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US Government Accountability Office Recommends Changes Regarding US Participants in Foreign Retirement Plans

The US Government Accountability Office (known as the GAO) recently issued a report (GAO-18-19) recommending, among other things, that the IRS clarify how US taxpayers report their participation in foreign plans for US tax purposes, and further analyze the information that is being reported to them in order to gain a better understanding of such plans that might lead to possible exemption. The report also recommends that Congress consider changing the tax law to allow tax-deferred transfers between foreign plans.

Though there are often long time lags between the issuance of such reports and their being acted upon (if ever), this GAO report is useful for highlighting a number of current tax concerns that arise when US taxpayers participate in non--US retirement plans. The report also recommends improvements for locating missing participants, but this alert will focus on the foreign plan issues raised.

Confusion Over How Participation in Foreign Plans is Reported

Reflecting the view of many practitioners, the report acknowledges that the reporting by US taxpayers of participation in foreign plans is complex and unclear in a number of cases, including different tax professionals taking different positions on various matters, and therefor is costly to comply with. As the report plainly states, "[e]xisting IRS guidance does not alleviate the confusion faced by individuals who participate in foreign retirement plans."

The report reviews the basic rules under Internal Revenue Code section 402(b) for taxation of non-qualified trusts (a category which would include most non-US retirement plans), and the impact of tax treaties, where present, which vary widely.

In addition to noting the Form 8938 under FATCA and FBAR filing requirements, the report acknowledges more obscure questions such as whether a participant might have to file a foreign retirement account as a Passive Foreign Investment Company (PFIC, Form 8621). The report notes that "IRS officials told us that it should generally be unnecessary to file a foreign retirement account as a Passive Foreign Investment Company (PFIC) if the foreign retirement plan is covered by a tax treaty with the United States", but that some tax advisors in foreign countries advise their U.S clients to file. GAO further raises the question of whether employees should report such foreign plans in some circumstances as foreign trusts using Form 3520.

In light of all this confusion, the GAO recommends that the IRS should clarify how US individuals report their foreign retirement accounts, including how the accounts should be designated, and how the taxpayer should report contributions, earnings and distributions from the account.

IRS Should Analyze Form 8938 Data on Foreign Retirement Accounts

Given the difficulty taxpayers have in complying with the reporting requirements, providing an exemption from some of those requirements might be helpful, but so far the IRS has not systematically analyzed Form 8938 data on foreign retirement accounts owned by US individuals, so the agency lacks an understanding of the accounts. The report recommends the IRS analyze that data to consider whether the IRS could offer individuals some exemptions from reporting their foreign retirement accounts.

Congress Requested to Allow Tax-Deferred Transfers Between Foreign Plans

Going a step further, the GAO raises the issue that, except for exemptions included in a handful of tax treaties, the IRS position is that a transfer between two foreign retirement plans is generally considered a taxable event for US tax purposes, even if it is treated as nontaxable, akin to a US rollover, under the laws of the local jurisdiction. The report examines Hong Kong law which provides that, when an employee terminates employment, their account under an employer pension scheme is required to be transferred from one type of account under the employer's pension scheme to another type of account, and concludes that the transfer is treated as a taxable distribution for purposes of US taxation if the employee is a US citizen.

Consequently, in order to ensure that US individuals who participate in workplace retirement plans can consolidate their accounts in a tax-deferred manner without being taxed on their entire balance when the amount is transferred, the GAO recommends that Congress consider an amendment to the Internal Revenue Code to allow routine transfers between foreign workplace retirement plans in the same country to be free from US tax if that country has a tax treaty with the US.

Final Observation

Cross-border pension issues are receiving heightened attention by US regulators, and this GAO report is evidence of a desire to foster more guidance in the area – and perhaps even some relief. While we will have to wait and see if that develops, in the interim, it is a good time for participants in such plan and their employers to review their compliance with the current state of the law.

If you have any questions about this, call David W. Powell or your current Groom lawyer.

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