The Global Phenomenon - How International Issues Impact Employee Plans

Internal Revenue Service: Employee Plans Webinar

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TRANSCRIPT

MONIKA: Hi, everyone. Welcome to our webinar, “The Global Phenomenon - How International Issues Impact Employee Plans” I’m Monika Templeman, Director of Employee Plans Examinations. The Employee Plans office of the IRS is responsible for administration of federal tax laws relating to retirement plans.

Our mission is to help you understand and comply with retirement plan tax laws and to apply the law with integrity and fairness. During this webinar we will share with you an overview of the IRS Employee Plans (EP) International Operating Priority, including EP’s role in supporting the overall Tax Exempt and Governmental Entities (TE/GE) and IRS Strategic Plan.

We will highlight key EP strategies and accomplishments and what we are focusing on in FY 2011 and beyond.

I’m joined today by Rhonda Migdail and Diane Bloom.

Rhonda is an Employee Plans Manager in Technical Guidance in the Employee Plans Rulings and Agreements function of the IRS. Rhonda also serves as the Tax Exempt and Government Entities (TE/GE) Division lead for our International Initiative. Diane is a Senior Tax Law Specialist and is also with the Employee Plans Rulings and Agreements function of the IRS

International issues are a Service-wide priority and improving international tax compliance by large corporations and high-wealth individuals a top concern at highest levels including, President Obama; Treasury Secretary, Timothy Geithner; and IRS Commissioner, Doug Shulman.

The Service is focusing on addressing existing abuse and preventing abuse going forward. To accomplish this, we are using a corporate approach to contribute to the Service-wide International Strategic Plan.

On June 10, 2009, Advisory Committee for TE/GE -- better known as the ACT -- presented their International Report, entitled “International Pension Issues in a Global Economy” to the IRS Commissioner and recommended a coordinated approach to international tax issues between the business operating Divisions. A copy of the ACT

Report can be found on the IRS website at www.irs.gov. The report was very well received by the public and the Service.

The long and comprehensive report illustrated that the Tax Exempt sector as a whole, and Employee Plans, specifically have a significant role in International tax compliance. The ACT also stressed the importance of Service-wide and Tax Exempt and Governmental Entities or TE/GE -wide collaboration with respect to an International initiative.

Since International issues impact all types of TE/GE customers, we are collaborating across TE/GE and IRS. We are applying our skills to tackle new issues using consistent strategies, but tailored as needed.

So, why International? Why Now?

If you are still questioning why EP is so focused on International and why now, just consider these facts:

Employers are globally focused and there is an unprecedented cross-border movement of employees. Assets are increasingly being sheltered offshore. Michigan's U.S Senator Carl Levin's website states that: "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."

It is not surprising that, as globalization continues to grow, the Service is challenged by International and U.S. territory non-compliance and constantly evolving issues.

The fast paced change in the global economy requires an equally fast pace of change within the IRS.

So Rhonda, since Globalization is clearly a phenomenon that is only increasing, how is this impacting corporate growth?

RHONDA: Okay, let's start by looking at some interesting International company facts and findings: that illustrate the global phenomenon.

Between 1990 to 2009, the number of multinational corporations nearly doubled, expanding from 37,000 to 64,000 and there are almost five times as many foreign subsidiaries; 870,000 in 2009, compared to only about 175,000 in 1990.

Increasingly, companies are being managed on regional or even global lines and 60% of international trade is within multinationals (firms trading with themselves)

As further proof of globalization, U.S. entities are doing business in well over 230 countries worldwide.

Foreign profits of U.S. corporations increased by approximately 235% ($89 to $298 billion from 1994 to 2004). These profits are currently over $1 Trillion (that's trillion with a t).

In comparison, U.S. source profits for these same companies have been decreasing.

As globalization continues to grow, the Service is challenged by lack of information reporting on many cross-border transactions; the ease of using complex international structures and constantly evolving compliance issues.

Since we will be referring to multinational employers throughout this webinar, as we discuss EP's International compliance activities, Diane, I think it would be helpful to give an example to clarify what we mean by this term.

DIANE: I would be happy to. The following is an example of a Multinational Employer The Plan sponsor is a U.S. corporation that is a member of a controlled group that includes numerous non-U.S. operating entities located throughout the world, including Puerto Rico.

I would also like to share some important questions for Plan Sponsors to consider:

- 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?
- If the answers are yes, the term multinational applies.

So now let's circle back and look at the role of IRS, Employee Plans in supporting the overall IRS strategic International initiative. Monika?

MONIKA: Let's start with EP's role.

EP International activities span the gamut from issues involving huge multinational corporations and high wealth taxpayers to issues involving money and taxpayers across the board at all economic levels and in all formats. To improve compliance with the international tax provisions TE/GE is working to ensure appropriate use of IRS-wide, TE/GE-wide and customer-tailored strategies; incorporate taxpayer perspectives as we provide targeted guidance and outreach; strengthen our partnership with tax professionals and third parties to ensure effective international tax administration; and continue to expand coverage in the territories.

Approximately $16 trillion is invested in the million plus retirement plans that cover over 90 million participants. EP is concerned about discovering where the trust records go and whether they are being used exclusively as retirement benefits for plan participants.

Retirement plans range from Global Corporations to IRAs maintained by retirees overseas, and everything in between. The impact of non-compliance left unchecked can be very costly to plan sponsors. The consequences of plan disqualification may result in the employer losing its tax deduction; earnings on the accounts are taxed immediately; distributions are not eligible for rollover treatment; and the contributions made to the plan become includible in the income of the participants to the extent they are vested.

Our FY 2011 overall Tax Exempt and Governmental Entities corporate International strategies include: enhancing coordination within TE/GE, other IRS Business Operating Divisions, and with international organizations to proactively target areas of significant risk through education & outreach, determinations, guidance, voluntary compliance, and enforcement activities.

We are accomplishing our EP International Operating Priority by:

- Collaborating with LB&I and other functions to educate employees, identify complex international transactions, and recognize target areas of significant risk and potential abuse impacting retirement plans;

- Continuing to identify workforce skills needed to work emerging international/US territory issues and provide appropriate training;

- Developing more sophisticated understanding of taxpayer segments with international and U.S. territory transactions to deliver education and outreach, identifying and develop guidance (formal and soft) and, as previously mentioned, Improving examination coverage by working with LB&I to expand EP presence in the U.S. Territories.

There are, of course, many potential international issues which can impact retirement plans.

RHONDA: That's right, Monika. Potential EP International compliance concerns can include, but are not limited to, the following issues:

- Special coverage rules for nonresident aliens and treatment of employees in U.S. territories with respect to testing of U.S. plans;
- Determination of limits for participants with foreign source income;
- The impact of sourcing rules on withholding taxes;
- The foreign tax credit limitation;
- Section 199 Domestic Production deduction;
- U.S. trust requirement for qualified plans; transfers between foreign and U.S. trusts and potential valuation issue;
- Withholding on distributions; Comparability of plans; Outsourcing; Taxation of contributions; earnings, distributions; and rollovers;
- Potential International Financial Reporting Standards (IFRS) issues;
- Tax shelter/promoter/abusive transactions and civil and/or criminal fraud, and

We are also seeing issues stemming from differences in law between the U.S. IRC and the Puerto Rico Code with respect to Retirement Plans and the impact on Retirement Plans that are Dual–qualified.

So you can tell that these issues go beyond the types of issues on which we have traditionally focused. We will need to expand our vision when working on international issues.

Now that we looked at potential issues and areas of concern, we will focus on actual EP International Work in Progress. Let's look at some highlights of current EP International activities and projects, starting with EPTA large case examinations with International issues and the EPCU International Compliance Check Projects.

MONIKA: Okay, let's first look at the EPTA focus on multi-national corporations and international tax issues.

Employee Plans Team Audit (EPTA) agents look at multinational corporations for any retirement plan implications. The EPTA large case program currently has over twenty large case examinations in process with international issues, including referrals from LM&I.

Retirement Plans that have more than 2,500 plan participants are considered potential EPTA cases; large plans cover about 60% of the plan participant universe and 70% of total plan assets.

The EPTA program has significant impact on protecting the retirement security of America's workers. Accordingly, we continue to increase the examinations of these large cases and have expanded our focus to include International issues. We are working closely with Large Business & International (LB&I) on global issues impacting retirement plans. EP is working on audits with LB&I and on independent EPTA audits involving International and US Territories issues.

To optimize our EPTA Program we are using a more systematic approach that efficiently identifies "Focused Issues" based on a comprehensive "pre-audit analysis" and a detailed study and evaluation of the "Internal Controls" related to the various payroll/ personnel systems and specific business environment that effect the administration of all qualified plans sponsored by a taxpayer. It is through this method of inquiry and analysis that areas of "audit risk" are identified and the related Focused Issues of an EPTA plan audit can be effectively determined.

So let's look at International Issues Encountered in EPTA Work. First I should explain that working global issues is relatively new for us. That said, some of the issues that we are encountering in EP large cases include the following:

U.S. individuals who are covered by both IRC 401(a) plans and foreign plans of multinational employers where accruals earned by such employees in the foreign plans are considered taxable compensation. This may have an impact on benefit accruals and/or deferrals in the IRC 401(a) plans. The existence of these foreign plans are being discovered when EPTA asks the taxpayers to reconcile their IRC 404 deductions with the Schedule M-3s reported & filed with the sponsor's Form 1120 returns ;

The treatment of U.S. employees who separate from domestic parent companies to work on a project for an overseas joint venture “affiliate” where the parent owns less than a 50% interest in the affiliate (for example, a 49% interest) and the U.S. employee subsequently returns to the parent. The domestic employer is treating the returning employees as new employees and not recognizing service with the overseas affiliate;

We are also seeing issues relating to foreign parent companies that own multiple domestic companies who sponsor IRC 401(a) plans providing different benefit structures but who do not normally communicate with each other so questions arise as to whether the plans are satisfying the tax-qualification requirements and whether they can be treated as Qualified Separate Lines of Business (QSLOBs); and

Compensation earned by domestic employees working for a domestic parent where such parent transfers this cost to a foreign subsidiary. Who do these employees actually work for, the domestic company or the foreign entity? This is very common and we are still exploring potential concerns. What if we also find foreign employees on the domestic payroll when should they be considered "impats" - non-US citizens working on extended contracts domestically? Can these employees be excluded since they are not "non-resident/ aliens?"

Now I would like to highlight two EPCU International compliance check projects being administered by the Employee Plans Compliance Unit.

First, I need to explain that a compliance check is not an audit or investigation under IRC section 7605(b). A compliance check is performed via correspondence. While a compliance check can verify information on return filings, the books and records are not inspected. The most significant difference is that an EPCU compliance check does not in any way preclude the plan sponsor from using our Voluntary Compliance Systems under the Employee Plans Compliance Resolution Systems (EPCRS), including, where feasible, self-correction.

So self-correction and Voluntary Compliance are a viable option to resolve compliance problems identified during a compliance check.

That said, I would like to highlight the two EPCU Current Compliance Check Projects involving international entities. The first project confirms if a domestic trust is being maintained by the foreign entity sponsoring a qualified plan for U.S. citizens and nationals. In general the trusts must be administered exclusively in the United States and substantive decisions must be under the control of persons in the United States.

To date, among responders we have found that the vast majority of foreign companies (approximately 95%) understand the rules regarding the need to maintain a domestic trust; and approximately 90% of the time, we can identify the foreign companies by their EIN;

This project should be concluded this fiscal year.

The focus of the second project is to verify that individuals with foreign addresses who receive premature distributions subject to 72(t) tax, but who are noncompliant regarding their reporting, or payment of the applicable taxes. Compliance letters were sent to individuals in 8 specific areas around the world — North America, South America, Asia, Africa, Middle East & North Africa, Europe, Central America & Caribbean, Australia & Oceania.

To date, we have determined that these global taxpayers are generally unaware of their obligation to file, report and pay taxes on their worldwide income, and more specifically, they were unaware that they were subject to an additional tax for early distributions under Code section 72(t). There appears to be a lack of clear and accurate information regarding the section 72(t) tax available to global taxpayers; International employers, and international tax preparers are not sufficiently knowledgeable of U.S. taxation filing, withholding and reporting requirements; Form 1099-R payers are inaccurately completing the form for global U.S. taxpayers regarding their "global" address. This project is also scheduled to be completed this fiscal year.

The Foreign Distributions Project is not limited to just individual retirement account distributions, but includes pension distributions as well. The project, however, does not encompass all applicable taxes, but focuses specifically on the section 72(t) tax (additional 10% tax on early distributions [before age 50 1/2]). We are not looking at potential 5330 taxes for prohibited transactions, early Roth IRA distributions, etc. In terms of compliance, we are securing Forms 1040, amended 1040, 5329, and tax dollars, as well as learning an enormous amount about international issues and our international taxpayers.

When these projects are complete a Summary Report of the findings will be posted to the web at www.irs.gov/ep

Rhonda, at this juncture, let's step back and clarify the definition and significance of a Domestic Trust.

RHONDA: Thanks Monika, I would be happy to. Let's start with the definition of a Domestic Trust Requirement Applicable To Qualified Plans. Under IRC § 401(a), a trust must be organized in the United States.

So when is a Trust Organized in the United States?

Well, there are two tests to determine whether a trust is organized in the United States: the U.S. Court test and the control test. A trust must pass both tests to be treated as a Domestic Trust.

So let's first look at the U.S. Court Test. Simply stated, a court within the U.S. must be able to exercise primary supervision over the administration of the trust. A court is defined as and considered a U.S. court only if it is a court within the geographical U.S. A court situated in a Territory of the U.S., or in a foreign country, does not qualify.

So you may be asking "What is the Control test?" The answer is that one or more U.S. persons must have the authority to control all substantial decisions of the trust.

So now we are going to look at an Example. As I describe the facts, ask yourself "Is the following a U.S. Trust?"

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.

The answer is that 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

Next, Diane will cover our efforts, working with LB&I, to expand EP presence and audit coverage in the US Territories. She will also provide a brief overview of key U.S. Territory compliance issue.

DIANE: Thanks Rhonda. Let's look at the Hacienda project and International Focus Team.

In 2000, EP created a team of employees from EP Examinations, EP Rulings and Agreements, EP Customer and Education and Outreach and TE/GE Counsel
The team's mission is to address the applicability of the Internal Revenue Code to pension plans maintained in US Territories; share pension plan information with Hacienda, the Puerto Rico tax authority; present a united compliance front with Hacienda to taxpayers and their representatives; Increase audit coverage; and leverage federal and commonwealth resources to achieve pension plan compliance.

A memorandum was drafted by TEGE Counsel and EP Rulings and Agreements (describing how the Internal Revenue Code applies to plans that cover Puerto Rico residents.)

A Memorandum of Understanding between TE/GE, EP and the Hacienda was executed on Sept. 22, 2006. This MOU provides for IRS training of Hacienda agents in pension law and auditing techniques, Voluntary Compliance assistance, and the exchange of referrals between the agencies.

Now I would like to share some general facts about Puerto Rico:

Puerto Rico occupies a unique status as a Commonwealth of the United States. It has its own Constitution and a system of government very similar to that of most states in the Union.

The Commonwealth of Puerto Rico falls under the jurisdiction of most federal laws of the United States. However, significant taxation differences exist.

In particular, Puerto Rican residents pay taxes to the Hacienda and generally pay no income tax to the IRS on any income derived from sources within Puerto Rico.

Under section 1022(i) of the Employees Retirement Income Security Act, known as ERISA, 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:

So let’s focus on ERISA §1022(i)(1). Under ERISA §1022(i)(1), if the Puerto Rico plan is exempt under §1081 of the Puerto Rican Code and all the participants are residents of Puerto Rico, the trust will be treated as exempt under Code §501(a) as though it were part of a qualified plan under IRC §401(a).

The effect of ERISA §1022(i)(1) is to exclude trust income earned in the U.S. from U.S. taxation. ERISA §1022(i)(2) provides that a sponsor of a Puerto Rican plan can make an irrevocable and prospective election for the plan to comply with all of the IRC qualification provisions except for the trust sites requirement. This election enables the plan to cover both U.S. and Puerto Rican employees. Puerto Rico is the only U.S. territory for which plan sponsors, whose plans cover both Puerto Rico and U.S. residents, can make an election under ERISA section 1022(i) (2) to qualify their plans under the Internal Revenue Code.

Plans with trusts sited in the United States that cover Puerto Rican employees, must qualify under the Puerto Rican Code, as well as, under the U.S. Code in order to provide the Puerto Rican participants with favorable tax benefits. These plans are known as dual-qualified plans. EP undertook a project to audit dual-qualified plans to determine whether they did, in fact, satisfy the Internal Revenue Code tax-qualification requirements.

All pension plans covered by ERISA are required to file a Form 5500 series return, even if they are based in a U.S. territory. Thus, plans under ERISA §1022(i)(1), §1022(i)(2) and dual-qualified plans must file. The fact that these plans file forms 5500 gave us a population of plans to look at.

In addition, retirement plans have to file Form 480.70 to the Hacienda. This form is the Hacienda counterpart to the Form 5500. Starting with the 2004 Form 5500, identifier code 3J was added to identify a plan as a dual-qualified plan. The plan identifier code of 3C -- (not intended to qualify with the requirements of 401(a)) -- is still used to identify the existence of the §1022(i)(1) plans. The absence of code 3C on the 5500 of a plan with a Puerto Rican address would indicate a §1022(i)(2) plan.

Also, since ERISA §1022(i)(2) and dual-qualified plans are not exempt from excise taxes under the US code, Form 5330 would have to be filed where applicable and the appropriate excise taxes paid.

A recent examination of a section 1022(i)(2) Defined Benefit Plan required the payment of excise taxes under Code Section 4971 due to a minimum funding deficiency. The excise taxes were applicable even though the plan had only Puerto Rico employees because an irrevocable election under ERISA §1022(i)(2) had been made. The case had been identified through the IRS EP Classification Unit that handles reported funding deficiencies as part of an ongoing program (U.S. as well as Puerto Rico). Excise taxes under the U.S. Code are not applicable to Section 1022(i)(1) plans qualified only in Puerto Rico.

EP has been auditing Puerto Rico plans since fiscal year 2007. The Hacienda Project with Puerto Rico (focusing on information reporting, referrals, joint pension plan audits and voluntary compliance) has been a very successful partnership.

In September 2009, agents from the Hacienda were trained to conduct pension audits. In March 2010, EP Gulf Coast Area agents worked side-by-side with Hacienda agents on their first few cases. We worked approximately 50 dual jurisdiction examinations cases with the Hacienda agents last fiscal year to provide on the job training and promote compliance. In March 2011, EP began 30 additional joint audits with the Hacienda agents as part of their on-the-job 401(k) plan training.

RHONDA: EP has provided two phases of pension audit classroom training and on the job training to the Hacienda agents, with emphasis on IRC 401(k) plans. I should explain that 401(k) plans are the most prevalent type of plan in Puerto Rico. Phase one of the training was held during fiscal year 2009 and Phase two is in 2011, during the current fiscal year.

We are also working with the Hacienda, at their request, to establish a voluntary compliance program for pension plan and other tax issues for Puerto Rico. The EP Voluntary Compliance Program has provided assistance with bringing structure to the Hacienda's Compliance Resolution System to make it more consistent with the U.S. system.

A number of issues have been found on audit that resulted from inconsistencies in the pension laws provided for in the Internal Revenue Code and Puerto Rico Code. We should note that in January 2011, Puerto Rico enacted a number of changes to the Puerto Rico Code, making their Code more similar to U.S. rules. Accordingly, some of the issues we will discuss may change.

With that caveat, let's take a quick look at issues we found during the examinations of dual jurisdiction Puerto Rico cases.

We found issues with respect to the definition of Highly Compensated Employee. For example, compare the 2009 compensation of $110,000 for a highly compensated employee under the U.S. Code with Puerto Rico's 1/3; 2/3 rule. We encountered issues with the different ADP test failure correction methods under the two codes. And, with respect to the ACP TEST, there is no ACP test required under the Puerto Rico Code.

We also found issues with respects to Contribution and Deduction Limits. For example, for years prior to 2012, there was no equivalent for Internal Revenue Code section 415 for defined contribution plans that limits total contributions on behalf of one employee to the lesser of 100% of compensation or $49,000, the applicable limit for 2009, or for the 2009 defined benefit limit of $245,000.

Other issues have also been discovered during the ongoing examinations of the U.S. dual-qualified and §1022(i)(2) plans, including Non-Amender issues; IRS Form 1099R and Hacienda Form480.6A & 6B Filing problems; the lack of a Mandatory Hacienda Determination Letter; and issues with respect to Puerto Rico Source Income/Distributions.

Again, please keep in mind that the very recent changes to the Puerto Rico Code, make it more similar to U.S. rules, eliminating or changing some of the issues we discussed.

MONIKA: Now let's look at our U.S. Virgin Islands Project (USVI).

A Memorandum of Understanding (or MOU) with the Bureau of Internal Revenue in the Virgin Islands was executed on May 3, 2010. It provides for training, EPCRS assistance, and exchange of referrals between EP and the Bureau of Internal Revenue in the U.S. Virgin Islands.

TE/GE Counsel and EP R&A collaborated on the preparation of a technical Legal Memo (analogous to the one for Puerto Rico) covering the fact that the Virgin Islands Code mirrors that of the IRS with the exception of excise taxes.

Earlier this fiscal year, a number of Bureau of Revenue (BIR) agents in the Virgin Islands received pension audit training and on the job training with emphasis on IRC 401(k) plans, primarily because 401(k) plans are the most prevalent type there as well as in Puerto Rico.

EP offered assistance with the BIR's Compliance Resolution Program and was informed that it uses the mirrored concept as it relates to IRS's EPCRS.

EP commenced audits of Virgin Island plans in spring of 2010. To date, issues found on audits include Non-amender issues; IRC 401(k) violations in terms of late deposits and missing election forms; no fidelity bond; filing incorrect payroll forms; and minimum funding violations.

We are working on future outreach to U.S. Territories and EP is partnering with Exempt Organizations and Governmental Entities (Fed, State and Local Government) in identifying venues for future outreach to audiences in Puerto Rico and the U.S. Virgin Islands.

EP is also collaborating with other TE/GE Functions to address similar partnering endeavors with the other U.S. Territories, which tend to have smaller customer bases than those of Puerto Rico and U.S. Virgin Islands

RHONDA: Thank you Monika. Now let's look at EP's efforts to identify and develop guidance and address key technical issues. EP continues to develop guidance on international tax issues related to retirement plans and International guidance has been included on last year's and this year's joint Treasury, IRS and Chief Counsel Guidance Priority Plan,.

A group of technical experts from Treasury, Chief Counsel and Employee Plans meet regularly to discuss informal and formal guidance on a variety of international issues. We have been exploring a number of the issues that were raised in the ACT Report that Monika previously mentioned.

So let's take a quick look at published and future guidance. To date, we have revised the section 402(f) notice to include a reference to the special rules applicable to withholding on distributions to nonresident aliens.

We also issued Revenue Ruling 2011-1 which raised the issue as to whether a Puerto Rico plan described in section 1022(i)(1) of ERISA may participate in an 81-100 group trust and extended the transition relief provided in Rev. Ruling. 2008-40, 2008-2 C.B. 166, relating to such plans.

I would like to highlight other current EP Outreach and Guidance Efforts (formal and soft) under development. These efforts include the development of: guidance on whether an amount distributed from a foreign pension plan may be rolled over to an IRA; and follow-up guidance pursuant to Revenue Ruling 2011-1 concerning the participation of Puerto Rico Plans in group trusts.

Also included is guidance on sourcing, withholding and reporting rules relating to pensions in foreign countries and U.S. possessions; application of the section 985 foreign currency conversion rules that apply for purposes of applying the IRC section 415, and other limitations; and Taxpayer Resources, including a variety of publications..

One of the issues mentioned with respect to developing guidance relates to the foreign currency conversion rules. There are a number of valuation issues relating to foreign currencies including the fact that the amounts need to be translated into U.S. dollars for tax purposes.

For example, where a US employee participates in a foreign plan and is paid in foreign currency. Also, exchanging one currency for another may itself result in taxable income or gain. IRC sections 985 through 989, and related regulations, provide guidance regarding those issues. The ACT raised the issue (in its 2009 Report that we mentioned previously) concerning the interaction of the timing of the conversion of the currency into U.S. dollars with the application of section 415.

Now let's briefly touch on Tax treaties

The U.S. has tax treaties with more than 50 countries. Keep in mind that Tax treaties have the same effect as legislation and so a provision in a tax treaty can have the same effect as a statutory provision. Accordingly, the treaty can change the result of the transaction.

Now let's take a look at International Financial Reporting Standards (IFRS) which are 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.

IFRS are intended to serve as a framework for financial reporting in cross-border offerings. These standards are currently used in a number of countries, including the European Union, Hong Kong, Australia, Pakistan, India, the Gulf Cooperation Council countries, Russia, South Africa, Singapore and Turkey.

Deductibility of contributions made to a pension plan is determined in accordance with Internal Revenue Code sections 412 and 404. The deductible amount is not the same as "pension cost" for financial accounting purposes under US GAAP or IFRS; therefore, we need to do reconciliation between the pension funding and accounting standards. As part of the International Initiative, LB&I is creating a matrix to identify areas where IFRS and U.S. GAAP differ in their treatment and which could thereby further impact the deductibility of contributions. EP has been working to identify those issues with respect to employee benefit plans.

MONIKA: According to our recent outreach and dialogue with multinational plan sponsors and practitioners on international issues, some a foreign related entity issues causing the most concern to plan sponsors include: Controlled Group; Eligibility; Exclusive benefit; Minimum coverage; Limitations on contributions and benefits under IRC section 415; Employer deductions for contributions to a plan; and U.S. taxability of distributions.

RHONDA: Let's dig a little deeper into those issues, beginning with controlled groups. Under Internal Revenue Code section 414, foreign entities may be members of a U.S. controlled group.

The employees of a foreign member of a U.S. controlled group must be taken into account in applying the qualification requirements of code section 401(a).

Next, let's look at 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

Please keep in mind that there are two additional important categories for many International Tax Issues. The two categories are:

1. Non-U.S. person
2. Nonresident alien

U.S. Immigration Law comes into play in defining who is not a U.S. person. Anyone Nonresident alien individuals; foreign corporations and partnerships and foreign trusts and estates are non-U.S. persons.

A nonresident alien is generally an individual who is not a resident alien such as a Green Card holder or someone who otherwise satisfies the substantial presence test.

Now let's look at the exclusive benefit requirement under Code section 401(a)(2).

The determination of who the members of the controlled group are in a plan can have an impact on the application of the exclusive benefit rule. 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.

To avoid an exclusive benefit rule violation the requirements of IRC § 406 must be satisfied; The 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 Internal Revenue Codes section 414(n).

Now, let's look at cover IRC 410, U.S. Source Income and IRC 415. Diane?

DIANE: Thanks Rhonda.

Let's start with Minimum Coverage Requirements of IRC § 410(b) and Nonresident Aliens. A qualified retirement plan must satisfy minimum coverage requirements under Internal Revenue Code section 410(b). Generally, a plan must pass either the ratio percentage test under section 410(b) (1) or the average benefits test under code section 410(b) (2) for the plan year.

Under section 410(b) (3) (C) nonresident aliens with no U.S.-source earned income are not taken into account in the ratio percentage test or the average benefits test even if they are benefiting under the plan.

In addition, if an employee is a nonresident alien, but does receive earned income from U.S. sources, the employee may be treated as an excludable employee if all of the employee’s U.S. source income from the employer is exempt from tax under a tax treaty. The employer must treat all employees the same way in applying this rule.

However, an employee who does not fall into any of the excludable employee categories must be treated as a non-excludable employee for coverage testing purposes, regardless of whether he has waived participation in the plan and even if that waiver is irrevocable.

Finally, 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.

Although bona fide residents of U.S. territories are considered non-U.S. persons for federal tax purposes, they are for the most part citizens of the U.S. As such, they are not statutorily excludible employees under IRC § 410(b) (3) (C).

However, a U.S. qualified plan may not include in nondiscrimination testing any benefits provided to such employees under a plan maintained in a U.S. territory, because the territory plan is not a qualified plan under U.S. law. Because of this, employers of such employees may encounter difficulties in passing the nondiscrimination tests with respect to their U.S. qualified plans.

In order to determine whether a nonresident alien employee is excludable from coverage testing, it must first be determined whether any of the employee’s income for the testing period is U.S. source income.

Under IRC § 861(a)(3), income is not treated as U.S. source income if --

1. The nonresident alien is temporarily present in the U.S. for a period not exceeding a total of 90 days during the taxable year;
2. Such compensation does not exceed an aggregate of $3,000, and
3. The compensation is for labor or services performed as an employee of, or under a contract with, another nonresident alien, a foreign partnership, or a 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.

In addition, compensation for labor or service performed in the U.S. by a nonresident alien individual in connection with the individual's 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 is also not U.S. source income for this purpose.

If an employee is otherwise a nonresident alien and receives income for services performed in one of the U.S. territories, that alone would not cause the nonresident alien employee to have U.S. source income.

For further information see IRS Publication No. 519, U.S. Tax Guide for Aliens and IRS Publication 570, and the Tax Guide for Individuals with Income from U.S. Territories.

Now let's turn to the annual benefit and contribution limitations under Code § 415. A qualified retirement plan is subject to benefits and contributions limitations under Code § 415. Under section 415(b), a defined benefit plan must limit the annual benefit payable to a participant not to exceed the lesser of $160,000 indexed for inflation ($195,000 for 2010) or 100 percent of the participant's highest consecutive three-year average compensation.

Under Code section 415(c), a defined contribution plan must limit the annual additions that are allocated to a participant's account for a limitation year not to exceed the lesser of $40,000 indexed for inflation ($49,000 in 2010) or 100 percent of the participant's compensation for the year.

Section 1.415(c)-2(g)(5) of the regulations provides that amounts paid to an individual as compensation are treated as compensation under section 415 even if those amounts are not includible in the individual's gross income on account of where the services were performed.

Similarly, the regulations provide that amounts paid to an individual as compensation for services are treated as compensation even if those amounts are paid by an employer with respect to which payments of compensation to the individual are excluded from gross income under sections 872, 893, 894, 911 or 933 of the Code.

Thus, for example, a participant who has worked only in Puerto Rico would be deemed to have includible compensation for purposes of section 415 even though, under section 933, it may not be includible in gross income for determining his or her U.S. income tax liability.

So, now let's discuss Treatment of Foreign Source Income. The effect of these rules is to allow an employee who is a nonresident alien with no U.S. source income to participate in a qualified plan sponsored by the employee's employer, even though the § 415 compensation limitations are generally determined based on compensation that is included in gross income.

These rules, however, do not modify other qualified plan rules, such as those relating to the entity that is properly entitled to a deduction for contributions made to the plan on account of the employee's participation.

The regulations also provide a rule of administrative convenience under which section 415 compensation does not include compensation paid to a nonresident alien, provided that the individual does not participate in the plan and the compensation is not effectively connected with the conduct of a trade or business within the United States, but only to the extent that the compensation is excludable from the individual's gross income either on account of the location of the services or because compensation paid by the employer is excludable from gross income.

This is relevant for purposes of determining who is a key employee under the top-heavy rules of code section 416 of the Code and who is a highly compensated employee under the rules of section 414(q) of the Code for nondiscrimination testing.

RHONDA: I would like to point out that under Code section 404, a U.S. employer may make deductible contributions to a foreign stock bonus, pension or profit sharing trust if the foreign trust satisfies all of the tax-qualification requirements applicable to such plans under Internal Revenue Codes section 401(a), other than the mandate that the trust be a domestic trust. However, even if a deduction under § 404 is unavailable, a deduction for contributions to a foreign deferred compensation plan may be allowed under code section 404A, provided certain requirements under that section are satisfied.

In order to satisfy the requirements of § 404A, the plan must be a written plan maintained by the employer that provides for the deferred compensation. The plan must be maintained for the exclusive benefit of the employer’s employees or their beneficiaries, 90% or more of the amounts taken into account under the plan have to be attributable to services performed by nonresident aliens and the compensation for which services are performed is not subject to U.S. federal income tax.

Finally, an election under Treasury Regulation section 1.404A-6 or 1.404A-7 must be made to treat the plan as either a qualified funded plan, or a qualified reserve plan and to select a plan year.

To determine the U.S. taxability of a pension distribution, the source of the distribution must be determined. To determine the source of a pension plan distribution, it is necessary to break the payment into two separate pieces. First, those parts that are attributable to employer contributions; and then those pieces that are attributable to earnings on such contributions.

The portion of a distribution attributable to employer contributions with respect to services rendered is treated as U.S. source income if the services are rendered within the U.S. The portion of sources rendered outside the U.S. is treated as foreign source income. The portion of any qualified plan distribution attributable to earnings is always treated as U.S. source income.

A final word about Distributions and Treaties. Remember that many tax treaties provide that private pensions and annuities are exempt from tax.

MONIKA: If you'd like more information on retirement plans, including our Employee Plans Team Audit (EPTA) large case program and IRS correction programs, please visit us at www.irs.gov/ep.

We hope you've found today's session helpful.

I'd like to thank Rhoda and Diane for providing our audience with this valuable information on International issues affecting retirement plans.

I'd also like to thank you for taking the time to join us today. If this presentation has provided you with helpful information, please tell us as well as others! Do join us for future events.