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Re: Comments on Certain Pension Aspects of the United States Model Tax Treaty

Dear Mr. Harrington, Ms. Morrison and Mr. Julianelle;

As you know, IRS Commissioner Douglas Shulman recently remarked in a speech before the Organisation for Economic Co-operation and Development (the "OECD") that international tax issues have moved to center stage in the U.S. and that he has made international tax issues a top priority since "day one" of his tenure as Commissioner. In furtherance of that effort, we would like to make four recommendations as to ways in which the United States Model Income Tax Convention of November 15, 2006 (the "2006 U.S. Model Tax Treaty") could be helpfully modified or expanded with regard to certain pension-related matters.

As suggested in the Advisory Committee on Tax Exempt and Governmental Entities Report of Recommendations dated June 10, 2009 (the "ACT Report"), the IRS' overarching goal in addressing international pension issues should be "to break down the barriers and impediments to U.S. employers desiring to provide pensions to nonresident aliens working in the United States and to U.S. citizens and resident aliens transferred to affiliates of U.S. employers outside the

United States."[1] This goal is also consistent with Article 2(d) of the Convention on the OECD, which provides that member states such as the U.S. are to "pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and maintain and extend the liberalisation of capital movements." To further this goal, we wish to make the following suggestions with regard to the 2006 U.S. Model Tax Treaty's treatment of pension-related matters:

1. <u>The "lesser of" clause with respect to corresponding pension plan limitations should be omitted as both unnecessary and difficult to administer for U.S. tax purposes.</u>

Paragraph 2 of Article 18 of the 2006 U.S. Model Tax Treaty provides as a general rule that:

> Where an individual who is a member or beneficiary of, or participant in, a pension fund that is a resident of one of the States exercises an employment or self-employment in the other State:
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> a) contributions paid by or on behalf of that individual to the pension fund during the period that he exercises an employment or self-employment in the other State shall be deductible (or excludible) in computing his taxable income in that other State; and
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> b) any benefits accrued under the pension fund, or contributions made to the pension fund by or on behalf of the individual's employer, during that period shall not be treated as part of the employee's taxable income and any such contributions shall be allowed as a deduction in computing the taxable income of his employer in that other State.

This provision is available only to "corresponding" pension funds (which are generally those pension funds recognized by both states as roughly corresponding to U.S.-type tax-qualified plans and IRAs) in circumstances where contributions to the pension fund in the other state were made before the individual began to exercise employment in the other state. 2006 U.S. Model Tax Treaty, Article 18, ¶ 3.

However, Paragraph 4(b) of Article 18 also provides that:

> b) The relief available under this paragraph shall not exceed the lesser of:

[1] "International Pension Issues in a Global Economy: A Survey and Assessment of IRS' Role in Breaking Down the Barriers", Pub. 4344, at 1, *available at* http://www.irs.gov/pub/irs-tege/tege_act_rpt8.pdf.

> i) the relief that would be allowed by the United States to its residents for contributions to, or benefits accrued under, a generally corresponding pension plan established in the United States; and
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> ii) the amount of contributions or benefits that qualify for tax relief in [the other State].

In this letter, we will refer to this provision as the "lesser of clause." The United States Model Technical Explanation Accompanying the 2006 U.S. Model Tax Treaty (the "2006 U.S. Technical Explanation") states that:

> Paragraph 4 generally provides U.S. tax treatment for certain contributions by or on behalf of U.S. citizens resident in the other Contracting State to pension funds established in the other Contracting State that is comparable to the treatment that would be provided for contributions to U.S. funds. Under subparagraph (a), a U.S. citizen resident in the other Contracting State may exclude or deduct for U.S. tax purposes certain contributions to a pension fund established in the other Contracting State. Qualifying contributions generally include contributions made during the period the U.S. citizen exercises an employment in the other Contracting State if expenses of the employment are borne by an employer or permanent establishment in that other Contracting State. Similarly, with respect to the U.S. citizen's participation in the pension fund in the other Contracting State, accrued benefits and contributions during that period generally are not treated as taxable income in the United States.
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> The U.S. tax benefit allowed by paragraph 4, however, is limited under subparagraph (b) to the *lesser of* the amount of relief allowed for contributions and benefits under a pension fund established in the other Contracting State *and the amount of relief that would be allowed for contributions and benefits under a generally corresponding pension fund established in the United States*. [Emphasis added.]

The lesser of clause was apparently intended to prevent an employee from playing an "arbitrage" game of moving employment between countries while choosing to participate in the tax-qualified plan with the highest benefit limits. However, it is not at all clear that this hypothetical situation is a significant problem, or that the lesser of clause is necessary in order to prevent such a situation. However, it is clear that the lesser of clause creates a number of potential tax issues for little apparent purpose.

Bear in mind that that the lesser of clause only applies to corresponding pension funds and where contributions were made for the employee to the plan concerned before the employee moved to the other country. Thus, if a particular type of pension fund in another state raises a realistic possibility of distorting plan participation because there are significant differences in the applicable contribution or benefit accrual limits, perhaps that might suggest that such a pension fund does not necessarily correspond to a U.S. tax-qualified plan.

Further, there are many questions, but little guidance, on how the lesser of clause applies. One of the principal questions is how to translate the U.S. Internal Revenue Code ("Code") section 415 limits on annual additions and benefits accruals to plans which may generally correspond to U.S. tax-qualified plans but which in such purely technical aspects are very different. For example, the annual limit on contributions for an occupational pension in the U.K. for 2008/2009 is £235,000, while the lifetime allowance for 2008/2009 is £1.65M. However, those limits apply in the aggregate to defined contribution and defined benefit arrangements, while in the U.S. there are two separate and additive limits. These technical differences raise a question as to whether a benefit or accrual under a U.K. plan is compared to the Code section 415(b) limit, the Code section 415(c) limit, or both; or, if the latter, which would seem most comparable, whether and how the limits should be applied by using actuarial equivalence in order to be comparing apples with apples. For example, if a U.K. citizen long employed in the U.K. but now transferred to and resident in the U.S. while still participating in the U.K. plan is not able to contribute the annual U.K. limit to the U.K. plan (even though he or she may not have been able to make full annual contributions while in prior years in the U.K. and be well below the U.K. lifetime limit), then if that person were limited to $49,000 in contributions for 2009, when that person retires to the U.K. he or she may not then have the full pension that he or she would have earned had the person stayed in the U.K. - even though the person's resulting U.K. pension may be less than what he or she could have accumulated had he or she been contributing the maximum Code section 415(c) amount to a U.S. plan all of those years, as well as less than the value of what the person could have accrued as a defined benefit in the U.S. under Code section 415(b).

Needless to say, applying these contribution limitations also gives rise to the question of how to make appropriate currency conversions. When the respective contribution limits are close, the currency exchange rate applied can determine whether or not the lesser of the contribution limits is in fact exceeded. The lack of clarity in currency conversion for employee benefits purposes is one of the issues mentioned in the ACT Report.[2]

The introduction of Code section 409A in 2004 heightened the importance of this issue. At the time the lesser of clause came into being, it was primarily an income tax concern for

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[2] ACT Report *supra* note 1, at 24–25.

individual employees, and large amounts were not at stake.[3] But a 409A violation can result in substantial penalties and generally applies to all deferred compensation unless exempted. Further, even a minor violation of 409A in one plan can cascade into violations by the employee under all plans of similar type. The regulations under 409A provide two possible exemptions for foreign plans, but both exemptions have flaws that make them difficult to fully meet. One exemption is for broad-based foreign plans that requires that the foreign plan be nondiscriminatory.[4] This is a difficult requirement because most foreign plans do not apply U.S. Internal Revenue Code nondiscrimination testing, and it would be prohibitively expensive to do so. As we understand it, such testing could also be problematic because of the exclusion of nonresident aliens from testing,[5] and the application of the benefit, right or feature rules of the nondiscrimination rules.[6]

Consequently, the 409A exemption that most employers would rely on is the exemption for corresponding plans under a tax treaty. However, that exemption only applies where amounts "are excludable by such individual for federal income tax purposes pursuant to any bilateral income tax conventions to which the United States is a party,"[7] so that the exemption presumably does not apply to the extent the lesser of clause limits nontaxability. Thus, it appears that a potential 409A violation, carrying with it draconian penalties, can be created if the "lesser of" the limitations is exceeded in a year, even by a small amount, and even though it may not be clear, as described above, whether the "lesser of" the limitations can be effectively determined.

We would suggest that a better approach would be to evaluate, at the time a determination is made regarding whether two pension funds are "corresponding", whether the contribution and benefit limits are roughly comparable, taking into account limits over a lifetime of work and aggregating relevant plans, and the possibility of reasonable currency fluctuations, so that it is not necessary to rely on the lesser of clause. If there remains a wide (not merely a minor or hypothetical) discrepancy in contributions or benefits in the aggregate so that it is determined that there is a danger that employees will "game" the system, then the lesser of clause could be applied to those limited situations. But, for example, we would suggest that for corresponding pension funds in the OECD countries, the contribution limits are sufficiently comparable that the lesser of clause is unnecessary and a trap for the unwary.

[3] We note that the lesser of clause was not in the United States Model Income Tax Convention of September 20, 1996 (the "1996 U.S. Model Tax Treaty"); we believe the lesser of clause dates to the U.S.-U.K. Tax Treaty of 2001.
[4] *See* Treas. Reg. § 1.409A-1(a)(3)(v).
[5] *See* ACT Report V.D.1, at 44.
[6] *See* Treas. Reg. § 1.401(a)(4)-4.
[7] *See* Treas. Reg. § 1.409A-(1)(a)(3)(i).

2. <u>Add reciprocity of tax exemptions for pension investments other than the withholding exemptions for dividends and interest as is the case in the European Union.</u>

It is increasingly well established under the rules of the European Commission (EC) that European Union (EU) Member States are obliged to give tax relief to pension funds in other Member States to the extent they do so for payments to domestic funds.[8] Most recently, the EC has requested that Denmark and Finland tax dividends paid to nondomestic pension funds at the same rate as those paid to domestic pension funds.[9]

This approach is also consistent with the Commentary to the OECD Model Tax Convention, which expressly recognizes that where both contracting states exempt pension fund investment, reciprocity may be appropriate, and provides model language:

> Where, under the domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, those States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:
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> "Notwithstanding any provision of this convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognized as such for tax purposes by that State, shall be exempt from tax in that State."[10]

Currently, the 2006 U.S. Model Tax Treaty provides a general exemption for withholding on dividends paid from one state to a pension plan in another state. *See* Article 10, ¶ 3

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[8] *See, e.g.*, *Commission of the European Communities v. Kingdom of Belgium*, C-522/04 of 5 July 2007 and *Commission of the European Communities v. Denmark*, C-150/04 of 3 January 2007; "With regard to the need to ensure the cohesion of the tax system, the Commission takes the view that all pension schemes taken out with pension institutions established in other Member States should enjoy the same tax advantages as those taken out in Denmark." EUECJ C-150/04, ¶ 62.

[9] Cases 2006/4103 (Denmark) and 2006/4096 (Finland). According to the related EU press release, in Finland, dividends paid by a company which is resident in Finland for tax purposes to a non-resident pension fund are subject to a withholding tax on gross income at a rate of 19.5%, while Finnish pension funds are effectively taxed on only 75% of dividend income. In Denmark, dividends paid to foreign pension funds are effectively subject to a tax rate of 15% on the gross amount of the dividend, while domestic Danish pension funds are subject to a tax of 15% on a net basis. The press release is available on the internet at europa.eu.

[10] Section 69 of the Commentary to Article 18 of the OECD Model Tax Convention on Income and Capital.

(dividends), ¶ 4 (REITs, subject to limitations). Under Article 11, interest is generally taxable in the state of residence, while real estate taxes generally apply based on the state in which the real estate is located. Article 18, Paragraph 1 would also arguably require the other state to grant a tax exemption to investments by U.S. tax-qualified pension plans, but its effect is principally on taxation of the individual participant, not the pension fund. Consequently, other taxes in a state where the pension plan invests may apply. In many cases, there may be an exemption for such taxes in that other state for pension plans in that state, but not necessarily pension plans in other states.

We would recommend that the U.S. follow the lead of the EC and OECD in this regard and seek to provide that exemptions from taxation of investment by pension funds in one state also be extended to corresponding pension plans in the other contracting state. As noted above, the OECD Model Tax Convention Commentary already provides a sample provision for doing so, and such a rule is also generally consistent with the concept of nondiscrimination under Article 24 of the 2006 U.S. Model Tax Treaty. Such a provision would both facilitate the free flow of investment capital and benefit plan participants and beneficiaries by allowing plans to diversify by appropriate international investment at a lower cost. Again, any abuse of such provision could be prevented by appropriate determination of what constitutes a "corresponding" plan.

3. <u>Expand the third-state pension plan exemption from the U.S.–Belgium treaty of 2006 to other OECD state treaties.</u>

The U.S.–Belgium Tax Treaty of 2006 states, in paragraphs 9 and 10 of Article 17 regarding pensions, that:

> 9. a) Where a citizen of the United States who is a resident of Belgium exercises an employment in Belgium the income from which is taxable in Belgium, the contribution is borne by an employer who is a resident of Belgium or by a permanent establishment situated in Belgium, and the individual is a member or beneficiary of, or participant in, a pension fund that is a resident of Belgium (*or in a similar fund that is a resident of a comparable third State*) [emphasis added],
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> > i) contributions paid by or on behalf of that individual under a pension plan during the period that he exercises the employment in Belgium, and that are attributable to the employment, shall be deductible (or excludible) in computing his taxable income in the United States; and

ii) any benefits accrued under the pension plan, or contributions made under the pension plan by or on behalf of the individual's employer, during that period, and that are attributable to the employment, shall not be treated as part of the employee's taxable income in computing his taxable income in the United States.

* * *

10. a) For purposes of paragraphs 7 and 9 [of Article 17], a similar fund that is a resident of a State other than a Contracting State will be considered to be a resident of a comparable third State only if that third State:

i) is a member state of the European Union or any other European Economic Area state or any party to the North American Free Trade Agreement or Switzerland;

ii) provides, under a tax treaty or otherwise, comparable favorable treatment for contributions to a pension fund that is a resident of the Contracting State that is providing benefits under paragraph 7 or 9; and

iii) has an information exchange provision in a tax treaty or other arrangement with the Contracting State that is providing benefits under paragraph 7 or 9 that is satisfactory to that Contracting State;

b) a pension plan is recognized for tax purposes in a Contracting State if contributions to the plan would qualify for tax relief in that Contracting State.

The Technical Explanation to the U.S.–Belgium Treaty of 2006 states that:

Paragraph 10 provides guidance for the application of paragraphs 7 and 9 by delineating when a similar fund that is a resident of a State other than a Contracting State will be considered to be a resident of a "comparable third State." The paragraph requires that such a state will be considered a comparable third State only if the following three requirements are met: (1) the third State is a member state of the European Union or any other European Economic Area state

> or any party to the North American Free Trade Agreement or Switzerland, (2) the third State provides, under a tax treaty or otherwise, comparable favorable treatment for contributions to a pension fund that is a resident of the Contracting State that is providing benefits under paragraph 7 (*i.e.*, host state) or paragraph 9 (*i.e.*, the United States), and (3) the third State has an information exchange provision in a tax treaty or other arrangement with the Contracting State that is providing benefits under paragraph 7 or paragraph 9 that is satisfactory to that Contracting State.
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> Subparagraph (b) provides that a pension plan is recognized for tax purposes in a Contacting State if contributions to the plan would qualify for tax relief in that Contracting State.

This provision is similar to a provision allowed under Section 38 of the Commentary to Article 18 (Pensions) of the OECD Model Tax Convention on Income and Capital:

> As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (e.g. through the exchange of information provisions of a tax convention concluded with a third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar relief to an individual contributing to a pension scheme established in the host State.

The reservations expressed in that Commentary would be mooted to the extent that such third state plans are recognized by the U.S. as corresponding pension plans in the treaty with such third state, and there exists adequate information sharing by treaty with that third state. Those conditions would most commonly apply, of course, with other OECD countries. Given that participation in such third state pensions is likely to become more common as a result of the EC activities in leveling pension taxation within the EU described above, we would suggest that it would be appropriate to expand the current third state pension exemption in the U.S.–Belgium treaty to other treaties with other OECD countries, or at least the countries of the EU.

4. <u>Allow transfers between corresponding plans of different states.</u>

There has long been some confusion as to whether a transfer of a benefit from a pension fund resident in one state to a pension fund in another state may be tax-deferred in a manner similar to an "eligible rollover distribution"[11] or "plan-to-plan transfer"[12] between tax-qualified plans in the U.S. This confusion appears at least in part to be due to the words of Paragraph 1 of Article 18 of the 2006 U.S. Model Tax Treaty, which provides that:

> Where an individual who is a resident of one of the States is a member or beneficiary of, or participant in, a pension fund that is a resident of the other State, income earned by the pension fund may be taxed as income of that individual only when . . . it is paid to, or for the benefit of, that individual from the pension fund (*and not transferred to another pension fund in that other State*). [Emphasis added.]

A simple reading of this provision is that such a transfer is tax-deferred only between plans of the same state (*i.e.*, both plans are in the "other State" where the person is not resident). However, paragraph 4(c) of Article 18 goes on to state that:

> For purposes of determining an individual's eligibility to participate in and receive tax benefits with respect to a pension plan established in the United States, contributions made to, or benefits accrued under, a pension plan established in [the other State] shall be treated as contributions or benefits under a generally corresponding pension plan established in the United States to the extent relief is available to the individual under this paragraph.

Moreover, the U.S.–U.K. Income Tax Convention of 2001 had different wording - it did not include the words "in that other State" but merely provided "and not transferred to another pension scheme."

Thus, notwithstanding the "such other State" reference in paragraph 1, there is a suggestion in paragraph 4 that distributions from a corresponding plan in one state would be treated for tax purposes the same as a distribution from a corresponding plan in the other state - a concept that would permit cross-border rollovers and transfers to and from U.S. plans by, essentially, deeming the non-U.S. plan to be the same as a U.S. plan for tax purposes (provided that it was determined by the U.S. to be a "corresponding" plan).

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[11] *See*, Code § 402(c).
[12] *See, e.g.*, Code § 414(l), Treas. Reg. § 1.411(d)-4, Q&A-3.

Further, the prior 1996 U.S. Model Tax Treaty seems to have permitted such cross-border rollovers. To begin with, paragraph 6(c) of Article 18 of the 1996 U.S. Model Tax Treaty stated that:

> Distributions from the plan to the individual shall not be subject to taxation in the other Contracting State if the individual contributes such amounts to a similar plan established in the other State within a time period and in accordance with any other requirements imposed under the laws of the other State.

As the Technical Explanation accompanying the 1996 U.S. Model Tax Treaty states:

> Subparagraph 6(c) permits the individual to withdraw funds from the plan in the first mentioned (home) State *for the purpose of rolling over the amounts to a plan established in the other (host) Contracting State without being subjected to tax in the other State with respect to such amounts*. This benefit is subject to any restrictions on rollovers under the laws of the other State. For instance, in the United States a rollover ordinarily must be made within 60 days of the withdrawal from the first plan under section 408(d)(3)(A)(i) and section 402(c). Rollovers from plans covered by Article 19 (Government Service) would not be covered by this provision. It is understood that, for the purposes of maintaining the tax-exempt status of a pension arrangement receiving rolled-over amounts, the assets received will be treated as assets rolled over from a qualified plan. [Emphasis added.]

However, over the years, the IRS has issued various guidance treating attempted cross-border rollovers as taxable distributions or contributions.[13]

Where a non-U.S. person participating in a non-U.S. plan retires to the U.S. and begins drawing a pension, the general treaty rule of Articles 17 and 18 of the 2006 U.S. Model Tax Treaty is that the person will be taxed on the pension in the state of residence. We would suggest that it would not do harm to this structure to change the current IRS position and allow the rollover of such distributions to an IRA (or, if the person were to become a participant in a U.S. qualified plan due to new U.S. employment, such qualified plan). A tax deferral would be extended, but the amount would have been tax-deferred in both countries until distribution had it simply remained sitting as a deferred vested pension in the pension plan in the other state. But, for example, the individual now retired in the U.S. would be better able to invest in U.S.

[13] *See, e.g.*, Memorandum from Associate Chief Counsel (International) to Michael Julianelle, Director Employee Plans (TEGE) No. AM 2008-49 (August 21, 2008) (transfers not allowed from U.K. to U.S. plans), IRS PLR 9833020 (transfers from Canada to U.S. plans) and IRS Rev. Proc. 2008-40 (transfers from U.S. to foreign trusts not qualified under U.S. tax law generally).

securities and dollar denominated investments within a U.S. IRA or qualified plan than might be possible were the assets to remain in the non-U.S. corresponding plan, and thus the individual would be better prepared for retirement in the U.S. (In some cases, such as the U.K., where lump sum distributions are to some extent nontaxable, it may not, of course, be in the interest of the individual to roll over amounts into a U.S. IRA or plan.)

Similarly, in the case of a person who has participated in a U.S. tax-qualified plan and then retires to another country, if the person is a U.S. citizen, they will remain subject to U.S. income tax on the distribution from the other state under the U.S. extraterritorial tax system, through the treaty savings clause. A person who was participating in the U.S. qualified plan but who is not a U.S. citizen, and then retires to their home country, might then rollover their pension to a home country corresponding plan, and be taxed by their home country on eventual distribution as it was then the country of residence, just as under the current tax treaty for a distribution from a U.S. qualified plan.[14]

Finally, in the case of a truly mobile employee who has accrued benefits or had contributions to tax-qualified plans which are corresponding plans in both states because he or she has worked in both states over the years, the ability to transfer or rollover the money from a plan in one state to a plan in the other state, thereby permitting consolidation of the individual's retirement assets in one tax-exempt vehicle, would greatly simplify the administration of that individual's retirement, facilitate investing in the currency of the state of residence, and likely reduce investment costs, a key component of investment returns in retirement plans. This arrangement will still result in the application of the general treaty rule of taxation in the state of residence for payments, subject to the savings clause and the extraterritorial reach of taxation for U.S. citizens. Such portability could, though, lessen the need for special nonqualified plans, often referred to as "third country national" or "TCN" plans in order to keep mobile employees whole while they move from country to country. And portability would certainly remove "obstacles to the exchange of goods and services" between OECD member countries, which is one of the announced goals of the U.S.

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[14] For a similar non-treaty based rule where for a participant in a U.S.-qualified plan but who performed no service in the U.S. can receive an annuity payment not taxable in the U.S. but taxable in the country of residence, *see* Code section 871(f) (it is noted that this exception does not apply to all tax-qualified U.S. plans, notably IRAs and 403(b)s, though that seems mostly for historical rather than policy reasons).

We hope that you will find these recommendations useful in addressing international pension issues. Thank you for your consideration of these matters. Please call me if you have any questions or if we can be of any assistance.

Yours sincerely,

David W. Powell

cc: William Bortz