



May 2011

Employee Plans Webinar

**The Global Phenomenon:
How International Issues
Impact Employee Plans**

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Topics Covered

- IRS Service-wide International Focus
- Employee Plans International Operating Priority & Strategies
- Ongoing Efforts to Improve International/US Territories Compliance & Audit Coverage
- Work in Progress Highlights - Projects, Compliance Activities, Outreach & Guidance
- International Financial Reporting Standards
- IRC 410 (special coverage rules) & IRC 415 (foreign source income limits)

Service-wide International Focus Background Highlights

- International issues = Service-wide priority
- Improving international tax compliance by large corporations and high-wealth individuals a top concern
 - President Obama
 - Treasury Secretary Timothy Geithner
 - IRS Commissioner Doug Shulman
- The Service is focusing on
 - addressing existing abuse
 - preventing abuse going forward

Advisory Committee for TEGE (ACT) International Project Report

- On June 10, 2009, ACT presented International Project Report to IRS Commissioner
 - Report very well received
- In FY 2010 and FY 2011, working on implementing recommendations from report

Why International? Why Now?

- Employers are globally focused
- An unprecedented cross-border movement of employees
- Assets are increasingly being sheltered offshore
 - Experts estimate that Americans now have \$1 trillion in assets offshore and illegally evade between \$40 and \$70 billion in U.S. taxes each year through offshore tax dodges

Globalization is a World-wide Phenomenon

- As globalization continues to grow the Service is challenged by:
 - International/U.S. territory non-compliance
 - Lack of information reporting on many cross-border transactions
 - The ease of using complex international structures
 - Constantly evolving compliance issues
- The fast paced change in the global economy requires an equally fast pace of change within the IRS

Globalization is a World-wide Phenomenon

- International company facts & findings
 - Close to twice as many
 - 37,000 to 64,000 (1990 to 2009)
 - Almost five times as many foreign subsidiaries
 - 175,000 to 870,000 (1990 to 2009)
 - Increasingly, companies being managed on regional or even global lines
 - 60% of international trade is within multinationals (firms trading with themselves)

Globalization is a World-wide Phenomenon

- International company facts & findings
 - US entities doing business in over 230 countries
 - Foreign profits of U.S. corporations increased by 235%
 - \$89 to \$298 billion (1994 to 2004)
 - profits are currently around \$1 trillion
 - U.S. source profits for these same companies have been decreasing

Example of Multinational Employer

- Plan sponsor is a U.S. corporation
- Member of a controlled group
- Includes numerous non-U.S. operating entities located throughout the world, including Puerto Rico.



Some Important Questions For Plan Sponsors

- Does the plan have assets in foreign jurisdictions?
- Has the plan transferred assets to a foreign jurisdiction?
- Does the plan sponsor have related entities in foreign jurisdictions?

Key TE/GE International Strategies

- Increasing cross-functional collaboration Service-wide to identify complex international transactions
- Enhancing coordination with:
 - Territories (ex. Hacienda Project)
 - Large Business & International (LB&I)
 - International organizations
- Targeting areas of significant risk through:
 - Education and outreach
 - Guidance and voluntary compliance
 - Compliance/enforcement activities

EP International Operating Priority FY 2011 Key EP Strategies

- Collaborate with LB&I and other functions
 - Educate employees
 - Identify complex international transactions
 - Recognize target areas of significant risk and potential abuse impacting retirement plans
- Continue to identify workforce skills needed to work emerging international/US territory issues and provide training

EP International Operating Priority FY 2011 Key EP Strategies

- Develop better understanding of taxpayer segments with international/US territory transactions to deliver education and outreach
- Identify and develop formal and soft guidance
- Improve examination coverage
 - Work with LB&I to expand EP presence in the US Territories

Potential EP International Issues

- Special coverage rules for nonresident aliens and treatment of employees in US territories with respect to testing of US plans
- Determination of limits for participants with foreign source income
- Impact of sourcing rules on withholding taxes
- Foreign tax credit limitation
- Section 199 Domestic Production deduction
- US trust requirement for qualified plans; transfers between foreign and US trusts potential valuation issues

Potential EP International Issues

- Law differences between the US IRC and the Puerto Rico Code with respect to retirement plans and the impact on retirement plans that are Dual-qualified
- Taxation of contributions; earnings, distributions; and rollovers
- Withholding on distributions
- Comparability of plans
- Outsourcing
- International Financial Reporting Standards (IFRS)
- Tax shelter/promoter/abusive transactions and civil and/or criminal fraud

EP International Work in Progress

- EPTA large case examinations
- EPCU compliance checks
- Hacienda Project with Puerto Rico
 - Information reporting
 - Voluntary compliance
 - Joint audits
- Virgin Islands audits
- Outreach and guidance efforts

Employee Plans Team Audit (EPTA) International Work

- EPTA focus on multi-national corporations and international tax issues
- EPTA agents will look at multinational corporations for any retirement plan implications
- Formed a team with LB&I to coordinate referral of cases with international issues involving retirement plans
- Over 20 EPTA audits with International issues are in process

International Issues Encountered in EPTA Work

- U.S. individuals covered by IRC 401(a) plans and foreign plans
- U.S. employees separate from a domestic parent to work on a project for overseas joint venture “affiliate” and then return to parent
- Foreign parent companies own multiple domestic companies who sponsor IRC 401(a) plans providing different benefit structures
- Compensation earned by domestic employees working for a domestic parent - parent transfers this cost to a foreign subsidiary

EPCU International Compliance Check Projects

- Employee Plans Compliance Unit (EPCU) launched two international compliance check projects
 - Confirm whether a domestic trust is being maintained by the foreign entity sponsoring a qualified plan
 - Identify individuals with foreign addresses who failed to report premature distributions subject to Section 72(t)

Domestic Trust Requirement Applicable To Qualified Plans

- Under IRC § 401(a), trust must be **organized in the United States**

When Is a Trust **Organized in the United States?**

Two tests:

- U.S. Court test and
- Control test

What Is the **U.S. Court Test**?

- A court within the U.S. must be able to exercise primary supervision over the administration of the trust

U.S. Court Defined

- Only a court within the geographical U.S. is considered *a court within the U.S.*
- A court situated in a territory or possession of the U.S., or in a foreign country, does not qualify



What Is the **Control Test**?

- One or more **U.S. persons** must have the authority to control all substantial decisions of the trust

Is the WX Trust a U.S. Trust?

(A “not a U.S. Trust” Example)

- The WX Corporation (*WX*), a U.S. corporation, established the WX Corporation Employee Stock Ownership Plan Trust (*ESOP Trust*).
- The ESOP Trust has 3 trustees: Arthur, Beatrice, and Francois. Arthur and Beatrice are U.S. citizens. Francois is a French citizen residing in France.
- No substantial decisions with respect to the ESOP Trust may be made without the unanimous agreement of the trustees

Is the WX Trust a U.S. Trust? (A “not a U.S. Trust” Example)

- The ESOP Trust is **not** a domestic trust for U.S. tax purposes
 - U.S. persons do not control all substantial decisions of the ESOP Trust
 - No substantial decisions can be made without the agreement of Francois, who is a nonresident alien and not a U.S. person

Hacienda Project and International Focus Team

- The Hacienda Project team includes members from
 - EP Exam
 - EP R&A (Guidance and Voluntary Compliance)
 - EP CE&O
 - TE/GE Counsel

Hacienda Project and International Focus Team

- Its mission
 - Address applicability of IRC to pension plans maintained in US Territories
 - Share pension plan information with Puerto Rico
 - Present a united compliance front to taxpayers and their representatives
 - Increase audit coverage
 - Leverage federal and commonwealth resources to achieve pension plan compliance

Hacienda Project and International Focus Team

- A memo from TEGE Counsel and EP R&A spells out how the IRC applies to plans covering Puerto Rico residents
- An MOU between TEGE, EP and the Hacienda was executed on 9-22-06
 - Training
 - EPCRS assistance
 - Exchange of referrals between agencies

PUERTO RICO GENERAL FACTS

- **A Commonwealth of the United States**
 - Its own Constitution
 - Its own system of government
- **Hacienda v. IRS**
 - Puerto Rico falls under jurisdiction of most laws of the United States
 - Significant taxation differences exist
 - Pay taxes to the **Hacienda**
 - Pay no income tax to the **IRS** on any **income derived from sources within Puerto Rico**
- **Social Security**
 - Applies to residents of Puerto Rico who are U.S. citizens

ERISA §1022(i)

Trusts of pension, profit sharing or stock bonus plans created or organized in Puerto Rico are eligible for two types of favorable tax treatment under the Internal Revenue Code (IRC) as follows

- **ERISA §1022(i)(1)**
- **ERISA §1022(i)(2)**

ERISA §1022(i)(1)

If the PR plan is exempt under §8565 of the Puerto Rican Code and all the participants are **residents** of Puerto Rico, the trust will be treated as exempt under IRC §501(a) as though it were part of a qualified plan under IRC §401(a)

The effect is to exclude trust income earned in the U.S. from U.S. taxation

ERISA §1022(i)(2)

A sponsor of a Puerto Rican plan can make an **irrevocable election** for the plan to comply with all of the IRC qualification provisions except for the trust situs requirement.

This election enables the plan to cover both U.S. and Puerto Rican employees

Reporting Requirements

- Form 5500
 - All pension plans covered by ERISA are required to file
 - Plans under ERISA §1022(i)(1), §1022(i)(2) and dual-qualified plans must file
- Form 5330
 - ERISA §1022(i)(2) and dual-qualified plans are not exempt from excise taxes
 - Form 5330 would have to be filed where applicable

Hacienda Project Timeline

- EP auditing Puerto Rico plans since fiscal year 2007
- The Hacienda Project focuses on
 - Information reporting
 - Referrals
 - Joint pension plan audits
 - Voluntary compliance
- September 2009 - Twelve Hacienda agents trained to do pension audits
- March 2010 - Gulf Coast agents worked side-by-side with Hacienda agents on approximately 50 Puerto Rico dual jurisdiction examinations
- In March, 2011, EP began 30 additional joint audits with the new Hacienda agents

Training to Hacienda/ Voluntary Compliance

- Two phases of pension audit classroom training/on-the-job training (emphasis on IRC 401(k) plans) to twelve Hacienda agents
 - Phase One FY-2009
 - Phase Two during FY-2011
- Working with Hacienda and EP VCP to establish a voluntary compliance program for pension plan and other tax issues for Puerto Rico

Typical Issues Found on Audits

Inconsistencies in the pension laws provided for in the IRC and Puerto Rico Code:

- **HCE Definition**
- **ACP TEST**
- **Contribution and Deduction Limits**
- **Compensation Limit**

Other Issues Found on Audit

- **Non-Amender**
- **Form 1099R/480.6A & 6B Filing (2007-480.7C)**
- **Mandatory Hacienda Determination Letter**
- **Puerto Rico Source Income/Distributions**

U.S. Virgin Islands Project (USVI)

- An MOU executed on 5-3-10
- A memo is currently underway through collaboration between TEGE Counsel and EP R&A
 - Noting the Virgin Islands Code mirrors that of the IRS with the exception of excise taxes
- In FY-2011, ten Bureau of Revenue (BIR) Virgin Islands agents received pension audit and on-the-job training with emphasis on IRC 401(k) plans
- The BIR's Compliance Resolution Program uses the mirrored concept as it relates to IRS's EPCRS

Issues found on USVI Audits

- EP commenced audits of Virgin Island plans in FY- 2010
- Issues found on audits include:
 - Non-amenders
 - IRC 401(k) violations
 - late deposits
 - missing election forms
 - No fidelity bond
 - Filing incorrect payroll forms
 - Minimum funding violations

Future Outreach to U.S. Territories

- EP to partner with EO and FSLG in identifying outreach opportunities in Puerto Rico and the US. Virgin Islands
- EP and other TEGE Functions to identify similar partnering endeavors with the other US Territories

EP Outreach and Guidance Efforts

- Included on 2010 and 2011 joint Treasury, IRS and Chief Counsel Guidance Priority Plan
- Technical experts meet regularly to discuss informal and formal guidance on a variety of international issues
- Exploring many issues that were raised in the ACT Report or that have otherwise been raised with us

Published and Future Guidance

- Revised section 402(f) notice
 - Withholding rules applicable to distributions to nonresident aliens
- Revenue Ruling 2011-1
 - Whether a Puerto Rico plan described in section 1022(i)(1) may participate in an 81-100 group trust
- Other EP Outreach and Guidance Efforts include
 - Foreign pension plan distributions and IRA rollovers
 - Revenue Ruling 2011-1 follow-up guidance
 - Sourcing, withholding and reporting pension rules in foreign countries and U.S. possessions
 - Section 984 foreign currency conversion rules that apply for purposes of applying the IRC section 415 and other limits

Valuation Issues Relating to Foreign Currencies

- Amounts must be translated into U.S. dollars for U.S. tax purposes
- Exchanging one currency for another may itself result in taxable income or gain
- IRC §§ 985 through 989, and related regulations, provide guidance regarding these issues



Tax Treaties

- The US has tax treaties with more than 50 countries
- Tax treaties have the same effect as legislation
- Tax treaty provisions affect all TE/GE functions
 - Each function has a treaty issue coordinator

International Financial Reporting Standards (IFRS)

- A core set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements
 - Issued by the International Accounting Standards Board
 - Intended to serve as a framework for financial reporting in cross-border offerings

International Financial Reporting Standards (IFRS)

- Used in many countries - including
 - The European Union
 - Hong Kong
 - Australia
- Deductibility of pension plan contributions >IRC sections 412 and 404
 - The deductible amount not equal to “pension cost” under US GAAP or IFRS
- LB&I is identifying areas where IFRS and U.S. GAAP differ & could impact the deductibility of contributions
 - EP working to identify employee benefit plan issues

Multinational Plan Sponsors Concerns

- Eligibility
- Exclusive benefit
- Minimum coverage
- IRC § 415 limitations
- Employer plan contribution deductions
- U.S. taxability of distributions

Foreign Entities and U.S. Controlled Groups

- Under IRC § 414, foreign entities may be a member of a U.S. controlled group
- Employees of a foreign member of a U.S. controlled group must be taken into account in applying the qualification requirements of IRC § 401(a)

Plan Eligibility

- Employees of a foreign member of a U.S. employer's controlled group may be eligible to participate in the U.S. employer's qualified plan
- The language of each U.S. pension plan should be reviewed to determine whether **nonresident alien individuals** are eligible to participate

Two More Important Definitions for Many International Tax Issues

- Foreign person
- Nonresident alien

Foreign or Non-U.S. Person Defined

- Anyone who is not a **U.S. person**, including:
 - **Nonresident alien individuals**
 - Foreign corporations and partnerships
 - Foreign trusts and estates

Nonresident Alien Individual Defined

- A nonresident alien individual is generally a non-U.S. person who is not a resident alien individual

Exclusive Benefit

If an employee of a foreign affiliate of a U.S. employer participates in the qualified plan of the U.S. employer, and the foreign affiliate is not a member of the U.S. employer's controlled group, this may constitute an exclusive benefit rule violation under IRC § 401(a)(2)

Avoiding an Exclusive Benefit Rule Violation

- Requirements of IRC § 406 are satisfied
- Foreign affiliate and U.S. employer form an affiliated service group under IRC § 414(m)
- Foreign affiliate adopts the plan to create a multiple employer plan **or**
- Employee is a leased employee under IRC § 414(n)

Minimum Coverage Requirements of IRC § 410(b) and Nonresident Aliens

- Nonresident aliens with no US source income are not taken into account even if benefit under the plan
- Employees not in any excludable category are treated as non-excludable employees for coverage testing purposes, regardless of whether participation is waived in the plan
- If two or more plans are permissively aggregated for coverage testing purposes, the excludable employees are determined as if the plans constitute a single plan
 - §1.410(b)-6(a)(2) of the regulations

Application of Coverage Rules for U.S. Citizens Resident in U.S. Territories

- While bona fide residents of U.S. territories are considered non-U.S. persons - they are essentially citizens of the U.S.
 - They are not statutorily excludible employees under IRC § 410(b)(3)(C)
- A U.S. qualified plan may not include any benefits provided to such employees under a plan maintained in a U.S. territory in nondiscrimination testing because territory plan is not a qualified plan under U.S. law
- Employers of such employees may encounter difficulties in passing the nondiscrimination tests with respect to their U.S. qualified plans

What is **U.S. Source Income**?

Requires an inquiry into
the nature or type of
income at issue



Determination of U.S. Source Income

- To determine whether a nonresident alien employee is excludable from coverage testing, one must first determine whether any of the employee's income for the testing period is U.S. source income

Determination of U.S. Source Income

- Income is not treated as U.S. source income if:
 - A nonresident alien is present in the U.S. not exceeding a total of 90 days during the taxable year
 - Compensation does not exceed \$3,000 in the aggregate and
 - Compensation is for labor or services performed as an employee of or under a contract with—
 - a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the U.S., or
 - an individual who is a citizen or resident of the U.S., a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of U.S by such individual, partnership, or corporation

Determination of U.S. Source Income

- Compensation is in connection with temporary presence in the U.S as a regular member of the crew of a foreign vessel engaged in transportation between the U.S and a foreign country or a U.S. possession
- If employee is a nonresident alien and receives income for services performed in an U.S. territory, that alone would not cause the nonresident alien employee to have U.S. source income
- Reference materials
 - § 861(a)(3) of the Code
 - IRS Publication No. 519, U.S. Tax Guide for Aliens
 - IRS Publication 570, Tax Guide for Individuals with Income from U.S. Possessions

Non-U.S. Source Compensation Under IRC § 415

- A qualified retirement plan is subject to benefits and contributions limitations under IRC §415
- Defined benefit plans
 - lesser of \$160,000 (\$195,000 for 2010) or 100 percent of the participant's average compensation for the period of the participant's high-3 years of service
- Defined contribution plans
 - lesser of \$40,000 (\$49,000 in 2010) or 100 percent of the participant's compensation

Treatment of Foreign Source Income

- Amount is included in § 415 compensation without regard to whether:
 - Services performed inside or outside US
 - Compensation is excluded from gross income under §§ 872, 893, 894, 911, or 933 of the Code
- **EXAMPLE:** A participant who has worked only in Puerto Rico would be deemed to have includible compensation for purposes of § 415 even if it is not includible in gross income under § 933 for purposes of U.S. income tax liability

Treatment of Foreign Source Income

- Nonresident alien employee with no U.S. source income
 - Participation in the plan
 - Entity contribution deductibility
- § 415 compensation rules in relation to
 - § 416 top heavy rules
 - § 414(q) highly compensated employee determination
- Definition of compensation under § 415 used as a basis for other compensation definitions
 - § 414(q)
 - § 414(s)

Deductions Allowed Under § 404 For Contributions To Certain Foreign Plans

A U.S. employer may make deductible contributions to a foreign stock bonus, pension, or profit sharing trust under IRC § 404 if the foreign trust satisfies all of the requirements under § 401(a), other than the mandate that the trust be a domestic trust.

Deductions for Contributions Under IRC § 404A

If a deduction under § 404 is unavailable, a deduction for contributions to a foreign deferred compensation plan may be allowed under IRC § 404A, provided certain requirements are met.

IRC § 404A Requirements

- Written plan
- Maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries
- Provides deferred compensation
- 90% or more of the amounts taken into account under the plan are attributable to services performed by nonresident aliens
- An election is made to treat the plan as either a *qualified funded plan* or a *qualified reserve plan*

U.S. Taxability of Distributions

- Source of pension distributions
- To determine the source of a pension plan distribution, it is necessary to break the payment into those parts that are attributable to
 - employer contributions and
 - earnings on such contributions

Source of Distributions Attributable To Employer Contributions

- The portion of a distribution attributable to employer contributions with respect to services rendered:
 - Within the U.S. is treated as U.S. source income; and
 - Outside the U.S. is foreign source income.

Source of Distributions Attributable To Earnings

The portion of any qualified plan distribution attributable to earnings is always treated as U.S. source income.

Distributions and Treaties

Many tax treaties provide that private pensions and annuities are exempt from tax.

www.irs.gov/ep

