The migration of workers into and out of the United States is a fact of the modern interconnected world. Consequently, many U.S. taxpayers acquire an interest in a foreign pension plan or other deferred compensation arrangement during time spent working abroad. Because of the beneficial tax treatment of these plans in the originating country, a taxpayer might easily—but incorrectly—assume that there are no U.S. tax implications or reporting requirements for these foreign plans. It is a mistake to overlook a taxpayer’s interest in a foreign pension plan for U.S. tax purposes, and thus it is important to be well versed in the rules relating to foreign pensions, as well as how to bring previously noncompliant individuals into compliance.

Income Tax Implications and Reporting Requirements of Foreign Pension Plans

Many individuals may have an interest in some type of foreign pension plan, including U.S. residents or naturalized citizens who worked abroad before moving to the United States as well as American citizens who spent time working abroad. These individuals are all likely to participate in deferred compensation plans in order to receive the beneficial tax treatment provided under local law. U.S. taxpayers may assume that this preferential tax treatment conveys the same or similar tax benefits under U.S. law and that they therefore do not have to report the increase in value of or their interest in a foreign pension plan on their U.S. tax returns. This assumption is almost always incorrect. Therefore, when dealing with individuals who have worked abroad, CPAs must inquire about interests in a foreign pension plan or other type of deferred compensation arrangement.

If the taxpayer has such an interest, the next step is to determine U.S. tax and reporting obligations. This analysis can be complicated, as many foreign plans do not fit easily into the U.S. legal framework. Foreign pension plans will almost certainly not be considered a qualified plan under Internal Revenue Code (IRC) section 401(a) due to the stringent requirements for qualification and the fact that sponsor are not likely to consider these qualifications.

Plans Covered by Tax Treaties

It is possible that, despite not qualifying under section 401(a), the foreign plan will be treated similarly to a qualified plan because of a tax treaty with the foreign country. For example, the U.S.–U.K. income tax treaty includes a provision addressing pensions, which allows U.S. citizens investing in U.K. pension plans to deduct contributions made to the plan and defers the taxation of earnings from the plan until distributions start. It
is important to note, however, that although treaty provisions may provide beneficial income tax treatment, the treaty will generally not exempt the foreign pension plans from reporting requirements. If the country in which the foreign pension plan exists has a tax treaty with the United States, the provisions of the treaty should be carefully examined, especially with respect to pension plans and deferred compensation arrangements. The structure and organization of the plan should also be scrutinized to determine whether it is covered by the treaty.

**Plans Not Covered by Tax Treaties**

The United States lacks tax treaties covering pension contributions with a number of countries that are popular destinations for American expatriates. Deferred compensation arrangements from such countries and that do not qualify under IRC section 401(a) are governed by section 402(b).

The income tax implications to these plans depend on whether the plan is discriminatory and whether the employee is considered to be highly compensated. Whether a plan is discriminatory depends on the coverage ratio of non–highly compensated employees to highly compensated employees, defined as employees with a 5% ownership of the company or who meet a compensation limit [§120,000 for 2015, adjusted periodically; see IRC section 414(q)]. In a discriminatory plan, highly compensated employees are taxed on the increase in the pension value each year [IRC section 402(b)(4)(A)]. Non–highly compensated employees must include in their gross income the vested employer contributions to the plan; the income recognized is added to the employee’s basis [IRC section 402(b)(1)]. Distributions are taxable to the extent they exceed a pro rata portion of the employee’s basis in the pension plan [IRC § 402(b)(2)]. Participants in non-discriminatory plans are treated like non–highly compensated employees participating in discriminatory plans. Therefore, a U.S. taxpayer who is subject to income tax on deferred compensation contributions may find some relief in the possibility of offsetting his U.S. tax liability by using foreign tax credits against the income provided by the foreign pension plan.

Another consideration is whether IRC section 409A, which provides comprehensive rules governing nonqualified deferred compensation arrangements, applies to the foreign plan. Some exceptions may apply; for example, section 409A does not apply to benefits paid pursuant to a foreign social security system if the benefits are provided under a government-mandated plan. In addition, foreign pension plans that fall under section 402(b) are exempt from section 409A.

To complicate matters further, many foreign pension plans are invested in passive foreign investment companies (PFIC) and may be subject to the additional filing requirements of Form 8621. A foreign corporation is a PFIC if 1) 75% or more of the gross income is derived from passive investments or 2) at least 50% of the average assets held produce passive income [IRC section 1297]. In determining whether a pension plan is subject to PFIC reporting requirements, it is helpful to turn to the rules relating to trusts.

Under certain circumstances, a foreign pension plan may be considered a trust, and furthermore, the employee can sometimes be considered an owner of the plan/trust. Such an employee/owner is exempt from filing Form 8621 if the trust is a foreign pension fund “operated principally to provide pension or retirement benefits, and, pursuant to an income tax convention to which the United States is a party, income earned by the pension fund may be taxed as the income of the owner of the trust only when and to the extent the income is paid to, or for the benefit of, the owner” [Treasury Regulations section 1.1298-1T(b)(3)(iii)]. Where the employee is not considered the owner of the foreign trust, however, the employee is subject to the filing requirements for PFICs unless no special election has been made for the PFIC and the employee “is not treated as receiving an excess distribution … or as recognizing gain that is treated as an excess distribution … with respect to the stock” [Treasury Regulations section 1.1298-1T(b)(3)(iii)].

In addition to the above income tax implications, it is imperative to determine whether there are any additional reporting requirements related to the taxpayer’s interest in the plan. Certain plans may need to be disclosed on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). In addition, they may need to be disclosed on IRS Form 8938, depending on the value of the plan and the taxpayer’s other foreign assets. Furthermore, if the plan is considered a trust, it could trigger filing requirements on IRS Forms 3520 and 3520-A. The failure to file the required forms can subject the taxpayer to significant penalties.

**How to Fix Past Noncompliance of a Foreign Pension Plan**

Taxpayers who have failed to report interest in or income from a foreign plan or include the foreign plan on an FBAR have several options to bring themselves into compliance. In cases where there is no additional tax due but the taxpayer has failed to file a required information return, such as Forms 8938, 8921, or 3520, a qualifying taxpayer may consider using the IRS’s delinquent international information return submission procedures. The taxpayer must have reasonable cause for failure to file, and a reasonable cause statement must be attached to each delinquent information return filed. Similarly, if the taxpayer was required to but has failed to report her pension plan on an FBAR, she may elect to use the IRS’s delinquent FBAR submission procedures.

When there is tax due in connection with noncompliance, a taxpayer has two options. In many cases, a taxpayer’s past
noncompliance with U.S. tax laws with respect to foreign pension plans is non-willful and due to simple lack of awareness. In such cases, the taxpayer may be eligible to participate in the IRS’s Streamlined Filing Compliance Procedures. Through these procedures, the taxpayer must file three years of amended tax returns and six years of delinquent FBARs and certify that his noncompliance has been non-willful. Under certain circumstances, including where the taxpayer has other undisclosed foreign assets, he should consider participating in the IRS’s Offshore Voluntary Disclosure Program. No matter which program the taxpayer uses, the disclosure should be made with the help of a tax professional, who should determine the particular reporting requirements with respect to the foreign pension plan and make sure the disclosure of the foreign pension is full and accurate.

CPAs bringing a taxpayer’s foreign pension plan into compliance should consider the full set of individual circumstances and may benefit from the assistance of an attorney. There are many things to consider when dealing with foreign pension plans, including applicable tax treaties, income tax regulations, information form filing requirements, and cleaning up past noncompliance. It is essential to be aware of all of the potential implications of a taxpayer’s investment in a foreign pension plan in order to provide the correct advice and service.

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