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New US Model Tax Treaty Makes Pension-Related Changes

On February 17, 2016, the U.S. Department of the Treasury (the "Treasury Department") issued a revised U.S. Model Income Tax Convention (the "2016 Model"), which will serve as the baseline text the Treasury Department uses when it negotiates tax treaties. Significantly, the 2016 Model departs from the prior model income tax convention (the "2006 Model") by adding a protocol where contracting countries will expressly define what qualifies as a "pension fund". This is a departure from the 2006 Model where "pension funds" included entities that are generally exempt from income taxation in a country and that operated principally either to administer or provide pension or retirement benefits or to earn income for entities that administer or provide pension or retirement benefits. In addition to the change to the definition of "pension fund", the 2016 Model clarifies the tax treatment of income earned by a person from a pension fund in a different country in the event of a tax-deferred transfer to another plan. The two changes are described in additional detail below.

We note that the Treasury Department will be preparing a detailed technical explanation of the 2016 Model and is accepting comments on the model until April 18, 2016.

Definition of Pension Fund

In the 2016 Model, the definition of "pension fund" has been significantly narrowed. For U.S pension plans, this change may not be significant. But for some non-U.S. pension funds, this change could lead to less tax benefits under the treaty.

The definition of "pension fund" is primarily important for purposes of a reduction or exemption for resident pension funds from withholding on dividends or interest paid from another country.

The definition was narrowed in two ways. First, under the 2006 Model, entities that are operated "principally" to administer, earn income for, or provide pension or retirement benefits were treated as pension funds. The 2016 Model replaces the word "principally" with the phrase "exclusively or almost exclusively". Second, the 2016 Model adds a protocol where countries will be asked to further define "pension fund". In the U.S., the term "pension fund" is defined further to include:

> "In the case of the United States, the term "pension fund" includes the following: a trust providing pension or retirement benefits under an Internal Revenue Code section 401(a) qualified pension plan (which includes a Code section 401(k) plan) and a profit sharing or stock bonus plan, a Code section 403(a) qualified annuity plan, a Code section 403(b) plan, a trust that is an individual retirement account

> under Code section 408, a Roth individual retirement account under Code section 408A, a simple retirement account under Code section 408(p), a trust providing pension or retirement benefits under a simplified employee pension plan under Code section 408(k), a trust described in section 457(g) providing pension or retirement benefits under a Code section 457(b) plan, and the Thrift Savings Fund (section 7701(j)). A group trust described in Revenue Ruling 81- 100, as amended by Revenue Ruling 2014-24 and Revenue Ruling 2011-1, qualifies as a pension fund only if it is operated exclusively or almost exclusively to earn income for the benefit of pension funds that are themselves entitled to benefits under the Convention as a resident of the United States."

This is similar to the concept of "corresponding" pension plans under the 2006 Model, which are funds specifically designated, usually in notes or protocols, to be eligible for the special tax treatment on contributions and earnings of the fund when a resident of one country participates in a plan in another country, for example, where a U.S. taxpayer might participate in a UK tax-qualified plan while seconded to the UK for work. This concept of specifically designated corresponding plans seems to have been extended to the definition of pension fund in general. Consequently, under future treaties, sponsors of non-U.S. pension plans may need to make efforts to ensure that their plans are properly designated by protocol.

Interestingly, the definition of pension fund continues to include a prong that it be generally exempt from income taxation, where it has become more clear in connection with the implementation of FATCA that plans in some jurisdictions are only tax advantaged, not entirely tax exempt.

Tax Treatment of Pension Fund Transfers

The 2006 Model had left unclear the tax treatment of income to a plan participant in one country earned by a pension fund resident in another country on transfer to another pension fund. The 2016 model provides that the income earned should not be treated as income to the individual unless, and then only to the extent that, it is paid to or for the benefit of that individual, which does not include a transfer from a plan in another country to a plan in the same country unless it qualifies as a tax-deferred transfer under the laws of that country.

Limitation on Benefits 50% Rule Not Changed.

One of the provisions that has not changed from the 2006 Model is the provision in the limitations on benefits article that 50 percent or more of a pension fund's participants and beneficiaries be residents of the two contracting states. Clarifying how this applies to cross-border pension funds, such as in the EU, may be worth commenting on.

As noted above, a more in-depth explanation from the Treasury of the 2016 Model is to be forthcoming. If you have any question about the pension ramifications of the new model, please call your Groom lawyer.

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