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TAXATION
A Section of the American Bar Association

Section of Taxation

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January 31, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments Regarding Section 402(b) and Foreign Plans

Dear Acting Commissioner Kautter:

Enclosed please find comments concerning section 402(b) of the Code and its impact on foreign plans (the "Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Dana L. Trier, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Robert S. Choi, Director, Employee Plans, Internal Revenue Service
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Robert Neis, Benefits Tax Counsel, Department of Treasury
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ABA SECTION OF TAXATION
COMMENTS ON THE APPLICATION OF
SECTION 402(b) TO FOREIGN PLANS

These comments (the "Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Mark C. Jones, past Chair of the Subcommittee on Multinational Employee Benefits & Compensation Issues of the Employee Benefits Committee of the Section of Taxation, and Kurt L. Lawson, past Chair and Council Director for the Employee Benefits Committee. Substantive contributions were made by Maureen J. Gorman, James P. Klein, Danny A. Martin Jr., Rhonda G. Migdail, Veena K. Murthy, Alan A. Nadel, Rita M. Patel, David W. Powell, Susan P. Serota, Angela M. Stockbridge, Marina Vishnepolskaya, and Karen D. Youngstrom. The Comments were reviewed by Kathryn J. Kennedy, Chair of the Employee Benefits Committee. The Comments were further reviewed by Mark A. Bodron of the Section's Committee on Governmental Submissions, Catherine Engell, Council Director for the Employee Benefits Committee, and Julian Y. Kim, the Section's Vice-Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 31, 2018

EXECUTIVE SUMMARY

The United States ("U.S.") workforce is becoming increasingly mobile. Visas issued to foreign workers increased from 794 in fiscal year 1990[1] to 181,351 in fiscal year 2016.[2] Although the State Department does not keep formal statistics on U.S. expatriates, it estimates that the number of nonmilitary citizens living abroad increased from four million in 1999[3] to nine million in 2016.[4] It is common for non-U.S. employees who are assigned temporarily to a U.S. entity or location to continue participating in a retirement plan in their home country, by arranging for either their permanent non-U.S. employer or the U.S. service recipient to make contributions. It also is common for U.S. taxpayers working overseas to participate in a retirement plan sponsored by the service recipient in their host country – either because they are required to do so under local law or because they are working in the host country on a permanent basis.

Contributions to, accruals under, and distributions from trusts that are part of foreign retirement plans generally are governed by section 402(b),[5] which describes the tax treatment of interests in employees' trusts that are not tax-exempt under section 501(a).[6] As a rule, trusts that are part of foreign plans are not tax-exempt under section 501(a) because the trusts or the plans do not satisfy one or more of the qualification requirements of section 401(a), such as the contribution and accrual limits of sections 401(a)(17) and 402(g), the benefit limitations of sections 415 and 436 or the nondiscrimination rules of section 401(a)(4). As explained in more detail below, depending on how section 402(b) is interpreted, the tax treatment of employees and their beneficiaries under such trusts can be quite harsh – harsher even than the tax treatment of many deferred compensation arrangements available outside of a trust, such as annuity

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[1] U.S. Department of State, *Classes of Nonimmigrants Issued Visas (Detailed Breakdown) (Including Crewlist Visas and Border Crossing Cards) Fiscal Years 1987-1991*, http://travel.state.gov/content/dam/visas/Statistics/Non-Immigrant-Statistics/NIVClassIssuedDetailed/NIVClassIssued-DetailedFY1987-1991.pdf.

[2] U.S. Department of State, *Table XVI(B) Nonimmigrant Visas Issued by Classification (Including Border Crossing Cards) Fiscal Years 2012-2016*, http://travel.state.gov/content/dam/visas/Statistics/AnnualReports/FY2016AnnualReport/FY16AnnualReport-TableXVIB.pdf.

[3] *See* James P. Schachter, U.N. Secretariat, Dep't of Econ. & Soc. Aff., Stat. Div., *Estimation of emigration from the United States using international data sources* 4, U.N. Doc. ESA/STAT/AC.119/19 (2006), https://unstats.un.org/unsd/Demographic/meetings/egm/migrationegm06/DOC%2019%20ILO.pdf.

[4] U.S. Department of State, *CA by the Numbers* (June 2016), https://web.archive.org/web/20160616233331/https://travel.state.gov/content/dam/travel/CA_By_the_Numbers.pdf.

[5] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."), unless otherwise indicated.

[6] *See, e.g.*, REG-209826-96, 61 Fed. Reg. 50778, 50780 (Sept. 27, 1996) ("The rules of section 402(b) apply to a beneficiary of a nonexempt employees' trust regardless of whether the trust is a domestic trust or a foreign trust.")

contracts and whole life insurance. This is especially true for employees who are highly compensated employees ("HCEs") within the meaning of section 414(q).

The legislative history of section 402(b)(4)(A) suggests that the provision was intended to remedy perceived abuses within U.S. qualified plans, not foreign plans. However, the regulations under section 402(b) do not discuss its application to foreign plans, and the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") have issued no formal guidance in this context. These Comments were produced upon the invitation of officials in Treasury and the Service. We appreciate that invitation. In response, as explained in more detail below:

1. We recommend that formal guidance be issued clarifying that the term "trust" in section 402(b) means the same thing as it does in section 402(a) and the regulations under section 7701.

2. We recommend that formal guidance be issued excluding from section 402(b) trusts under (1) plans subject to totalization agreements and other foreign social security systems, and broad-based foreign retirement plans, that are described in the exemptions in the regulations under section 409A; and (2) "corresponding plans" under U.S. income tax treaties that are described in the exemption in the regulations under section 409A, but without regard to whether contributions or accruals are excludable from the income of a participant under the applicable treaty. If Treasury and the Service are reluctant to recognize an exemption from all of section 402(b), then we recommend that the guidance recognize an exemption from section 402(b)(4).

3. We recommend the Service make available a compendium of current "corresponding plans" and social security totalization agreements as a reference tool for tax practitioners.

4. We recommend that formal guidance be issued clarifying that employers may, but are not required to, elect to include nonresident aliens ("NRAs") for purposes of determining whether a foreign plan otherwise subject to section 402(b)(4) would fail section 410(b), taking into account non-U.S. source income.

5. We recommend that formal guidance be issued excluding from the definition of "compensation" used to determine whether an employee on assignment is an HCE for purposes of section 402(b)(4) any items solely attributable to the assignment (*e.g.*, assignment allocations and tax equalization payments).

6. We recommend that in the case of a trust under a foreign plan, "investment in the contract" under section 72(c) and (f) be defined to include actual contributions while the employee is an NRA plus all subsequent earnings on the contributions

while the employee remains an NRA, or at least while the contributions remain unvested.

7. We recommend that in the case of a trust under a foreign plan, "investment in the contract" in section 402(b)(4) be defined to mean the same thing it does under section 72(f), taking into account our recommendations above.

8. For defined benefit plans or other plans under which the contribution amount for each employee is not readily determinable, we recommend that Treasury and the Service allow taxpayers to determine both employer and employee contributions for purposes of sections 72 and 402(b), as well as under the sourcing rules, based on a procedure similar to that described in Rev. Proc. 2004-37.[7]

We also make a number of other primarily technical recommendations involving section 402(b) and related provisions of the Code.

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[7] 2004-26 I.R.B. 1099.

I. BACKGROUND

A. Participation in Foreign Plans

The globalization of business leads to the growing frequency of employees participating in a company-sponsored retirement plan or similar arrangement maintained outside their home country. U.S. employees working overseas frequently participate in a non-U.S. retirement or other deferral plan maintained by their non-U.S. employer. In other cases, non-U.S. employees who work temporarily in the U.S. may nevertheless continue to participate in their non-U.S. home country employer plan. While some of these programs are quite similar to U.S.-based defined benefit or defined contribution plans (except for their situs), others have features that preclude a clear definition and tax treatment within the current rules of the Code.

These foreign plans can take various forms, for example:

- Plan is funded and benefits accrue annually, but no benefits are vested until the employee attains "retirement age" (for example, age 50 or government certified retirement age).

- Employee accrues an annual benefit with the actual benefit delivered limited to the employee's share of plan assets accumulated from employer contributions to the plan at retirement date or a prescribed age.

- Employee accumulates a benefit that is determined based on the cash value of the employer's stock at the time of retirement; the employer funds the benefit by reserving shares or units either in trust or in treasury shares.

- Plan established in low or no-tax jurisdiction only for "career expatriate" employees who effectively have no base country and no "home country" pension plan – sometimes referred to as third country national (or "TCN") plans.

The most similar features in these plans include:

- A non-U.S. compensatory arrangement whereby participants accrue deferred benefits over an extended period of years.

- Participants generally include -

    - Expatriate employees who work outside their home country, generally for more than a short period or on an extended temporary basis, on a particular assignment with the intention to return to their home country at the end of the assignment. They may or may not be eligible to accrue home country benefits during their overseas assignment depending on the nature of the particular country's rules.

  - "Career expatriate" employees who move frequently from one country to another at various companies within a controlled or related group and are never with a single company or in a single country for a sufficient period to accrue or vest in meaningful benefits.

  - Employees working outside their home country who may not be entitled to retirement benefits under a home country plan.

  - U.S. resident alien ("RA") and NRA employees working in the U.S. while accumulating benefits under a non-U.S. retirement or deferred compensation plan.

- Accrued benefits typically are funded by or charged to the company (parent or subsidiary) for which the employee currently is working, consistent with applicable treaty provisions and the requirements of the respective country's transfer pricing rules.

- Funded amounts are placed in a trust or another similar arrangement, often situated in a low-tax or no-tax country, and accumulated for future payouts.

- Benefits are paid to the employee upon attainment of predetermined age or years of service.

B. Requirements of Section 402

Section 402 is labeled "Taxability of Beneficiaries of Employees' Trusts." It is in Part I of Subchapter D of the Code, which deals with tax-qualified retirement plans and related trusts. In addition to requiring that there be a written plan document and that plan assets be held in a trust, Part I imposes extensive and detailed requirements on such plans and trusts relating to nondiscrimination, minimum coverage, vesting, benefit accruals and other issues. If they satisfy those requirements, then the trusts are tax-exempt under section 501(a).

Subsection (a) of section 402 describes the tax treatment of interests in an "employees' trust" that is exempt from tax under section 501(a). It subjects a distributee under such a trust to tax on any amounts actually distributed from the trust in the year in which they are distributed under the rules of section 72. Section 402(a) does not expressly address the tax treatment of contributions to such a trust, but the regulations provide that the employee is not required to include them in income regardless of whether they are forfeitable or nonforfeitable.[8]

Subsection (b) of section 402 describes the tax treatment of interests in an "employees' trust" that *is not* exempt from tax under section 501(a). Briefly:

- Paragraph (1) requires an employee to include a contribution to such a trust in income in accordance with the rules in section 83 (relating to compensatory transfers of property), substituting the value of the employee's interest in the trust for the fair market value of the property when applying section 83.

- Paragraph (2) subjects a distributee under such a trust to tax on any amounts actually distributed from or made available under the trust in the year in which they are distributed or made available under the rules of section 72. Thus, undistributed earnings generally are shielded from tax if this paragraph applies.

- However, subparagraph (A) of paragraph (4) requires an HCE within the meaning of section 414(q) to include his or her vested accrued benefit under such a trust, less his or her "investment in the contract," in income at the end of each year in lieu of the amount determined under paragraph (1) or (2) if *one* of the reasons that the trust was non-exempt was that the plan of which it is a part failed to satisfy the minimum participation requirements of section 401(a)(26) or the minimum coverage rules of section 410(b). Thus, undistributed earnings are *not* shielded from tax if this paragraph applies. Paragraph (4) overrides both paragraph (1) and paragraph (2) when it applies.

- Subparagraph (B) of paragraph (4) also relieves a non-HCE from any tax under paragraph (1) or (2) for the current or prior years, if the sole reason that such a trust was non-exempt was that the plan of which it is a part failed to satisfy those requirements.

- Finally, paragraph (3) provides that such a trust is not considered a grantor trust under Subpart E of Part I of Subchapter J with respect to a beneficiary of the trust.

C. History of Section 402

The Revenue Act of 1921 exempted employees' trusts from tax for the first time.[9] This was done by adding a subsection to the section describing how "Estates and Trusts" were taxed. The only requirements it imposed for the exemption to apply were those now found in the prefatory language in section 401(a) and in section 401(a)(1) that the trusts

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[8] Reg. § 1.402(a)-1(a)(1)(i).
[9] Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227, § 219(f).

be part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees or their beneficiaries and that contributions be made for the purpose of distributing the trust corpus and income to employees and their beneficiaries. The same subsection also included a sentence that was the predecessor to current section 402(a). It required a distributee to include a distribution from such a trust in income only "in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him." Like current section 402(a), it did not expressly address the tax treatment of contributions to such a trust, but implied that they were not subject to tax.

The Internal Revenue Code of 1939 (the "1939 Code") consolidated the various laws relating to taxes into one document. It put the provisions dealing with estates and trusts in their own part labeled "Supplement E – Estates and Trusts" and put the subsection added by the Revenue Act of 1921 in its own separate section 165 labeled "Employees' Trusts."[10]

The Revenue Act of 1939 added to section 165 the requirement now found in section 401(a)(2) that it must be impossible under an employees' trust instrument for the corpus or income of the trust to be "used for, or diverted to, purposes other than for the exclusive benefit of . . . employees."[11]

The Revenue Act of 1942 added to section 165 the first set of minimum coverage and nondiscrimination requirements for retirement plans, and put them in their own subsection (a).[12] These were the predecessors to section 401(a)(3)-(6). Congress thought these were needed because of "the use of discriminatory plans which either cover only a small percentage of employees or else favor the higher paid or stock-holding employees as against the lower-paid or non-stock-holding employees."[13] The same section of the Act that added these requirements also put the predecessor to current section 402(a) in its own subsection (b) and added the predecessor to section 402(b)(1) in a new subsection (c). Section 165(c) required an employee to include in income any contribution to an employees' trust that did not satisfy the new requirements (or any other qualification requirements) for the taxable year in which the contribution was made if the contribution was nonforfeitable at that time. It did not change the tax treatment of distributions from such a trust; apparently, they continued to be subject to the same rules as distributions from exempt trusts.

The Internal Revenue Code of 1954 (the "1954 Code") renumbered old section 165(a) as new section 401 and renumbered old section 165(b)-(c) as new section 402(a)-(b). Section 402 was now labeled "Taxability of Beneficiary of Employees' Trust." It

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[10] Act of August 10, 1939, Pub. L. No. 76-1, 53 Stat. 1347, § 165.
[11] Pub. L. No. 76-155, 53 Stat. 862, § 218.
[12] Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, § 162(a).
[13] H.R. Rep. No. 77-2333, at 51 (1942), *reprinted in* 1942-2 C.B. 372.

also added section 72 and sentences to section 402(a)-(b) stating that distributions from both exempt and non-exempt trusts would be subject to tax in the year in which they were distributed or made available under the rules of section that section.[14] (The sentence that applied to non-exempt trusts thus was the predecessor to section 402(b)(2).) The prefatory language in section 401(a) also specifically prohibited all employees' trusts not "created or organized" in the U.S., including those of U.S. employers, from qualifying as tax-exempt trusts. Congress explained that this would force them "to make investments which produce [U.S.] source income." However, the 1954 Code also added the predecessors to sections 402(d) and 404(a)(4) in essentially their current forms. Congress explained that this was necessary in order to avoid "the harsh results of denying an American employer a deduction for his contributions" and taxing U.S. employees.[15]

The Tax Reform Act of 1969 added section 83. Congress explained that this was necessary to equalize the treatment of restricted stock plans and "pension or profit-sharing trust[s] which [do] not meet the nondiscrimination and other requirements set forth in the tax law." Specifically, under prior law if restricted stock was transferred directly to an employee, it was not included in income until the restrictions lapsed, and any increase in the value in the stock between the time it was granted and the time the restrictions lapsed was not treated as compensation, but if the same restricted stock was contributed to a non-exempt employees' trust, the contribution was included in income at the time of the transfer.[16] Section 83 is often described as having codified the pre-existing "economic benefit" doctrine. The same section that made these changes also amended sections 402(b) and 403(c) "to conform them with the treatment of restricted property."[17] It also added the predecessor to section 402(b)(3) to ensure that "income earned by such trusts which is not distributed to the employee . . . shall not be taxed to the employee prior to its distribution."[18]

The Tax Reform Act of 1986 ("TRA '86") added the minimum participation requirement as new section 401(a)(26), and significantly tightened the existing minimum coverage requirement in section 410(b) and nondiscrimination requirements in section

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[14] Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 1.

[15] S. Rep. No. 83-1622, at 92 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4688; *see also* Staff of the Joint Committee on Tax'n, 83d Cong., *Summary of the New Provisions of the Internal Revenue Code of 1954 as Agreed to by the Conferees* 59 (Comm. Print 1955). Section 402(d) provides that for purposes of both subsections (a) and (b) of section 402 a trust that would be tax-exempt under section 501(a) except that it is "created or organized" outside the U.S. will be treated as if it were a trust exempt from tax under section 501(a). Regulation section 1.401-1(a)(3)(i) also requires the trust to be a "domestic" trust, but that is considered part of the statutory requirement rather than a separate requirement, *see* Rev. Rul. 70-242, 1970-1 C.B. 89, and in any event Regulation section 1.402(c)-1 interprets section 402(d) as covering both requirements.

[16] H.R. Rep. No. 91-413 (Part 1), at 86-89 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1734-37.

[17] *Id.*; Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 533, § 321.

[18] H.R. Rep. No. 91-413 (Part 2), at 64 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1945.

401(a)(4) and related sections.[19] Congress explained that the minimum participation requirement was needed because "the IRS lacks sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans."[20] It thought the minimum coverage and nondiscrimination requirements needed to be tightened because current rules "have permitted employers to obtain the tax benefits accorded to highly compensated participants in qualified plans without providing similar benefits to a comparable percentage of rank-and-file employees."[21] The same section of TRA '86 that made these changes also amended section 402(b) to add the predecessor to section 402(b)(4). Explaining this amendment, Congress described section 402(b)(4) as a "the sanction applicable to a plan that fails to qualify due *solely* to a failure to satisfy the *new* coverage rules."[22]

The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") made technical changes to the minimum participation requirement in section 401(a)(26) and the minimum coverage requirement in section 410(b) that were added or amended by TRA '86.[23] These were "meant to carry out the intent of Congress in enacting the original legislation."[24] The same section that made these changes also amended section 402(b)(4) to essentially its current form. Explaining this amendment, Congress described section 402(b)(4) as a "sanction applicable to a plan that *ceases* to be qualified based on a failure to satisfy either the minimum participation rule or the coverage rules." It also said that section 402(b)(4) is relevant only to "the amount includible in the year of disqualification."[25] The Unemployment Compensation Amendments of 1992 (the "UCA") moved and renumbered the subsections of section 402(b) to their current arrangement.[26] The renumbering made it clear that section 402(b)(4) overrode both section 402(b)(1) (contributions) and section 402(b)(2) (distributions).[27]

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[19] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, § 1112.

[20] S. Rep. No. 99-313, at 588 (1986), *reprinted in* 1986-3 C.B. 518.

[21] *Id.* at 578.

[22] H.R. Conf. Rep. No. 99-841, at II-416-17 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4504 (emphasis added).

[23] Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. No. 100-647, 102 Stat. 3342, § 1011(h)(4).

[24] H.R. Rep. No. 100-795, at 3 (1988).

[25] S. Rep. No. 100-445, at 161 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4676 (emphasis added). Since the Treasury Regulations were amended in 1978, they have provided that when a tax-exempt trust is disqualified an employee is not taxed on the value of his or her vested interest in the trust to the extent it is attributable to contributions made while the trust was tax-exempt. *See* Reg. § 1.402(b)-1(b)(1), as revised by T.D. 7554, 43 Fed. Reg. 31911 (July 24, 1978) (explaining that "[t]his is a change prompted by public comments on the rule announced in the 1971 notice of proposed rulemaking, which taxed employees on their entire vested interest in a trust upon the trust's loss of exempt status.") Presumably section 402(b)(4) was intended to override this rule.

[26] *See* Pub. L No. 102-318, 106 Stat. 290, § 521(a).

[27] It is not clear whether this was intended. The legislative history of TAMRA suggests that the 1986 provision was intended to override only the language that became paragraph (1). *See* S. Rep. No. 100-445, at 161 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4676. Section 6102(j)(1)(A) of H.R. 11,

D. Relationship with Section 83

As noted above, section 402(b)(1) says that a contribution to a non-exempt trust subject to that section is included in income in accordance with the rules in section 83, except that the value of the employee's interest in the trust is substituted for the fair market value of the property when applying section 83. For purposes of section 83, "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. It also includes a beneficial interest in assets, including money or other assets transferred or set aside from the claims of the transferor's creditors, for example in a trust or escrow account.[28] Hence, neither section 83 nor section 402(b) applies to a trust that is bankruptcy-remote – *i.e.*, that is not set aside from the claims of the transferor's creditors (commonly known as a "rabbi trust").[29] Property subject to section 83 is included in income when it is "substantially vested" – *i.e.*, either transferable or not subject to a substantial risk of forfeiture when the contribution is made.[30] Thus, a contribution to a non-exempt trust is included in income under section 402(b)(1) to the extent that the employee's interest in the trust is substantially vested.[31] To the extent the contribution is *not* substantially vested at that time, the entire amount attributable to the unvested contribution (*i.e.*, the contribution plus subsequent earnings) is included in income at the time that amount becomes substantially vested.[32]

However, section 83 applies to a contribution subject to section 402(b) only to the extent provided in that section.[33] Therefore the rules in section 402(b) – not section 83 – apply if both apply and there is any conflict between them.[34] This is important because although Congress sought to equalize the treatment of transfers of restricted property and contributions to non-exempt trusts by adding section 83, the rules that apply to transfers of "property" under section 83 remain more favorable. For example, under section 83, the value of stock transferred to an employee is taxable as ordinary income when the shares are no longer subject to a substantial risk of forfeiture. Thereafter, any increase in the value of the stock is not taxable until the stock is sold or otherwise disposed of, and the increase is eligible for capital gains treatment. In contrast, if the stock is held in an entity considered to be a trust under section 402(b), the value of the stock allocated to the

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102d Cong., 2d Sess., which Congress passed after it enacted the UCA in 1992, would have deleted the reference to paragraph (2). However, President Bush pocket-vetoed H.R. 11, and it never became law. PLR 9417013 (Jan. 24, 1994) says that, as a result, "[t]he tax consequences to Plan participants of distributions from [a] Trust are unclear," but "it appears that Congress intended to tax distributions to highly compensated employees from nonexempt employees' trusts in accordance with the rules of § 72."

[28] Reg. § 1.83-3(e).

[29] *See, e.g.*, PLR 201031043 (May 11, 2010).

[30] Reg. § 1.83-3(b).

[31] *See* Reg. § 1.402(b)-1(a)(1).

[32] *See* Reg. § 1.402(b)-1(b)(1)-(3).

[33] *See* Reg. § 1.83-8(a).

[34] *See, e.g.*, *Lowe v. Commissioner*, 101 T.C.M. (CCH) 1525 (2011).

employee's account is taxable under section 402(b)(1) as ordinary income when the stock is no longer subject to a substantial risk of forfeiture, but under section 402(b)(2) any increase in value of the stock thereafter is taxable when the stock is distributed even if the stock has not been sold or otherwise disposed of, and the increase is not eligible for capital gains treatment because the distribution is subject to section 72.[35] Furthermore, if the trust is subject to section 402(b)(4), then any increases in value of the stock might be taxable each year if the employee is an HCE.

E. Definition of "Employees' Trust"

The term "employees' trust" appears in both section 402(a) and section 402(b), and as explained above, springs from the same source. However, the term is not defined. At least four definitions of the "trust" portion of the term are possible for purposes of section 402(b). One is the definition that is used for section 402(a) purposes. That has the compelling advantage of allowing the term to be defined the same way for purposes of all of section 402, which would be consistent with the history of that section. However, there is relatively little guidance on the definition. A leading case suggests that there are certain essential elements that must be present to create a trust for purposes of section 401(a): a settlor, a res, beneficiaries, a trustee, fiduciary duty between the trustee and the beneficiaries, and the intent to create a trust.[36] Another possibility is the definition of "trust" under section 7701. That says "the term 'trust' as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[37] The Service refers to this definition in several recent private letter rulings on section 402(b).[38] Another possibility is the definition used in a 1979 private letter ruling on section 402(b), which appears to be the only time the Service attempted to define the term specifically for purposes of that section. It says:

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[35] *See, e.g.*, *Tobias v. Commissioner*, 110 T.C.M. (CCH) 222 (2015) ("Section 72 mandates the inclusion of annuity payments in petitioners' hands as ordinary income.").

[36] *Trenton Times Corp. v. United States*, 361 F. Supp. 222, 225 (D.N.J. 1973); *cf.* Rev. Rul. 89-52, 1989-1 C.B. 110 (the term "trust" is not a term of art or of fixed content, and its meaning for the purposes of section 401(a) is not necessarily the same as it is under state law, but generally it must be a valid trust under the law of the jurisdiction in which the trust is located).

[37] Reg. § 301.7701-4(a). Rev. Rul. 2013-14, 2013-26 I.R.B. 1267, concluded that a fideicomiso (Mexican Land Trust) was not a trust under that definition.

[38] *E.g.*, PLR 201323043 (March 15, 2013); PLR 200703012 (Sept. 28, 2006). One potential difficulty with that definition is that a trust under a plan could be considered an association, *i.e.*, a corporation, instead of a trust, because of the broad investment powers typically granted to trustees. The Service has said that the reason it does not treat a trust under a tax-exempt plan as an association is that it would discourage employers from establishing tax-exempt plans, which would be contrary to Congressional intent. *See* GCM 36726 (May 13, 1976). That reluctance might not apply to section 402(b) plans.

> Generally, a section 402(b) trust is a legal entity, having legal assets, legal liabilities and a fiduciary relationship between the grantor and the trustee subject to State law. It is established by a bilateral agreement between a grantor and a trustee, whereby the grantor conveys certain assets, usually money, to the trustee for the purpose of distributing the corpus and income of the fund accumulated by the trust to the employee or his beneficiary in accordance with a deferred compensation plan.[39]

A fourth possibility is the definition used for section 404A purposes in the proposed regulations under that section.[40]

The alternatives for defining the "employees" portion of the term "employees' trust" are less clear-cut. One option would be to stick with the original meaning of the term. When it first appeared in the 1939 Code, "employees' trust" appeared in the heading and meant a trust that was part of a stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees or their beneficiaries, and was used to distinguish such a trust from an ordinary trust. Nothing has occurred since that necessarily changed that meaning. "Pension," "profit-sharing" and "stock bonus" plans all were defined in the regulations under the 1939 Code,[41] and continue to be defined in the regulations under current law, and could be used to give substance to the term. That originalist interpretation seemed to prevail for some time after the enactment of the predecessor to section 402(b), with both the courts and the Service tending to apply the economic benefit doctrine instead of section 402(b) to compensatory transfers of interests in trusts having no connection with the qualified plan rules.[42] More recently, they seemed to interpret the term more broadly, although until the predecessor to section 402(b)(4) was enacted in 1986 that might have been because the rules under section 402(b) were roughly the same as the rules under section 83 and the economic benefit doctrine, and therefore no distinction was necessary.[43] When they addressed the scope of section 402(b) directly, they seemed to be influenced by their view of the purpose of that section, which they often concluded was to serve as a backstop to the nondiscrimination rules in section 401.[44] Therefore an interpretation based on the purpose of section 402(b) appears appropriate, as well.

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[39] PLR 7926007 (March 20, 1979).

[40] *See* Prop. Reg. § 1.404A-1(e) (definitions of "trust" and "equivalent of a trust"), 58 Fed. Reg. 27219 (May 7, 1993).

[41] *See* 26 C.F.R. § 39.165-1 (1953).

[42] *See*, *e.g.*, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952); Rev. Rul. 55-691, 1955-2 C.B. 21; *see also Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960); *Carter v. Commissioner*, 17 T.C. 994 (1951); *McEwen v. Commissioner*, 6 T.C. 1018 (1946).

[43] *See*, *e.g.*, *Estate of Harrison v. Commissioner*, 62 T.C. 524 (1974) ("We think either theory presents the same question which will control the outcome of the instant case.").

[44] *See*, *e.g.*, *Teget v. United States*, 552 F.2d 236 (8th Cir. 1977) ("The language of § 402(b)[(1)] was intended to close a tax loophole previously benefiting executive employees such as Teget.");

F. Grantor Trust Rules

Income of a trust that is not exempt from tax under section 501(a) is subject to tax under section 641 if the trust is a U.S. trust, and can be subject to tax under foreign law if the trust is non-U.S. trust. The income generally avoids tax under section 661 only if it is distributed to beneficiaries in the year it is earned or shortly thereafter. This can result in double-taxation of any accumulated income: once to the trust and later to the employee.

Double-taxation can be avoided if the trust is a grantor trust under sections 671-679 with respect to the employer (an employer grantor trust) or the employee (an employee grantor trust). However, for many years the Service has taken the position that a non-exempt retirement trust subject to section 402(b) cannot be considered an employer grantor trust under Subpart E.[45] Also, Regulation section 1.402(b)-1(b)(6) provides that such a trust can be considered an employee grantor trust under Subpart E only if employee contributions are not "incidental" when compared to employer contributions (and even then only with respect to the portion of the trust that is attributable to employee contributions) and treats an employee's contributions as more than incidental if they exceed in the aggregate the total contributions of the employer on the employee's behalf on any date.[46]

G. Sourcing Rules

A U.S. trust, U.S. citizen or RA generally is subject to tax on any amount required to be included in gross income regardless of the source of the amount or whether it is attributable to services performed in the U.S.[47] A non-U.S. trust or NRA, on the other hand, generally is subject to tax on any amount that is compensation for services performed in the U.S. or otherwise from sources within the U.S.[48] A trust that is part of a plan maintained by a foreign government can, however, share the government's tax exemption under section 892 if certain requirements are satisfied.[49]

Machacek v. Commissioner, 111 T.C.M. 1248 (CCH) (2016) ("A different reading of section 402(b)(4) would result in condoning widespread employee discrimination through the use of nonqualified plans.").

[45] *See, e.g.*, PLR 9502030 (Oct. 13, 1994); PLR 9212024 (Dec. 20, 1991); PLR 9206009 (Nov. 11, 1991); *cf.* Proposed. Reg. § 1.671-1(g)(1).

[46] *See also* PLR 201749007 (Sept. 8, 2017).

[47] *See* I.R.C. §§ 1 & 61; Reg. § 1.61-1. *Cf. Cook v. Tait*, 265 U.S. 47 (1924) ("the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen").

[48] *See* I.R.C. §§ 2(d), 864(b), 864(c)(3) & 871-72.

[49] *See* Treas. Reg. § 1.892-2T(a) & (c) (defining "foreign government" to include controlled entities, including certain pension trusts); *cf.* Rev. Rul. 72-183, 1972-1 C.B. 213 (concluding that income earned by retirement fund for employees of OECD is exempt from tax under section 892, but noting that fund "has no separate juridical personality" and its earnings "are the property of OECD").

An individual is an RA if he or she satisfies the "Substantial Presence" test in section 7701(b)(1)(A)(i) or the "Green Card" test in section 7701(b)(1)(A)(ii). An individual generally is a RA under the Substantial Presence test if he or she is present in the U.S. on at least 31 days during the current calendar year and the sum of the following equals or exceeds 183 days: (i) the number of days he is present in the U.S. during the current year, (ii) one-third of the number of days he or she was present in the U.S. during the preceding calendar year, and (iii) one-sixth of the number of days he or she was present in the U.S. during the second preceding year.[50] Similar and sometimes broader exceptions exist under various U.S. tax treaties. An individual is a RA under the Green Card test if he or she was a lawful permanent resident of the U.S. at any time during the calendar year.

A trust is a U.S. trust if: (1) a court within the U.S. is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust.[51] A trust subject to section 402(a) is deemed to satisfy clause (2) if U.S. trustees control all of the substantial decisions made by the trustees of the plan, even if the trustees' discretion is limited.[52] There is no guidance on whether the same rule applies to trusts subject to section 402(b) or (d). In our experience, most practitioners assume that a trust that is a U.S. trust under this definition also satisfies the domestic-trust requirement in section 401(a) and the regulations,[53] but there is no direct guidance on this point, either.

A distribution from a trust subject to section 402(a) or (d) is sourced as follows: the portion of the distribution that constitutes the compensation element (generally the employer contributions) is sourced the same as compensation for personal services (*i.e.*, it is treated as U.S. source income to the extent that it is attributable to services performed in the U.S., and otherwise it is treated as foreign source income), while the portion of the distribution that constitutes the earnings element (generally subsequent investment income) is sourced the same as interest income (*i.e.*, it is treated as U.S. source income if the trust is a U.S. trust, and otherwise it is treated as foreign source income).[54] Again, in our experience, most practitioners assume that the same rule applies to a distribution from a trust subject to section 402(b), but there is no direct guidance on this point, either.

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[50] *See* I.R.C. § 7701(b)(3)(A)(i)-(ii).

[51] I.R.C. § 7701(a)(30)(E).

[52] Reg. § 301.7701-7(d)(1)(iv).

[53] *See* footnote 15 *supra*.

[54] *See* Rev. Rul. 79-388, 1979-2 C.B. 270; *see also* Rev. Proc. 2004-37, § 2, 2004-26 I.R.B. 1099; Program Manager Technical Assistance 01152 (July 7, 2007); *Clayton v. United States*, 33 Fed. Cl. 628 (1995), *aff'd*, 91 F.3d 170 (Fed. Cir. 1996).

H. Basis Rules

1. Section 402(b)(1)

As noted above, section 402(b)(1) says that a contribution to a non-exempt trust subject to that section is included in income in accordance with the rules in section 83 (*i.e.*, when it substantially vests), except that the value of the employee's interest in the trust is substituted for the fair market value of the property when applying section 83. Presumably, this means that the amount subject to tax is reduced by "the amount (if any) paid for such property" as defined in the regulations under section 83,[55] and also does not include any amount previously subject to tax under section 402(b)(1).

2. Section 402(b)(2)

As noted above, section 402(b)(2) provides that amounts actually distributed or made available under a trust described in section 402(b)(1) are subject to tax in the year in which they are distributed or made available under the rules of section 72. Section 72(b) reduces the amount subject to tax by the portion of each payment that represents a return of the distributee's "investment in the contract." Section 72(c)(1) defines "investment in the contract" as of the annuity starting date as (1) the aggregate amount of premiums or other consideration paid for the contract minus (2) the aggregate amount received under the contract before the annuity starting date which was excludable from U.S. gross income.

Section 72(f) provides that "investment in the contract" also includes employer contributions to the extent that they (1) were includible in U.S. gross income or (2) would not have been includible if they had been paid directly to the employee.[56] The phrase "would not have been includible" means that employer contributions made on behalf of an NRA employee for services performed outside the U.S., which would be excluded from gross income under section 872 if they had been paid directly, are included in the employee's "investment in the contract" even though they never were subject to U.S. tax.[57] Service guidance confirms that pre-tax elective deferrals are treated like employer contributions for this purpose.[58] However, section 72(f) provides that "investment in the contract" does not include contributions that would not have been includible in U.S. gross income because of section 911.[59]

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[55] *See* I.R.C. § 83(a)(2); Reg. § 1.83-3(g).

[56] *See also* Reg. § 1.72-8.

[57] *See*, *e.g.*, IRS INFO 2002-0069, 2002 WL 31991630 (April 10, 2002); PLR 8837009 (June 2, 1988); PLR 5707268250A (July 26, 1957).

[58] *See*, *e.g.*, PLR 8837009 (June 2, 1988) (elective contributions under section 401(k)); PLR 6403138200A (March 13, 1964) (contributions withheld from salary).

[59] The legislative history of this rule asserted that it "nullifies" section 72(f), S. Rep. No. 87-1881, at 77, 1962 U.S.C.C.A.N. 3297, 3380, but section 911 applies only to U.S. citizens and RAs, and thus it is

American Jobs Creation Act of 2004 (the "AJCA")[60] added section 72(w) to the Code. It largely supersedes section 72(f)(2) for U.S. taxpayers. Section 72(w)(2) provides that, in the case of a distribution to a person who is a U.S. citizen or RA at the time of the distribution, the employee's "investment in the contract" does not include nontaxable employer or employee contributions with respect to services performed outside the U.S. while the employee was an NRA if the contributions were not subject to foreign or U.S. income tax, but would have been if they had been paid directly to the employee.[61] Section 72(w)(3) provides a similar rule for nontaxable earnings.

Treasury has regulatory authority under section 72(w) to allow contributions and earnings relating to non-U.S. source income for services performed as an NRA to be taxable at distribution, if they were subject to no more than "nominal" tax in the foreign country. The legislative history provides that regulations to carry out the purpose of the section could include "regulations treating contributions and earnings as not subject to income tax under the laws of any foreign country under appropriate circumstances. For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the 'subject to income tax' requirement."[62]

3. Section 402(b)(4)

As noted above, section 402(b)(4)(A) requires an HCE to include his or her vested benefit under a non-exempt trust subject to that section, less his or her "investment in the contract," in income at the end of each year, in lieu of the rules in paragraph (1) or (2), above, if one of the reasons the trust was non-exempt was that the plan of which it is a part failed to satisfy section 401(a)(26) or 410(b). Neither the statute nor its legislative history defines "investment in the contract" for this purpose. One option would be to use the definition in section 72. Another would be to create a new definition. The Tax Court found the phrase "ambiguous in that it is susceptible of at least two different meanings," but after consulting the legislative history ultimately agreed with the Service that it meant the amount previously taxed to the employee, "so as to avoid double taxation."[63] It disagreed with the taxpayer that the term meant the same thing it did in section 72 or

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clear that section 72(f) continues to apply to contributions that were tax-exempt because the employees were NRAs at the time.

[60] Pub. L. No. 108-357, 118 Stat. 1418, § 906.

[61] PLR 200828037 (April 14, 2008) ruled that contributions made by an employee while a nonresident alien were described in that section and thus were not includible in the employee's investment in the contract. The same provision added a similar basis rule to section 83(c). It is not clear whether the latter was needed: Regulation section 1.83-4(b)(1) includes in an employee's basis only "the amount paid for such property and any amount includible in the gross income of the person who performed the services," and section 872(a)(1) states that, in the case of a nonresident alien, gross income includes only U.S. source income and income effectively connected with the conduct of a U.S. trade or business, *e.g.*, income attributable to services performed in the U.S.

[62] H.R. Rep. No. 108-755, at 777 (2004), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1828.

[63] *Yarish v. Commissioner*, 139 T.C. 290, 296 (2012).

should be interpreted *in pari materia* with the term in section 72, noting that that "identical terms or phrases used in the Code need not be interpreted to have the same meaning where the sections in which they are found serve different legislative purposes."[64] Rev. Rul. 2007-48 also assumes that "investment in the contract" includes any amount previously includible in income under section 402(b)(4).[65]

I. Tax Treaties

1. Pension Provisions in U.S. Model Income Tax Treaties

In order to avoid double income taxation, coordinate overlapping tax jurisdictions, and serve other purposes, the U.S. has entered into income tax treaties with a number of foreign countries. U.S. income tax treaties typically address one or more of the following pension areas: exemptions from taxation of certain types of income paid to resident pension funds (*e.g.*, interest, dividends and royalties), exclusion or deductibility of contributions to or benefit accruals under a pension plan in one country while performing services in or being a citizen of the other country, and when and in which jurisdiction pension distributions are taxable. These areas were addressed under the 1996 U.S. model income tax treaty,[66] and dealt with in more detail in the 2006 and 2016 U.S. model income tax treaties[67] (the "2006 and 2016 model tax treaties").

The definition of "pension" is not open-ended. For example, Treasury's Technical Explanation for the 1996 model tax treaty requires that the plan (1) be "written," (2) be "nondiscriminatory" in the case of an employer-sponsored plan, (3) contain restrictions on non-retirement use of assets by participants, and "in all cases be subject to tax provisions that discourage participants from using the assets for purposes other than retirement;" and (4) require minimum distributions so that death benefits to survivors are merely incidental.

Recognizing the global nature of services, and that individuals performing services in a "host" country (*i.e.*, the country in which they are working, when it is not their long-term country of tax residence or permanent residence) can have difficulties with retirement planning, the 2006 and 2016 model tax treaties attempt to remove some of the barriers to the flow of personal services between countries by specifically addressing the taxation of cross-border pension contributions and distributions.

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[64] *Id.*, citing *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 580–582 (1977). *See also National Credit Union Admin. v. First Nat'l Bank & Trust Co.*, 522 U.S. 479, 501 (1998).

[65] 2007-30 I.R.B. 129.

[66] U.S. Model Income Tax Treaty (Sept. 20, 1996) ("1996 model tax treaty").

[67] U.S. Model Income Tax Treaty (Nov. 15, 2006) ("2006 model tax treaty"); U.S. Model Income Tax Treaty (Feb. 17, 2016) ("2016 model tax treaty").

In the context of pension contributions made by a foreign assignee to his or her home country plan (in the context of this discussion, this typically relates to non-U.S. persons on assignment within the U.S.), the 2006 and 2016 model tax treaties generally provide that if an individual prior to the assignment participated in the home country pension plan and continues such participation during the assignment, the host country may not tax any contributions or accretions under the plan, provided local limitations on tax relief of both the home country and the host country are met.[68] In addition, the host country employer may take a deduction for the contributions to the individual's home country plan, subject to the limitations on deductibility on pension contributions in the host country.

If, however, rather than continuing to contribute to the pension plan in the individual's home country, contributions are made to a plan maintained by the employer in the host country (in the context of this discussion, this typically relates to U.S. persons providing services outside the U.S.), the 2006 and 2016 model treaties include a provision for relief from home country taxation, but again the amount of relief is limited. Only the amount up to the lesser of the amount eligible for relief under the rules applicable to pension plans in the host country or the amount that would be eligible for relief in the home country with respect to a "corresponding pension fund" is eligible for treaty relief.

Under either scenario, the limits under sections 402(g) and 415 would apply, and pension plans eligible for such benefits would be only those that have been determined to correspond to U.S. tax-qualified plans. Amounts contributed to the relevant plan in excess of the allowed amounts recognized in a "corresponding plan" will immediately be taxable to the individual. One issue is that many countries provide contribution limits in amounts greater than (or structured differently from) those in the U.S. In addition, if specific plans are not identified as "corresponding plans," individuals participating in the plans will not benefit from this treaty relief, and thus may face adverse and harsh tax consequences.

Under the 2006 and 2016 model tax treaties, periodic and single-sum distributions of pensions and other similar remuneration for past services (except for governmental services) generally are taxed in the country in which the individual is a resident at the time of distribution (without regard to where the pension was earned through the performance of services) and only to the extent not taxed in the other country prior to distribution, thus preventing double taxation on distributions. With respect to earnings

[68] At present, it appears that only 13 treaties to which the U.S. is a party provide this limited treaty relief from immediate taxation on participant contributions (Austria, Belgium, Canada, France, Germany, Ireland, Italy, Malta, the Netherlands, South Africa, Sweden, Switzerland, and the United Kingdom). Only seven of these 13 treaties also provide relief for earnings (Belgium, Canada, Germany, Malta, the Netherlands, South Africa, and the United Kingdom).

under a pension plan established in the individual's home country, the 2006 and 2016 model tax treaties provide that the host country cannot tax the earnings until they are distributed.[69]

2. Examples of Pension Provisions in U.S. Income Tax Treaties

One of the first tax treaties to be based on what would become the new 2006 model tax treaty was the U.S.-United Kingdom ("U.K.") income tax treaty.[70] The U.S.-U.K. income tax treaty generally provides in Article 18, Sections 2 and 3, that contributions and benefit accruals by a U.S. citizen to a U.S. plan while employed in the U.K. (or vice-versa, a U.K. citizen continuing to participate in a U.K. plan while employed in the U.S.) are excludable (and under Section 18.1, are not taxable until paid and are then taxable in the country of residence, subject to the limitation of benefits provisions of the treaty), provided that (1) the plan is a "corresponding plan" as designated by Treasury and the U.K. HMRC (Her Majesty's Revenue and Customs), (2) contributions to the plan were made before the individual began to exercise employment in the other country, and (3) the contributions do not exceed the applicable "reliefs" (contribution or accrual limits) that would be allowed by the other State to residents of that State for contributions to, or benefits accrued under, a pension scheme established in that State – in other words, the host country limits.[71] Article 18, Section 2 allows similar tax relief for U.S. taxpayers participating in U.K. plans, but provides that the U.S. limitations on contributions and accruals apply.[72]

These particular treaty limitations on pensions can create traps for the unwary. One reason is that a person may be hired in the home country but immediately begin working in the host country. Under the literal limitations of the treaty, a person who manages to make one small contribution (*e.g.*, a U.S. citizen to a U.S. 401(k) plan) before going to work in the host country can participate in the home country plan (*i.e.*, the 401(k) plan), while a person who does not manage to make one contribution before

[69] For purposes of amounts paid pursuant to social security benefits or similar legislation, a different rule applies. The 2006 and 2016 model tax treaties provide that such payments are taxable only by the country making the payment. Individuals receiving payments from a governmental pension plan are subject to tax in the individual's home country (*i.e.*, the country with respect to which the services were performed).

[70] *See* Protocol Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains of July 24, 2001, July 19, 2002, U.S.-U.K., T.I.A.S. No. 13161.

[71] *Id*. Article 19 provides the common governmental plan exception that any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State unless the individual is a resident of, and a national of, the other State (*e.g.*, is an employee of a U.S. State, but a resident and citizen of the UK).

[72] *Id*. This particular provision is available in only a handful of U.S. income tax treaties to date.

moving to the host country cannot, and must wait to participate until they return to the home country to enjoy treaty relief.

Another issue is created by the application of one country's limit to a plan organized in the other country. For example, the U.S. has separate limits under section 415 for both defined benefit and defined contribution plans, while the U.K. has one combined limit for both types of plans, with both an annual and a lifetime limit. And those amounts, of course, do not precisely correspond. This is further complicated by the fact that U.S. and U.K. tax years do not match up. Similar pension limitations can be found in a number of the more recent treaties.

Another type of limitation on treaty benefits may be a time limit for continuing to participate in the home country plan while working in the host country. For example, the U.S.-Belgian tax treaty provides an additional requirement that the individual has not performed personal services in the host country for a cumulative period exceeding ten calendar years.[73] The U.S.-Ireland tax treaty provides for a limit of five years.[74] Canada, on the other hand, has a somewhat unique situation, undoubtedly due to the common border. Special rules apply to pensions and annuities with respect to certain short-term assignments, cross-border commuters and individuals who participate in Canadian qualifying plans. Generally, distributions in such cases are deemed to be earned in the country in which the plan is established, without regard to where the services were rendered.[75]

Under Article XVIII of the U.S.-Canada treaty, pensions and annuities from one country paid to the resident of the other are subject to tax by the country from which it is paid, but the tax is limited to 15 percent of the gross amount (if a periodic pension payment) or of the taxable amount (if an annuity), and the taxable amount in the country of residence also is limited to the amount that would be included in income for tax purposes if the person was a resident in the country from which it is paid.[76]

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[73] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Nov. 27, 2006, U.S.-Belg., T.I.A.S. No. 07-1228.2. Notably, the U.S.-Belgian treaty also added a provision that a citizen of the U.S. who is a resident of Belgium can obtain tax relief not only for participation in a pension fund that is a resident of Belgium but also "a similar fund that is a resident of a comparable third State," an apparent nod to the creeping utilization of cross border pension plans in Europe, but also indicative of the growing need for broader tax relief for foreign pensions.

[74] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, with Protocol and Related Agreement, July 28, 1997, U.S.-Ir., T.I.A.S., Tax Treaties (CCH) ¶ 4401.02.

[75] Convention with Respect to Taxes on Income and Capital, with Exchange of Notes, Sept. 26, 1980, U.S.-Can., T.I.A.S. No. 11087, 1986-2 C.B. 258.

[76] These rules apply to both public and private plans (with some special rules for social security-type benefits). In addition, a distribution from a Roth IRA is exempt from Canadian tax, to the extent that it would be exempt from U.S. tax if paid to a U.S. resident.

The U.S.-Canada treaty includes provisions that contributions made to, or benefits accrued under, a qualifying retirement plan in one country shall be deductible or excludible in computing the individual's taxable income in the other country, and contributions made to the plan by the individual's employer shall be allowed as a deduction in computing the employer's profits in that other country, but similar to other treaties, has limitations, including that this applies only to "corresponding plans" and that (1) the individual was participating in the plan immediately before the individual began performing the services in the other country, (2) the individual was not a resident of that other country immediately before the individual began performing the services in that other country, and (3) the individual has performed services in that other country for the same employer (or a related employer) for no more than 60 of the 120 months preceding the individual's current tax year.

3. U.S. Totalization Agreements

A U.S. citizen working outside the U.S. for a non-U.S. employer generally is not subject to U.S. social security taxes, but generally is subject to social security taxes of the country in which he or she is working. A U.S. citizen working outside the U.S. for a U.S. employer generally is subject to both.[77] In order to avoid double social security taxation, coordinate overlapping tax jurisdictions, and serve other purposes, the U.S. has entered into social security tax treaties ("Totalization Agreements") with a number of foreign countries. The agreements provide that a worker is subject to social security tax in only one of the two countries that are parties to the agreement, based on a variety of rules. The agreements also provide continuity of benefits for workers who have worked in multiple countries. The U.S. currently has totalization agreements with 29 countries: Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, Norway, Poland, Portugal, Slovak, Republic, Spain, Sweden, Switzerland and the United Kingdom.[78]

J. Exemptions Under Section 409A and FATCA

Section 409A requires "nonqualified deferred compensation plans" to comply with strict rules regarding the time and manner for making deferral and payment elections and the time and manner for making benefit payments. If a plan violates the rules in section 409A, (1) all compensation deferred under the plan is included in gross income and subject to regular income tax as soon as it is earned and vested, (2) an additional 20-percent income tax is imposed on "the compensation required to be included in gross

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[77] *See* I.R.C. §§ 3101-3111 (imposing FICA taxes on "wages" with respect to "employment"); I.R.C. § 3121(a) (generally defining "wages" as all remuneration for "employment"); I.R.C. § 3121(b) (generally limiting "employment" to services performed inside the U.S. or outside the U.S. by a U.S. citizen as an employee for an "American employer").

[78] *See* https://www.ssa.gov/international/status.html.

income" by the preceding clause, and (3) interest is charged (at the underpayment rate plus one percent) from the date the compensation was earned and vested until it is included in gross income and subject to tax. Like section 402(b), section 409A is a backstop to other provisions. It was added by the AJCA in response to a history of perceived abuse of the constructive receipt tax doctrine, in particular by Enron executives before the company went bankrupt.[79] Like section 402(b)(4) in relation to the qualified plan rules, it subjects earnings that accrue on previously taxed amounts to tax each year as long as the plan continues to violate section 409A; that is, it does not delay taxation until the earnings are distributed. Like section 402(b), it does not contain any express exemptions for foreign plans. Nevertheless, regulations under section 409A exempt certain foreign plans.[80] Specifically:

- A foreign plan is not subject to section 409A to the extent "amounts constituting income" under the plan are excluded from U.S. income tax by treaty.[81] U.S. tax treaties typically have provisions allowing pension income to be taxed only by the country of residence, but which apply only to plans that are retirement-type plans resembling the broad-based foreign plans described below.[82]

- A foreign country's social security system is not subject to section 409A if contributions or benefits under the system are covered under a "totalization agreement" with the U.S., or if contributions are made to or benefits are provided under a government-mandated plan as part of that system.[83]

- Subject to certain restrictions, a "broad-based foreign retirement plan" is not subject to section 409A in the case of an individual who is a U.S. citizen or RA under the "Green Card" test.[84] A "broad-based foreign retirement plan" for this purpose is a written scheme, trust, arrangement or plan (1) under which eligibility to make or receive contributions or accrue benefits (*i.e.*, active participation) is available to wide range of employees, substantially all of whom are NRAs, aliens who are considered RAs solely under the "Substantial Presence Test", and/or bona fide residents of a possession, (2) that provides significant, nondiscriminatory benefits for a substantial majority of covered employees, and

[79] *See* 2005 Blue Book at 469; Staff of the Joint Committee on Tax'n, 108th Cong., *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (Comm. Print 2003) (JCS-3-03).

[80] *See* REG-158080-04, 70 Fed. Reg. 57930, 47938-39 (Oct. 4, 2005), for an explanation of the origin of these exemptions.

[81] Reg. § 1.409A-1(a)(3)(i).

[82] *See* Reg. § 1.409A-1(a)(3)(v).

[83] Reg. § 1.409A-1(a)(3)(iv).

[84] Reg. § 1.409A-1(a)(3)(iii).

(3) that generally discourages use of benefits for other than retirement or restricts access during employment.

- Subject to more limited restrictions, a "broad-based foreign retirement plan" also is not subject to section 409A in the case of an individual who is an NRA, an RA under the "Substantial Presence" test, or a bona fide resident of a possession.[85]

The treaty exemption for foreign plans to be treated as "exempt beneficial owners" under the more recent regulations under the Foreign Account Tax Compliance Act ("FATCA") takes an even broader approach. That exemption excludes "[a] fund established in a country with which the U.S. has an income tax treaty in force, provided that the fund is entitled to benefits under such treaty on income that it derives from sources within the U.S. (or would be entitled to such benefits if it derived any such income) as a resident of the other country that satisfies any applicable limitation on benefits requirement, and is operated principally to administer or provide pension or retirement benefits."[86] In other words, the FATCA exemption applies to a pension fund any time the fund derives treaty benefits on its income (*e.g.*, reduced withholding on dividends and interest).

II. DISCUSSION

A. Scope of Section 402(b)

1. Issues

a. In General

Sections 402(b)(1) and 402(b)(2) treat trusts subject to that section more harshly than section 83 or the economic benefit doctrine would. As explained above, it does not give the taxpayer the flexibility to make a section 83(b) election before contributions vest, and subjects earnings on vested contributions to tax as ordinary income when they are received. Section 402(b)(4) treats trusts subject to that section even more harshly: As explained above, it taxes benefits under such trusts annually on a mark-to-market basis, and effectively double-taxes trust earnings by taxing them both to the trust and to the employee each year.

The harsh treatment is especially pronounced for trusts under foreign plans. The timing rules of section 402(b) often effectively double-tax not just trust earnings but also the contributions themselves because the recognition events under section 402(b) usually do not coincide with recognition events under foreign tax law and thus are less likely to result in offsetting tax credits. Also, the basis and timing rules often effectively tax

[85] Reg. § 1.409A-1(a)(3)(ii).
[86] *See* Reg. § 1.1471-6(f)(1).

individuals with few connections with the U.S. on benefits they earned and ultimately will receive primarily outside the U.S.

These are not isolated problems. It is very common for companies with business operations inside and outside the U.S. to send key employees from one jurisdiction to another. In other situations, employees with special skills may be hired locally. In either case, the employee may find himself or herself participating in a foreign plan that is not recognized by the U.S. as a qualified retirement plan for U.S. tax purposes.

The problems are magnified if "employees' trust" is interpreted broadly. In common law countries, many foreign plans are funded through actual trusts. Elsewhere, other funding vehicles that nevertheless have some attributes of trusts may be used, including insurance contracts, "provident funds," foundations, escrow accounts, and U.K. EBTs (Employee Benefit Trusts).

The problems generally cannot be avoided by qualifying the plans under section 401(a). As a rule, trusts under foreign plans are not tax-exempt under section 501(a) because the plans do not satisfy one or more of the qualification requirements of section 401(a), such as the contribution and accrual limits of sections 401(a)(17) and 402(g), the benefit limitations of sections 415 and 436, or the nondiscrimination rules of section 401(a)(4), 401(a)(26) or 410(b). Most foreign plans do so not because they are designed to avoid U.S. tax-qualification requirements but rather because they are designed to comply with home-country requirements, traditions and needs. That is particularly true for broad-based or government-mandated foreign plans, including foreign social security systems.

Indeed, many foreign plans cannot comply with the qualification requirements of section 401(a) even if they try. The reason has to do specifically with section 410(b) and the definition of an HCE, which are triggers for section 402(b)(4) to apply. Treasury regulations seem to require – not permit – NRAs with no U.S.-source income to be excluded when applying section 410(b), as well as when determining the top-paid group for purposes of section 414(q).[87] Consequently, the only employees deemed to be covered by such a plan generally are U.S. mobile executives, *i.e.*, mobile executives who either are U.S. citizens or are in the U.S. long enough to be RAs, and U.S. local hires, even if the plan actually covers a wide cross-section of home-country employees.[88] These individuals tend to be HCEs, since they are either assignees with special compensation and benefits, or local hires with special skills.

[87] *See* Reg. §§ 1.410(b)-6(c)(1) & 1.414(q)-1T, Q&A-9(b)(1)(ii).

[88] Situations can exist where the employer has significant U.S. operations and chooses to extend coverage to rank-and-file employees in the U.S. rather than creating a U.S.-only plan, or hires rank-and-file U.S. employees in the country where the foreign plan is located, but they are unusual.

b. Examples

This harsh treatment is illustrated by the following examples:

- A foreign "In-Pat" accrues benefits under his home country plan, which is a non-U.S. social security plan or other broad-based pension plan, while working for years outside of the U.S., moves to the U.S. on assignment just long enough to become a U.S. RA, vests in his benefits under the plan while here, and then returns to his home country. Assuming that section 402(b)(1) applies, the entire amount of his benefits under the plan, including both employer contributions and earnings, will be subject to U.S. tax, even if he will be subject to home-country tax when he eventually receives distributions from the plan, unless the employer contributions and earnings are treated as "amounts paid" under the rules of section 83. He will have no opportunity to avoid U.S. tax on the benefits by making a section 83(b) election before coming to the U.S.

- The facts are the same as above, except the In-Pat both accrues and vests in his benefits under the home country plan while working outside of the U.S. Assuming that section 402(b)(4) applies, the entire amount of his benefits under the plan, including both employer contributions and earnings, will be subject to U.S. tax, even if he will be subject to home-country tax when he eventually receives distributions from the plan, except to the extent the employer contributions and earnings are treated as "investment in the contract." He will be taxed in the U.S. despite not experiencing any vesting or distribution event while here, meaning it is unlikely he will be entitled to any tax credit, and will have no opportunity to lock in his pre-U.S. basis by possibly transferring his interest in the plan for value before coming to the U.S. All this will happen despite his lack of any long-term connection with the U.S. A similar but smaller problem will exist if he does not become a U.S. RA and is taxed only on the employer contributions and earnings that are U.S.-source.

- A U.S. "Ex-Pat" accrues benefits while participating on assignment in her host country plan, which is a non-U.S. social security plan or other broad-based pension plan. Assuming that section 402(b)(4) applies, the entire amount of her benefit under the plan will be taxed each year as long as she participates in it. She will be taxed in the U.S. despite not experiencing any vesting or distribution event, meaning it is unlikely she will be entitled to any tax credit.

- An NRA receives distribution from a U.S. funded plan in which she participated when she worked in the U.S. The earnings component probably will be treated as U.S. source and subject to U.S. tax if the funding medium is treated as a trust that is located in U.S., even though it would be exempt from U.S. tax as capital gains if the arrangement were outside section 402(b).

2. Recommendations

a. Limits on Definition of "Trust"

We recommend that formal guidance be issued clarifying that the term "trust" in section 402(b) means the same thing is does in section 402(a) and the regulations under section 7701.

b. Limits on Definition of "Employees' Trust"

We recommend that formal guidance be issued excluding from section 402(b) trusts under (1) plans subject to totalization agreements and other foreign social security systems, and broad-based foreign retirement plans, that are described in the exemptions in the regulations under section 409A, and (2) "corresponding plans" under U.S. income tax treaties that are described in the exemption in the regulations under section 409A, but without regard to whether contributions or accruals are excludable from the income of a participant under the applicable treaty. If Treasury and the Service are reluctant to recognize an exemption from all of section 402(b), then we recommend that the guidance recognize an exemption from section 402(b)(4).

c. Compendium of Treaty Plans

We recommend the Service make available a compendium of current "corresponding plans" and social security totalization agreements as a reference tool for tax practitioners.

d. Inclusion of NRAs for Testing Purposes

We recommend that formal guidance be issued clarifying that employers may, but are not required to, elect to include NRAs for purposes of determining whether a foreign plan otherwise subject to section 402(b)(4) would fail section 410(b), taking into account non-U.S. source income.

e. Exclusion of Assignment-Related Benefits for Testing Purposes

We recommend that formal guidance be issued excluding from the definition of "compensation" used to determine whether an employee on assignment is an HCE for purposes of section 402(b)(4) any items solely attributable to the assignment (*e.g.*, assignment allocations and tax equalization payments).

3. Explanations

As explained above, the taxation of individuals participating in foreign plans can create inequities for assignees who provide services within the U.S. and become U.S.

taxpayers, as well as for U.S. persons who are required to participate in such non-U.S. plans while on foreign assignment or who have "localized" permanently to the non-U.S. jurisdiction. We believe that adopting these recommendations would be the most effective means of avoiding those inequities while at the same time placing the least burden on Treasury and the Service.

a. Limits on Definition of "Trust"

Any plan with assets that are beyond the reach of the employer's creditors in bankruptcy is "funded" according to existing guidance, including the regulations under section 83. However, not every funded plan is funded with a "trust," as required by section 402. If it were, there would be no need for both a trust and a funding requirement for tax-qualified plans, or rules in section 401(f) and (g) treating plans funded with custodial accounts or annuities as satisfying the trust requirement. The regulations appear to require taxpayers to use the definition of "trust" under section 7701. At the same time, the long history of using "trust" to mean the same thing in sections 401-402 and their predecessors appears to make guidance under section 401(a) applicable, as well. One significant element of a trust under both sets of guidance is the existence of a fiduciary duty between the trustee and the beneficiaries. Not every funding vehicle, especially outside of the U.S., creates such a duty.

Clarifying these points should reduce the extent of the problems created by the application of section 402(b) to foreign plans. Relying on existing rules to determine whether a "trust" exists should eliminate any need for Treasury and the Service to draft new regulations or other guidance and make this limitation more administrable.

b. Limits on Definition of "Employees' Trust"

Congress has consistently used section 402(b) as a means of enforcing the qualified plan rules, in particular those relating to coverage. Each time it made meaningful changes to the coverage requirements in the Code – in the Revenue Act of 1942, TRA '86 and TAMRA – it added or made corresponding changes to section 402(b) in the very same section of the Act. Nowhere in the legislative history of section 402(b) did it appear to contemplate that bona fide foreign plans, which never were intended to be U.S. tax-qualified and find it difficult or impossible to satisfy the coverage and other qualification requirements, were subject to that section.[89] We believe this is particularly true of section 402(b)(4), which created a tax regime very different from the standard income tax timing rules and was associated directly with specific changes to the

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[89] *Cf.* Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is it 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 Tax L. Rev. 1, 31 & n.100 (1993) ("the legislative history . . . implies that this rule was intended to apply only if the plan had been previously qualified").

nondiscrimination rules in TRA '86. As noted above, subsequent court decisions have recognized this association.[90] We believe that Congress's purpose is implicit, among other places, in the use of the term "employees' trust" in both section 402(a) and section 402(b). Penalty provisions in the Code are supposed to be narrowly interpreted.[91] Therefore, we believe that this term – which is not otherwise defined – can and should be interpreted in a principled manner that is consistent with its purpose, and that this limitation be applied to all of section 402(b).

Recognizing the exemptions suggested above should reduce the extent of the problems created by the application of section 402(b) to foreign plans. Relying on the definitions in the existing exemptions under section 409A should eliminate any need for Treasury and the Service to draft new regulations or other guidance and make this limitation more administrable.

We believe that trusts under foreign social security systems, including but not limited to plans subject to totalization agreements, are out-of-place under section 402(b). Not only are such systems inherently broad-based, but their terms typically are dictated by statute, and they are employment-related only in the sense that governments often rely on employers to collect and remit contributions from employees. We believe that broad-based foreign plans described in the regulations under section 409A are subject to enough controls that they are very unlikely to be used to circumvent the U.S. qualified plan rules, and in any event violate section 410(b) only if and to the extent that rank-and-file NRAs must be treated as excluded employees. Finally, we believe that the historically narrow view of a "pension" under U.S. income tax treaties means that "corresponding plans" described in the exemption in the regulations under section 409A also are very unlikely to be used for abusive purposes. We believe that the additional requirement found in those regulations that contributions or accruals be excludable from income should not apply in this context. If it did, the availability of the exemption for a particular individual would depend on the scope of the pension provision in the applicable treaty and the individual's own tax and benefit situation. Therefore, applying the requirement would make the exemption more fact-specific and difficult to administer. It also would focus on facts that arguably have little bearing on whether the plan could be a vehicle for abuse. Furthermore, it would limit significantly the scope of the exemption in the case of treaties that provide limited tax exemptions – for example only for distributions and not contributions or accruals – and for U.S. citizens and Green Card holders in the case of nearly all treaties because of their "savings clause." Finally, as noted above, specific rules found in various treaties, such as the requirement for contributions to have

[90] *See* footnote 44 *supra*.
[91] *See, e.g.*, *Commissioner v. Acker*, 361 U.S. 87, 91 (1959).

commenced in the home country before working in the host country, and the limit on the period for which the exemption will apply, could create traps for the unwary.[92]

Although we do not favor this result, the rationale for recognizing an exemption only from section 402(b)(4) rather than all of section 402(b) would be that section 402(b)(4) represented a radical departure from the longtime U.S. approach to taxing benefits under funded plans as set forth in sections 83 and 402(b)(1) and the economic benefit doctrine, and that this departure seems to have been precipitated by the sweeping changes Congress made to the nondiscrimination rules in TRA '86. Those changes were intended to close down what Congress considered to be significant abuses by highly paid executives in designing pension plans. These included "individual defined benefit plans" designed to benefit solely those executives, who could influence the adoption of the plans by the employer. There was a concern that many such plans would just be "frozen," with no further contributions but with accumulation of earnings that would be tax-deferred until distribution. We believe that section 402(b)(4) was added to remove any incentive to that and thus to force those plans to be significantly amended or terminated or face disqualification.

c. Compendium of Treaty Plans

We recommend the Service make available a compendium of current "corresponding plans" and social security totalization agreements as a reference tool for tax practitioners.[93] While this recommendation might appear to overlap with the recommendation immediately above, we believe that each is necessary. Even if the recommendation above is adopted, more often than not the guidance under income tax treaties on which plans constitute a "corresponding plan" falls short or is out of date. Making such a list available also would give the Service another opportunity to vet foreign plans and determine which ones are substantially similar to section 401(a) plans and not a potential vehicle for abuse. Thus, the list would increase compliance as well as make section 402(b) (and section 409A) easier for taxpayers and the IRS to administer.

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[92] We note that the treaty exemption for foreign plans to be treated as "exempt beneficial owners" under the more recent regulations under FATCA takes a broader approach. That exemption excludes "[a] fund established in a country with which the U.S. has an income tax treaty in force, provided that the fund is entitled to benefits under such treaty on income that it derives from sources within the U.S. (or would be entitled to such benefits if it derived any such income) as a resident of the other country that satisfies any applicable limitation on benefits requirement, and is operated principally to administer or provide pension or retirement benefits." Reg. § 1.1471-6(f)(1). In other words, the FATCA exemption applies to a pension fund if the fund derives treaty benefits on its income (*e.g.*, reduced withholding on dividends and interest). Thus, while the purpose of the exemption for FATCA withholding may be different than the purpose of U.S. taxation of pension participants, nevertheless there is precedent for Treasury not limiting exemptions to corresponding plans that meet the additional technical limitations.

[93] The former is more important than the latter because a current list of social security totalization agreements is available on the Social Security Administration web site.

d. Inclusion of NRAs for testing purposes

We believe that Treasury and the Service have the flexibility to allow foreign plans to take NRAs into account in determining whether they satisfy the requirements of section 410(b) for purposes of section 402(b)(4).[94] The pre-TRA '86 regulations under section 410(b) made the exclusion permissive even though they interpreted statutory language that was word-for-word identical to the current language.[95] The Senate Finance report describing the changes made to section 410(b) by TRA '86 also described the exclusion as permissive.[96] Even the preamble to the proposed regulations under section 410(b) as amended by TRA '86 used that language.[97] Clarifying this point should reduce the extent of the problems created by the application of section 402(b)(4) to broad-based foreign plans by making it possible for them to demonstrate that in they are not, in fact, discriminatory.

e. Exclusion of Assignment-Related Benefits for Testing Purposes

We believe that Treasury and the Service have the flexibility to exclude items solely attributable to an assignment, such as assignment allocations and tax equalization payments from the definition of "compensation" used to determine whether an employee on assignment is an HCE under section 414(s) for purposes of section 402(b)(4). Section 414(s)(1) cross-references section 415(c)(3) for the definition of "compensation." Section 415(c)(3) does not contain a precise definition, although it contains many supplemental rules. Recognizing that, Treasury and the Service have asserted broad authority under section 7805 to define "compensation" in the regulations under section 415.[98] We believe they could do the same in the regulations under section 402(b). Again, clarifying this point should reduce the extent of the problems created by the application of section 402(b)(4) to broad-based foreign plans by making it possible for them to demonstrate, in many cases, that in they are not discriminatory, and by preventing the harsh treatment under that section from applying to individuals who are not, in context, highly paid.

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[94] The exclusion under section 401(a)(26) already clearly is permissive. *See* I.R.C. § 401(a)(26)(B)(i); Reg. § 1.401(a)(26)-6(b)(3).

[95] *See* Reg. § 1.410(b)-1(c)(3)(i) (1985) ("An employee who is excluded from consideration under section 410(b)(3)(C) (relating to certain nonresident aliens) *may* be treated as an excludable employee.") (emphasis added).

[96] *See* S. Rep. No. 99-313, at 583 (1986) ("as under present law, nonresident aliens with no U.S. source income *may* be disregarded") (emphasis added).

[97] *See* 54 Fed. Reg. 21437, 21440 (May 18, 1989) ("The proposed regulations provide guidance relating to those employees who *may* be disregarded – the excludable employees – in applying section 410(b).") (emphasis added).

[98] *See* T.D. 9319, 72 Fed. Reg. 16878, 16894 (April 5, 2007).

B. Basis Issues

1. Section 402(b)(2)

a. Issue

As noted above, when a benefit under a trust described in section 402(b)(1) is distributed or made available, the amount subject to tax does not include the distributee's "investment in the contract" as defined in section 72. There is no express guidance on whether "investment in the contract" under section 72(c) or (f) includes only actual contributions while the employee is an NRA, or actual contributions plus some or all subsequent earnings while the employee remains an NRA. (This issue is relevant mostly for distributees who are NRAs, because section 72(w) largely supersedes section 72(f)(2) for distributes who are U.S. citizens and RAs.)

b. Recommendation

We recommend that, in the case of a trust under a foreign plan, "investment in the contract" under section 72(c) and (f) be defined to include actual contributions while the employee is an NRA plus all subsequent earnings on the contributions while the employee remains an NRA, or at least while the contributions remain unvested.

c. Explanation

Section 72(f) refers to "contributions," and does not expressly include earnings on those contributions. However the AJCA strongly suggests that all earnings while the employee is an NRA should be included. The Joint Committee Blue Book states that "Congress was aware that some employers took the position that there was basis in the earnings on such contributions, even though such amounts had not been subject to tax."[99] To address this, Congress added section 72(w)(3), which simply applied the same rule to earnings as section 72(w)(2) did to contributions. That would have been unnecessary if "investment in the contract" did not include earnings to begin with.

We believe that such a result would be consistent with the purpose of section 72(f), which we believe reflects a decision by Congress not to extend U.S. taxing power to the portion of the value of an annuity that was earned outside the U.S. A similar approach seems already to have been accepted by the Service in implementing article 29,

[99] Staff of the Joint Committee on Tax'n, 109th Cong., *General Explanation of Tax Legislation Enacted in the 108th Congress* 510 (Comm. Print 2005) (JCS-5-05).

paragraph 5 of the U.S.-Canada Treaty, providing for deferral of U.S. tax with respect to certain earnings accrued in a Canadian registered retirement savings plan ("RRSP").[100]

Even if all earnings while the employee is an NRA are not included in "investment in the contract," we believe it would be consistent with section 402(b)(1) to include earnings on contributions while they remain unvested. That is implied by the definition of "basis" in Regulation section 1.402(b)-1(b)(5), and would be consistent with the approach taken in other regulations.[101]

2. Section 402(b)(4)

a. Issues

As noted above, section 402(b)(4) reduces the amount that an HCE is required to include in income under that section by his or her "investment in the contract." There is no definition of "investment in the contract" for this purpose. Many taxpayers [should this be practitioners?] interpret it to mean the same thing the identical term does under section 72(f). (Section 72(w) generally does not apply in this context because there is no distribution.) However, as noted above, even the meaning of that term in section 72(f) is not completely clear. Furthermore, as explained above the Service has taken the position in litigation and in Rev. Rul. 2007-48 that the term in section 402(b)(4) includes only amounts previously taxed to the employee, so as to avoid double taxation. It is not clear whether that means only double U.S. tax, or also includes overlapping U.S. and foreign taxes. Even if Treasury and the Service recognize the limits on the scope of section 402(b)(4) that we recommend above, a narrow interpretation of "investment in the contract" could create significant hardships for foreign employees with interests in trusts subject to that section.

b. Recommendations

We recommend that, in the case of a trust under a foreign plan, "investment in the contract" in section 402(b)(4) be defined to mean the same thing it does under section 72(f), taking into account our recommendations above.

c. Explanation

We believe that "investment in the contract" in section 402(b)(4) should mean the same thing it does in section 72(f) because we believe there is no compelling reason for it

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[100] *See* Rev. Proc. 89-45, 1989-2 C.B. 596 (investment in the contract under section 72(c)(1)(A) is "the sum of the contributions to the plan plus earnings accrued in the plan at the time the beneficiary became a U.S. citizen or resident," or, if less, "the fair market value of the assets in the plan at the time the beneficiary became a U.S. citizen or resident").

[101] *See* Reg. § 1.72-8(d) (similar rule applied under section 403(d) before 1969); Proposed Reg. § 1.457-12(a)(5) (similar rule applies under section 457(f)); *cf.* I.R.C. § 403(b)(6) (stricken in 2002).

to mean something different. In a case involving a domestic trust, the Tax Court concluded that it should in part because "the general purpose of section 402(b)(4)(A) is to penalize highly compensated individuals."[102] However, we believe that purpose is not well-served in the case of a trust under a foreign plan that is not being used to circumvent the tax-qualification rules and has no realistic chance of satisfying them. The Tax Court ultimately agreed with the Service that "investment in the contract" meant the amount previously taxed to the employee "so as to avoid double taxation." However, we believe that purpose is better-served in the case of a trust under a foreign plan by using the definition under section 72(f) because, in many cases, an employee subject to section 402(b)(4) will have been subject to foreign tax at the time the contributions were made or will be at the time the benefits are distributed. While the individual might be able to claim a U.S. tax credit or deduction at that time, it is unlikely that he or she would have any U.S. taxable income to apply it against, meaning that in many cases it would be worthless. U.S. tax concepts are supposed to be followed in determining credits for taxes on income earned in foreign jurisdictions in order to avoid double-taxation. Defining "investment in the contract" in section 402(b)(4) to mean the same thing it does in section 72(f), taking into account our recommendations above, would have that effect.[103] Limiting "investment in the contract" to an amount previously subject to U.S. tax would apply a rule even more demanding than the rule under section 72(w) (in that section 72(w) also gives credit for amounts previously subject to foreign tax), and do so without requiring that there be any distribution to a U.S. taxpayer and the commitment to the U.S. that often entails.

Consider an employee with a vested $500,000 benefit under a trust subject to section 402(b)(4), all of which was earned outside the U.S., who transfers to the U.S. and becomes an RA for a short time, and while here is credited with an additional $25,000 in earnings. If "investment in the contract" means only amounts not previously subject to U.S. tax, the entire value of the accrued benefit, plus earnings, or $525,000, will be subject to U.S. tax at the end of the taxpayer's first year as an RA, even though the only connection of those amounts to the U.S. will be the employee's temporary presence here, and even though in all likelihood the benefit will eventually be subject to foreign tax.

If Treasury and the Service are concerned that the benefit in a situation like this might never be subject to U.S. or foreign tax, or be subject to a "merely nominal" tax, we believe they would have the legal authority to apply section 72(w) if and when a distribution was made from the trust to a U.S. distributee. As noted above,[104] it is not clear whether section 72 applies directly to distributions from such a trust. But even if it does not, we believe that applying section 72(w) to amounts not previously taxed under

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[102] *Yarish*, *139 T.C. at* 295-96.

[103] *See* Deborah Walker and Sallie Olson, *Maximizing the Benefits of Deferred Compensation Plans Funded Through Secular Trusts*, 77 J. Tax'n 90 (1992).

[104] *See* footnote 27 *supra*.

section 402(b)(4) would be analogous to including deferred compensation in FICA wages if they were not previously included under section 3121(v)(2).[105]

C. Defined Benefit and Similar Plans

1. Issues

Contributions to foreign plans often are not allocated to specific employees, do not have a fixed relationship with the employees' benefits, and might not even be known to the employees. This problem is most common in defined benefit plans, but can occur in defined contribution plans, as well. The drastic market declines in 2008 provide a good example of this. Sponsors of many foreign plans that experienced significant asset declines during 2008 were required by the terms of the plans or local authorities to make substantial restorative contributions to make up for severe market declines. Because such contributions were required in order to restore the diminished pool of trust assets used to fund the benefits of existing retirees, former employees and current employees, attempts to allocate such contributions to current employees would have resulted in excessive income amounts being imputed to current employees, including RAs. In some cases, the allocation would have exceeded the rest of the employee's compensation for the year. The gap is even wider between the amount of the contributions and the modest amount by which the employee's accrued benefit actually increased during the tax year, based on the change in the actuarial present value.

This raises questions under sections 72 and 402(b), as well as the sourcing rules, because all three distinguish between "contributions" and "earnings." Section 402(b)(4) is affected to the extent that "investment in the contract" requires a determination of previous "contributions" versus "earnings." It also requires taxpayers to value an employee's vested accrued benefit under a trust subject to that section, which is not a simple matter of adding "contributions" and "earnings" if they are not allocated to specific employees. Section 72(w) and the grantor trust rules in section 402(b)(3) further distinguish "employer contributions" from "employee contributions."

2. Recommendations

For defined benefit plans or other plans under which the contribution amount for each employee is not readily determinable, we recommend that Treasury and the Service allow taxpayers to determine both employer and employee contributions for purposes of sections 72 and 402(b), as well as under the sourcing rules, based on a procedure similar to that described in Rev. Proc. 2004-37.

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[105] *See* Reg. § 31.3121(v)(2)-1(d)(1)(ii) (nonduplication rule).

3. Explanations

Rev. Proc. 2004-37 addresses the sourcing of qualified plan benefits paid to an NRA. To do so, it does not rely on actual employer contributions for specific participants. The methodology consists of determining hypothetical total employer contributions on behalf of each employee using an accumulation table and a present value table (both listed in the revenue procedure). These hypothetical contributions are then allocated to sources within and without the U.S. Sourcing is determined on a month-by-month basis by reference to service credited under the plan. The methodology can be modified easily to calculate a hypothetical contribution amount for an individual employee in a given year.

It would be helpful to borrow from the principles of Rev. Proc. 2004-37 to measure "employer contributions," "employee contributions," and "earnings" in a defined benefit or similar plan where they are not allocated to specific employees. We believe that Rev. Proc. 2004-37 also would provide a fair and equitable method for determining the source of contributions where some services are rendered outside the U.S. and some inside the U.S., both for general income tax purposes in the case of NRAs and for purposes of applying section 72(w)(3), which contains a similar allocation requirement. We also believe that Rev. Proc. 2004-37 principles could usefully be used to measure vested accrued benefits in defined benefit and similar plans under section 402(b)(4).

D. Other Technical Issues

1. Application of Section 72(f) to NRAs

It would be helpful for Treasury and the Service to issue formal guidance confirming the position taken by the Service in various information memoranda and private letter rulings that employer contributions earned in connection with the performance of services outside the U.S. by an NRA constitute "investment in the contract" under section 72(f)(2) if such amounts would be exempt from U.S. taxation as non-U.S. source income if paid directly to the employee.[106]

2. When Foreign Taxation is "Merely Nominal"

As noted above, the legislative history of section 72(w) suggests that foreign taxation that is "merely nominal" may not be considered income tax that satisfies the requirement in that section that the amounts in question were subject to foreign tax. It would be helpful for Treasury and the Service to confirm that, in the absence of regulations, this rule is not yet effective. If regulations are issued, it would be helpful to

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[106] *See* footnote 57 *supra*.

state whether “merely nominal” means a rate that is significantly lower than the rate applicable to regular income (and if so, how significant), or a regular income tax rate that itself is low (and if so, how low). It also would be helpful to state whether after-tax contributions that may be deducted on the personal tax return are considered subject to tax.

3. Sourcing Rules

As noted above, Treasury and the Service have issued guidance, which the courts have endorsed, for determining the source of distributions from a trust subject to section 402(a) or (d), and most practitioners assume that the same rule applies to a distribution from a trust subject to section 402(b). Also, most practitioners assume that a trust that is a U.S. trust under section 7701(a)(30)(E) also satisfies the domestic-trust requirement in section 401(a) and the regulations. It would be helpful for Treasury and the Service to confirm these points.

The regulations also deem a trust subject to section 402(a) to satisfy the requirement in section 7701(a)(30)(E) that one or more U.S. persons have the authority to control all substantial decisions of the trust if U.S. trustees control all of the substantial decisions made by the trustees of the plan. It would be helpful for Treasury and the Service to clarify that the same rule does not apply to trusts subject to section 402(b).

4. Impact of Constructive Receipt

It is not uncommon for portions of an employee’s interest in a trust under a foreign plan to be, as a matter of local law, accessible prior to distribution. For example, amounts may be rolled over on a tax-free basis under local rules from one eligible plan to another, similar to U.S. rules for eligible qualified plans, even while the employee is still performing services. Such amounts might even be considered constructively received under section 451 and Regulation section 1.451-2(a). In most if not all cases, the employees do not take such actual distributions until retirement, and have no control over the local laws that require the amounts to be made available. It would be helpful for Treasury and the Service to confirm that constructive receipt of an amount does not constitute a “distribution” for purposes of section 72(w)(1).

5. Employee Contributions

Section 72(f)(2) and (w), and the grantor trust rules in section 402(b)(3), apply only to “employer contributions” or distinguish “employer contributions” from “employee contributions.” It would be helpful for Treasury and the Service to issue formal guidance confirming the position taken by the Service in various rulings that pre-tax elective deferrals are treated as employer contributions for this purpose.[107] This position would be consistent with section 402(e)(3), under which pre-tax salary deferrals to qualified plans are considered to be employer contributions.

Under this approach, by contrast, contributions that are made on an after-tax basis by an employee, or that are subject to taxation when made, including taxation under foreign laws, would be "employee contributions" rather than "employer contributions." This position would be consistent with the regulations under section 401(m), which provides nondiscrimination rules for employee contributions.[108]

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[107] *See* footnote 58 *supra*.
[108] *See* Reg. § 1.401(m)-1(a)(3).