PENSION BENEFITS CONSIDERATIONS FOR MULTINATIONAL COMPANIES: CROSS-BORDER ISSUES IN THE GLOBAL ECONOMY

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Introduction

- Increased globalization
- Cross-border transfer of employees
- Choice of benefit plans
  - Impact on employees
  - Plans must comply with U.S. and host country laws
    - Tax
    - Benefits
    - Treaty issues

Eligibility to Participate of Outbound Workers

- Exclusive benefit rule
  - Participants limited to employees of plan sponsor
- Frequently met by controlled group rules
  - Plan can cover employees of any consolidated group member
  - Controlled group members treated as single employer
    - Tax rules
    - Controlled group concept not universal

Definition of Controlled Group

- 2 types of controlled groups
  - Parent subsidiary
    - 80% ownership test
  - Brother-sister
    - 80% test by 5 or fewer persons
    - 50% test by same 5 persons
- Foreign entity may be a controlled group member
  - Unlike Code section 1563 rule used for non-benefits purposes

Code Section 406 - Eligibility of Foreign Affiliate Employees

- Code §406
  - Allows U.S. employees of foreign affiliate to participate in U.S. parent’s plan
- Conditions
  - Plan document expressly covers all U.S. taxpayers working for affiliate
    - Coverage extends to all subsidiaries with foreign operations
  - No contributions to other plans for these workers
  - Social Security Agreement covers U.S. workers

Code Section 407 - Eligibility of Domestic Subsidiary Employees

- Code §407
  - Allows U.S. employees of 80% owned domestic sub to participate in U.S. parent's plan
- Conditions
  - Plan document covers U.S. workers employed abroad by domestic sub
  - No contributions to another plan
  - U.S. plan must cover all offshore U.S. citizens & resident aliens
  - 95% of subsidiary's income from non-U.S. sources
- §407 redundant, because of controlled group rules

Other Techniques for Complying with Exclusive Benefit Rule

- Code §414(n)
- Lease employees of U.S. parent to affiliated entities with foreign operations
- Control over hiring, firing, reassignment and pay stays with U.S. parent.
- Leasing fees should provide reasonable profit to U.S. parent
- Conditions for leased employee status
  - Full time
  - One year of service
- Potential foreign law employment issues for U.S. parent

Credited Pay of the Outbound Worker

- Code §415: foreign pay not taxed by U.S. can be counted to determine limits on benefits
- Code §401(k): no salary reduction contributions for foreign pay not taxed by U.S.
- Plan design issues
  - Whether to count housing subsidies & cost of living allowances in benefit formula
  - Set time for converting foreign currency to U.S. dollars

Outbound Worker's Imputed Service and/or Pay

- Service and pay with unaffiliated foreign company can be imputed under defined benefit plan
  - Discrimination prohibited
  - Legitimate business reason needed
  - General expectation that employee will return to service with plan sponsor
  - Imputed pay not allowed under defined contribution plan

Employer Deduction

- General rule: no deduction for contribution on behalf of another employer’s employees
- Contributing parent may treat contribution as capital contribution and sub can claim deduction
  - Sub needs to adopt plan to claim deduction
- 10% excise tax on nondeductible plan contributions
  - Penalty not applicable if nondeductibility caused by working for affiliate

Deduction of Contributions on Behalf of Another Employer

- Code §406(b) gives deduction to foreign sub
  - Statute applies contribution to capital theory if U.S. parent makes contribution
  - Inefficient if foreign sub lacks U.S. tax liability
- Code §407(b) gives deduction to U.S. sub with foreign operations, even if U.S. parent makes contribution
  - U.S. domestic sub likely to have U.S. taxable income that can be reduced by deduction

U.S. & Foreign Taxation of Accruals for Employees Working Abroad – Tax Qualified Plans

- No U.S. taxation of tax-qualified contributions or accruals for service abroad
- Foreign country can impose tax on tax-qualified contributions or accruals
  - Treaty exemption may limit foreign tax
  - French treaty provides conditional relief
    - Relief limited to amount deductible under comparable French plan
    - Must have participated in U.S. plan before working in France
  - Similar relief in U.S. model treaty

U.S. Taxation of Accruals for Employees Working Abroad – Non Qualified Plans

- U.S. citizen taxable by U.S. on value of funded and vested nonqualified deferred compensation
  - Includes taxation of foreign plans
- Code §409A may apply to foreign retirement plan that is not U.S. tax qualified
  - Exception for "broad based" foreign plans
    - Plan must be in writing
    - Rank and file employees must be covered
    - Substantially all participants must be nonresident aliens
    - Limited in-service access to funds to ensure plan is for retirement purposes

U.S. Taxation of Plan Distributions to Employees Working Abroad

- Residence in foreign country at time of distribution can result in taxation not only by U.S. but also by the foreign country
- Tax treaty relief from double taxation
  - Under some treaties, distribution from U.S. qualified plan is taxable only by U.S.
    - U.S. – France treaty
  - Other treaties provide for taxation only by the country in which plan participant resides

U.S. Withholding on Plan Distributions

- U.S. citizens and resident aliens can elect out of withholding on retirement plan distributions
  - Withholding will generally apply to plan distributions outside U.S.
- Form W-4P allows U.S. citizens and residents to elect not to have withholding apply or to specify the amount of withholding
- Nonresident aliens would use Forms W-8BEN or 8233 to claim relief if a tax treaty exempts distributions from withholding

Tax Treatment of Trust Earnings

- Qualified plan trust must be subject to jurisdiction of U.S. courts
  - If non-citizens are trustees, U.S. trustees must control "substantial decisions"
  - Trust assets can be held abroad if subject to control of U.S. trustee
- U.S. tax imposed on non-qualified foreign trust earnings that are U.S.-source income
  - 30% withholding rate
- Foreign country may attempt to tax U.S. citizens working abroad on U.S. tax-qualified plan earnings unless exception under tax treaty applies

ERISA's Domestic Trust Requirement

- ERISA separately requires that indicia of ownership of all trusteed U.S. benefits be held within jurisdiction of U.S. courts
- DOL regulations provide for exceptions
  - Exceptions apply mainly to non-U.S securities and foreign currency
  - Exception for assets held in Canada if required by Canadian law
  - Pooling arrangements with foreign cash and securities can use foreign sub-custodians
    - Foreign sub-custodian must be subject to government regulation and U.S. trustee

Reporting by Foreign Trusts – Form 5500

- Foreign plans are generally exempt from making annual reports on Form 5500
- Certain foreign plans must file Form 5500-EZ
  - Foreign plans maintained by U.S. employer
  - Plan maintained by a foreign employer with U.S.-source income offset by plan contributions

Other Reporting Requirements Applicable to Foreign Trusts

- Sponsors of nonqualified foreign plans may use a grantor trust to fund benefits, because of rights retained by the grantor over trust assets
  - IRS From 3520 must be filed by grantors of foreign situs trust
    - Exemptions
      - Tax-qualified foreign plans
      - Foreign plans funded by contributions subject to Code §404A
- Form 3520 also used to report distributions from foreign trust
- Form 3520A used by foreign grantor trust to report the interest of any of its U.S. grantors

FBAR Reporting

- Plan trusts (qualified or nonqualified) are subject to FBAR report if they have a financial interest in a foreign account
  - Legal title
  - Owner of record
  - Accounts held by bank or broker as nominee for plan trust
- Private funds not subject to FBAR reporting
- Plan trust with foreign mutual fund must make FBAR reports

Tax on Vesting under Code Section 457A - Overview

- Gaming of system where payor of deferred compensation pays no tax
- Code §457A provides plan participants will be taxed when deferred compensation from “nonqualified entity” vests
  - Participant owes tax even if compensation not paid
- Nonqualified entity
  - Foreign corporation unless
    - All corporate income is effectively connected with U.S. trade or business, or
    - Corporation is subject to a comprehensive income tax
  - Foreign or domestic partnership unless substantially all income allocated to persons other than
    - Foreign persons not subject to foreign income tax, or
    - Tax-exempt U.S. organizations

Entities Subject to Section 457A

- Affected plan sponsors include entities which would be entitled to compensation deduction under U.S. tax law principles if the entity paid the deferred compensation in cash
  - §457A cannot be avoided by covering all employees under parent's deferred compensation plan if services are performed for parent's foreign subsidiary
- Determination as to whether a plan sponsor is a nonqualified entity is to be made on the last day of an employee's taxable year (generally December 31)
  - If plan sponsor becomes disqualified entity during the year, amounts accrued up to that point will be subject to §457A

Foreign Corporations under Section 457A

- Foreign Corporation prong of "Nonqualified Entity" definition
- First way to avoid Nonqualified Entity status:
  - Substantially all (80%) effectively connected with U.S. trade or business
  - Income must be subject to tax and cannot be exempt under a treaty
- Second way to avoid Nonqualified Entity status"
  - Substantially all of Foreign Corporation's income subject to comprehensive foreign income tax
  - Corporation must be eligible for benefits under income tax treaty between U.S. and country of residence

Partnerships under Section 457A

- All pass-through entities (*e.g.*, LLCs) fall under partnership prong of "Nonqualified Entity" definition
  - 80% of partnership gross income must be allocated to "Eligible Persons"
  - Eligible persons generally subject to U.S. tax
    - U.S. citizen
    - U.S. resident
    - Domestic corporation
    - Domestic partnership
- If more than 20% of partnership's gross income allocated to parties not subject to U.S. or foreign income tax, the partnership becomes a Nonqualified Entity

Compensation Arrangements Subject to Section 457A

- Same definition of deferred compensation as Code §409A
  - “Legally binding right” to payment of compensation in later taxable year
    - Legally binding right exists if there is enforceable promise even if not vested
- Definition includes SERPs, elective deferrals, excess benefit plans, long-term incentive arrangements
- Excluded arrangements: stock options and SARS settled with employer stock
- Short term deferral exception
  - Distribution within 12 months of last day of employer’s taxable year in which compensation vests
  - 12 month distribution deadline is longer than 2½ months under Code §409A

Vesting under Section 457A

- Importance of vesting
  - Trigger for taxation
  - 12 month short-term deferral exception measured from vesting date
- Under Code §457A, vesting is based solely on performance of substantial future services
- Code §457A disregards performance based vesting and vesting conditioned on noncompete agreement
- Vesting period cannot be lengthened once legally binding right arises

Amount and Timing of Income under Section 457A

- Timing and amount of taxation follows proposed regulations under Code §409A
- Taxable income for year in which vesting occurs
  - Total amount deferred as of December 31 plus
  - Deferred compensation actually paid during year
- Year by year taxation of earnings on vested amounts
  - Different treatment than Code §457(f) under which earnings not taxed until distributed

Section 457A Treatment of Indeterminable Amounts

- Taxation deferred on vested deferred compensation if amount is indeterminable
  - Applies to benefits based on a formula using variable factors that remain unknown
    - Bonus based on profits as of specified date is indeterminable until date specified
    - Benefits that can be calculated using reasonable actuarial assumptions not affected
- On vesting, indeterminable amounts subject to additional tax liability
  - Regular income tax
  - 20% additional tax
  - Penalty interest charge

Treatment of Inbound Workers – Overview

- No question regarding exclusive benefit rule or ability to deduct contributions for foreign nationals who are employees of U.S. plan sponsor
- U.S. nondiscrimination rules
  - Inapplicable to nonresident aliens working outside U.S.
  - Receipt of U.S source income would require foreign nationals to be included in nondiscrimination testing
- Tax treaty relief generally available with respect to foreign income taxes imposed on accruals or contributions for foreign nationals under U.S. retirement plan
- Treaties may provide that foreign nationals returning home are taxed on distributions from U.S. plan only by home county

Taxation of Plan Distributions to Nonresident Aliens

- Complex U.S. sourcing and characterization rules apply to U.S. plan distributions to foreign nationals
- U.S. source income:
  - Portion of plan distribution attributable to employer contributions while foreign national worked in U.S.
  - Distribution of investment earnings on plan contributions regardless of work location
- U.S. source income generally subject to graduated tax rates, because effectively connected with U.S. trade or business
- Distributions not effectively connected with U.S., even if they constitute U.S. source income
  - Investment earnings on plan contributions
  - Distributions subject to 30% flat rate tax

Special Sourcing Rule for Defined Benefit Plan Distributions

- Determine total of employer contributions for foreign national participating in U.S. plan
  - Number of years of participation
  - Present value of foreign national's pension on annuity starting date
- Apportionment of contributions to non-U.S.-source income based on ratio
  - Numerator: number of months credited for service performed outside U.S.
  - Denominator: total months of credited service
- Remaining U.S.-source portion of distribution subject to 30% withholding, including
  - Services generated contributions and
  - Investment earnings on contributions

Special Exemption for Certain Annuity Distributions

- Annuity distributions to nonresident alien from U.S. qualified plan exempt from gross income under Code §871(f)
  - At least 90% of plan participants are U.S. citizens or U.S. resident aliens and
  - Services requirement:
    - Services that earned benefits were performed outside U.S. or
    - Foreign national works in U.S. for not more than 90 days and compensation did not exceed $3000

Withholding on Distributions

- General rule on pension distributions requires flat 30% withholding
  - Applies even if a portion of the pension was earned by service performed within U.S.
  - No exceptions if foreign national recipient does not have U.S. Social Security number
  - No exception if recipient has address in foreign country without U.S. tax treaty
  - Lower graduated tax rates apply if pension earned by services in U.S.
    - Nonresident alien pensioner may need to file for refund on IRS Form 1040NR
- Claiming income tax relief under tax treaty
  - Nonresident alien files IRS Form 8233 with plan administrator
- Claiming exemption under Code §871(f)
  - Nonresident alien files Form W-8BEN with plan administrator

Overview of Employer Deductions for Foreign Plans under Section 404A

- Long-term transfers abroad create need for host-country retirement plan or for international plan
  - Foreign and international plans seldom meet U.S. rules for tax qualification
  - If plan is not tax-qualified, deductions for employer contributions become problematic
- Code §404(a)(5) limitation applies to deductions for contributions to nonqualified plans
  - Deduction allowed only when participant includes benefit in taxable income
  - Deduction for contributions to foreign plans lost forever
- Code §404A enacted to enable deductions of expenses associated with foreign plans

Section 404A Mechanics

- Code §404A allows deduction for contributions to foreign funded plan subject to conditions:
  - Contribution paid directly to participant of beneficiary
  - Contribution paid to insurance company to buy annuity
  - Contribution to trust or foreign law trust equivalent
    - Trust must contain must restrict use of assets to exclusive benefit of participants
- Code §404A also grants reductions in e&p for unfunded reserve plans
  - Reserve plan is unfunded and e&p offset equals annual increase in a bookkeeping reserve credited with the present value of vested benefits
- Two methods for electing coverage under Code §404A

Qualifying Plans under Section 404A

- Foreign plan must provide deferred compensation
  - Foreign social security systems and welfare benefit plans do not qualify
  - Plan must be in writing
    - Writing must prohibit diversion of assets for purposes other than benefit of participants
    - Exclusive benefit rule also applies to unfunded reserve plans with no assets
  - At least 90% of plan contributions must be attributable to services performed by nonresident aliens exempt from U.S. taxation
    - Defined contribution plans tested on account balances
    - Defined Benefit plans tested on the actuarial present value of benefits
    - Safe harbor simplifies test by referring to relative amounts of current compensation of U.S. taxpayers and nonresident aliens but increases 90% requirement to 95%

Trust Requirement under Section 404A

- Criteria for foreign trust equivalent
  - Segregation of corpus and income from sponsor's assets
  - Not subject to claims of employer's creditors
  - Exclusive benefit of participants until all plan liabilities met
  - Corpus and income held by a person with a legally enforceable duty to operate the fund prudently
- Foreign law may not be consistent with Section 404A principles
  - Example: the law in some countries may require reversions to employer of overfunded plan

FACTA
(Foreign Account Tax Compliance Act)

- Foreign financial institutions (“FFIs”) required to report and/or withhold on off-shore holdings of U.S. taxpayers
  - Regulations hold non-U.S. retirement fund can be an FFI
  - Withholding agents required to impose 30% withholding on U.S.-source income (*e.g.* investments in U.S. securities)
    - To avoid withholding, plan must qualify for exception or cooperate in reporting pension benefits owed to U.S. taxpayers
- FACTA withholding not applicable if country in which plan is located has intergovernmental agreement (“IGA”) with U.S.
  - Plan registers with IRS and reports tax information about U.S. participants to home country tax authorities
  - Home country reports to IRS regarding plan’s U.S. participants

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