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A PROPOSAL FOR TAKING THE COMPLEXITIES OUT OF TAXING U.S. RETIREMENT DISTRIBUTIONS TO FOREIGN NATIONALS

by

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ABSTRACT

As the global mobility of workers increases, more and more foreign nationals participate in U.S. retirement plans and eventually receive payments from these plans. The current system for U.S. taxation of these payments is exceedingly complex and uncertain. An elderly recipient of these payments living outside the U.S. finds it difficult and expensive to obtain the tax advice necessary for filing an accurate nonresident Form 1040NR. As a result, many do not file the return, and few are likely to be contacted by the IRS. Whatever tax, if any, was withheld by the payer becomes by default the final tax, even though it is unlikely to correspond with the actual tax liability prescribed by Congress and the applicable U.S. treaty. Moreover, foreign recipients are often able to avoid disclosure of their payments to tax authorities in their home countries.

We recommend a new system for taxing retirement payments to foreign nationals that would alleviate these serious administrative burdens. Under our proposal, Congress would establish two withholding rates for these distributions: a low rate of 15% for periodic distributions or minimum required distributions; and a 30 percent rate for other lump sum distributions, which are most conducive to avoiding home country tax and depleting retirement savings. The 30 percent withholding rate would also apply whenever a payee fails to provide documentation of his U.S. or foreign

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status. These rates would be, by design, the final U.S. tax liability for foreign nationals, who would generally have no need to file a nonresident Form 1040NR. In addition, the Treasury would provide more detailed guidance to payers regarding the types of distributions that qualify for treaty relief; and a recipient's request for treaty relief would always trigger notification to the home country so as to permit it to collect its own tax. Our proposal would greatly reduce administrative burdens for the IRS, for payers and for payees, and would provide greater assurance that the tax prescribed by Congress and by our treaty partners is accurately collected.

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I. INTRODUCTION

The federal income taxation of pension distributions and the rules for tax withholding and reporting by the pension administrator are quite complex. However, the level of complexity, uncertainty, and administrative difficulty is much greater when the recipient of the pension distribution is a foreign national. In part, this is due to a lack of adequate guidance provided by the Internal Revenue Service to payers and recipients of these distributions.[1] However, a large part of the confusion and difficulty stems from rules adopted by Congress in the Internal Revenue Code and the ambiguity of treaties negotiated by the Treasury Department.

In part II of this article, we describe the rules governing the taxation of distributions from tax-qualified retirement vehicles in a fully domestic context. In part III, we briefly describe the common situations in which a foreign national receives distributions from a U.S. qualified retirement vehicle. In part IV, we discuss the complex rules that govern retirement distributions to a foreign national who is not a U.S. resident alien. In part V, we discuss the shortcomings and disadvantages of these existing rules. In part VI, we propose a new system for withholding on, and taxation of, distributions to foreign nationals that will greatly reduce administrative complications for the withholding agent, the recipient, and the Internal Revenue Service. Part VII is our conclusion.

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1. *See* Letter from Paula N. Singer, Esq., Vacovec, Mayotte & Singer LLP, to Internal Revenue Serv. (May 16, 2008), http://services.taxanalysts.com/taxbase/eps_pdf2008.nsf/DocNoLookup/10719/$FILE/2008-710719-1.pdf, suggesting that the "IRS issue comprehensive published guidance relating to cross-border pension and other retirement payments made to nonresident aliens." [hereinafter Singer Letter].

II. TAXATION OF DISTRIBUTIONS FROM U.S. RETIREMENT PLANS IN A DOMESTIC CONTEXT

A. Substantive Rules

Congress has authorized employers to establish various types of tax-advantaged retirement plans for their employees. If a retirement plan meets the requirements established in the Internal Revenue Code,[2] the plan may be funded with contributions that are not currently taxed to the employee and yet are currently deductible by the contributing employer.[3] The retirement plan itself is not taxed on the income from its investments.[4] The employee is taxable only when he or she receives a distribution from the plan.[5] Loans from a plan are classified as distributions if they do not meet certain requirements.[6] The rules of section 72 of the Code (allowing recovery of basis, if any) are applicable.[7] The taxable portion of the distribution is

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2. Section 401(a) refers to "a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries." I.R.C. § 401(a) (first clause). Qualification further depends on meeting "[m]inimum participation standards . . . [a] prohibition against contributions and benefits discriminating in favor of highly compensated employees . . . [m]inimum vesting standards . . . [l]imits on the benefits and contributions accruing to certain participants . . . [a] prohibition of assignments or alienation of benefits . . ." and various other requirements. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, ¶ 61.2, at 61–45 to 46 (rev. 3d ed. 2005) [hereinafter BITTKER & LOKKEN, FEDERAL TAXATION].

3. *See* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.1 at 61-5, ¶ 61.14.1, at 61–311 to 12. Of course, governmental units and tax-exempt organizations do not claim deductions.

4. *See id*. ¶ 61.1.1, at 61–5.

5. *See id*., at ¶ 61.14.1, at 61–311 to 61–312.

6. I.R.C. § 72(p)(1)-(2); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.14.2 at 61–315 to 61–316; I.R.S., Publication 575, Pension and Annuity Income, 17–18, http://www.irs.gov/pub/irs-pdf/p575.pdf.

7. I.R.C. § 402(a) (providing that amounts distributed from employer trust shall be taxable to the distributee under section 72); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.14.1 (discussing taxation of distributions from an employer trust); I.R.C. § 408(d) (providing that IRA distributions shall be taxable to the distributee under section 72); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.3.5 (discussing taxation of distributions from an IRA). For discussion of basis recovery, see I.R.S., Publication 575, *supra* note 6, at 10–17. *See also* I.R.S., Publication 939, General Rule for Pensions and Annuities, http://www.irs.gov/pub/irs-pdf/p939.pdf, providing rules for nonqualified plans and for qualified plans in certain limited circumstances. For distributions from a

classified as ordinary income; the character of the income earned by the plan (e.g., dividends or capital gains) does not pass through to the payee[8] (except in the case of distributions of stock[9]). A ten percent penalty tax applies to certain premature distributions not used for retirement.[10] On the other hand, beginning at age 70 1/2, a retired employee must receive at least a "minimum required distribution."[11] In some cases, payments occur in the form of a commercial annuity purchased by the plan or employee from an insurance company.[12]

One type of qualified plan is a *pension* plan, i.e., a plan "established and maintained by an employer primarily to provide systematically for the

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traditional IRA, *see* I.R.S., Publication 590, Individual Retirement Arrangements (IRAs), 40–41, http.www.irs.gov/pub/irs-pdf/p590.pdf .

8. *See*, *e.g.*, Rev. Rul. 72-99, 1972-1 C.B. 115, *cited in* Clayton v. United States, 33 Fed. Cl. 628 (Fed. Cl. 1995), *aff'd without published opinion*, 91 F.3d 170 (Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996). *See also* I.R.S. Priv. Ltr. Rul. 87-21-006 (Jan. 30, 1987) (distribution to nonresident alien beneficiary of decedent's rollover IRA did not retain its character as savings bank deposit so that interest on deposit after decedent's death did not qualify for treatment as foreign-source under section 861(c)(2)).

9. *See* I.R.C. § 402(e)(4); Regs. § 1.402(a)-1(b)(1)(i); I.R.S., Publication 575, *supra* note 6, at 15.

10. I.R.C. § 72(t); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.13.2, at 61–256; *see also* I.R.S., Publication 575, *supra* note 6, at 30–32. A distribution made before the taxpayer attains age 59 1/2 is generally subject to the penalty unless it is made after the death of the employee, is attributable to the employee's being disabled, is part of a series of substantially equal periodic payments made for the life or life expectancy of the employee (or the employee and his designated beneficiary), or made after separation from service after attainment of age 55. There are exceptions for certain medical expenses, and, in the case of an individual retirement plan, for certain expenses for health insurance premiums while unemployed, higher education expenses, and first-time home purchases. I.R.C. § 72(t)(B), (D)-(F).

11. I.R.C. § § 401(a)(9), 408(a)(6) (IRA); I.R.S., Publication 575, *supra* note 6, at 32-34; BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, *supra* note 2, ¶¶ 61.13.4, 62.3.4. Bittker and Lokken explain that "[t]he purpose . . . is to limit the extent to which employees and their beneficiaries may use qualified plans as tax shelters longer than is reasonably necessary to accomplish the objective of providing retirement income." *Id.* ¶ 61.13.4, at 61-267.

12. Regs. § 1.401(a)(9)-5(e) (defined contribution plan); Regs. § 1.401(a)(9)-6 A-4 (defined benefit plan); Regs. § 1.401(a)(9)-8 A-2(a)(3) (purchase by employee); Regs. § 1.402(a)-1(a)(2) (distribution to an employee of a nontransferable annuity contract by a qualified plan will not be considered income). A commercial annuity contract would also be a section 403(a) plan or tax-sheltered annuity plan under section 403(b). *See infra* notes 14, 30. In addition, the owner of a traditional IRA can instruct the trustee or custodian to purchase an annuity contract for him. I.R.S., Publication 590, *supra* note 7, at 41.

payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement."[13] A pension plan may take the form of a trust or of an employee annuity plan pursuant to section 403(a).[14] Under a traditional pension plan, benefits are determined under a formula based on factors such as years of service and rate of compensation.[15] A pension plan may also take the form of a cash balance plan.[16] Pension plans are defined benefit plans.[17]

Another type of qualified plan is a *profit-sharing*[18] or *stock bonus* plan,[19] such as a section 401(k) plan. These plans are defined contribution plans:[20] each participant has a separate account, which reflects contributions, trust income and expense, or gains and losses, and the account balance is the basis for determining the participant's benefits.

In 1974, Congress first authorized an individual earning compensation to establish his own tax-favored "individual retirement account (IRA)."[21] An IRA is defined as a trust or custodial account "created or organized in the United States for the exclusive benefit of an individual or

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13. Regs. § 1.401-1(b)(1)(i); *see also* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.2, at 61–35, ¶ 61.13.2, at 61–254.

14. *See* I.R.C. §§ 403(a), 404(a)(2); Regs. § 1.404(a)-3(a) ("an 'annuity plan' means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust."); *see* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.2, at 61–39 (noting that "[a]nnuity plans must satisfy all the requirements of section 401(a) except those that are inapplicable because of the absence of a trust."); *see also id.* ¶ 61.1.2, at 61–10 ("essentially a pension plan").

15. *See* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.2, at 61–10.

16. *Id.* at 61–12 to 14. Bittker and Lokken describe a cash balance plan as "a defined benefit plan that functions somewhat like a defined contribution plan." *Id.* at 61–12. Benefits are defined by reference to a hypothetical account for each employee. *Id*

17. A "defined benefit plan" by definition lacks separate accounts for individual employees. I.R.C. § 414(i)-(j). *See* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.2, at 61–12 n.28. Bittker and Lokken note that "benefits to be received by employees . . . are prescribed by the plan or determined by a formula stated in the plan." *Id.* at 61–12.

18. *See* Reg. § 1.401-1(b)(1)(ii); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.2, at 61–10.

19. *See* Reg. § 1.401-1(b)(1)(iii); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.2, at 61–11.

20. I.R.C. § 414(i); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.2, at 61–11.

21. *See* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.3.1, at 62–49 to 50. *See generally* I.R.S., Publication 590, *supra* note 7.

his beneficiaries."[22] In a traditional IRA, the employee's (or self-employed individual's) contribution is deductible up a specified dollar limit, which may be reduced for an individual who is an active participant in an employer sponsored plan.[23] The IRA is not taxable on its earnings, and the individual is taxed only upon receipt of distributions (and without any pass-thru of the character of the IRA's earnings).[24] An alternative to the traditional IRA is the Roth IRA. In this type of account, deductions are not allowed for contributions; however, qualified distributions are nontaxable.[25]

Yet another type of qualified plan is a "simplified employee pension," an employer-sponsored plan consisting of an IRA for each individual employee.[26] The employer may make deductible contributions to these IRAs (subject to dollar limitations and nondiscrimination rules).[27] These are referred to as SEP IRAs and are subject to the rules for distributions from traditional IRAs.[28] A self-employed individual may establish a SEP IRA, section 401(k) plan, or defined benefit plan, and contribute based on his earned income.[29]

Additional types of retirement plans are available for certain employers. A public school or section 501(c)(3) organization may create a tax-sheltered annuity plan for its employees pursuant to section 403(b).[30] A

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22. I.R.C. § 408(a), (h); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.3.3, at 62–60.

23. I.R.C. § 219; BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 61.1.1, at 61–9, ¶62.3.1, at 62–48; I.R.S., Publication 590, *supra* note 7, at 12–16.

24. BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.3.1, at 62–49. Basis recovery is allowed when nondeductible contributions have been made. *See* I.R.S., Publication 590, *supra* note 7, at 38–44.

25. BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.4.1, at 62–83; I.R.C. § 408A; I.R.S., Publication 590, *supra* note 7, at 54–66. *See generally* NATALIE B. CHOATE, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS 316 (7th ed. 2011). She notes that Roth IRAs offer other advantages over traditional IRA's, i.e., "no minimum required distributions during the participant's life . . . no maximum age for making contributions . . . and the ability to withdraw the participant's own contributions, separately from the earnings thereon, income tax-free at any time." *Id.* at 316–17.

26. I.R.C. § 408(k); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.6.1; I.R.S., Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans), at 5–8, http://www.irs.gov/ pub/irs-pdf/p560.pdf.

27. BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.6.1.

28. I.R.C. § 402(h)(3); BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.6.1, at 62–97 & n.18. In addition, an employer with no more than 100 employees may establish "simple retirement accounts" for employees. I.R.C. § 408(p).

29. I.R.C. §§ 401(c), 408(k)(7).

30. *See generally* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.8; I.R.S., Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans),

state or local government, or a tax-exempt organization, may create a deferred compensation plan for its employees pursuant to section 457.[31]After an employee's death, a spouse or other beneficiary may be entitled to receive distributions from a qualified plan or IRA. A distribution to a beneficiary (at least to the extent that the pension accrued before death) may be characterized as "income in respect of a decedent," and therefore the characterization of the payment is the same for the beneficiary as it would be for the employee if he were alive to receive it.[32]

B. Withholding by Payer

The withholding and reporting obligations of a payer of a retirement distribution depend on whether the distribution is a "periodic payment" or a "nonperiodic payment." In the case of a "periodic payment,"[33] the payer is required to withhold tax in the same manner[34] as for wage payments.[35] The

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http://www.irs.gov/pub/irs-pdf/p571.pdf; IRVING S. SCHLOSS & DEBORAH V. ABILDSOE, UNDERSTANDING TIAA-CREF: HOW TO PLAN FOR A SECURE AND COMFORTABLE RETIREMENT 14 (2000). Such a plan may provide either for individual annuity contracts or for individual custodial accounts for regulated investment company stock. *See* I.R.C. § 403(b)(1), (7).

31. A section 457 plan is not a qualified plan. However, in the case of an "eligible deferred compensation plan," as defined in section 457(b), the recipient is taxed only at the time of distribution. I.R.C. § 457(a). This treatment is, in effect, an exception to the rule that compensation deferred by a governmental unit or tax-exempt organization outside of a qualified plan is taxable to the employee as soon as there is no substantial risk of forfeiture. I.R.C. § 457(f). See discussion in BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 62.9.

32. I.R.C. § 691(a)(1), (3); Rev. Rul. 69-297, 1969-1 C.B. 131 (distribution from qualified profit-sharing trust to employee's estate); Rev. Rul. 92-47, 1992-1 C.B. 198 (distribution from IRA treated as "income in respect of a decedent" to extent of balance in IRA at owner's death). *See* discussion of payments to beneficiaries in Publication 575, *supra* note 6, at 34.

33. Under section 3405, the payor of a "periodic payment" is required to withhold "the amount which would be required to be withheld from such payment if such payment were a payment of wages by an employer to an employee for the appropriate payroll period." I.R.C. § 3405(a)(1). A "periodic payment" is defined as a "designated distribution which is an annuity or [other] similar periodic payment." I.R.C. § 3405(e)(2). A designated distribution is generally any distribution or payment from an employer deferred compensation plan, an individual retirement plan, or a commercial annuity. *See generally* Publication 575, *supra* note 6, at 8–9.

34. See I.R.S., Publication 15-A, Employer's Supplemental Tax Guide (Supplement to Publication 15 (Circular E), Employer's Tax Guide), at 22, http://www.irs.gov/pub/irs-pdf/p15a.pdf, stating that:

> Withholding from periodic payments of a pension . . . is figured in the same manner as withholding from wages. . . . If the recipient

recipient may waive withholding unless the payment is delivered outside the United States.[36] The payer is required to report the tax withheld on Form 945 and report the distribution on Form 1099-R.[37]

Nonperiodic (or lump sum) distributions from a qualified plan that do not exceed the "required minimum distribution" or that are made pursuant to a hardship exception are subject to withholding at a flat 10 percent rate,

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> wants income tax withheld, he or she must designate the number of withholding allowances on line 2 of Form W-4P and can designate an additional amount to be withheld on line 3. If the recipient does not want any federal income tax withheld . . . , he or she can check the box on line 1 of Form W-4P. . . . If the recipient does not submit Form W-4P, you must withhold on periodic payments as if the recipient were married claiming three withholding allowances. . . . If you receive a Form W-4P that does not contain the recipient's correct taxpayer identification number (TIN), you must withhold as if the recipient were single claiming zero withholding allowances even if the recipient chooses not to have income tax withheld.

See also Regs. § 35.3405-1T B-4.

35. Wage withholding is governed by sections 3401 and 3401 of the Code. Section 3402(a)(1) imposes on an employer making a payment of wages a requirement of withholding tax. Under section 3401(a), wages are defined as "all remuneration . . . for services performed by an employee for his employer. . . .;" *see* Regs. § 31.3401(a)-1(a)(2) (pensions treated as compensation for services). However, under section 3401(a)(12), the term "wages" does not include a payment to an employee under a trust described in section 401(a) which is exempt from tax under section 501(a), under an annuity plan described in section 403(a), or under an arrangement to which section 408(p) applies, i.e., a "simple retirement account" involving a qualified salary reduction arrangement.

36. A recipient filing Form W-4P, with a valid taxpayer identification number, may waive withholding. I.R.C. § 3405(a)(2) (individual may elect not to have withholding under section 3405(a)(1) apply with respect to periodic payments made to such individual). However, if the payment is delivered outside of the United States, no election may be made. I.R.C. § 3405(e)(13)(A). An exception applies if the recipient certifies to the payer that such person is not a United States citizen or a resident alien and is not an individual to whom section 877 applies. I.R.C. § 3405(e)(13)(B). *See also* I.R.S., Publication 15-A, *supra* note 34, at 22; Russell E. Hall, International Pension Planning, 320 Tax Mgmt. (BNA) A-67 (stating that under I.R.S. Notice 87-7, 1987-1 C.B. 420 "the IRS has made the place of delivery irrelevant to the application of this rule. Instead, mandatory withholding will be required in any case where the participant has furnished a residence address outside the United States or has not provided any residence address to the payor."). Under the notice, "a payee who has provided the payor with an address for the payee's nominee, trustee or agent . . ." is not considered to have thereby provided a residence address. Notice 87-7, 1987-1 C.B. 420.

37. I.R.S. Publication 15-A, *supra* note 34, at 22–23.

unless withholding is waived by the recipient.[38] This same treatment applies to distributions from an IRA (other than a Roth IRA).[39] Other lump sum distributions are classified as "eligible rollover distributions" because they are eligible to be rolled over[40] to another qualified plan or an IRA within sixty days without triggering income tax to the recipient.[41] These distributions (except when made directly to the trustee of the receiving plan) are subject to withholding at a flat rate of 20 percent, and this withholding may not be waived.[42]

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38. In the case of a nonperiodic payment that is not an eligible rollover distribution, withholding is at a flat rate of 10 percent, but can be waived on a Form W-4P, with a valid taxpayer identification number, if delivery is not made outside the United States. *Id*. at 22; I.R.C. § 3405(b)(1) (the payer "of any nonperiodic distribution . . . shall withhold an amount equal to 10 percent of such distribution."); I.R.C. § 3405(b)(2)(A) (an individual may elect not to have such withholding apply to any nonperiodic distribution); I.R.C. § 3405(e)(3) (a "nonperiodic distribution means any designated distribution which is not a periodic payment."); I.R.C. § 3405(e)(13) (no election allowed if delivery is outside the U.S.).

39. IRS instructions state that "[t]he 20 percent withholding does not apply to distributions from any IRA, but withholding does apply to IRAs under the rules for periodic payments and nonperiodic distributions." I.R.S. 2011 Instructions for Forms 1099-R and 5498, at 11, http://irs.gov/pub/irs-pdf/f1099r.pdf. The IRS further explains that "[i]n most cases, designated distributions from any IRA are treated as nonperiodic distributions subject to withholding at the 10 percent rate even if the distributions are paid over a periodic basis." *Id*. *See also* Regs. § 35.3405-1T, F-15 ("[d]istributions from IRAs that are payable on demand are not periodic payments"). Twenty percent withholding does not apply to an IRA distribution because 20 percent withholding applies only to an "eligible rollover distribution," and this term does not include a distribution from an IRA. *See infra* notes 40–42 for definition of "eligible rollover distribution."

40. Distributions from an IRA that exceed the required minimum distribution may also be rolled over. I.R.C. § 408(d)(3).

41. I.R.C. § 402(f)(2)(A) ("eligible rollover distribution" has same meaning as when used in sections 402(c), 403(a)(4), 403(b)(8)(A)); I.R.C. § 402(c)(4) ("'eligible rollover distribution' means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust", but with exceptions for certain substantially equal periodic payments, certain required distributions, or hardship distributions).

42. I.R.C. § 3405(c) ("in the case of a designated distribution which is an eligible rollover distribution," as defined in section 402(f)(2)(A), withholding under section 3405(a) or (b) does not apply and the payer is required to withhold an amount equal to 20 percent of the distribution). A direct rollover is exempt from withholding pursuant to section 3405(c)(2). *See* Publication 15-A, *supra* note 34, at 22.

III. TYPICAL SITUATIONS IN WHICH FOREIGN NATIONALS RECEIVE DISTRIBUTIONS FROM U.S. RETIREMENT PLANS

A. *Foreign National Classified as Resident Alien While Working and in Retirement*

A foreign national who is a U.S. lawful permanent resident (i.e., "green card" holder) or who meets the substantial presence test for "resident alien" classification under section 7701(b) is taxed in the same manner as a U.S. citizen. By contrast, nonresident aliens are taxed under a special tax and withholding scheme.[43]

Some foreign nationals who are classified as resident aliens while they are working and participating in a qualified U.S. retirement plan (or are contributing to an IRA) continue in this status if they are green card holders (or become U.S. citizens) for the rest of their lives.[44] In fact, an individual may manage to maintain green card status even though spending most of his time abroad. Distributions from U.S. retirement plans to these individuals would be taxed in the same way as distributions to U.S. citizens.[45] Resident aliens (and U.S. citizens) are generally not eligible for tax treaty benefits because U.S. treaties generally include a "saving clause" preserving the right of the U.S. to tax its citizens and residents as if the treaty had not come into effect.[46]

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43. *See* I.R.C. §§ 2(d), 871-874, 1441.

44. Moreover, some foreign nationals may remain in the United States, upon retirement, despite lack of authorization under the immigration laws. Because they meet the "substantial presence" test, they are classified as resident aliens for U.S. tax purposes. I.R.C. § 7701(b)(3).

45. Resident aliens may receive, and be subject to tax on, distributions from foreign retirement plans as well. PAULA N. SINGER, INTERNATIONAL ASPECTS OF INDIVIDUAL U.S. TAX RETURNS 68 (2010). Whether such foreign plan distributions result in U.S. tax depends on their basis in the distribution as determined under section 72(w). *See id.*; I.R.S., Publication 519, U.S. Tax Guide for Aliens, at 27, http://www.irs.gov/ pub/irs-pdf/p519.pdf.

46. *See* United States Model Income Tax Convention of November 15, 2006, art. 1, para 4, (U.S. Dep't of the Treasury 2006) [hereinafter 2006 U.S. Model Treaty], http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/ model006.pdf. Exceptions are typically provided for specified treaty articles for "individuals who are neither citizens of, nor have been admitted for permanent residence . . . ." *Id.* at art. 1, para. 5(b). Double taxation is avoided by offsetting U.S. federal (but not state) taxes on foreign pension benefits with foreign tax credits. Tax treaties with most countries cede taxation of social security benefits to the government paying the benefits, however. Under most treaties, the article providing exemption from tax on "payments . . . under provisions of the social security or similar legislation" of the treaty country overrides the saving clause. *Id.* art. 17, para. 2. A few treaties cede taxation of social security benefits to the residence country.

B. Foreign National Classified as Resident Alien While Working But Later Changing to Nonresident Alien Status

In many cases, a foreign national who is classified as a resident alien while contributing to a qualified U.S. retirement plan subsequently becomes a nonresident alien before receiving some or all of his distributions from the plan. In these cases, the individual's status as resident or nonresident at the time that the distribution is received is determinative of the tax regime applicable to the distribution.[47] Moreover, if the distributee is resident in a country that has a tax treaty with the United States, U.S. taxation of the distribution may be limited or eliminated by the treaty.

A foreign national who loses or abandons long–held green card status on or after June 17, 2008, may be taxed under a special regime[48] for "covered expatriates."[49] This regime is applicable only if the individual's

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Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Jul. 24, 2001, art. 17, para. 3, 2224 U.N.T.S. 247 [hereinafter 2001 U.S.–UK Convention], http://www.irs.gov/pub/irs-trty/uk.pdf (recipients of both U.S. and foreign social security benefits will generally have their U.S. benefits reduced under the windfall elimination provision).

47. In some cases, an individual's status changes in the middle of a calendar year, so that the year is divided into a resident portion and a nonresident portion (a "dual status" year). *See* I.R.C. § 7701(b)(1)-(2); I.R.S., Publication 519, *supra* note 45, at 8.

48. *See* I.R.C. § 877A; *see generally* Henry P. Alden II & Thomas S. Bissell, *The Increased Cost of Expatriation: Is This the Final Chapter?*, 38 TAX MGM'T INT'L J. 429 (2009). Expatriation must occur after June 16, 2008. *See* Heroes Earning Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, § 301(g), 122 Stat. 1624, 1642-44 (codified as amended at I.R.C. § 877A(g)).

49. For this purpose an "expatriate" includes "any long-term resident of the United States who ceases to be a lawful permanent resident of the United States (within the meaning of section 7701(b)(6))." I.R.C. § 877A(g)(2). A long-term resident is defined as

> any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years ending with the taxable year during which [he ceases to be a lawful permanent resident]. . . . For purposes of the preceding sentence, an individual shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of such treaty applicable to residents of the foreign country.

average annual net income tax for the period of five taxable years ending before the expatriation date is greater than $124,000 (as adjusted for inflation), his net worth as of such date is at least $2 million, or he has failed to make a certification of U.S. tax compliance for the five preceding years.[50]

C. Foreign National Who Maintains Nonresident Alien Status While Contributing to a U.S. Retirement Plan and While Receiving Distributions

In some situations, a foreign national classified as a nonresident alien may nevertheless participate in a U.S. qualified plan or contribute to an IRA. For example, an individual living throughout the year in the United States may nevertheless be classified as a nonresident alien because he is present in certain immigration categories, typically as a student, trainee, or teacher, researcher or cultural visitor, in which case his days of presence for certain (but not necessarily all) calendar years are not counted toward the "substantial presence" test for resident status.[51] A nonresident alien employee of a U.S. company may be covered by a U.S. retirement plan even if most or all of his services are performed abroad. A self-employed nonresident alien who derives earned income that is effectively connected with a U.S. trade or business may be eligible to establish a SEP IRA or other qualified retirement plan.[52]

If an individual in this situation simply maintains his nonresident alien status, then distributions from the U.S. retirement plan are governed by the taxing regime for nonresident aliens, subject to treaty provisions.

I.R.C. § 877(e)(2); *see* I.R.C. § 877A(g)(5) (referring to section 877(e)(2)); I.R.C. § 7701(b)(6) (last sentence). See Alden & Bissell, *supra* note 48, at 432, noting that "[t]he 2008 law provides in effect that if a green card holder is classified as a resident of a treaty country under the 'tie-breaker' rule of an income tax treaty, he is treated as if he had ceased to be a lawful permanent resident . . . ." For a review of expatriation rules prior to the 2008 law, *see id.* at 429–30. Former long-term residents who expatriated after June 3, 2004, and before June 17, 2008, are subject to a different regime described below at text accompanying *infra* notes 84–85. *See also* I.R.S., Publication 519, *supra* note 45, at 23.

50. I.R.C. § 877A(g)(1)(A) (referring to section 877(a)(2)); I.R.C. § 877(a)(2). Exceptions to coverage are contained in section 877A(g)(1)(B). Certification is made on a Form 8854.

51. *See* I.R.C. § 7701(b)(3)(D), (5). Immigration status in which U.S. days do not count for some, but not necessarily all calendar years of presence are "F", "J", "M" and "Q." I.R.C. § 7701(b)(5)(D). Tax rules for determining when a calendar year's days do not count apply to principal and dependent aliens individually. *See* I.R.C. § 7701(b)(3).

52. *See* SINGER, INTERNATIONAL ASPECTS OF INDIVIDUAL INCOME TAX RETURNS, *supra* note 45, at 93; I.R.S., Publication 519, *supra* note 45, at 27.

D. *Foreign National Who is Beneficiary of Participant in U.S. Retirement Plan*

A foreign national may receive distributions from a U.S. retirement plan by reason of being designated as a beneficiary by the plan participant in the event of death or pursuant to a qualified domestic relations order (QDRO).[53] The distributee's status as resident or nonresident (or as entitled to treaty protection) will determine the U.S. tax treatment of the distribution.[54]

IV. TAX RULES GOVERNING TAXATION OF RETIREMENT DISTRIBUTIONS MADE TO NONRESIDENT ALIENS

A. *Determination of Recipient's Tax Liability*

If the distributee of a retirement distribution is a nonresident alien, determination of the proper amount of tax depends upon additional variables not relevant in a purely domestic context: (1) whether the distribution constitutes income from U.S. or from foreign sources; (2) whether the U.S. source income, if any, is considered to be "effectively connected with the conduct of a trade or business within the United States;" and (3) whether an income tax treaty entered into by the United States with the country of the individual's tax residence allows an election to reduce or eliminate U.S. tax.[55] Apart from any treaty, a nonresident alien usually is not taxed on foreign-source income[56] and is taxed at a flat rate of 30 percent on U.S.

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53. *See* I.R.C. §§ 402(e)(1), 414(p).

54. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 98-06-012 (Nov. 10, 1997) (nonresident alien beneficiary of U.S. citizen's estate, stating that: "The United States tax treatment of distributions to a nonresident alien individual characterized for U.S. tax purposes as originating from a U.S. pension fund or an annuity depends on both the statutory and regulatory rules of withholding and taxation and, where the recipient is a citizen or resident of a country with which the United States has an income tax treaty, the application of that treaty."); I.R.S. Priv. Ltr. Rul. 2000-04-030 (Nov. 2, 1999) (distributions from an estate of interest on Series E bonds to nonresident alien); I.R.S. Priv. Ltr. Rul. 87-28-048 (Apr. 15, 1987) (pension article of treaty exempted pension distributions to beneficiaries of U.S. estate who were residents of Ireland). Note that I.R.S. Priv. Ltr. Rul. 98-06-012, *supra*, is misleading in suggesting that treaty benefits are based on citizenship. *See infra* note 66.

55. I.R.S., Publication 519, *supra* note 45. Treaties became elective rather than mandatory with the introduction of the current section 894(a) by the Technical and Miscellaneous Revenue Act of 1988. H.R. Conf. Rep. No. 100-1104, pt. 1, at 12–13 (1988), reprinted in 1988 U.S.C.C.A.N. 5048, 5072–73.

56. I.R.C. §§ 871(a)–(b), 864(c)(4)–(5).

source income that is not "effectively connected with the conduct of a trade or business within the United States."[57] However, "effectively connected" U.S. source income is taxed at the progressive rates of section 1 (applicable to U.S. citizens and residents), with the allowance of a personal exemption and certain other deductions.[58]

Application of these rules requires characterization of a retirement distribution. For this purpose, the IRS treats a retirement distribution as consisting of two separate parts: (1) the portion attributable to employer contributions and tax-advantaged employee contributions to the plan, characterized as personal services income, and (2) the portion attribution to "earnings and accretions" thereon.[59] The "earnings and accretions" portion is apparently viewed as U.S. source, but not "effectively connected," income, in the case of a U.S. retirement plan; as such, it is taxed to a nonresident alien at a flat rate of 30 percent.[60] The "contributions" portion is classified as either U.S. source or foreign source depending on where the services were performed.[61] The foreign source portion is not subject to U.S. tax. The U.S. source portion is treated as "effectively connected income" to the extent that the services were performed after 1986 and, therefore, taxed at graduated rates.[62] An exclusion from U.S. tax is provided in section 871(f) for

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57. I.R.C. § 871(a)(1).

58. I.R.C. §§ 871(b)(1), 873(a)-(b).

59. Rev. Rul. 79-388, 1979-2 C.B. 270; *see also* Clayton v. United States, 33 Fed. Cl. 628 (Fed. Cl. 1995), *aff'd without published opinion*, 91 F.3d 170 (Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996) (earnings and accretions portion of cash distribution from qualified stock bonus plan was from U.S. sources). Prior to the issuance of this ruling, IRS Chief Counsel had argued that the entire distribution from a qualified pension plan should be viewed as compensation income. See discussion in Cynthia Blum, *U.S. Income Taxation of Cross-Border Pensions*, 3 FLA. TAX REV. 259, 304 (1996).

60. Similarly, the IRS treats the income of a nonresident alien from a commercial annuity contract issued by a foreign branch of a U.S. life insurance company as from U.S. sources and as fixed and determinable income subject to 30 percent withholding. Rev. Rul. 2004-75, 2004-2 C.B. 109.

61. The source of income from compensation is determined under section 861(a)(3). David W. Ellis, *Covering Expatriate Employees in Qualified Plans (Both Inbound and Outbound)*, SP039 A.L.I.-A.B.A. 577, 591 (2009); s*ee also supra* note 52.

62. *See* I.R.S. Priv. Ltr. Rul. 90-41-041 (July 13, 1990); I.R.S. Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988); Blum, *supra* note 59, at 279 n.101. *See also* T.D. 8288, 1990-1 C.B. 163, 164 (explaining that section 864(c)(6) applies to pensions, because "[p]ensions are treated as compensation for services under section 31.3401(a)-1(a)(2)."). *See also* I.R.S., Publication 519, *supra* note 45, at 19, stating that "[i]f you were a nonresident alien engaged in a U.S. trade or business after 1986 because you performed personal services in the United States, and you later receive a pension or retirement pay attributable to these services, such payments are

distributions from a qualified plan if the employee performed all his services outside of the United States as a nonresident alien and 90 percent of the covered employees are U.S. citizens or residents.[63]

The treatment of the "contributions" portion of the retirement distribution as "effectively connected income" to the extent that the services were performed in the United States after 1986 results from the application of section 864(c)(6) of the Code. Although a recipient of a retirement distribution may not be currently engaged in a U.S. trade or business, for example, by current performance of services in the U.S.,[64] section 864(c)(6) provides that income from deferred compensation is characterized as if the income were taken into account in the year that the services were performed.[65]

A final consideration is whether the recipient is protected by a U.S. treaty with his country of residence.[66] Most treaties[67] entered into by the

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effectively connected income in each year you receive them." This statement suggests that the IRS views the provision as not applying to services performed before 1986. *See* Ellis, *supra* note 61, at 591 n.55. *But see* ADVISORY COMM. ON TAX-EXEMPT AND GOV'T ENTITIES, INTERNAL REVENUE SERV., INTERNATIONAL PENSION ISSUES IN A GLOBAL ECONOMY: A SURVEY AND ASSESSMENT OF IRS' ROLE IN BREAKING DOWN THE BARRIERS 32 (2009) [hereinafter ACT] (indicating that guidance is needed on this "effective date" issue).

63. I.R.C. § 871(f). A limited amount of United States services (the section 864(b) short-term business travel exception) is also permitted. *Id.* In addition the requirement that 90 percent of employees be U.S. persons is eliminated when there is a reciprocal exclusion in the residence country or it is a developing country under the Trade Act of 1974. *See* I.R.S., Publication 515 Withholding of Tax on Nonresident Aliens and Foreign Entities, at 20–21, http://www.irs.gov/pub/irs-pdf/p515.pdf; BITTKER & LOKKEN, FEDERAL TAXATION, *supra* note 2, ¶ 67.2.5, at 67–34.

64. A taxpayer who receives compensation for services currently performed in the U.S. (when the amount does not qualify under the "de minimis" business traveler rule of sections 861(a)(3) and 864(b)(1)) is considered to be engaged in the conduct of a U.S. trade or business and receives income from compensation that is effectively connected with that business. I.R.C. § 864(b), (c)(2); Regs. §§ 1.864-2(a), 1.864-4(c)(6)(ii).

65. I.R.C. § 864(c)(6), added by Pub. L. 99-514, sec. 1242(a), 100 Stat. 2085, and amended in Pub. L. 100-647, sec. 1012(r), 102 Stat. 3342, 3525 (codified as amended at section 864(c)).

66. Although the Resident Article of most U.S. treaties includes citizenship in the definition of "resident of a Contracting State," eligibility for treaty benefits is based on tax residence in the treaty country, not citizenship. *See* 2006 U.S. Model Treaty, *supra* note 46, at art. 4, para. 1 & art. 1, para. 1. U.S. treaty partners generally include a provision denying treaty benefits for individuals claiming U.S. residence under the treaty solely on the basis of citizenship or green card status. *See, e.g.*, 2001 U.S.–UK Convention, *supra* note 46, at art. 4, para. 2.

United States either eliminate or reduce the rate of U.S. tax imposed on private[68] pension distributions made to a treaty resident. Whether a payment is a "pension distribution" depends upon the terms of the particular treaty.[69] A separate treaty exemption may be provided for annuities (paid in return for consideration other than for services rendered).[70]

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67. *See* I.R.S., Publication 515, *supra* note 63, at 38–41 (Table 1). *See generally* Thomas St.G. Bissell, U.S. Income Taxation of Nonresident Alien Individuals, 907 Tax Mgmt. (BNA); David S. Foster, *Treaty Issues in Cross–Border Retirement Benefits*, 56 N.Y. U. ANN. INST. ON FED. TAX'N 14, § 14.05 (1998); Hall, *supra* note 36, at A-81 to A-93; Ellis, *supra* note 61.

68. Under the 2006 U.S. Model Treaty "any pension and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority . . ." is taxable only by that State, except that source country taxation is not allowed if the "individual is a resident of, and a national of, [the other] State." 2006 U.S. Model Treaty, *supra* note 46, at art. 19, para. 2. However, Article 17 (private pensions) applies to a pension in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof. *See* I.R.S., Publication 901, U.S. Tax Treaties, at 34–35, http://www.irs.gov/pub/irs-pdf/p901.pdf (Table 1, indicating with the letter "d" the countries that permit full taxation by the source country of U.S. government (federal, state, or local) pensions and annuities). Footnote "d" also lists countries that bar U.S. taxation if the individual is a resident of, and a national of (or in some cases, a citizen of), that country. *Id.* at 37.

69. As reported by Lee Sheppard, the Treasury deputy international tax counsel for treaty affairs explained, at a June 19, 2007, meeting, that the Technical Explanation of the 2006 U.S. Model Treaty was "meant for use by treaty negotiators," and "is not meant as guidance for taxpayers." Lee A. Sheppard, *Treasury Official Explains New Model Treaty*, 115 TAX NOTES 1249, 1249 (June 25, 2007). Sheppard states that "a Treasury technical explanation is not legally binding, though, as the NYSBA pointed out, the IRS sometimes cites it in interpreting treaties." *Id*; *see also* N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON THE MODEL INCOME TAX CONVENTION RELEASED BY THE TREASURY ON NOVEMBER 15, 2006, at 3 nn.7–8 (2007) [hereinafter NYSBA REPORT].

70. *See infra* note 72 for 2006 U.S. Model Treaty; *see also* I.R.S. Priv. Ltr. Rul. 87-17-046 (Jan. 27, 1987) (annuity option distributions from a qualified employee trust were pensions under the old U.S.-U.K. treaty.) For example, under the U.S.–South Africa Treaty whereas a pension is taxable at the reduced rate of 15 percent, a separate rule is provided for annuities (obtained for consideration other than for services rendered). Convention Between the Government of the United States of America and the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Feb. 17, 1997, art. 18, para. 1–3 [hereinafter 1997 U.S.-South Africa Convention], http://www.irs.gov/pub/irs-trty/safrica.pdf. These are exempt from source country tax, but are fully taxable if purchased in the source country while the individual was a resident of that country. *Id.* art. 18, para. 3. Under the treaty with

The 2006 U.S. Model Treaty exempts pensions[71] as well as annuities[72] from source country taxation. The Technical Explanation defines pensions as including both periodic and single sum payments from qualified private retirement plans.[73] By contrast, some U.S. treaties allow source

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the Philippines, annuities (obtained for consideration other than for services rendered) are exempt from source country tax, but pensions are not exempt from tax in the country where services were rendered. Convention Between the Government of the United States of America and the Government of the Republic of the Philippines with Respect to Taxes on Income, Oct. 1, 1976, art. 18, para. 1, 4, 5 [hereinafter 1976 U.S.-Philippines Convention], http://www.irs.gov/pub/irs-trty/philip.pdf. Under the treaty with Indonesia, pensions may be taxed by the source country at a rate of 15 percent, but annuities (other than for services rendered) are exempt. Convention Between the Government of the United States of America and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 11, 1988, art. 21, para. 1–2, 4–5 [hereinafter 1988 U.S.-Indonesia Convention], http://www.irs.gov/pub/irs-trty/indo.pdf. In the U.S.-Denmark Treaty, pensions are taxable by the source country; however, annuities (other than for services rendered) are exempt. Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 19, 1999, art. 18, para. 1, 3 [hereinafter 1999 U.S.-Denmark Convention], http://www.irs.gov/pub/irs-trty/denmark2.pdf.

71. *See* 2006 U.S. Model Treaty, *supra* note 46, at art. 17, para. 1, providing that "[p]ensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that State."

72. Under the 2006 U.S. Model Treaty, annuities are exempted from source country taxation. 2006 U.S. Model Treaty, *supra* note 46, at art. 17, para. 3. An annuity is defined as "a stated sum paid periodically at stated times during a specified number of years, or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered)." *Id.* The Technical Explanation states that, "[a]n annuity received in consideration for services rendered would be treated as either deferred compensation that is taxable in accordance with Article 14 . . . or a pension that is subject to the rules of Article 17." U.S. Dep't of the Treasury, Technical Explanation to the United States Model Income Tax Convention, Nov. 15, 2006, at 54, http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf. *See* I.R.S. Priv. Ltr. Rul. 87-17-046, *supra* note 70 (old U.S.-U.K. treaty).

73. In the Technical Explanation, the Treasury states that article 17 refers to "distributions from pensions and other similar remuneration . . . in consideration of past employment . . . ." Technical Explanation to the 2006 U.S. Model Treaty, *supra* note 72, at 54. It states that "[t]he term 'pensions and other similar remuneration' includes both periodic and single sum payments." *Id.* It further explains that the term

> is intended to encompass payments made by qualified private retirement plans. In the United States, the plans encompassed by Paragraph 1 include: qualified plans under section 401(a),

country taxation of pensions,[74] and some provide for source country taxation of all (or certain) lump sum payments. [75]

> individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions under section 457 plans may also fall under Paragraph 1 if they are not paid with respect to government services covered by Article 19.

Id.

74. Under the 2004 Protocol to the U.S.–France Treaty, pension distributions are taxed exclusively by the source country. U.S. Dep't of the Treasury, Technical Explanation of the Protocol Between the United States of America and The French Republic, Dec. 8, 2004, art. III, http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/tefranceprot09.pdf. Under the U.S.–Denmark Treaty, pension distributions are taxable solely in the source country unless the distributee was already receiving distributions on March 31, 2000. 1999 U.S.–Denmark Convention, *supra* note 70, art. 18, para 1. Under the U.S.–South Africa Treaty, the U.S. may tax a distribution from a U.S. pension, but the rate of tax may not exceed 15 percent; the reduced rate is inapplicable if the distribution is subject to the early withdrawal penalty. 1997 U.S.-South Africa Convention, *supra* note 70, at art.18, para. 1. Under the U.S.–Philippines Treaty, pensions may be taxed by the country in which the services were rendered. 1976 U.S.–Philippines Convention, *supra* note 70, at art. 18, para. 1, 4. Under the treaty with Indonesia, the source country may tax pensions at a rate of 15 percent. 1988 U.S.–Indonesia Convention, *supra* note 70, art. 21, para. 1. The U.S.–Poland Treaty does not contain a pension provision. Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 8, 1974, 28 U.S.T. 891, http://www.irs.gov/pub/irs-trty/poland.pdf.

75. Under the U.S.–U.K. Treaty, pensions and other similar remuneration are taxable only in the residence country; however, only source country taxation is allowed for a "lump-sum payment." *See* 2001 U.S.-UK Convention, *supra* note 46, at art. 17, para. 1–2. The Treasury's Technical Explanation states that this treatment of lump sum distributions is designed to avoid "double non-taxation" in that "the United Kingdom does not tax lump-sum distributions from pension funds." U.S. Dep't of the Treasury, Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, March 5, 2003, at 63, http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf. Under the U.S.-Italy Treaty, pensions are taxable only in the residence state; however, if a lump sum payment is received after a change of residence from the country where the employment was exercised to the other country, the payment is taxable only in the source country. Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on

A special tax regime applies, however, if a foreign national participating in a U.S. retirement plan[76] is a "covered expatriate."[77] The employee has the option of notifying the payer under the plan of his "covered expatriate" status and making an irrevocable waiver of any right to claim a treaty reduction in withholding on any distribution from the plan; in that case, any distributions under the plan will be subject to 30 percent withholding by the payer.[78] Presumably, the distributee may then file a Form 1040NR claiming the benefits of a treaty or graduated rates on effectively

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Income and the Prevention of Fraud or Fiscal Evasion, Aug. 25, 1999, art. 18, para. 1, 3, http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/italy.pdf policy/treaties/Documents/italy.pdf. See U.S. Dep't of the Treasury, Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, Oct. 27, 1999, at 61–62, http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teitaly.pdf, explaining that this provision "prevents a U.S. resident who anticipates receiving a lump–sum distribution from a U.S. pension plan with respect to employment in the United States from establishing residence in Italy in order to obtain more favorable Italian tax treatment under Paragraph 1." Under the U.S.–Canada Treaty, the source country may tax a periodic pension distribution at a rate not exceeding 15 percent and is not limited in taxing a lump sum distribution. Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, art. XVII, para. 1–2, 1469 U.N.T.S. 189, http://www.irs.gov/pub/irs-trty/canada.pdf. *See* Memorandum from M. Grace Fleeman, Senior Technical Reviewer, Internal Revenue Serv., on United States–Canada Income Tax Treaty and the United Nations Joint Staff Pension Fund to Andrew Zuckerman and Tony Montanaro (July, 11, 2007), http://services.taxanalysts.com/taxbase/eps_pdf2009.nsf/DocNoLookup/2413/$FILE/2009-2413-1.pdf. *See* Ellis, *supra* note 61, at 594 nn.65–66 and accompanying text. Under the U.S.-Netherlands Tax Treaty, a lump sum payment may be taxed by the source country if the recipient has been a resident of the source country within the previous five years. Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 29, 1948, art. 19, para. 2, http://www.irs.gov/pub/irs-trty/nether.pdf. *See* I.R.S. Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996) (applying this rule to a spouse of the employee receiving a distribution from a pure-rollover IRA pursuant to a QDRO).

76. The rule applies to any "deferred compensation item," defined in section 877A(d)(4), and includes "any interest in a plan or arrangement described in section 219(g)(5)." Alden & Bissell note that that provision "embraces most U.S. tax qualified plans. . . ." Alden & Bissell, *supra* note 48, at 437–38.

77. *See supra* notes 48–49 and accompanying text.

78. In this case, the deferred compensation is classified as an "eligible deferred compensation item." I.R.C. § 877A(d)(3).

connected income,[79] but this is not[80] clear.[81] If the employee does not choose this option, he is treated as receiving a constructive distribution of the present

79. The statute states that "[a]ny item subject to the withholding tax imposed under paragraph (1) [of section 877A(d)] shall be subject to tax under section 871." Section 877A(d)(6)(B) entitled "Application of Tax." Section 877A(d)(6)(A) states: "Rules similar to the rules of subchapter B of chapter 3 [i.e., sections 1461 et seq.] shall apply for purposes of this subsection." Subparagraph (C) states that: "Any item subject to withholding under paragraph (1) shall not be subject to withholding under section 1441 or chapter 24 [26 USCS §§ 3401 et seq.]." Thus far, IRS has not provided clear guidance. It has stated that "[b]ecause the expatriate must waive his or her right to claim treaty benefits with respect to an eligible deferred compensation item, the 30 percent withholding tax cannot be reduced or eliminated by treaty." Notice 2009-85, Sec. 5.C. However, the Notice further provides that "Section 877A(d)(6) provides that the tax that is imposed on taxable payments from eligible deferred compensation items by section 877A(d)(1) is imposed under section 871, but that the payment is subject to withholding under section 877A(d)(1) and not under section 1441 or Chapter 24. Any amount due under section 871 that is not paid by means of withholding must be reported on the income tax return filed by the covered expatriate for the relevant taxable year." *Id.* at Sec. 5.F.

80. *See* BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, *supra* note 2, at ¶ 66.1A.5 (concluding that "it is a final tax"); compare Alden & Bissell, *supra* note 48, at 438–39, suggesting treaty relief may be available; *see* Mark A. Spielman, *Service Issues Guidance on Section 877A Exit Tax*, News Quarterly, Vol. 29, No. 2, pp. 11–13, Winter 2010, "several important interpretative questions remain unanswered by [Notice 2009-85], including the relationship and application of section 871 to section 877A." *See also* Thomas St. G. Bissell, An "Exit Tax" Enters the U.S. Tax Lexicon — Section 877A and Guidance under Notice 2009-85, Tax Management Memorandum, April 12, 2010, stating that "the expatriate's actual tax must be calculated under the provisions governing payments to nonresident aliens under section 871, and the 30 percent withholding tax is then credited against the expatriate's substantive federal income tax liability." (Footnotes omitted.) He further states that "it should be possible for him to claim treaty relief in the final determination of tax under section 871." He argues that both the Instructions to Form 8854 and Notice 2009-85 are "silent on the issue — possibly a tacit admission on the part of the IRS either that it agrees with this conclusion but does not wish to concede this point as yet, or else that it is still studying the issue." *Id*. *See also* Edward Tanenbaum, *More on Individual Expatriation — Notice 2009-85*, 39 TAX MGMT. INT'L J. 94 (2010), noting that "[t]his withholding requirement applies in lieu of any other withholding requirements under current law, but items that are subject to the withholding requirement are nevertheless subject to tax under section 871." *Id.*

81. Apparently the Treasury does not intend to take the position that treaty protection would be barred by provisions in a treaty's savings clause extending it for ten years to long-term residents who have expatriated. (For such provisions, *see infra* note 85) This is suggested by the fact that the treaty signed with Hungary on Feb, 4, 2010 contains this type of extension of the savings clause, but the Technical

value of the accrued retirement benefit on the day before the expatriation date.[82] Moreover, without regard to any election, a covered expatriate is generally deemed to receive a distribution of his entire interest in an individual retirement account on the day before the expatriation date (when no treaty protection would be available).[83]

A former long-term resident who expatriated after June 3, 2004 and before June 17, 2008, is not subject to the rules for covered expatriates. However, the U.S. source portion of any distributions received within ten years after expatriation is taxed at graduated rates[84] and is excluded from treaty protection in many cases.[85]

B. Withholding or Other Payment of Tax

If the recipient of a distribution from a U.S. qualified retirement plan is a nonresident alien, a distinct set of withholding rules apply.[86] Except when a treaty applies, a distribution to a nonresident alien retiree or

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Explanation provides that it refers to the application of section 877 to long-term residents or citizens who expatriated before June 17, 2008. Convention between the United States and Hungary for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Hungary, Feb. 4, 2010, Treaty Doc. 111–7.

82. I.R.C. § 877A(d)((2)(A). *See* discussion in Alden & Bissell, *supra* note 48, at 438 (noting the unavailability of the $600,000 exemption of section 877A(a)(3)(A) or the deferral election of section 877A(b)).

83. *See* I.R.C. § 877A(e). This rule does not apply to simplified pensions or retirement accounts described in section 408(k) or (p). No early distribution tax applies. I.R.C. § 877(e)(1)(B). *See* Notice 2009-85, 2009–2 C.B. 598, Sec. 6. *See* discussion in Alden & Bissell, *supra* note 48, at p. 431.

84. *See* I.R.C. § 877(a), (b).

85. As explained by Alden & Bissell, the 1996 Act, which first applied section 877 to former long-term residents, contained a treaty override, expiring in 2006. Many treaties that were negotiated or amended after 1996 contain a provision extending the savings clause to long-term residents who have expatriated. See Alden & Bissell, *supra* note 48, at text accompanying notes 16–18, (citing 2006 U.S. Model Income Tax Convention, Art.1 (4); 1997 U.S.–South Africa Tax Treaty, art. 1(4).) *See also* Protocol to U.S.–Mexico Treaty, September 8, 1994, article 1, T.I.A.S. 1404; Protocol to 2001 US–UK Convention, *supra* note 46, at art. 6.

86. Regs. § 1.1441-4(b)(1). *See* I.R.C. § 1441(a), (b) (30 percent withholding required on payments to nonresident alien individuals of wages, annuities, compensations or other fixed or determinable annual or periodical income); I.R.C. § 1441(c) (no withholding required in the case of any item, other than compensation for personal services, which is effectively connected with the conduct of a U.S. trade or business and is included in gross income of the recipient under 871(b)(2) for the taxable year).

beneficiary is subject to 30 percent withholding under section 1441[87] (and not under the rules provided for distributions to U.S. citizens).[88] The payer is required to provide the foreign person with Form 1042-S and report the tax withheld on Form 1042.[89] An IRS publication states that the nonresident has the option to request that the payer instead implement wage withholding; however, this treatment appears inconsistent with the Treasury Regulations.[90]

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87. Regs. § 1.1441-4(b)(1)(ii),(iv). Prior to 1987, section 1441 withholding was required. However, after the enactment of section 864(c)(6), withholding under section 3405 was permitted for pensions with respect to services performed in the U.S. after 1986. *See* discussion in T.D. 8288, 1990-1 C.B. 163 (adopting Temp. Reg. § 1.1441-4T(b)(ii), which required withholding under section 1441 if the recipient elected out of section 3405 withholding); ACT, *supra* note 62, at E–14, n.118 (prior to 2001, regulations allowed nonresident alien to elect withholding at graduated rates on a pension distribution to avoid 30 percent withholding tax, even though only a portion of the distribution was effectively connected income). However, when proposed regulations under section 1441 were issued in 1996 (in a major revision of the withholding regulations), *see* 61 FR 17614-01, 1996-1 C.B. 773, April 22, 1996, the Treasury stated that "A new paragraph (b)(1)(ii) is added to require that withholding on distributions from certain qualified pension plans and annuities occur under section 1441 rather than under section 3405 as was required under section 1.1441-4T(b)(ii) (which expired on February, 1993)." *See also* discussion in Blum, *supra* note 59, at n.231. In 2000, the regulation was modified to add a reference to individual retirement accounts under section 408; the Preamble stated that the result of the regulation was "that section 1441, rather than section 3405, applies to retirement distributions. This rule considerably eases the burdens that would otherwise apply to retirement distributions. Commentators noted that the regulations did not provide the same rule for distributions from individual retirement accounts and annuities described in section 408. The regulation has been amended so that those distributions will be subject to section 1441 as well." T.D. 8881, 2001-1 C.B. 1158.

88. However, an eligible rollover distribution can be rolled over into an IRA to avoid withholding. *See* ACT, *supra* note 62, at E–15, citing I.R.S. Priv. Ltr. Rul. 92-06-015 (Nov. 7, 1991). The ruling explains: "The primary reason for imposing withholding tax at the source on distributions to NRAs . . . is that it may be difficult or impossible to collect the tax once the income is out of the United States. This concern is addressed, however, if a qualified plan distribution is rolled over to an IRA." I.R.S. Priv. Ltr. Rul. 92-06-015 (Nov. 7, 1991), quoted in ACT, *supra* note 62, at E–15.

89. I.R.S., Publication 15-A, *supra* note 34, at 23.

90. *See* I.R.S., Publication 15-A, *supra* note 34, at 22; I.R.S., Publication 519, *supra* note 45, at 50 ("If you receive a pension as a result of personal services performed in the United States, the pension income is subject to the 30 percent (or lower treaty) rate of withholding. You may, however, have tax withheld at graduated rates on the portion of the pension that arises from the performance of services in the United States after December 31, 1986. You must fill out Form W-8BEN and give it to the withholding agent or payor before the income is paid or credited to you.");

A payer who receives a Form W-8BEN (or 8233)[91] from the payee claiming a treaty exemption would not withhold U.S. tax on the distribution. In that case, the payer is required to file Form 1042-S, showing the treaty exemption, with the IRS.[92] The IRS automatically sends this information to the treaty country, which puts it in a position to seek tax from its resident.[93]

Although the IRS instructs a nonresident alien to file a Form W-8BEN with the payer before receiving any payment from a qualified U.S. retirement plan,[94] some nonresident alien payees fail to file the form. In that

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I.R.S., Publication 515, *supra* note 63, at 20. This appears to be inconsistent with the current version of Regulation 1.1441-4(b) described in *supra* note 87; s*ee also* ACT, *supra* note 62, at E-14 & n.119 (noting that the section 1441 regulations "explicitly state that [section] 3405 does not apply to any distribution subject to [section 1441] withholding"). *See also* Hall, *supra* note 36, at A-68, stating that under the current regulations, which came into effect in 2001, "the withholding rules of [section] 1441 now entirely supplant the domestic rules when payments are made to a nonresident alien from a qualified plan or annuity, a [section] 403(b) arrangement or an IRA," and citing section 3405(e)(1)(B)(iii) and Regs. section 1.1441-4(b)(1)(ii). The authors further note that "It is not possible for a nonresident alien to elect a lower rate of withholding in a situation where the individual's substantive U.S. tax liability is expected to be lower than the amount required to be withheld," (citing Regs. § 1.1441-1(b)(3)(iii)(C)). *Id*.

91. According to ACT, *supra* note 62, at E–15, a nonresident alien claiming treaty relief for a pension distribution should file Form 8233, or instead W-8BEN "when a distribution is subject to U.S. income tax solely because of the investment earnings (*i.e*., no portion of the distribution is attributable to employer contributions for services within the United States)." Form 8233, (Rev. June 2011), states that it should be used to claim treaty exemption in respect of compensation for dependent services performed in the U.S. The form indicates that a nonresident alien receiving such compensation and not claiming treaty exemption should file Form W-4. However, the Form 8233 instructions state that a SSN, and not an ITIN, must be included on line 2 of the W-4. No specific mention of pension income is made in Form 8233 or the instructions. Form W-8BEN appears to be the more appropriate form since Form 8233 requires information relevant to foreign nationals engaged in activities in the United States such as visa and immigration status, which are not relevant for foreign nationals residing abroad who are receiving retirement distributions. *See* I.R.S. Form 8233, (Rev. June 2011).

92. On Form 1042-S, in Box 1 "Income Code," the withholding agent would use "14," the code for pensions, annuities, alimony and/or insurance premiums. *See* I.R.S. Form 1042-S (2011) Explanation of Codes.

93. *See* I.R.C. § 6103(k)(4) (return may be disclosed to competent authority of a foreign government pursuant to the terms of an income tax treaty).

94. *See* I.R.S. Form W-4P (2011), p. 4 ("A foreign person should submit Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, to the payer before receiving any payments" and it "must contain the foreign person's TIN."). The current Form W-8BEN requiring certification that the income is not "effectively connected income" (unless exempted by treaty) might

case, a payer without actual knowledge of the payee's U.S. or foreign status may rely on a presumption provided in section 1.1441-1(b)(3)(iii)(C) of the Treasury Regulations: if the payer has a social security number for the payee and the payer relies on a mailing address in the United States or in a treaty country, the payee is presumed to be a U.S. person; otherwise, the payee is presumed to be a foreign person.[95] In many cases, a taxpayer who has worked for a significant period in the United States will have a social security number, which is on file with the payer; if payment is made to a U.S. address or to an address in a treaty country, the payer should then be withholding in the same manner as for a U.S. person who has not filed a Form W-4P, i.e., by wage withholding on periodic distributions (as if the recipient were married claiming three withholding allowances), or at a flat 10 percent or 20 percent rate on other distributions.[96]

As noted above, if the payer has received a notification that the taxpayer is a covered expatriate and is waiving treaty benefits, the payer should withhold from distributions at a 30 percent rate.

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cause confusion for foreign recipients who know the taxation rules for such retirement payments. *See* I.R.S. Form W-8BEN (Rev. February 2006), Part IV.

95. Under this regulation, "a payment from a trust described in section 401(a), an annuity plan described in section 403(a), a payment with respect to any annuity . . . or retirement income account described in section 403(b), or a payment from an individual retirement account . . . described in section 408 that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person only if the withholding agent has a record of a Social Security number for the payee and relies on a mailing address [of the following sort, i.e.,] an address used for purposes of information reporting or otherwise communicating with the payee that is an address in the United States or in a foreign country with which the United States has an income tax treaty in effect and the treaty provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts described in this paragraph (b)(3)(iii)(C)." In the absence of a SSN and treaty address, this type of payment "is presumed to be made to a foreign person." *Id*. This is an exception to the general rule that a payment that the withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person. Reg. §1.1441-1(b). However, these presumptions will not protect a payer to the extent that he has actual knowledge or reason to know the actual status of the payee if such status would require withholding of a higher amount. Reg. § 1.1441-1(b)(3)(ix)(B). *See also* Reg. § 1.1441-1(b)(3)(x) Example 4.

96. *See supra* notes 33–42 and accompanying text.

V. PROBLEMS CAUSED BY CURRENT RULES

A. *Need for Many Nonresident Alien Payees to File Form 1040NR if Correct Amount of U.S. Tax is to be Collected*

A key defect of the current rules regarding distributions from a U.S. qualified plan is the frequent discrepancy between the amount of tax withheld from the distribution by the payer and the actual tax liability of the nonresident alien receiving the distribution.[97] The tax withheld (absent a treaty claim and assuming the recipient files a Form W-8BEN or Form 8233, indicating foreign status) is 30 percent of the amount distributed; however, the actual liability will often differ because any portion of the distribution attributable to contributions for U.S. services performed after 1986 is classified as effectively connected income and therefore taxable at section 1 rates with allowance of a personal exemption. Moreover, any portion attributable to contributions for services performed outside the United States[98] is exempt from U.S. tax; but there is no requirement that the payer determine this portion and exempt it from withholding.

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97. *See* ACT, *supra* note 62, at 33, noting the "mismatch between amounts withheld and the tax actually owed by a nonresident alien receiving a distribution from a qualified plan, 403(b) plan or IRA that is attributable to effectively–connected income." The report concludes that "[t]his results in the recipient either having to file and pay estimated taxes if the flat 30 percent rate (or treaty rate) is too little or having to file for a refund if the 30 percent rate is too high." *Id. See also* Hall, *supra* note 36, at A-68 noting the "disconnect between the flat 30 percent rate of withholding . . . and the substantive U.S. income tax liability related to these retirement payments."

98. *See* I.R.S., Publication 519, *supra* note 45, at 14 ("If you receive a pension from a domestic trust for services performed both in and outside the United States, part of the pension payment is from U.S. sources. That part is the amount attributable to earnings of the pension plan and the employer contributions made for services performed in the United States."); *see* Rev. Proc. 2004-37, 2004-1 C.B. 1099, providing "a method for determining the source of a pension payment to a nonresident alien individual from a defined benefit plan" involving a trust qualified under section 401(a). The revenue procedure provides a formula for determining "the portion of each payment that is deemed to be attributable to contributions for services rendered outside the United States, and thus treated as income from sources without the United States." It notes that "the remainder of the payment, which represents the sum of deemed contributions for services rendered within the United States plus earnings on all contributions, is treated as income from sources within the United States." *Id*. at § 4; *See also* BISSELL, T.M. PORTFOLIO, *supra* note 67, at A-72, noting that the rule provided may not lead to correct results "because over a 30-year career an employee's salary would typically be increased each year," but concluding that "[t]he rule, nevertheless, provides for administrative convenience,

As a result of the discrepancy, the taxpayer would be required to file a U.S. tax return on Form 1040NR[99] if additional tax is due;[100] moreover, if withholding is more than the actual tax liability, the taxpayer would need to file Form 1040NR to claim the refund to which he is entitled. Yet the nonresident alien may be unaware of any requirement of, or potential benefit from, filing the Form 1040NR.

In addition, a retiree who lives outside the United States is not in a good position to obtain accurate, reasonably priced U.S. tax advice. The retiree may be elderly (and thus less likely to use IRS.gov or other internet

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because it may be difficult to reconstruct the employee's annual salary information over the course of his entire career." *Id*.

99. IRS instructions for Form 1040NR state that the part of the pension payment attributable to contributions in respect of services performed in the U.S. after 1986 is reported as effectively connected income on page 1, line 17, of the form and that, generally, the remaining amount is reported on page 4, Schedule NEC, line 7. Instructions for I.R.S. Form 1040 (2010), at pp. 14–15. As noted by ACT, *supra* note 62, estimated tax may also be due. *See supra* note 97.

100. Reg. § 1.6012-1(b)(1)(i) (Form 1040NR required of any nonresident alien individual who is engaged in a U.S. trade or business during the taxable year or who has income which is subject to taxation under Subtitle A of the Code, sections 1 through 1563). There is an exception in section 1.6012-1(b)(2)(i) for cases where tax liability is fully satisfied by section 1441 withholding, but it would not apply if tax is due. *See* Hall et al., *supra* note 36, at A-68, stating that "if the effectively connected income is subject to substantive income tax at a rate greater than 30 percent, it is contemplated that the nonresident alien recipient would file a Form 1040NR to pay the additional U.S. tax." Even if the tax liability is fully satisfied by withholding, the exception from return filing is not available if the retiree is engaged in a U.S. trade or business at any time during the taxable year or if he has income treated as effectively connected under section 871(c) or (d) or by reason of section 897. Reg. § 1,6012-1(b)(2)(i). It is not clear whether the failure to mention income treated as effectively connected income by reason of section 864(c)(6) was intentional. *See* Singer Letter, *supra* note 1, concluding that "[r]etirees receiving payment, from defined contribution plans have [effectively connected income] which results in a tax return requirement even if the income is treaty–exempt." The 2010 instructions for Form 1040NR, at 3, simply state that a nonresident alien is required to file if either "You were . . . engaged in a trade or business in the United States during 2010" or, if not, "you received income from U.S. sources that is reportable on Schedule NEC, lines 1 through 12 [and n]ot all of the U.S. tax that you owe was withheld from that income." The items reportable on Schedule NEC are items of income not effectively connected with a U.S. business. *See* BISSELL, T.M. PORTFOLIO, *supra* note 67, at A-49–50, suggesting that if any tax has not been fully paid by withholding then a tax return is required, but if not, then "the regulations and the Instructions imply that" no return is required. Bissell further points out that "if no actual tax were due and the IRS took that position that this type of income required the filing of a return, there is no civil penalty on the income recipient." *Id*. at A-50. *See* I.R.C. § 6651(a).

sources)[101] and may not be financially sophisticated. There is no commercial software such as Turbotax that could be used by the retiree to complete a Form 1040NR.[102] There is little walk-in help from the IRS in foreign countries,[103] and limited access to tax return preparers with sufficient familiarity with U.S. tax issues to prepare the Form 1040NR accurately.[104]

Moreover, the plan administrator may not have provided the retiree with information about the composition of the distribution that would be required for an accurate determination on the Form 1040NR.[105] The retiree

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101. *See* Treasury Inspector General for Tax Administration, Memorandum for Commissioner, Wage and Investment Division, Reference Number 2009-30-076, May 28, 2009, at 2009 TNT 113-37, noting that a 2008 Gallop Organization survey indicated that "more than half of all Americans have visited a government web site" but that "those Americans aged 65 or older comprised the smallest group of Internet users." The memorandum concluded that "it is likely that taxpayers aged 65 or older are not utilizing IRS.gov." *Id*.

102. The GAO notes in a recent report that "IRS does not engage in outreach to tax software providers on nonresident alien tax issues, primarily because Form 1040NR currently cannot be filed electronically. . . ." The Form 1040NR "contains fields that cannot easily be transcribed into an electronic format," although IRS "redesigned Form 1040NR for tax year 2009, in part to address this problem." The IRS "does not plan to accommodate electronic filing of the form until at least 2014." United States Government Accountability Office, IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden, Report to the Chairman, Subcommittee on Select Revenue Measures, Committee on Ways & Means, April 2010, at 2010 TNT 94-56 ["hereinafter GAO Report"].

103. The GAO notes, in a recent report, that "IRS employees at foreign posts are available to provide guidance to nonresidents, although these posts generally are staffed by few employees, making outreach difficult." GAO Report, *supra* note 102. Publication 901, *supra* note 68, notes that taxpayer assistance is available in Beijing, Frankfurt, London or Paris; it also provides a telephone number for use by those outside the U.S., but the number is not toll-free. *Id*. at 56.

104. A recent report by the GAO noted, however, that "a greater proportion of Forms 1040NR than Forms 1040 were prepared by a paid tax return preparer, a disparity which may be due to several factors, such as the complexity of the nonresident tax law and that some employers with employees traveling internationally may hire tax professionals to assist in preparing employees' returns." GAO Report, *supra* note 102.

105. The Advisory Committee on Tax Exempt and Government Entities notes that "[c]onspicuous by its absence from [Rev. Proc. 2004-37, *supra* note 98, dealing with defined benefit plans,] is guidance for determining the portion of a distribution that is effectively connected with the United States." It concludes: "By failing to provide this guidance, the IRS is effectively requiring withholding at the 30 percent flat rate for both employer contributions for services performed within the United States and the investment earnings, rather than allowing withholding at the graduated income tax rates for the portion of the distribution constituting effectively

(particularly in the case of a defined benefit plan) may not be in a position to obtain and apply the information herself. For example, there is no regulation requiring an employer to track contributions to a retirement plan based on whether services were performed inside or outside the United States. A resident alien employee, who may not currently anticipate that he will retire as a nonresident alien, would also have no reason to keep track of days spent working abroad unless the information is needed for claiming a section 911 exclusion or foreign tax credit on his current return.

Even if the retiree has sufficient information about the distribution, she still faces the need to resolve significant uncertainties in the proper application of the U.S. rules. For example, it is unclear whether "effectively connected" treatment applies to employer contributions to a retirement plan if made on behalf of a *resident* alien individual or U.S. citizen (rather than a nonresident alien) performing services in the United States.[106] It is also unclear whether distributions from an IRA account attributable to deductible employee contributions or from a SEP IRA attributable to contributions determined by reference to earnings from self-employment are viewed as "effectively connected" income. Finally, it is not clear whether in cases where a portion of a distribution is treated as effectively connected income (because attributable to contributions in respect of post-1986 U.S. services), this treatment also extends to the "earnings and accretions" portion of the distribution.[107]

In summary, many retirees will not be aware that filing a Form 1040NR is required or would be beneficial, and those who are aware may decide that it is too difficult (or expensive) to prepare and file the return. It is

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connected income because it is attributable to employer contributions for service within the United States." ACT, *supra* note 62, at E-13.

106. *See* ACT, *supra* note 62, at 31–32, explaining that a literal reading of section 864(c)(6) would preclude its application in such cases. *Cf.* Field Service Advice Memoranda, May 31, 1996, 1996 FSA LEXIS 183, stating that "[s]ection 864(c)(6) does not apply to foreign source option income that would not have been effectively connected income to a nonresident, which is earned by a taxpayer, as a resident, in one year but that is received by the taxpayer, as a nonresident, in another year."

107. BISSELL, T.M. PORTFOLIO, *supra* note 67, at text accompanying n.417, citing Instructions to 2009 Form 1040NR, at 13–14, to the effect that, in this case, the entire U.S. portion is treated as effectively connected. Bissell states that "[a]lthough the IRS rule may not be technically correct, it has the advantage of administrative convenience . . . [and] is also a 'taxpayer-friendly' rule." *Id.*; *see also* Instructions to 2010 Form 1040NR at 15. The Advisory Committee also recommends that there be further guidance as to "[w]hether the earnings and accretions portion of the distribution from a U.S. pension plan would always be fixed, determinable, annual, periodic (FDAP) income or whether they would be ECI if the contributions are ECI." ACT, *supra* note 62, at 32.

not clear how likely it is for IRS to request filing of a Form 1040NR.[108] The result is that the correct amount of tax will not be paid (and either the IRS or the taxpayer will be shortchanged). On the other hand, those nonresident aliens who do file the Form 1040NR will be subject to considerable expense and inconvenience and may file incorrectly.[109]

B. Flawed Presumption Rule

Another defect of the current system is that the presumption rule prescribed for use by withholding agents will often cause them to treat a nonresident alien (with a U.S. SSN and a treaty address) as a U.S. citizen for purposes of withholding. As a result, the payer withholds U.S. tax at wage withholding rates for periodic payments or at a flat 10 percent (or 20 percent) rate on nonperiodic payments. Since no Form 1042-S is filed by the payer, the residence country is not informed of the payment, unless the payee reports it, and thus the residence country may not collect any tax. The nonresident alien may not file a Form 1040NR with a treaty claim to obtain a refund of the U.S. tax, either to avoid the possibility of disclosure to the treaty country[110] or simply out of ignorance of his treaty claim.

This outcome is inconsistent with the expectations under most U.S. treaties that the United States would surrender its source–based tax, while the resident country would obtain the information needed to impose its own tax on the payment received by its resident. Moreover, the United States is not collecting the correct amount of tax from the nonresident alien even if one assumes that the treaty resident has the right not to press his treaty claim.

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108. According to the GAO, "IRS has not developed estimates for three types of nonresident alien tax noncompliance: (1) failing to file a tax return . . . (2) underreporting income on filed returns, and (3) filing Form 1040 instead of Form 1040NR." GAO Report, *supra* note 102.

109. The Treasury Inspector General recently audited the processing of Forms 1040NR by the IRS and concluded that "inaccurate and fraudulent Forms 1040NR are not being detected during processing," and that "[a]s long as proper controls are not in place, the risk of fraudulent returns and refunds is substantial." Treasury Inspector General for Tax Administration, Improvements Are Needed to Verify Refunds to Nonresident Aliens Before the Refunds Are Sent Outside of the United States, Reference No. 2010-40-121, Sept. 15, 2010. As a result, the IRS is tightening its procedures for allowing treaty claims resulting in tax refunds when no Form 1042-S indicating a treaty exemption from withholding (Exemption Code 04) is included with the return.

110. Filing a claim for refund on Form 1040NR currently does not result in disclosure to the treaty country. The Form 1042-S information exchange is pursuant to section 6103(k)(4). This section allows for disclosure of treaty claims made on a tax return as well but such disclosures will not be feasible until Form 1040NR can be filed electronically. *See* I.R.C. § 6103(k)(4).

One might speculate that the intended purpose of the presumption rule provided in the Regulations is to thwart the operation of treaty rules requiring the United States to completely surrender source-based taxation. In fact, it might be more appropriate for the United States to agree to a reduced rate of tax on U.S. source pension distributions, rather than complete exemption under a treaty. However, that goal should be achieved by modification of the treaty itself, not by undermining its application.

C. Inadequate Treaty Guidance and Inappropriate Treaty Claims

A third defect of the current rules is that the payer and payee are often unable to determine whether a particular treaty will apply to the type of retirement distribution being made. IRS guidance is limited. The Treasury's Technical Explanation of the 2006 U.S. Model Tax Convention specifies the types of retirement plans eligible to make payments that are exempt under the Convention and also specifies that both periodic and single sum payments are covered.[111] However, the Technical Explanation is not authority for interpreting actual treaties entered into by the United States with other countries.[112] For example, in the case of older treaties, it is unclear whether the pension article covers IRAs,[113] 401(k) plans, or other pension products that were not available when the treaty was signed.[114] It is often

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111. *See supra* note 73.

112. *See supra* note 69. The Technical Explanation of the 2006 Model Treaty does not indicate that it is intended as an interpretation of existing treaties. By contrast, the Technical Explanation of the 1996 Model stated that the pension article of the Model included "both periodic and single sum payments" and that "[t]he same result is understood to apply in U.S. treaties that do not make this point explicitly." At the same time, the 1996 Model imposed certain limitations, i.e., "the employee must have been either employed by the same employer for five years or be at least 62 years old at the time of the distribution. In addition, the distribution must be made either (A) on account of death or disability, (B) as part of a series of substantially equal payments over the employee's life expectancy (or over the joint life expectancy of the employee and a beneficiary), or (C) after the employee attained the age of 55. Finally, the distribution must be made either after separation from service or on or after attainment of age 65." As described by BISSELL, T.M. PORTFOLIO, *supra* note 67, these limitations had been previously mentioned in a series of private letter rulings. *Id*. at n.420.

113. *See* ACT, *supra* note 62, at B-5, noting that "lower treaty rates are not automatic for IRAs," and that if a treaty does not specify that a distribution from an IRA is pension income "most IRA payers default to the 30 percent withholding rate."

114. More than 20 treaties became effective in the mid-1980's or before. Private letter rulings issued in the 1980's or 1990's cannot be cited as precedent. Moreover, these rulings are not necessarily consistent with newer treaties or the

unclear whether a treaty article that refers to "periodic payments" would also apply to lump sum payments.[115] In some cases, there is a possibility that the "Other Income" article of a treaty might cover payments not covered by the Pension article.[116] It is also unclear whether a treaty exemption for a pension also prevents application of the 10 percent early withdrawal penalty.[117] Finally, the treatment of annuities under qualified plans is uncertain.

This ambiguity in the treaty rules leads payers to withhold at the statutory rate, rather than take a risk that the treaty claim is not valid. The result is that a Form 1040NR must be filed in order for a treaty claim to be made, a burdensome process, as noted above.

A further problem is that some nonresident aliens may make inappropriate treaty claims based merely on the fact that their address is in a treaty country. They may not appreciate the requirement that they actually be a resident in the treaty country for tax purposes and that they be subject to tax on their retirement distributions in that country.[118] Or they may be resident of a treaty country that requires that, for their type of tax residency

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Technical Explanation of the U.S. Model. Singer Letter, *supra* note 1. *See supra* notes 73 and 112.

115. *See* BISSELL, T.M. PORTFOLIO, *supra* note 67, at A-73, discussing uncertainty regarding classification of lump sum payments. *See* Foster, *supra* note 67, at §§ 14.05, 14.07, and 14.14 (treaties with Australia, Cyprus, Egypt, Greece, Iceland, India, Korea (South), Morocco, Norway, Philippines, Romania, and Trinidad and Tobago refer to "periodic payments") *Id*. And, further the "Technical explanation to the Treaty with India states that 'the definition excludes from the pension definition a single lump-sum payment.'" *Id*.

116. For example, since IRAs are "not dealt with" in the Pension articles of various treaties, such as Finland, France, Russia, and Germany, they are arguably covered under the Other Income article.

117. *See* I.R.S Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992), stating that under the U.K. treaty, a distribution from a rollover IRA before age 59 1/2 is treated as exempt from U.S. tax as "other income" under Art. 22(1), and that therefore section 72(t) penalty tax does not apply. Section 72(t) imposes a 10 percent additional tax only on "the portion of [the amount received] which is includible in gross income." The ruling reasons that since the amount distributed "is excluded from the Taxpayer's United States gross income under . . . the Treaty, the ten percent additional tax . . . does not apply." *Id*. By contrast, the ruling concludes that the treaty would not "prevent the application of" the 15 percent penalty on excess distributions under section 4980A "because the tax imposed is an excise tax." *Id*.

118. The Form 1040NR does require a taxpayer claiming a treaty exemption to enter the exempt income and answer "yes or no" whether he is subject to tax on "any of the income" entered. 2010 I.R.S. Form 1040NR, p. 5, Schedule OI, Part L, Question 2.

status in the treaty country, income must be remitted to the treaty country in order to be accorded treaty exemption from tax.[119]

VI. Proposed Solution: A New System for Taxing Nonresident Alien Recipients of U.S. Retirement Distributions

A. *Brief Description*

We propose a new simpler and more administrable system for taxing nonresident alien payees of U.S. retirement distributions. Under our proposal, payers would withhold a flat 15 percent tax on (1) periodic distributions from a qualified retirement plan, (2) distributions to the extent not exceeding the required minimum payments from a defined contribution plan or IRA, and (3) hardship distributions (that are not early distributions).[120] For other distributions from U.S. qualified retirement plans (hereinafter referred to as "lump sum distributions"), withholding would be at a 30 percent flat rate. Most significantly, these withholding taxes would also be the final tax liability of the nonresident alien recipient, so that there would generally be no need for the recipient to file a Form 1040NR. These

119. Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, March 19, 1984, art. 4, para. 6, U.S.–Cyprus, 35 U.S.T. 4737; Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, July 28, 1997, art. 24, para. 6, U.S.–Ireland, 2141 U.N.T.S. 167; Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income, Nov. 20, 1975, art. 6, para. 6, U.S.–Israel, http://www.irs.gov/pub/irs-trty/israel.pdf; Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, Nov. 6, 2003, art. 4, para. 5, U.S-Japan, http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/japantreaty. pdf; Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, May 21, 1980, art. 4, para. 5, U.S.–Jamaica, 33 U.S.T. 2865; Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, Aug. 1, 1977, art. 20, para. 7, U.S.–Morocco, 33 U.S.T. 2545; 2001 US-UK Convention, *supra* note 46, at art. 1, para. 7.

120. Hardship distributions are excluded from the category of "eligible rollover distributions" under section 402(c)(4). Hardship distributions are defined in Reg. sections 1.401(k)-1(d)(3). We use the term "early distributions" to refer to distributions that are described in section 72(t)(2)(A), i.e., distributions made before the employee attains age 59 1/2 unless: (i) on or after the death of the employee, (ii) attributable to the employee being disabled, or (iii) after separation from service after attainment of age 55. The payer indicates these early distributions with Code 1 in Box 7 on Form 1099. These early distributions may include distributions avoiding 72(t) penalty tax under exceptions in subparagraphs (B),(D),(E) and (F) of section 72(t).

taxes would not apply to the portion of a distribution attributable to contributions in respect of services performed outside the United States. However, this exception would have limited application because services performed by an employee while a U.S. citizen or resident would be treated as performed in the United States.

By filing a Form W-8BEN with the payer, a treaty resident would be able to claim an exemption or reduced rate of withholding provided for in his residence country's treaty with the United States. This form requires that the taxpayer certify under penalties of perjury that he or she is a resident of the treaty county. As under current rules, the payer would file a Form 1042-S, and information about the payment would be shared automatically with the treaty country. Alternatively, a treaty resident could seek a refund of withheld tax by making a treaty claim on Form 1040NR, p. 4, which would include the same certification; this filing should also trigger notification of the treaty country (if at all feasible).[121] The individual would have to provide an address on the Form W-8BEN or 1040NR that is in the claimed treaty country. In addition, in either case, the individual would certify on the form that the distribution is actually subject to tax in the treaty country. Thus, for example, this certification could not be made if the distribution was made after an individual had established residency in the treaty country but is subject only to tax on income sourced in the treaty country for a specified period of time following becoming a treaty country resident.[122]

Under our proposal, if a distribution is sent outside the United States, or the payer is instructed to send the payment to a financial institution (whether U.S. or foreign), and the payee fails either to file a Form W-9 (or a W-4P with a U.S. address and a U.S. SSN) or to file a W-8BEN (as a certificate of foreign status), the payer would treat the distribution as made to a nonresident alien. Moreover, the 30 percent withholding rate would apply to all distributions (even if periodic or if not in excess of minimum required distributions or if on account of hardship). (The higher rates for undocumented distributees would provide an incentive for them to submit the proper withholding certificates to the pension administrator.) There would be no presumption of U.S. status by reason of the payee having a U.S. SSN and an address in a treaty county.

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121. We recognize that automatic notification of the treaty country may not be feasible unless the Form 1040NR is filed electronically, but we believe that providing this notification, especially for lump sum distributions, is an important goal. With the elimination of the "U.S. person" presumption rule and greater treaty guidance for payers under our proposal, the number of filings of Form 1040NR should decrease significantly.

122. For example, Australia provides a three-year period during which income from sources outside the country are not taxed.

Finally, under our proposal, the Treasury would publish guidance as to the types of retirements distributions covered by pension articles (or "other income" articles) in all existing treaties.[123] Both withholding agents and distributees would be able to easily determine the status (at least in the Treasury's view) of all types of distributions. In addition, the IRS would revise the Form 1042-S income codes to provide greater reporting guidance to those distributees who still find it necessary to file a Form 1040NR.

B. *Further Explanation of Our Proposal*

The objective of our proposal is to reduce the administrative burden for the IRS, plan administrators, and nonresident aliens receiving distributions from U.S. qualified pension plans and to assure that the United States and its treaty partners actually collect the amount of tax imposed by law, as modified by treaties.

1. *Substituting a Flat Rate Tax Liability; Rejection of "Effectively Connected" Treatment*

The complications and administrative burden of the current regime are largely due to the treatment of the portion of a retirement distribution attributable to contributions in respect of post-1986 U.S. services as "effectively connected income" after enactment of section 864(c)(6). However, we do not believe that the policy justification for applying section 864(c)(6) to qualified retirement distributions is strong.

"Effectively connected" treatment of a nonresident alien's income is generally reserved for situations in which the nonresident alien is engaged in a trade or business, including performance of services, in the United States, during the current taxable year. In this way, the need for filing a Form 1040NR is generally limited to taxpayers with a current business connection to the United States. Congress made an exception when it adopted section 864(c)(6), which treats compensation paid for U.S. services as effectively connected income even though the taxpayer is not engaged in a U.S. trade or business in the year of receipt. In the legislative history, Congress expressed concern that "foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the United States where payment

123. The guidance should cover various categories of retirement arrangements, such as private pensions and annuities, individual retirement agreements, Roth IRAs, money-purchase annuities, social security, and government plans and annuities, and should include footnotes explaining which types of distributions are covered in each category (i.e., periodic, lump sum, hardship, premature, etc.).

of the income is deferred until a subsequent year in which the individual is not present in the United States."[124]

It was logical for the IRS to apply this new rule not only to unfunded deferred compensation, but to the "contribution" portion of distributions from a U.S. qualified retirement plan. However, in a qualified retirement plan, different considerations apply because deferral of tax for contributions to a qualified retirement plan is deliberately sanctioned by Congress to encourage a worker's savings for retirement. Moreover, a withheld tax computed at a flat 30 percent rate would often not be lower (and may be higher) than a tax at graduated rates (with a 35 percent maximum) and one personal exemption. Therefore, we do not believe "effectively connected" treatment is required to prevent tax avoidance.

In fact, a better justification for "effectively connected" treatment may be that the resulting graduated rates and personal exemption often result in a lower effective tax than the 30 percent rate and may serve to prevent hardship to a taxpayer who has no other source of income. But in light of the administrative burden from the filing of a Form 1040NR, we believe that a better way to address this concern would be for Congress to provide a flat 15 percent rate of withholding for the entire amount of a qualified retirement distribution to a nonresident alien.[125]

Our proposal does not apply this reduced rate of 15 percent to lump sum distributions. A less favorable treatment of lump sum payments is appropriate because, outside of a treaty context, these payments carry a greater risk that the recipient will be able to arrange for the payment to escape the notice of tax authorities in his residence country.[126] Moreover, a lump sum payment often results in depletion of savings without assuring income throughout retirement; this undermines Congress's goal to encourage retirement savings. Therefore, it seems fair for the United States to recoup a portion of the tax benefits previously enjoyed through imposition of tax on the distribution. However, it would be possible for an individual receiving a lump sum retirement distribution to roll over the distribution into an IRA account within sixty days, and to receive periodic payments from the IRA

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124. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT 1048 (Comm. Print 1987).

125. *See* ACT, *supra* note 62, at 4, recommending that there be an evaluation of the current withholding rates "to determine if another rate or series of rates would more closely relate the rate to the actual tax owed by the nonresident alien." *Id*.

126. We apply the 15 percent rate to required minimum distributions in that these distributions are encouraged by Congress as part of its retirement policy. Similarly, we consider it appropriate to apply the 15 percent rate to hardship distributions because of their involuntary nature; however, if the distribution is an early distribution, it is hard to view it as made "on account of retirement."

account (not in excess of the required minimum distribution) that are eligible for the reduced 15 percent rate. This could be explained to the recipient in the notice that is required to be provided to lump sum recipients.[127]

If our proposal is adopted, we believe that it should also apply to a long-term U.S. resident who is a "covered expatriate" provided that he makes timely notification of his status to the payer under the retirement plan.[128] We also recommend that such a taxpayer be able to claim treaty benefits (if not at the point of withholding, at least by filing a Form 1040NR).

2. Clarifying Treaty Rules

With our proposed elimination of the "U.S. person presumption rule," payers of retirement distributions would have more need to focus on treaty rules that would exempt distributions from tax or would reduce the applicable rate. We believe that the Treasury has the responsibility to provide clear guidance regarding the circumstances in which existing treaties apply to exempt or to reduce the rate of tax on retirement distributions of various sorts. It should not be necessary for each payer or each recipient of a distribution to independently interpret an ambiguous treaty provision (for example, by deciding whether to apply an "ambulatory" or "static" approach).[129] Moreover, if the rules were clear to the payer so that the payer would allow a treaty exemption when warranted, there would less need for the filing of a Form 1040NR by the recipient.

Even if the IRS itself is uncertain about the proper treatment of a type of distribution under a particular treaty, it should stake out a clear position. It could, for example, create a new chart detailing the application of each treaty to each type of distribution. This would greatly simplify the task of withholding agents. It would also be simpler for recipients. For example, if the IRS chart were to indicate that a lump sum distribution from a traditional IRA is not exempt under a particular treaty, the recipient would have a clear choice. He could either accept the IRS position, thus avoiding

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127. *See* Notice 2009-68, 2009-2 C.B. 423, providing "safe harbor explanations that may be provided to recipients of eligible rollover distributions from an employer plan in order to satisfy section 402(f)." The safe harbor explanation states that "[i]f you are a nonresident alien and you do not do a direct rollover to a U.S. IRA or U.S. employer plan, instead of withholding 20 percent, the Plan is generally required to withhold 30 percent of the payment for federal income taxes. If the amount withheld exceeds the amount of tax you owe (as may happen if you do a 60-day rollover), you may request an income tax refund by filing a Form 1040NR and attaching your Form 1042-S."

128. Such notification is made on Form W-8CE, Covered Expatriate.

129. *See* ACT, *supra* note 62, at 49, recommending that the IRS consider updating Publication 515 "to specifically address whether or not treaties cover IRAs."

the need for filing Form1040NR; or he could file Form 1040NR claiming the treaty exemption, with the knowledge that the IRS would reject his claim and that he would be required to challenge the IRS position in a refund suit in a U.S. district court or the U.S. Claims Court. Moreover, if the IRS position regarding a particular treaty is unfavorable to some retirees, they might put pressure on the tax authorities of the residence country to renegotiate that aspect of the treaty.

An example of the level of detail required in such a chart is shown in Appendix A. Specifically, payors and retirees need to know: (1) the treaty rate of U.S. withholding applicable to private pensions, (2) whether or not this treaty rate applies to distributions from each of the following plans: qualified plans under section 401(a), including 401(k) plans, section 403(a) qualified annuity plans, section 403(b) plans, pure rollover IRA's, traditional IRAs, Roth IRA's, SEP IRA's (under section 408(k), or a section 408(p) account, and whether covered plans include plans created by the self-employed;[130] (3) whether the treaty rate for pensions applies to a nonperiodic payment, including a premature distribution[131] subject to the 10 percent penalty tax under section 72(t) or an "eligible rollover distribution;" (4) whether amounts not treated as "pensions" will be covered by the "Other Income" article of the treaty,[132] (5) whether a distribution from a pure rollover IRA is treated differently from a distribution from other types of IRAs,[133] (6) whether the treaty bars imposition of the 10 percent penalty tax

130. *See supra* notes 13–31, relating to such plans. If a treaty covers distributions from Roth IRAs, there is still a question as to whether a nonqualified distribution would be covered.

131. *See e.g*., I.R.S. Priv. Ltr. Rul. 84-22-069 (Feb. 28, 1984) (premature distribution from IRA to UK resident was not a pension under article 18(1), but was "other income" under article 22(1); s*ee also* I.R.S. Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992).

132. We do not believe that a distribution from a qualified retirement plan that fails to meet the definition of a "pension" in the treaty should be eligible to be treated as "Other Income" under the treaty. The application of the "Other Income" Article should be limited to income when the treaty lacks an applicable provision such as for money purchase annuities (e.g., art. 17 of the U.S.–Russia treaty).

133. *See* I.R.S. Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996) (lump sum distribution paid to divorced spouse, pursuant to QDRO, from rollover IRA, was pension under article 19(2) of the U.S.–Netherlands treaty); I.R.S. Priv. Ltr. Rul. 89-04-036 (Oct. 31, 1988) (distribution from rollover IRA was exempt as a pension under Art. 18(1) of the old U.S.–Italy Treaty); I.R.S. Priv. Ltr. Rul. 95-41-043 (July 6, 1998) (distribution from pure rollover IRA was pension under Art. 20 of U.S.–India treaty; recipient was over 55, and distributions were made after his separation from service); I.R.S. Priv. Ltr. Rul. 98-06-012 (Nov. 10, 1997) (distributions from a rollover IRA and from an IRA funded by decedent's tax–deductible contributions

under section 72(t), and (7) the treatment of pensions for government services.

The rules established to cover the various types of distributions should be rules that can be easily applied by the payer with information in his possession. For example, it might be sensible to interpret treaties to apply to nonperiodic distributions from a traditional IRA only to the extent of a minimum required distribution.[134] Other distributions from a traditional IRA could be classified as not eligible for treaty protection (including under the Other Income article).[135] To facilitate a taxpayer's correct application of the rules in preparing his return, the IRS should assign additional Income Codes for use by the payer on Form 1042-S.

3. Possible Implications for Future Treaties

If our proposal (summarized in Appendix B) were to be adopted, the U.S. taxation of retirement distributions made to nonresident aliens would be much simpler for both withholding agents and retirees; in addition, the rate of tax for nontreaty taxpayers would be relatively modest, provided that periodic payments are made. These two factors might lead to a rethinking of the Treasury's current policy in the 2006 U.S. Model Treaty of providing complete exemption from source country tax, for both periodic and lump sum payments. From the U.S. standpoint, it might be preferable for the source country to take a share of the revenues from taxing retirement distributions made to nonresidents. (As noted above, this could be the Treasury's motivation behind the "U.S. person presumption" rule of current law since this rule allows the United States to collect a U.S. tax in situations where a treaty exemption could potentially be claimed.)

Under our proposal, it might make sense to consider adoption of the reduced rate approach in our treaties with Canada, South Africa and Indonesia.[136] Moreover, as in the treaties with Canada, Italy, the U.K., and the Netherlands, the source country could be given greater leeway to tax lump sum distributions.[137] At the same time, the treaty could allow a tax–free

were treated as pension payments to his beneficiary under Article 18(1) of the U.S.–Germany Treaty).

134. *Compare* I.R.S. Priv. Ltr. Rul. 2010-09-012 (Mar. 5, 2010), (ruling that a payment from a traditional IRA is a pension under Article XVIII(3) of the U.S.–Canada treaty, and that a required minimum distribution amount that is distributed in accordance with section 408(a)(6) is a "periodic pension" for purposes of Article XVII(2)(a), eligible for the 15 percent reduced treaty rate).

135. *See supra* note 132.

136. *See supra* note 74–75.

137. *See supra* note 75.

rollover from a qualified retirement plan of the source country to a qualified plan of the residence country.[138]

We also recommend that Treasury reconsider the provision of the Model Treaty requiring the residence country to exempt from tax any portion of a distribution that would be exempt in the source country if paid to a resident of that country, such as a qualified distribution from a Roth IRA.[139] In order for a treaty resident to take advantage of this provision, he would need to consult a tax professional familiar with the source country's tax law; this seems unduly burdensome, particularly, if the treaty provides for exclusive residence country taxation. In addition, we question the wisdom of applying the treaty exemption for pensions to a distribution from a Roth IRA, which often is not used for retirement.[140] However, the treaty should bar the residence country from taxing a rollover between qualified plans within the source country.

VII. CONCLUSION

Current tax rules regarding taxation of U.S. retirement distributions to foreign nationals impose serious administrative burdens on payers, recipients and the IRS. We propose that Congress eliminate "effectively connected" treatment for any part of a qualified retirement distribution, that the IRS revise its regulations to end the flawed "U.S. person" presumption rule applicable to such distributions, and finally that the IRS issue more specific guidance regarding the treatment of such distributions under individual treaties. Our proposed changes would greatly alleviate administrative burden, provide an appropriate level of U.S. taxation for such retirees, and assure that the tax articulated in the statute, and allowed by treaties, is actually collected.

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138. *See* discussion in Letter of David Powell, Groom Law Group, July 13, 2009, Comments on Certain Pension Aspects of the United States Model Tax Treaty, at 2009 WTD 134-24.

139. 2006 U.S. Model Treaty, *supra* note 46, at article 17.1.b. *See* discussion in NYSBA REPORT, *supra* note 69. That report explains that this clause is meant to cover "Roth IRAs, rollovers and distributions that are a return of non-deductible contributions."

140. The absence of a minimum distribution requirement before the death of the participant and of a maximum age for making contributions is inconsistent with the goal of saving for retirement (versus accumulating savings for heirs). We see no reason why the U.S. decision to provide an income exclusion for a qualified distribution from a Roth IRA should require the residence country to forgo taxation. If the Roth distribution is nonqualified, it will bear even less resemblance to a retirement distribution; in that case, there seems to be little reason for the U.S. to renounce source–based taxation under the pension article.

APPENDIX A

BELGIUM

Code	Category of Income	Payer	Beneficial Owner[1]	Tax Rate	Treaty Article
14	Private Pensions (and Annuities)[2] Qualified Plan under sec. 401(a)[3] Qualified Plan under sec. 403(a) Qualified plan under sec. 403(b)[3] Individual retirement plan under section 408(k) Section 408(p) accounts Section 457 plans[3]	Any		0	17(1)(a)
New	Individual Retirement Agreements Traditional IRA[4] Nondeductible IRA[4]	Any		0	17(1)(a)
New	Roth IRA[4]	Any		0	17(1)(a)
New	Money-Purchase Annuities[5]	Any		0	17(3)
New	Social Security	US Gov't		30	17(2)
New	Gov't Pension or Annuity[6]	US Gov't	Resident and National	0	18(2)(b)

1. The beneficial owner must be a treaty country resident not eligible for an exemption from tax by the treaty country on the distribution.

2. Defined by the treaty as qualified retirement plan distributions whether paid periodically or in a lump sum; includes annuities purchased using plan assets.

3. To the extent not covered under the provisions for government pensions and annuities.

4. Included in the applicable treaty definition of a private pension.

5. Sums paid periodically under an obligation to make payments in return for adequate and full consideration (other than services rendered).

6. Pensions for government services generally include sections 457, 401(a), and 403(b) plans established for government employees and Thrift Savings Plans under section 7701(j). Government services include services for the United States, a political subdivision, or local authority thereof, or a corporation performing services of a governmental nature which is owned by one of these governmental authorities.

APPENDIX B

Withholding on Retirement Distributions Under Our Proposal

Type of Distribution	USC or RA Inside US (Current law)	USC or RA Outside US (Current law)	NRA (documented) **Our proposal**	Undocumented Outside U.S. **Our proposal**	Treaty Exemption[1] **Our proposal**
PERIODIC PAYMENTS	GR[2] or 0[3]	GR	15%	30%	Yes
NONPERIODIC PAYMENTS					
1. Amounts not in excess of required minimum distribution	10% or 0[3]	10%	15%	30%	Yes
2. Distributions made upon hardship of employee[4] that are not early distributions[5]	10% or 0[3]	10%	15%	30%	Yes
3. Other Distributions[6]	20% or 0[7] If from IRA, 10% or 0[3,7]	20% If from IRA, 10%	30% or 0[7]	30%	Yes; Perhaps no for early distributions, unless rolled over into treaty country plan

1. Must be tax resident in the treaty country and distribution must be subject to tax by the treaty country.

2. Graduated rates.

3. If withholding waived by recipient.

4. Hardship as used in section 402(c)(4); defined in Regulation section 1.401(k)-1(d)(3).

5. Early distributions are those described in section 72(t)(2)(A), i.e., distributions made before age 59 1/2 (unless (i) on or after death of employee, (ii) attributable to employee being disabled, or (iii) after separation from service after attainment of age 55). The payor indicates these early distributions with Code 1 in Box 7 on Form 1099-R. These early distributions may include distributions avoiding section 72(t) penalty tax under exceptions in subparagraphs (B),(D),(E) and (F) of section 72(t).

6. These are eligible for rollover (apart from early distributions for hardship). *See* sections 402(c)(4), 408(d)(3).

7. No withholding on direct rollovers.