to certain exceptions, the U.S. person is treated as the owner of the portion of the trust attributable to such property if the trust has a U.S. beneficiary. Under Section 679(c), a foreign trust is treated as having a U.S. beneficiary unless (i) under the terms of the trust, no part of the trust's assets can be used for the benefit of a U.S. person and (ii) if the trust were terminated during the year, no part of the trust's assets could be paid to or for the benefit of a U.S. person. In general, however, Section 679 should not pose a problem with respect to covering outbound employees under foreign pension plans since Section 679(a)(1), by reference to Section 6048(a)(3)(B)(ii), exempts nonqualified employees' trusts described in Section 402(b), trusts described in Section 501(a) that would be qualified except that the trust is located outside the United States, and foreign pension plan trusts covered by Section 404A.[61]

IV. SERPs, Excess Benefit Plans, and Elective Nonqualified Deferred Compensation

In addition to sponsoring tax-qualified plans, most large U.S. employers also sponsor one or more nonqualified deferred compensation plans. The most common types of nonqualified deferred compensation plans are: supplemental executive retirement plans (commonly referred to as ''SERPs''), under which employees are provided with retirement benefits that supplement their tax-qualified plan benefits; so-called ''excess benefit plans,'' under which employees are provided with benefits that ''replace'' tax-qualified benefits to which the employee would otherwise be entitled under the employer's tax-qualified plans absent the code's limitations on benefits; and elective nonqualified deferred compensation plans, under which an employee may elect to defer receipt of an elected portion of the employee's salary or bonus. The benefits provided under these plans are, in the vast majority of cases, unfunded and unsecured for federal income tax purposes. As a result, employees generally do not recognize any income with respect to accrued benefits under such plans until the actual or constructive receipt of benefits.[62]

Because U.S. citizens and residents are taxable on their worldwide income without regard to whether its source is U.S.-based or foreign-based, a U.S. citizen or resident who accrues benefits under a nonqualified deferred compensation plan attributable to U.S. and foreign service recognizes the full amount of all distributions from the plan as income for federal income tax purposes. If the employee has excess foreign tax credits in respect of prior foreign service or is a resident of a foreign country for the year during which a nonqualified deferred compensation plan distribution is received (such that the distribution is subject to tax in the foreign country), the treatment of a portion of the distribution as foreign source income can increase the employee's foreign tax credit limitation.

In the case of a foreign national who is transferred to a U.S. employer and becomes a U.S. resident, the employee is subject to U.S. federal income taxes on his worldwide income as a U.S. resident and is also potentially subject to the income taxes of the employee's country of citizenship. Although accruals under one or more of a U.S. employer's unfunded nonqualified deferred compensation plan generally are not taxable income for U.S. federal income tax purposes to a U.S. resident, they could potentially be taxable under the income tax laws of the employee's country of citizenship. Unlike the United States, however, most countries do not impose income taxes on income earned abroad by nonresident citizens, and such accruals therefore generally will not be subject to income tax under tax laws of the inbound employee's home country.

The tax consequences of a distribution to an inbound employee who is a nonresident alien at the time he or she receives a distribution from a U.S. employer's nonqualified deferred compensation plan may depend, in part, upon whether the recipient is a resident of a country with which the United States has an income tax treaty. If a treaty applies and the distribution qualifies as a ''pension,'' it generally would be taxable only in the country in which the employee is resident. Of note is that the Treasury Department's explanation of the 2006 U.S. model tax treaty states that the phrase ''pension and other similar remuneration,'' as used in the model treaty, is intended to encompass payments made by ''qualified private retirement plans,'' including, with respect to U.S. plans, certain listed arrangements such as IRAs.[63] It provides that competent authorities may agree that distributions from other types of plans that ''generally meet similar criteria'' to those applicable to the listed plans also qualify.[64]

If no treaty provision applies to a distribution from a nonqualified deferred compensation plan, the distribution is allocated between U.S. source and foreign source income based on where the employee performed the services giving rise to the accruals. The extent to which any U.S. source income component of the distribution is treated as effectively connected with a U.S. trade or business would be determined in accordance with Section 864(c)(6).

[60] PBGC Opinion Letter 74-25 (Nov. 8, 1974).

[61] Foreign pension plan trust income may nonetheless potentially be subject to U.S. federal income taxes to the extent the plan is treated as overfunded. *See* Prop. Treas. Reg. § 1.671-1(h).

[62] *See* Rev. Rul. 60-31, 1960-1 C.B.174 and *supra* note 48 and related text.

[63] *See* United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 (Nov. 15, 2006), p. 54.

[64] *Id*. In Private Letter Ruling 200416008, the IRS ruled that a distribution from a U.S. nonqualified supplemental retirement plan to an Australian citizen who would be a resident of Australia at the time of the distribution (and who would have relinquished his permanent resident status in the United States prior to distribution) would be treated as a ''pension'' exempt from U.S. income tax under the U.S.-Australia tax treaty. The ruling did not address whether the terms of the plan satisfied any requirements applicable to qualified plans. *See* PLR 200416008, *supra* note 32.

V. Conclusion

A key aspect of managing cross-border employee transfers is properly structuring employees' participation in pension and deferred compensation plans. Whether and how inbound and outbound employees are covered under U.S. tax-qualified pension plans, U.S. nonqualified deferred compensation plans, and/or foreign pension plans can impact compliance with the code's plan qualification rules and can have other important tax consequences for the employer and employee. In general, there are a range of alternatives available to employers with respect to structuring inbound and outbound employees' plan coverage. Which alternative best suits a particular situation requires analysis of U.S. and foreign tax laws affecting pensions and the impact of any governing treaty.

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