FLORIDA TAX REVIEW

VOLUME 3 | *1996* | *NUMBER 6*

U.S. Income Taxation of Cross-Border Pensions

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I. INTRODUCTION

This article will explore the U.S. income tax rules applied to deferred compensation transactions that cross national borders; it will consider whether the rules that the U.S. has developed, as a source country and as a residence country, constitute both a coherent and administrable approach and one that meshes harmoniously with the laws of other countries. One objective in this context is to avoid erecting barriers to the free movement of employees across borders. Others are to avoid creating unwarranted loopholes for employees and to insure that the U.S. obtains its rightful share of tax revenues. This topic is of increasing significance because of the growth in cross-border movements of employees in recent years.[1]

There are a number of troubling features of the U.S. rules for taxing cross-border deferred compensation that suggest the need for this exploration. The rules for U.S. source-based taxation are often complex and difficult to administer. In stark contrast to its stringent source-based taxation under the Code, the U.S. in its treaties completely surrenders source-based jurisdiction over "pensions." However, no such treaty relief is provided for other forms of deferred compensation; yet the term "pension" has not been defined by the IRS in an authoritative form, and the rationale for the special treatment of "pensions" remains unclear.

It seems doubtful that U.S. residence-based jurisdiction over "pensions" is exercised effectively, at least when the employer is not affiliated with a U.S. multinational. U.S. tax concepts employed in a domestic context are employed to characterize foreign retirement schemes even though the effects of such characterizations probably were not foreseen when the concepts were developed. The U.S. residence-based rules, even as supplemented by treaty, fail to take into account the manner of taxation by the source-country so as to guard against double taxation or inadvertent tax exemption.

Part II of this article is a brief introduction, reviewing the U.S. income taxation of deferred compensation in a domestic context and the rationale for these rules.

Parts III and IV will examine the use of these concepts in the development by the U.S. of its rules for cross-border transactions. Part III will first describe the U.S. assertion of source-based jurisdiction over cross-border

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1. See Richard E. Andersen, New OECD Model Updates Employment, Self-Employment Provisions, 4 J. Int'l Tax'n 94 (1993). Andersen states that "[a]ccompanying the globalization of financial capital during recent decades has been a somewhat less publicized, but no less significant, increase in the volume of cross-border movement of *Human* capital, i.e., international transfers of employees in the public and private sector, as well as a heightened degree of global activity by self-employed persons. . . ." Id.

deferred compensation transactions. It will then explore the rationale for source-based taxation of deferred compensation and the disadvantages and difficulties associated with such taxation by the U.S., concluding with a discussion of the basis for U.S. treaty policy surrendering source-based taxation of pensions (as most recently expressed in the U.S. Treasury Department's 1996 Model Tax Convention and Technical Explanation[2]). Part IV first describes the U.S. assertion of residence-based jurisdiction over cross-border deferred compensation transactions. It will then explore the difficulties associated with U.S. residence-based taxation of deferred compensation and how they are occasioned by the U.S. attempt to apply its own tax concepts to a large variety of foreign retirement schemes. This part will then analyze the potential for "mismatching" of U.S. and foreign tax rules, with resulting under- or over-taxation.

Part V will consider alternatives that might improve the current U.S. rules governing cross-border deferred compensation. These alternatives will include unilateral revisions of the U.S. treatment under the Code and refinements of the U.S. treaty policy.

II. U.S. Taxation of Deferred Compensation in a Domestic Context

A. *Summary of Current Tax Rules*

A wage-earner who receives a current salary and invests it in a savings account is taxed on his salary upon receipt and then taxed on his interest income from the bank as it is earned.[3] This treatment is generally consistent with the ideal of a comprehensive income tax, i.e., a definition of income that includes both amounts consumed and amounts devoted to saving.[4]

However, there are a number of alternative means for a wage-earner to save for retirement. These generally involve an arrangement with the employer to defer payment of compensation to the employee. The tax

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2. See Treasury Department, United States Model Income Tax Convention, Sept. 20, 1996, 96 TNT 186-6 (Sept. 23, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter 1996 U.S. Model]; Treasury Department Technical Explanation for United States Model Income Tax Convention of Sept. 20, 1996, 96 TNT 186-7 (Sept. 23, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter 1996 Treasury Explanation].

3. Cf. Andrew Dilnot, The Taxation of Private Pensions, in Securing Employer-Based Pensions—An International Perspective 213, 215 (Zvi Bodie, et al, 1996) (noting that a regime in which contributions are taxed, fund earnings are taxed, and payment of retirement benefits is tax-free is "basically that applied to interest-bearing short-term saving in most OECD countries").

4. See David F. Bradford and the U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 2 (2d ed. rev. 1984); see also Dilnot, supra note 3, at 220.

treatment of these alternative arrangements, under the Internal Revenue Code, depends upon whether they are funded (i.e., whether the employee's rights under the plan are of a type to attract current taxation under the cash method of accounting),[5] and, if so, whether taxation is nevertheless deferred because the plan is a qualified plan.

1. *Unfunded*[6] *Deferred Compensation.*—Under the cash method of accounting, an employee who receives merely an unsecured promise of his employer to pay deferred compensation generally defers taxation until payment.[7] The tax deferral is unaffected by the employer setting aside assets for purposes of paying the deferred compensation in a so-called "rabbi trust" meeting IRS guidelines;[8] under these guidelines, the employee's rights must be limited to "mere unsecured contractual rights" against the employer, and the trust assets must be subject to the claims of the employer's general creditors in the event of insolvency.[9]

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5. See John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 180 (2d ed. 1995) (stating that "[t]he basic difference between funded and unfunded plans is that under a funded plan the employee may be taxed on contributions to the plan before the employee actually receives distributions," pursuant to IRC § 83 or 402(b)). See also discussion at infra note 6.

6. The term "unfunded" is used in this article to describe nonqualified deferred compensation arrangements that achieve tax deferral for a cash method employee. See Langbein & Wolk, supra note 5, at 190 (explaining that "[t]he key feature of the rabbi trust" described at infra notes 8-9, "is that the trust assets remain subject to the claims of the employer's creditors in the event of the employer's bankruptcy or insolvency," and "[i]t is this feature that makes the trust 'unfunded' for tax purposes, avoiding both constructive receipt and the application of the economic benefit doctrine").

7. See Rev. Rul. 60-31, 1960-1 C.B. 174; 2 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 60.2.1 (2d ed. 1990 & Supp. 1 1996). In addition, see Rev. Proc. 92-65, 1992-2 C.B. 428 (providing IRS guidelines for obtaining a ruling that the doctrine of constructive receipt is inapplicable to an unfunded deferred compensation arrangement). Under IRS guidelines, an election to defer payment of compensation must (with two specified exceptions) "be made before the beginning of the period of service for which the compensation is payable." Id. Further, "[t]he plan must provide that a participant's rights to benefit payments under the plan are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant". Id.

8. See Rev. Proc. 92-64, 1992-2 C.B. 422 (providing a model form for a rabbi trust). Following IRS guidelines insures that "an employee wili not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust." Id. § 3. See discussion of "rabbi trusts" in Daniel I. Halperin, Special Tax Treatment for Employer-Based Retirement Programs: Is it 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue? 49 Tax L. Rev. 1, 26 & nn.82-84 (1993). see also Yale D. Tauber, Funding Non-Qualified Deferred Compensation Benefits, 1 ERISA & Benefits L.J. 177, 179, 182-89 (1992).

9. Rev. Proc. 92-64, 1992-2 C.B. 422, § 5.02, Model Trust § 1(d).

When nonqualified deferred compensation is structured so as to defer the employee's tax until receipt of payment, the employer's deduction is also deferred until that time but includes the entire amount eventually paid to the employee.[10] Any investment return earned during the period of deferral is taxed currently to the employer (under the grantor trust rules, in the case of a rabbi trust).[11]

This type of deferred compensation results in overall tax savings to the employer and employee only to the extent that the employer's tax rate (applied to the investment return during the period of deferral) is less than the tax rate that would have applied to the investment return earned by the employee and to the extent that the employee's marginal tax rate at the time of pay-out is less than it would be at the time when the compensation was earned.[12]

2. *Qualified Retirement Plans.*—When an employer sets aside funds in a retirement trust for employees that is beyond the reach of the employer's creditors (and thus not a "rabbi trust"),[13] the treatment depends upon whether the trust is "qualified" under the pension provisions of the Code.

As provided in section 401 of the Internal Revenue Code, a "qualified" pension trust must be "created or organized in the United States," and must be "for the exclusive benefit of . . . employees or their beneficiaries."[14] In addition, the trust must satisfy a myriad of other requirements, e.g., it must meet the minimum participation standards of section 410, must not discriminate in contributions or benefits in favor of highly compensated employees, must meet minimum vesting standards of section 411, must comply with the limitations on contributions and benefits set forth in section 415, must prohibit assignment or alienation of benefits, and satisfy minimum funding standards of section 412.[15]

If the plan is qualified, the employer's contribution to the plan is currently deductible, up to specified limits.[16] The income of the pension

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10. See IRC § 404(a)(5); Bittker & Lokken, supra note 7, ¶ 60.2.2.

11. See IRC §§ 671-679. To meet the IRS guidelines for a model "rabbi trust," the trust agreement must provide that it is intended to be a grantor trust of the employer as grantor. Rev. Proc. 92-64, 1992-2 C.B. 422, § 5.02, Model Trust § 1(c).

12. See Halperin, supra note 8, at 13 & n.45, 23-24, 27; Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506, 520-23 (1986).

13. See supra notes 6, 8-9 and accompanying text.

14. IRC § 401(a).

15. Id.; see Bittker & Lokken, supra note 7, ¶¶ 61.2-61.10.

16. See IRC § 404(a)(1). The deduction is "limited to the amount necessary to fund the plan properly under the actuarial method and assumptions used." Bittker & Lokken, supra note 7, ¶ 61.14.1.

trust is tax-exempt pursuant to section 501(a).[17] The employee is taxed only when he or she receives distributions from the trust.[18] Certain premature distributions (i.e., withdrawals not used for retirement) are subject to a 10% penalty tax.[19]

In the case of a qualified plan, the investment return accumulates free of any tax.[20] This is consistent with the consumption tax model, under which amounts set aside for future consumption should accumulate at a before-tax rate of return.[21]

3. *Funded Nonqualified Plans.*—Until recently, employers have not deliberately sought to establish a funded nonqualified plan,[22] and thus the precise tax consequences have gone largely unexamined. Recently, however, employers have sought and obtained private rulings regarding the tax consequences of such arrangements.[23] The simplest case is a "defined contribution plan," in which each participant has a separate account; the account reflects contributions as well as trust income, expenses, and gains or

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17. See IRC § 501(a); Bittker & Lokken, supra note 7, ¶ 61.15.

18. See IRC § 402(a); Bittker & Lokken, supra note 7, ¶ 61.13. A further advantage is that "most pensions (but not employee contributions to 401(k) plans) are exempt from payroll taxes." Eric M. Engen & William G. Gale, Comprehensive Tax Reform and the Private Pension System, 96 TNT 137-82, para. 9 (July 15, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter Engen & Gale].

19. See IRC § 72(t); infra note 117. In addition, see Gene Steuerle, Tax Reform and Private Pensions, 70 Tax Notes 1693 (Mar. 18, 1996) (explaining that this penalty "might be viewed as an attempt to 'recapture' some of the tax benefits that may have accrued" in light of the fact that "the taxpayer turns out not to have saved for retirement"). He explains that "[t]he government's penalty tax might also be viewed as its attempt to save welfare or transfer payments down the road." Id. Similarly, the penalty on early withdrawal has been described as "ensur[ing] that the tax break for pensions is only given for retirement saving." Engen & Gale, supra note 18, para. 39.

20. See Halperin, supra note 8, at 13.

21. See Dilnot, supra note 3, at 214, 220 (noting that this "treatment confers a post-tax rate of return on saving equal to the pre-tax rate of return," and that, under this approach, "both present and future consumption are taxed on the same basis").

22. For a discussion of the tax treatment of "secular trusts," see Deborah Walker and Sallie Olson, Maximizing the Benefits of Deferred Compensation Plans Funded Through Secular Trusts, 77 J. Tax'n 90 (1992); Stuart M. Lewis, Secular Trusts—IRS Rulings Form New Pentateuch, 33 Tax Mgmt. Memo (BNA) 301 (1992) (discussing Priv. Ltr. Ruls. 88-41-023, 88-43-021, 92-06-009, 92-07-010, 92-12-019, and 92-12-024); Halperin, supra note 8, at 24-33; see also Washington Items: The Climate of Current Thinking on New Developments, "Tax Consequences of Distributions from Nonexempt Trusts Unclear," 35 Tax Mgmt. Memo (BNA) 268 (1994) (discussing Priv. Ltr. Rul. 94-17-013 (Jan. 24, 1994)); Internal Revenue Service, Notice of Proposed Rulemaking, Application of Grantor Trust Rules to Nonexempt Employees' Trusts [REG-209826-96], 96 TNT 190-4 (Sept. 27, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter 1996 Proposed Rulemaking].

23. See, e.g., Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994).

losses, and it serves as the basis for determining the participant's benefits.[24] An employer's contribution to this type of plan is currently includible by the employee pursuant to section 402(b)(1)[25] and, as a consequence, is currently deductible by the employer under section 404(a)(5), provided that amounts contributed to the plan are nonforfeitable (notwithstanding early termination of employment).[26] The trust is treated as a separate taxable entity (rather than as a grantor trust of the employer), and the trust's investment income is taxed under the rate schedule for trusts,[27] except to the extent of certain current distributions to beneficiaries.[28] The eventual distribution to the employee is taxable to him upon receipt pursuant to section 72, which allows for the amount already taxed at the time of contribution.[29]

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24. The term "defined contribution plan" is defined in § 414(i). For a further discussion, see Bittker & Lokken, supra note 7, ¶ 61.1.2.

25. Under § 402(b)(1), the contributions are included in income in accordance with § 83, except that the value of the employee's interest in the trust is substituted for the property's fair market value in applying § 83. See Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994). However, an exception to this current inclusion is provided for a non-highly-compensated employee if the sole reason the trust fails to qualify for exemption under § 501(a) is failure to meet the requirements of § 401(a)(26) or § 410(b). See IRC § 402(b)(4)(B); see, e.g., Priv. Ltr. Rul. 92-12-019 (Dec. 20, 1991) (ruling (5)).

26. Under § 83, the employee's inclusion is in the first year in which his rights are transferrable or are not subject to a substantial risk of forfeiture. See IRC §§ 83(a), 402(b)(1).

27. See Priv. Ltr. Rul. 92-12-019 (Dec. 20, 1991) (ruling (1)) (stating that "[t]he rules of sections 402(b) and 404(a)(5) of the Code preclude a section 402(b) employees' trust from being treated as owned by the employer under subpart E," and ruling that "the tax imposed by section 1(e) of the Code will apply to the taxable income of the Trust pursuant to section 641"); Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994) (rulings (1) & (2)) (giving a similar ruling); Halperin, supra note 8, at 30 & n.94. See also 1996 Proposed Rulemaking, supra note 22, ¶¶ 34, 37. Under the proposed regulations, "an employer is not treated for federal income tax purposes as an owner of any portion of a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is not a foreign trust within the meaning of section 7701(a)(31)." Id. ¶ 37.

28. See Priv. Ltr. Rul. 92-12-019 (Dec. 20, 1991) (ruling (3)) (ruling that "[f]or any taxable year, the Trust is entitled to a deduction under section 661(a) for amounts distributed to a participant or a participant's beneficiary . . . during that taxable year," with the deduction limited "with respect to each participant's account" to the "amount of distributable net income computed for each account as if each account were a separate trust"); see also Priv. Ltr. Rul. 94-17-013 (Jan. 24, 1994) (ruling (3)); Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994) (rulings (4)-(5)). A trust's distributable net income ("DNI") is its taxable income, determined with modifications described in § 643(a). See IRC § 643(a).

29. See IRC § 402(b)(2); see, e.g., Priv. Ltr. Rul. 92-12-024 (Dec. 20, 1991) (rulings (5) and (6)); Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994) (ruling (8)). Because no credit is given for the tax paid by the trust, investment income is double taxed, see Halperin, supra note 8, at 29-30 & n.94, except to the extent of the trust's distribution deduction (limited to DNI). Id. at 32 & n.105. For purposes of determining a participant's "investment in the contract," amounts previously taxed to the recipient under § 402(b) are classified as "premiums or other

If the plan deviates from this simple example there are additional complications. If the benefits become nonforfeitable only some time after the contribution is made, then the employee's inclusion is of the value of his interest when that occurs.[30] The employer's deduction is delayed to the time of the employee's inclusion but cannot exceed the original contribution.[31] No deduction is allowed to the employer at any time unless separate accounts are maintained for the various covered employees.[32] Thus, no deduction is generally allowed for contributions to a nonqualified "defined benefit plan" because a defined benefit plan does not maintain such accounts.[33] A defined benefit plan is a pension plan that provides for definitely determinable benefits, determined, for example, by reference to an employee's years of service or rate of compensation.[34]

Moreover, if the employee is a highly compensated employee[35] and the trust fails to meet certain requirements of a qualified plan for broad coverage and participation of employees,[36] then, according to the IRS, the

consideration paid for the contract." See Priv. Ltr. Rul. 92-12-024 (Dec. 20, 1991) (rulings (10) and (11)). See generally 1996 Proposed Rulemaking, supra note 22, ¶¶ 23-24 (describing the treatment of the beneficiary and employer in respect of a nonexempt employees' trust).

30. See IRC § 402(b)(1) (stating that benefits are includible in accordance with § 83); Yale D. Tauber, Funding Non-Qualified Deferred Compensation Benefits, 1 ERISA & Benefits L.J. 177, 190 (1992); Halperin, supra note 8, at 26 n.87; Bittker & Lokken, supra note 7, ¶ 60.3 (Supp. 1 1996).

31. See Halperin, supra note 8, at 30 & nn.95-96; Regs. § 1.404(a)-12(b)(1); Priv. Ltr. Rul. 94-17-013 (Jan. 24, 1994); see also Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994). In the case where there is a delay in the employer's deduction because the benefit is forfeitable, the employer is in effect taxed on the "after-tax income of the trust," with the result that this portion of the investment income is double taxed. See Halperin, supra note 8, at 30-31 & n.97.

32. IRC § 404(a)(5).

33. See IRC § 414(j) (defining a "defined benefit plan" as a plan which is not a defined contribution plan); supra note 24 and accompanying text (defining a "defined contribution plan"). But cf. Priv. Ltr. Rul. 92-12-019 (Dec. 20, 1991) (ruling that an employer was entitled to deduct contributions to the participants' accounts of a trust that secured the benefits for a nonqualified defined benefit plan and maintained separate accounts).

34. Regs. § 1.401-1(b)(1)(i); see Bittker & Lokken, supra note 7, ¶ 61.1.2 (explaining that Regs. § 1.401-1(b)(1)(i) is applicable because a defined benefit plan is a pension plan). An example of a defined benefit plan is "an annual pension equal to two thirds of the employee's average annual compensation during the last five years of employment." Id. In this example, the "employees . . . are not affected by the earnings actually realized by the trust fund, mortality experience, or employee turnover." Id.

35. The term "highly compensated employee" is defined for this purpose in § 414(q). See IRC § 402(b)(4)(C).

36. These requirements are contained in IRC §§ 410(b) and 401(a)(26), respectively, and are designed "to restrain discrimination in favor of highly compensated employees." See Bittker & Lokken, supra note 7, ¶ 61.3.1. See also id. ¶¶ 61.3.3-61.3.4 for a detailed description of these requirements.

employee must additionally include his vested accrued benefit[37] (other than his investment in the contract) on an annual basis.[38] In that situation, the amount taxable to the employee at the time of eventual distribution is unclear.[39] Some commentators have argued, however, that this unfavorable treatment of highly compensated employees was intended by Congress only for pension plans that originally had, but then lost, qualified status.[40]

These unfavorable results[41] of a nonqualified funded plan may be avoided to the extent that the arrangement is structured so that the trust is a grantor trust of the employee.[42] In that case, the results are the same as for current compensation invested by the employee.[43]

4. *Individual Retirement Accounts.*—The favorable treatment accorded a qualified pension plan is also available for individual savings of a limited amount contributed to an individual retirement account (IRA).[44] That is an individual who either does not participate in an employer pension plan or whose income falls below certain limits may contribute up to $2,000

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37. See IRC § 402(b)(4)(A); cf. Halperin, supra note 8, at 31 & n.99 (noting that the effect is that the "employee is forced to include as income both the unrealized appreciation and income as it accrues instead of at the time of distribution").

38. For IRS applications of § 402(b)(4)(A), reflecting its view that § 402(b)(4)(A) applies to any nonqualified funded plan, see, e.g., Priv. Ltr. Rul. 95-02-030 (Oct 13, 1994) (ruling (6)); Priv. Ltr. Rul. 94-17-013 (Jan. 24, 1994) (ruling (5)); Priv. Ltr. Rul. 92-12-019 (Dec. 20, 1991) (ruling (4)).

39. See Washington Items, supra note 22 (discussing Priv. Ltr. Rul. 94-17-013 (Jan. 24, 1994)). In that ruling, the IRS states that "[s]ection 402(b)(4)(A) of the Code in its current form does not apply section 402(b)(2) to trigger application of section 72 to distributions to a highly compensated employee from a nonexempt trust to which section 402(b)(4)(A) applies." Priv. Ltr. Rul 94-17-013 (Jan. 24, 1994) (ruling (a)). However, the IRS notes that this would have been accomplished by a "technical correction contained in H.R. 11, 102d Cong., 2d Sess. section 6102(j)(1)(A) (1992)" which was passed by both houses of Congress "but never signed into law by the president." Id. As a result, the IRS does not rule on this issue in Priv. Ltr. Rul. 94-17-013. Id.; see also Priv. Ltr. Rul. 95-02-030 (Oct. 13, 1994) (ruling (11)).

40. Halperin argues "the legislative history . . . implies that this rule was intended to apply only if the plan had been previously qualified." Halperin, supra note 8, at 31 & n.100 (citing S. Rep. No. 445, 100th Cong., 2d Sess. 159-60 (1988) and H.R. Rep. No. 795, 100th Cong., 2d Sess. 152-53 (1988)). This view, however, has not been accepted by the IRS. See supra note 38.

41. The portion of a distribution includible in income may also be subject to the 10% penalty tax under § 72(q) if the distribution is premature. See Priv. Ltr. Rul. 92-12-024 (Dec. 20, 1991) (ruling (12)).

42. See Halperin, supra note 8, at 32 (noting that this can be done by "giv[ing] the employee an option as to whether to receive cash or to contribute to a trust for her benefit"); Walker & Olson, supra note 22, at 91; Priv. Ltr. Rul. 88-43-021 (July 29, 1988).

43. See Halperin, supra note 8, at 32.

44. See generally Bittker & Lokken, supra note 7, ¶ 62.3.

per year to such an account on a tax deductible basis.[45] The IRA itself is exempt from tax.[46] No tax is imposed on the employee until distributions are made from the account.[47]

B. *Rationale for U.S. Tax Treatment of Qualified Retirement Plans*[48]

The tax treatment that the U.S. accords to current compensation invested by an employee in a bank account is in accord with the norm of a comprehensive income tax, with a base including both consumption and savings.[49] As discussed above, the overall tax treatment to the employer and employee of unfunded deferred compensation is comparable except to the extent of variation between the employer and employee's tax rate and any decline in the employee's tax rate at retirement.[50] By contrast, the tax treatment that the U.S. accords to qualified pension plans and IRA accounts (holding deductible contributions) is in accord with the norm of a cash flow tax, in which the tax base is limited to consumption.[51]

Many commentators view this favorable treatment of qualified pension plans as justifiable under an income tax only as a tax incentive to encourage workers to save for retirement[52] so as to reduce the need for

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45. See IRC § 219(a), (b), (g); Bittker & Lokken, supra note 7, ¶ 62.3.2.
46. See IRC § 408(e)(1).
47. See IRC § 408(d)(1); Bittker & Lokken, supra note 7, ¶ 62.3.4.
48. See generally Edward A. Zelinsky, Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax, 13 Va. Tax Rev. 591 (1994) [hereinafter Zelinsky, Flat, Plan Level Tax]; Halperin, supra note 8; General Accounting Office, Tax Policy: Effects of Changing the Tax Treatment of Fringe Benefits, reprinted in 92 TNT 76-16 (Apr. 7, 1992) (LEXIS, FEDTAX library, TNT file) [hereinafter GAO Report]; Norman P. Stein, Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky, 9 Am. J. Tax Pol'y 225 (1991) [hereinafter Stein]; Edward A. Zelinsky, Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein, 9 Am. J. Tax Pol'y 257 (1991) [hereinafter Zelinsky, Rejoinder]; Joseph Bankman, Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable, 55 U. Chi. L. Rev. 790 (1988); Edward A. Zelinsky, The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo, 66 N.C. L. Rev. 315 (1988) [hereinafter Zelinsky, Status Quo]; Nancy J. Altman, The Reconciliation of Retirement Security and Tax Policies: A Response to Professor Graetz, 136 U. Pa. L. Rev. 1419 (1988); Michael J. Graetz, The Troubled Marriage of Retirement Security and Tax Policies, 135 U. Pa. L. Rev. 851 (1987).
49. See supra notes 3-4 and accompanying text.
50. See supra note 12 and accompanying text.
51. See Bradford, supra note 4, at 54, 118; Dilnot, supra note 3, at 220. For discussion of the possible effects on pension savings if the current income tax is replaced with a form of consumption tax, see Gene Steuerle, Tax Reform and Private Pensions (pts. 1 & 2), 70 Tax Notes 1693 (Mar. 18, 1996), 70 Tax Notes 1831 (Mar. 25, 1996); Engen & Gale, supra note 18.
52. See, e.g., GAO Report, supra note 48, ch. 2 (stating that "Congress uses tax preferences to encourage employers to sponsor pension plans and employees to provide savings

government to provide direct support to the elderly.[53] The favorable tax treatment of qualified plans may accomplish this by making such plans attractive to relatively well-compensated employees, while the nondiscrimination rules insure that the pension benefits are not limited to such employees.[54] The minimum vesting and funding requirements and the fiduciary standards applied to qualified plans insure that a participant will in fact receive benefits.[55] The penalty for premature distributions assures that benefits will not be withdrawn before retirement.[56]

Some have expressed doubt that these goals are effectively achieved, either because the tax advantage of a qualified plan over a nonqualified plan is not sufficiently large[57] or because the nondiscrimination requirements are not in fact well-tailored to insuring broad coverage of employees.[58] And some have proposed eliminating the tax advantage by imposing a flat tax (designed to approximate the average tax rate of participants in the plan) on the earnings of qualified pension trusts.[59]

By contrast, Professor Zelinsky has argued that the current treatment of qualified retirement plans should not be characterized as a "tax expendi-

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for their future retirement"); Janet G. Stotsky & Emil M. Sunley, The Tax System of the United States, 9 Tax Notes Int'l 1755, 1765 (Dec. 5, 1994) (noting that "[t]here are various incentives in the tax code intended to increase retirement savings.").

53. See, e.g., Gene Steuerle, Tax Reform and Private Pensions, 70 Tax Notes 1693, 1693 (Mar. 18, 1996) (noting that the penalty for early pension withdrawals "might also be viewed as [the government's] attempt to save welfare or transfer payments down the road").

54. The reduction in the overall pre-tax compensation accepted by the well-compensated employees, as a result of the tax benefits, is used by the employer to partially fund an increase in overall pre-tax compensation for rank-and-file employees, who would not be willing to substitute deferred compensation for current compensation. See Halperin, supra note 8, at 13-15.

55. See Bittker & Lokken, supra note 7, ¶ 61.2, 61.5, 61.10, 61.16 (discussing the antidiversion requirements of § 401(a)(2), minimum vesting standards, funding requirements and prohibited transactions).

56. See supra note 19.

57. See Halperin, supra note 8, at 6-7, 15-21. Professor Halperin has suggested the possibility of a harsher treatment of nonqualified plans to preserve the relative attractiveness of qualified plans (with their prospect of greater rank-and-file coverage). Id. at 43-44.

58. See Bankman, supra note 48, at 805-13, 821-24, 828-30.

59. The tax advantage offered by the qualified pension plan, as compared to current compensation invested by the employee, is the exemption provided for the income of the pension trust. See supra text accompanying note 20. Under one proposal, a 15% flat tax would be imposed both on employer contributions and on pension trust earnings; however, no further tax would be imposed on employees receiving pension distributions. See GAO Report, supra note 48, chapter 2 & n.24; Zelinsky, Flat, Plan Level Tax, supra note 48, at 591-92 & nn.1-6. Zelinsky sharply criticizes this proposal. Id. at 591-608.

ture."[60] He emphasizes that a pure income tax treatment of a defined benefit pension plan (i.e., attribution of accrued benefits to employees) is impractical due to problems of valuation, liquidity and comprehensibility to the public.[61] He argues that the alternative of the flat tax on earnings in a qualified pension trust is not sufficiently accurate (since it would not reflect the individual tax rates of the individuals for whom the benefits are accrued).[62]

The favorable treatment of an IRA is viewed as an incentive for retirement savings for those who are not provided pension coverage by their employers.[63] The fairly small amounts permitted to be contributed and the denial of deductions to higher income individuals covered by an employer plan prevent the IRA incentive from undermining the incentive to participate in a qualified employer-sponsored plan.[64]

C. *Taxation of Pensions in Other Developed Countries*

The scholar Andrew Dilnot has recently compared the tax regimes applied to pensions in a number of developed countries.[65] "Almost all" of the fourteen countries studied "impose upper limits on the level of contribution and/or benefits that can be paid, although typically these limits affect only a small proportion of the workforce."[66] The dominant tax regime was found to be the same as that applied by the U.S. to tax-qualified plans, i.e., exemption from tax at the point of contribution and when earnings are derived, but full taxation on distribution, which is described by Dilnot as "exemption, exemption, taxation" or "EET."[67] By contrast, New Zealand has recently adopted the approach of taxing contributions as well as earnings as

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60. See Zelinsky, Status Quo, supra note 48, at 326-34; Zelinsky, Rejoinder, supra note 48, at 259-71.

61. See Zelinsky, Status Quo, supra note 48, at 334-47.

62. See id. at 358-60; Zelinsky, Flat, Plan Level Tax, supra note 48, at 602-07.

63. See, e.g., Stotsky & Sunley, supra note 52, at 1755, 1765.

64. See generally Graetz, supra note 48, at 895-96 (noting when the IRA deduction was enacted in 1974, it was opposed by "organized labor . . . because of fear that such a deduction would deter employers from establishing pension plans for employees"). Graetz observes that "the relatively small $2,000 limit . . . seems to have been quite significant in reducing the potential threat of IRAs to employer-provided plans." Id. at 896. He concludes that "by limiting availability of IRAs . . . the 1986 legislation should provide some protection for employer-provided pension plans from accelerating encroachment by more individualized retirement savings vehicles." Id. at 901.

65. See Dilnot, supra note 3, at 213-231.

66. Id. at 216.

67. Id. at 214, 217 (explaining that the tax treatment of pensions used by "the bulk of [the] countries" is "most like" the regime of "EET"). Dilnot explains that this regime is clearly followed by Canada, Ireland, the Netherlands, the U.K., and the U.S., and less clearly so by France, Germany, Greece, and Portugal. Id. at 217 tbl. 2.

they accrue, described by Dilnot as "taxation, taxation, exemption" or "TTE,"[68] which is the approach applied in the U.S. to wages invested in ordinary savings accounts; Australia has also "moved in a similar direction."[69] Sweden and Denmark do not tax contributions to pension plans but do tax earnings as they accrue.[70] In Japan, the earnings of a pension fund are taxed at a low rate and distributions are also taxable.[71]

D. *New Considerations in Cross-Border Context*

A number of new considerations arise in the context of cross-border employment because of a need to coordinate the treatment of a single employment and retirement arrangement under more than one country's laws.[72] There might be complications even if every other country in the world adopted exactly the same tax rules as the U.S.; the fact that they do not causes the complications to multiply. Other countries' laws may differ not only in the treatment accorded pension plans in a domestic context but also in the rules applied to deal with cross-border transactions.

If cross-border deferred compensation is to attract an overall tax burden similar to that applied in an entirely domestic situation, taxation on the basis of source needs to be coordinated (both in respect of amount and timing) with taxation on the basis of residence. This task is complicated by the fact that there are two potential bases for a claim to impose source-based taxation: (a) the location where the services are performed and (b) the situs of the retirement plan. In addition, since a long time may often elapse between the time that contributions are made to a pension plan and the time of eventual payout, there may also be more than one country with a potential claim to impose residence-based tax. Because of the potential number of interested countries, more than one treaty may be applicable to the transaction

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68. Id. at 215, 217 tbl. 2.

69. Id. at 217.

70. See id. at 217 tbl. 2.

71. See id.

72. See generally James P. Klein, International Benefits Planning, U.S. Income Tax Treaties and Deferred Compensation Plans, 14 Int'l Tax J. 379 (1988); Thomas St.G. Bissell & Alfred Giardina, International Aspects of U.S. Retirement Plans, Deferred Compensation and Equity-Based Compensation Plans: An Overview, 25 Tax Mgmt. Int'l J. 275 (1996) [hereinafter Bissell & Giardina]; David W. Ellis et al., Structuring International Transfers of Executives, RIA Tax Advisors Plan. Series 1 (Sept. 1994) [hereinafter Ellis & Navin]; Arthur A. Feder, Pension Planning in the International Context, in International Tax Problems of Charities and Other Private Institutions with Similar Tax Treatment, 39th Congress of the International Fiscal Association, 41-56 (1985) [hereinafter Feder]; Henry Ordower, A Theorem for Compensation Deferral: Doubling Your Blessings By Taking Your Rabbi Abroad, 47 Tax Law. 301 (1994); Leif Muten, International Experience of How Taxes Influence the Movement of Private Capital, 8 Tax Notes Int'l 743 (1994).

(at the same or different times). Finally, taxation of cross-border pensions (by other than the country where the plan is situated) requires that pension plan administrators be required to provide tax information that may not be relevant under their own country's laws.

Part III of this article will focus on the U.S. assertion of source-based jurisdiction over cross-border pension income, i.e., U.S. claims to tax pension income derived by an individual who is not a U.S. citizen or resident. Consideration will be given to the following situations,[73] depicted in the corresponding rows of Table 1, pages 358-59:

A nonresident alien performs services in the U.S., and:

(1) he earns unfunded deferred compensation; or
(2) his employer contributes to a qualified U.S. pension plan;[74] or
(3) his employer contributes to a nonqualified funded pension plan located in the U.S.; or
(4) his employer contributes to a funded pension plan located in a foreign country.

Alternatively, a nonresident alien performs services in his country of residence, and:

(5) his employer contributes to a qualified U.S. pension plan; or
(6) his employer contributes to a nonqualified funded pension plan located in the U.S.

Part IV of this article will focus on the U.S. assertion of residence-based jurisdiction over cross-border deferred compensation, i.e., jurisdiction to tax such income earned by a U.S. citizen or resident. Consideration will be given to the following situations, depicted in the corresponding rows in Table 2, pages 360-61:

A U.S. citizen or resident performs services abroad, and

(7) earns unfunded deferred compensation; or
(8) his employer contributes to a funded pension plan located in a foreign country.[75]

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73. Cf. Feder, supra note 72, at 55-56 (describing a number of common situations).

74. See, e.g., Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992).

75. See Feder, supra note 72, at 43-48, 51-53 (discussing Germany and U.K.). In many cases, however, a U.S. multinational may send a U.S. citizen employee to work in a foreign branch or subsidiary and may continue making contributions on behalf of the employee to a U.S. based pension plan. See, e.g., Rev. Rul. 79-389, 1979-2 C.B. 281 (employee retired abroad). See also Feder, supra, at 48-50.

A foreign national performs services abroad, and later becomes a U.S. resident before receiving payments:

(9) from an unfunded deferred compensation arrangement; or
(10) from a funded pension plan located in a foreign country.[76]

III. SOURCE-BASED TAXATION BY U.S. OF DEFERRED COMPENSATION PAID TO NONRESIDENT ALIENS

A. *Background: U.S. Taxation of Current Compensation and Investment Income of Nonresident Aliens*

A U.S. citizen or an alien classified by U.S. tax law as a "resident" (by virtue of "substantial presence" or immigration status as a permanent resident) is taxed by the U.S. on worldwide income.[77] By contrast, U.S. taxation of a nonresident alien extends only to income considered to have a sufficient nexus with the U.S. A nonresident alien is taxed at the usual U.S. individual rates on income considered to be effectively connected with a U.S. trade or business, and at a flat 30% rate on certain categories of U.S.-source income, such as fees, dividends and interest.[78]

Apart from a fairly narrow exception for short-term commercial travelers to the U.S., compensation for services performed in the U.S. is treated as from U.S. sources and as effectively connected income;[79] thus, it is taxed to a nonresident alien at usual U.S. rates[80] and subject to withholding; such withholding is even required of foreign employers, although compliance is apparently poor.[81] Compensation paid for services performed

76. See, e.g., Tech. Adv. Mem. 89-11-001 (Sept. 27, 1988) (pre-retirement distributions to Canadian citizen who became U.S. resident alien).

77. See Regs. § 1.1-1(b); cf. IRC § 2(d) (special rules for *non*resident alien individuals). In some cases, an alien classified as a resident under the Code will also be classified as a resident in another country. Such a conflict may be resolved in a treaty tie-breaker clause.

78. See IRC §§ 2(d), 871-874.

79. See IRC §§ 861(a)(3) (source rule for compensation), 864(b) (defining "U.S. trade or business"), 864(c) (defining "effectively connected income"); Regs. § 1.864-4(c)(6) (effectively connected income involving personal services). For taxable years beginning after December 31, 1975, if the services are performed partly within and partly outside the U.S., the allocation between U.S. and foreign sources is "determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case." Regs. § 1.861-4(b)(1)(i).

80. See Rev. Rul. 92-106, 1992-2 C.B. 258 (Situations 3 and 4); Thomas St.G. Bissell, IRS Rules on International Payroll Tax Issues, 22 Tax Mgmt. Int'l J. 145, 147 (1993).

81. Whether or not an alien's employer is a U.S. person or a foreign person, wages paid in respect of services performed in the U.S. (and not qualifying under the exception) are subject to income tax withholding under § 3402(a) and withholding of FICA taxes under § 3101(a) and (b). Rev. Rul. 92-106, supra note 80 (Situations 3 and 4). Such employers are

outside the U.S., whether or not paid by an American employer, is not subject to U.S. tax in the hands of a nonresident alien employee.

The exception from U.S. tax for compensation received by a short-term commercial traveler applies only if (1) the employee is present in the U.S. for no more than 90 days during the year, (2) the compensation does not exceed $3,000, and (3) either the employer is a foreign person not engaged in a U.S. trade or business or, if the employer is a U.S. person, the services are performed for the employer's foreign office.[82] Treaties entered into by the U.S.[83] commonly expand upon the "business traveler" exemption in the Code,[84] by eliminating the dollar limitation and extending the permitted period of presence to 183 days. Such treaties, however, do not otherwise limit U.S. taxation of compensation for services performed in the U.S. by employees.[85]

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subject to FICA taxes imposed under § 3111(a) and (b) and FUTA taxes imposed under § 3301. Id. According to Thomas St.G. Bissell, "it is quite common [however,] for a foreign employer who employs a NRA working in the United States not to establish a U.S. payroll system and thus to fail to withhold FICA, FUTA and wage withholding tax." Bissell, supra note 80, at 147. This may be because the employee, who has a temporary business visitor visa, "normally cannot obtain a U.S. Social Security number"; "more commonly" this situation is due to the employer's "concern that the filing of U.S. payroll tax forms may be likely to elicit inquiries from the IRS and/or from the relevant state tax authorities as to whether the employer is engaged in trade or business in the United States . . . and/or is 'doing business' for state corporate income tax purposes." Id. Where a nonresident alien is employed by a foreign employer in the U.S., "the IRS enforcement of all three payroll taxes . . . tends to be quite spotty." Id.

82. See IRC § 861(a)(3)(A)-(C).

83. Such a provision is included in the 1996 U.S. Model. See 1996 U.S. Model, supra note 2, art. 15; see also U.S. Treasury Department Model Income Tax Treaty, art. 15 (1981), 85 TNI 42-33 (April 21, 1990) (LEXIS, FEDTAX library, TNI file) [hereinafter 1981 U.S. Model]. The 1981 U.S. model was withdrawn in July 1992. See Treasury Announces Review of Model Income Tax Treaty, July 17, 1992, reprinted in 92 TNI 31-29 (July 29, 1992) (LEXIS, FEDTAX library, TNI file) (announcing withdrawal and undertaking of project for revision). See also Organization for Economic Cooperation and Development, Comm. on Fiscal Affairs, Model Tax Convention on Income and Capital, art. 15 (1992) [hereinafter 1992 OECD Model] (requiring that the recipient be present not more than 183 days, the remuneration be paid by or on behalf of a nonresident employer, and the remuneration not be borne by either a permanent establishment or fixed base of the employer in the source state); Jacques Sassesville, The OECD Model Tax Convention is Revised, 4 J. Int'l Tax'n 129, 131-32 (1993) (describing changes in the 183-day rule in the 1992 OECD Model); see generally IRS Publication 901, U.S. Tax Treaties at 2-10 (Revised Nov. 1995) (discussing how "residents" of other countries are taxed on personal service income under various treaties).

84. See Andersen, supra note 1, at 94.

85. These treaties also generally contain a separate article for compensation for independent services, which provides exemption unless the services are performed in connection with a fixed base in the host country. See 1992 OECD Model, supra note 83, art. 14; IRS Publication 901, supra note 83, at 2-10.

If a nonresident alien who performs services in the U.S. during the taxable year also receives investment income, the treatment of the investment income is generally separate from the treatment of the compensation income.[86] Dividends and interest from U.S. sources are subject to a flat 30% withholding tax,[87] subject to treaty reductions. However, much interest is exempted by the exception for portfolio interest and the exception for interest on bank deposits.[88] A nonresident alien would generally be taxed on capital gains[89] only if the individual is present in the U.S. for more than 183 days during the year[90] and has a tax home in the U.S.[91]

B. *U.S. Taxation of Deferred Compensation Received by a Nonresident Alien*

1. *Unfunded Deferred Compensation.*—When compensation for services performed in the U.S. is deferred by an employer in an unfunded arrangement, the full amount eventually paid is treated as compensation for services; thus, upon receipt, the full amount is from U.S. sources and is taxed to the nonresident alien as effectively connected income (absent satisfaction of the business traveler exception).[92] Prior to the Tax Reform Act of 1986, such compensation paid in a year that the nonresident alien was no longer performing services in the U.S. was treated as not effectively connected with a trade or business.[93] However, section 864(c)(6),[94] enacted in the Tax

86. See Regs. § 1.864-4(c)(6)(i) (U.S.-source income or gain derived from an asset by a nonresident alien who is engaged in a U.S. trade or business, by virtue of performing personal services in the U.S., is not treated as effectively connected "unless there is a direct economic relationship between his holding of the asset . . . and his trade or business of performing the personal services").

87. See IRC § 871(a)(1)(A).

88. See IRC § 871(h), (i)(2)(A).

89. Gains from the disposition of U.S. real property interests by nonresident aliens are, however, taxed and treated as effectively connected income. IRC § 897.

90. See IRC § 871(a)(2) (taxing U.S.-source capital gains for such taxpayers).

91. Income from the sale of personal property is generally U.S.-sourced only if derived by a U.S. resident. IRC § 865(a). A nonresident alien is classified as a U.S. resident only if he or she has a tax home (as defined in § 911(d)(3)) in the U.S. IRC § 865(g)(1).

92. See Bissell & Giardina, supra note 72, at 280-82 (describing the tax consequences for a nonresident alien receiving distributions from an unfunded retirement plan for executives (referred to as a "SERP")). Bissell & Giardina state that "[u]pon the payment of benefits from the SERP upon retirement or the termination of employment, the entire distribution would be treated as compensation and would be sourced in accordance with where the individual worked during the years that the accruals to the plan were made." Id. at 281; cf. Rev. Rul. 78-227, 1978-1 C.B. 242 (ruling that the portion of a foreign service retirement annuity representing payments from a current Congressional appropriation is attributable to an employer's contribution and thus treated as foreign source income to the extent allocable to services performed abroad).

93. See IRC § 864(c)(1)(B); Regs. § 1.864-3(b), ex. 3.

Reform Act of 1986,[95] changed this rule by requiring that the categorization of the income as effectively connected be made by reference to the year in which services are performed.[96] (This result is depicted at row 1 of Table 1, page 358.) By contrast, many foreign countries are said to impose immediate taxation upon vested, but unfunded retirement benefits.[97]

2. *Qualified Pension Plan.*—A different and more complex treatment applies to a funded plan for deferred compensation.[98] In the case of a qualified[99] U.S. plan, there are no tax consequences to the employee until

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94. Section 864(c)(6) provides that:

> in the case of any income or gain of a nonresident alien . . . which-(A) is taken into account for any taxable year, but (B) is attributable to . . . the performance of services . . . in any other taxable year, the determination of whether such income or gain is taxable under section 871(b) . . . shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year referred to in subparagraph (A).

For a detailed discussion of § 864(c)(6) and its relationship to treaties, see Meenakshi Ambardar, Comment: The Taxation of Deferred Compensation Under I.R.C. 864(c)(6) and Income Tax Treaties: A Rose is Not Always Arose [Sic], 19 Fordham Int'l L.J. 736 (1995).

95. Pub. L. No. 99-514, § 1242, 100 Stat. 2580. The Staff of the Joint Committee explained that "Congress believed that foreign persons should not be able to avoid U.S. tax on their income from performance of services in the United States where payment of the income is deferred until a subsequent year in which the individual is not present in the United States." Staff of the Joint Comm. on Taxation, 100th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 1048 (1987).

96. Apparently, under § 864(c)(6) "effectively connected" treatment results whether the individual was a nonresident alien or resident alien at the time the U.S. services were performed. See Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988) (dealing with "German citizens working in the United States" who participate in a U.S. company's 401(k) plan and then retire, whereby § 864(c)(6) applies to the distributions in excess of employee contributions, excluding earnings and accretions, "[b]ecause the [e]mployees' income would have been taxed on a net basis at graduated rates in the performance years").

97. See Bissell & Giardina, supra note 72, at 281 (noting that some "countries are often more lax . . . if the accrual consists of benefits under an actuarially based defined benefit plan, rather than under a defined contribution or salary reduction plan").

98. See generally Thomas St.G. Bissell, U.S. Pension Plan Distributions to NRAs: PLRs 9143067 and 9253049, 23 Tax Mgmt. Int'l J. 77 (1994); Charles M. Bruce & Martin A. Culhane, Qualified Plan Distributions to Nonresident Aliens Treated as "Effectively Connected" Income, 18 Tax Mgmt. Int'l J. 335 (1989); Barbara N. Seymon-Hirsch, IRPAC Discussion Paper on Nonresident Alien Withholding and Pension Payment Reporting, 95 TNI 91-11 (May 22, 1995) (LEXIS, FEDTAX library, TNI file) [hereinafter IRPAC Paper].

99. In many cases, an alien individual may work in the U.S. as a resident and become a nonresident only at a later point when pension distributions are being made. See, e.g., Rev. Rul. 79-388, 1979-2 C.B. 270. For a discussion of reasons why an "inbound executive" would participate in a U.S. qualified plan, see Ellis & Navin, supra note 72, at 82-83.

the time of a distribution. A distribution is disaggregated into (a) the contribution by the employer, classified as compensation, and (b) the investment return earned on the contributions (of employer or employee), referred to as "earnings and accretions."[100] With respect to the former component, contributions in respect of services performed in the U.S. are taxable as effectively connected income[101] (or as U.S. source fixed and determinable income in the case of pre-1986 Act contributions[102]). Assuming that the pension plan is located in the United States,[103] the earnings and accretions are treated as U.S. source *non*effectively connected income,[104] subject to a flat 30% tax collected by withholding.[105] This treatment applies even if the contributions were in respect of services performed outside the U.S. Moreover, the fact that the pension trust invests in a form that would have been free of U.S. tax in the hands of a nonresident alien investor is considered irrelevant because the trust is not viewed as a conduit.[106]

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100. See Rev. Rul. 79-388, 1979-2 C.B. 270.

101. See Priv. Ltr. Rul. 90-41-041 (July 13, 1990) (discussing a distribution made from a § 401(k) plan). The IRS ruled that "section 864(c)(6) applie[d] to the portion of each [d]istribution that consists of the Participant's deductible contributions and Employer's matching contributions to the extent the contributions are attributable to services performed after December 31, 1986 as long as the Participant's income would have been treated as effectively connected with the conduct of a U.S. trade or business in the years of performance." Priv. Ltr. Rul. 90-41-041 (July 13, 1990). See also Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988); Bruce & Culhane, supra note 98, at 335-42; Bissell, supra note 98, at 78 (Priv. Ltr. Rul. 89-04-035 "was apparently the first PLR in which the IRS ruled that § 864(c)(6) would be applied to non-treaty-exempt pension distributions."); T.D. 8288, 1990-1 C.B. 163, 164, Explanation of Temp. Regs. § 1.1441-4(b)(1)(ii) (explaining that § 864(c)(6) applies to pensions, because "[p]ensions are treated as compensation for services under 31.3401(a)-1(a)(2)").

102. Thus, this portion of the payment is subject to taxation under § 871(a)(1)(A) and withholding under § 1441(a). See Rev. Rul. 79-388, 1979-2 C.B. 270.

103. See IRC § 401(a) (defining a qualified trust as being "[a] trust created or organized in the United States").

104. See Rev. Rul. 79-388, 1979-2 C.B. 270; see also Priv. Ltr. Rul. 90-41-041 (July 13, 1990) (stating that § 864(c)(6) does not apply to distributions from § 401(k) plan attributable to earnings and accretions of the plan). But cf. Bissell & Giardina, supra note 72, at 278 (stating that "the rules at the moment are unclear" as to whether "the investment income portion will be subject to tax either at the 30% rate under § 871, or as wages taxable under § 1").

105. See Rev. Rul. 79-388, 1979-2 C.B. 270; Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988); Priv. Ltr. Rul. 90-41-041 (July 13, 1990); see also Rev. Rul. 79-389, 1979-2 C.B. 281 (similar analysis in application of § 901 to U.S. citizen retiring abroad); Rev. Rul. 84-144, 1984-2 C.B. 129 (application of § 901 to distribution from IRA established by a qualifying rollover distribution from a qualified U.S. pension plan).

106. See Clayton v. United States, 95-2 U.S. Tax Cas. (CCH) ¶ 50,391, 89,232, 76 A.F.T.R.2d (RIA) at 95-5197 (Cl. Ct. 1995) (endorsing IRS policy that "conduit theory of taxation embodied in Subchapter J does not apply to distributions from qualified employee

Rows 2 and 5 of Table 1, pages 358-59, depict the case of a nonresident alien participating in a U.S. qualified plan. In each case, tax is imposed only at the time of distribution. In row 2 where services are performed in the U.S., the "compensation" element is taxed as effectively connected income, and the "accretions" element is taxed at a 30% flat rate. In row 5, where the services are performed abroad, only the "accretions" element is taxed by the U.S.

This treatment of "earnings and accretions" was approved by the IRS in a 1952 pronouncement[107] that was later declared obsolete in 1970.[108] This approach was again adopted by the IRS in a 1979 Revenue Ruling after objections put forward by the IRS Chief Counsel in a 1975 General Counsel Memorandum were put aside.[109] Just recently, the U.S. Court of Federal Claims and the Court of Appeals for the Federal Circuit confirmed this approach in *Clayton v. United States*,[110] which involved the U.S. tax treatment of Canadians who were employed by Chrysler's subsidiaries operating in Canada and who received distributions on termination of Chrysler's employee stock ownership plan taking the form of cash proceeds of sales of Chrysler stock. Both courts endorsed the IRS position that U.S. taxation of earnings and accretions of a U.S. pension trust was intended by Congress.[111]

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plans"), aff'd, 96-1 U.S. Tax Cas. (CCH) ¶ 50,314, 77 A.F.T.R.2d (RIA) at 96-2484 (Fed. Cir. 1996). See also Priv. Ltr. Rul. 87-21-006 (Jan. 30, 1987) (holding that a distribution from a decedent's IRA, consisting of a deposit at a savings bank, made to a nonresident alien beneficiary could not be treated as foreign-source income pursuant to § 861(c)(2) because an IRA trust is governed by subchapter D rather than subchapter J).

107. IR-Mim. 71, 1952-2 C.B. 170.

108. Rev. Rul. 70-278, 1970-1 C.B. 281.

109. See Rev. Rul. 79-388, 1979-2 C.B. 270; Gen. Couns. Mem. 36,344 (July 23, 1975); Gen. Couns. Mem. 38,007 (July 10, 1979).

110. 95-2 U.S. Tax Cas. (CCH) ¶ 50,391, 76 A.F.T.R.2d (RIA) at 95-5197, aff'd, 96-1 U.S. Tax Cas. (CCH) ¶ 50,314, 77 A.F.T.R.2d (RIA) at 96-2484 (Fed. Cir. 1996).

111. The Claims Court first concluded that the capital gains characterization at the level of the trust did not pass through to the trust beneficiaries because the conduit rules of subchapter J do not apply to employer trusts. The Court further held that the treatment of the earnings and accretions component of distributions from qualified plans as U.S.-sourced based on the situs of the trust was a "long-standing [IRS] policy" that "Congress has repeatedly approved . . . by enacting narrow exclusions to the general tax rule." 95-2 U.S. Tax Cas. (CCH) at 89,232. The Claims Court noted Congress's 1960 enactment of § 402(a)(4) (the predecessor of § 402(e)(2)), containing an exception for certain distributions paid by the U.S. Government as employer. Id. at 89,233. The court further cited Congress's enactment in 1966 of § 871(f), providing an exclusion for certain amounts received as an annuity under a qualifying plan if services were performed outside the United States and the broadening of this provision in 1980. Id. at 89,234; see 96-1 U.S. Tax Cas. (CCH) ¶ 50,391, at 84,152 (approving Claims Court's analysis). The Senate Finance Committee noted, in approving § 871(f) in 1966, that "[u]nder present law a nonresident alien receiving pension or annuity income from a plan

Prior to the enactment of section 864(c)(6), the portion of the pension payment attributable to contributions with respect to U.S. services was noneffectively connected income if the pensioner was no longer engaged in the conduct of a U.S. business.[112] However, the IRS now takes the position that payments attributable to contributions made with respect to U.S. services in years beginning after December 31, 1986, are treated by reason of section 864(c)(6) as effectively connected income.[113]

An exception to U.S. source-based taxation of distributions from a U.S. pension trust is contained in section 871(f) (which is viewed by some as an implicit acknowledgement by Congress of the general rule that the 30% U.S. tax applies to the accretion element of a distribution from a U.S. pension trust).[114] Under this provision, first enacted in 1966,[115] any amount received as an annuity by a nonresident alien from a qualified annuity plan described in section 403(a)(1) or from a qualified trust described in section 401(a) is excluded from gross income if all the alien's services were performed outside the United States and 90% of the employees benefitting

located in the United States is subject to U.S. tax (flat 30% or lower treaty rate) on the interest portion of the pension income notwithstanding the fact that the services qualifying the nonresident alien for the pension were entirely rendered outside the United States." S. Rep. No. 1707, 89th Cong., 2nd Sess. (1966), reprinted in 1966-2 C.B. 1059, 1077. By contrast, Chief Counsel argued that this legislative statement merely reflects IR-Mim. 71, which was obsoleted in 1970, and indicates Congress's "dissatisfaction with the rule of taxing the interest element at least under the circumstances covered by the section." Gen. Couns. Mem. 36,344 (July 23, 1975). See also discussion in Gen. Couns. Mem. 38,007 (July 10, 1979).

112. See Rev. Rul. 79-388, 1979-2 C.B. 270.

113. See supra notes 93-95 and accompanying text.

114. See supra note 111 and accompanying text.

115. The provision was added to the Foreign Investors Tax Act by the Senate Finance Committee. See S. Rep. No. 1707, 89th Cong., 2d Sess. (1966), reprinted in 1966-2 C.B. 1059, 1077. There is no explicit rationale presented for the provision. The report states that "[u]nder present law, a nonresident alien receiving pension or annuity income from a plan located in the U.S. is subject to U.S. tax . . . on the interest portion of the pension income not withstanding [sic] the fact that the services qualifying the nonresident alien for the pension were entirely rendered outside the United States." Id. The report then explains: "Your committee has added an amendment to this provision of the bill which would exempt from U.S. tax the type of pension income described above if 90 percent of the persons under the plan were U.S. citizens." Id. In the Miscellaneous Revenue Act of 1980, Congress expanded this exemption to make "it available to an individual if (1) the recipient's country of residence grants a substantially equivalent [exemption] . . . or (2) the recipient's country of residence is a beneficiary developing country under section 502 of the Trade Act of 1974." S. Rep. No. 96-1036, 2d Sess. (1980), reprinted in 1980-2 C.B. 723, 724. The committee reasoned "that a pension paid to a nonresident alien should be exempt from withholding where his country of residence has unilaterally . . . enacted a provision granting the same relief to U.S. citizens and residents." Id. at 727. It further explained that "employers should be encouraged to provide pensions for their employees in certain developing countries." Id.

from the plan are U.S. citizens or residents.[116] (Thus, row 5 of Table 1, page 359, notes that where section 871(f) applies, no U.S. tax is imposed.)

Distributions from a qualified U.S. plan, if otherwise subject to U.S. tax, may also be subject to the penalty tax on premature distributions[117] and the 15% excise tax on excess distributions.[118]

3. *Funded But Nonqualified Plans.*—If an employer makes contributions to a funded deferred compensation plan in respect of U.S. services performed by a nonresident alien and the plan is not a qualified U.S. plan, then the employee is taxed pursuant to section 402(b)(1) on the value of his interest in the plan once it has vested. This could occur when contributions are made either to a U.S.-based nonqualified plan or to a foreign-based plan, which may be qualified under the foreign country's law, but not under U.S. law.[119] Thus, an alien performing services in the U.S. (not satisfying the exemption for short-term business travelers) is currently taxable on vested employer contributions made to a pension plan in his home country.[120]

If the plan has a U.S. situs, then the U.S. also has a claim to tax accretions on the contributions, which are classified as U.S. source noneffectively connected income. If the individual is a "highly compensated

116. See IRC § 871(f)(1)(A), (B). The latter requirement need not be met if "the recipient's country of residence grants a substantially equivalent" exemption to U.S. citizens and residents. IRC § 871(f)(2)(A). For a recent application of this provision, involving interpretation of the phrase "received as an annuity," see Priv. Ltr. Rul. 95-37-028 (June 21, 1995).

117. See, e.g., Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992) (ruling that a distribution from a rollover IRA to a nonresident alien was not subject to the 10% additional tax of § 72(t) because the distribution was excluded from U.S. gross income under the "other income" article of the U.S.-U.K. Income Tax Convention). See also Priv. Ltr. Rul. 88-37-009 (June 2, 1988) (ruling that § 72(t) was applicable to earnings and accretions distributed from a 401(k) plan to a nonresident alien to the extent the amounts were includible in gross income).

118. See Priv. Ltr. Rul. 88-37-009 (June 2, 1988) (ruling that the 15% excise tax on certain excess distributions is potentially applicable to a distribution to a nonresident alien from a § 401(k) plan, except to the extent of the investment in the contract as defined in § 72(f)). The IRS noted that "[t]here is nothing in the statute, the regulations or the legislative history to indicate that NRA employees should be exempt from this tax." Id. See also Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992) (ruling that a distribution that was excluded from U.S. income tax under the U.S.-U.K. Income Tax Convention was not thereby protected from the excise tax imposed by § 4980A); Bissell, supra note 98, at 79.

119. See 1996 Proposed Rulemaking, supra note 22, ¶ 23 (stating that "[t]he rules of section 402(b) apply to a beneficiary of a nonexempt employees' trust regardless of whether the trust is a domestic trust or a foreign trust"); see also infra notes 266-267 and accompanying text.

120. See Ellis & Navin, supra note 72, at 88; see also Bissell & Giardina, supra note 72, at 279.

individual," then the tax might be imposed as the accretions are earned.[121] Otherwise the tax would be imposed by withholding at the time of distribution. When a distribution is made from a funded but nonqualified plan, the income element is determined under section 72 for a nonresident alien recipient (as for a U.S. citizen).[122] All contributions by the employer are treated as investment in the contract pursuant to section 72(f).[123] Any amount of the distribution in excess of investment in the contract would apparently be considered to be earnings and accretions and would be classified as U.S. source noneffectively connected income subject to the 30% withholding tax of sections 871 and 1441. These results are depicted in Table 1, page 358; row 3 deals with a nonqualified U.S. plan, and row 4 deals with a foreign plan.

4. *Employee Contributions to Retirement Arrangements.*—When a nonresident alien performs services in the U.S., the portion of his compensation that he elects to defer in a 401(k) plan is not currently taxable to him.[124] Similarly, an amount contributed by him to an IRA account[125] is eligible to be deducted in computing his effectively connected income (e.g.,

121. Tax is imposed under § 871(a) on an "amount received." IRC § 871(a); cf. Central de Gas de Chihuahua S.A. v. Commissioner, 102 T.C. 515 (1994) (discussing § 482 allocation).

122. See IRC § 402(b)(2).

123. Contributions made in respect of services performed in the U.S. or as a resident alien would already have been taxable to the employee. See IRC § 402(b)(1). Contributions made in respect of services performed outside the U.S. as a nonresident alien would not have been taxable even if paid directly to the nonresident alien. See IRC § 72(f); Ellis & Navin, supra note 72, at 88. In the case of a highly compensated employee in a plan not satisfying the nondiscrimination requirements, the investment in the contract would presumably also include the accrued benefits prior to the distribution. See infra notes 322-329 and accompanying text.

124. See IRC § 402(e)(3) (providing that "contributions made by an employer on behalf of an employee to a . . . qualified cash or deferred arrangement" are not treated as made available to the employee even though the employee has an election to receive the amounts in cash); Bittker & Lokken, supra note 7, ¶ 61.8.1.

125. Section 219(a) allows any individual a deduction of up to $2,000 for the amount of his "qualified retirement contributions," which include cash payments to an individual retirement account. See IRC § 219(a), (e). Under § 873, a nonresident alien is allowed deductions for purposes of § 871(b) to the extent that such deductions are connected with effectively connected income. See IRC § 873(a). It has been suggested that an IRA might be an attractive investment for U.K. employees working temporarily in the U.S. See Artemis Velahos Koch, IRA Contributions by Foreign Nationals: Long-Term Investments with Short-Term Returns, 25 Tax Adviser 141, 142 (1994) [hereinafter Koch]; see also Bissell, supra note 98, at 77 (noting that aliens "on temporary U.S. assignments [if] excluded from U.S. retirement plans, . . . may often make fully tax-deductible IRA contributions even if their income exceeds the limits prescribed in § 219").

from services performed in the U.S.). However, the portion of a nonresident alien's compensation contributed by him (or by the employer on his behalf) to a foreign retirement arrangement is taxed by the U.S. as current compensation (whether or not the foreign retirement arrangement is qualified in the home country or is an employer-based or personal retirement arrangement).[126] Thus, the result is the same as if the employer makes a contribution to a funded foreign retirement plan (as in row 4 of Table 1, page 358).

5. *Period of U.S. Residence and Exit Tax Proposals.*—A foreign national working in the U.S. for an extended period will often be classified as a resident alien for U.S. tax purposes. The fact of U.S. residence may have little impact on the treatment of his participation in a U.S. qualified[127] plan, however. No tax will be imposed on the employee with respect to such participation prior to distributions being made to him. The entire amount of the distributions from the plan (assuming that the U.S. was the place of employment) would be taxable by the U.S. either on a source basis (if the individual has returned to his home country) or on a residence basis if he has not. See Table 1, row 2, page 358.

U.S. resident status may have greater significance for a foreign national working in the U.S. if he is participating in a *foreign* pension plan. See Table 1, row 4, page 358. The accretion element in a foreign plan has a foreign source and thus would be taxed by the U.S. only if the alien is a U.S. resident at the time when the accretion is properly subject to U.S. tax.[128] Thus, in this situation, a resident alien would generally seek to terminate U.S. resident status before the accretion is subject to tax.

It would be possible for the U.S. to counteract such tax planning by imposing U.S. tax on previously untaxed amounts of accrued foreign pension benefits at the time when an alien's long-term residence is terminated. Thus, the Senate recently approved an "exit tax" on appreciation in the worldwide

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126. An IRA is defined as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries." IRC § 408(a). In addition, the written instrument creating the trust must meet certain requirements in order for the trust to qualify as an IRA. See id.

127. If the individual is performing services in the U.S. and participating in a nonqualified U.S. plan (see Table 1, row 3, page 358), temporary U.S. residence also may be irrelevant because the contributions to a U.S. plan and earnings accrued thereon could be taxed either on a source basis or on a residence basis. However, in the absence of residence jurisdiction, taxation of the accretion might be delayed because § 871 requires an "amount received." See supra note 121.

128. The time for taxing the accretion element in a foreign pension plan may be as benefits accrue if the individual is a highly compensated employee. See supra note 38. Current taxation might also occur under § 679. See infra notes 272, 277-278 and accompanying text. Otherwise, tax would await the time of distribution.

assets of departing long-term residents,[129] including foreign pension plan interests, at least to the extent their value exceeds $500,000.[130] However, the Senate's "exit tax" was replaced in conference with a provision that subjects departing long-term residents (and expatriating citizens) for a period of ten years to expanded U.S. source-based jurisdiction;[131] and this expanded jurisdiction does not extend to foreign pension assets.[132]

C. *Treaty Position*

1. *Pension Distributions.*—The treatment of deferred compensation under U.S. treaties depends upon whether a payment is classified as a "pension" under the pension article of the treaty.

The preferred U.S. treaty position, embodied in the 1981 U.S. Model and most (old and new) U.S. treaties, is to include a pension article providing that pension payments are taxable only in the residence country.[133] This same position has now been endorsed by the Treasury in the 1996 U.S.

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129. See H.R. Rep. No. 736, 104th Cong., 2nd Sess. (1996), partially reprinted in 96 TNT 151-7 (Aug. 2, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter H.R. Rep. No. 736]. For discussion of "exit taxes" imposed by other countries, see infra notes 334-336 and accompanying text. Under the Senate Amendment, expatriating U.S. citizens and departing long-term U.S. residents "are treated as having sold all of their property at fair market value immediately prior to the [expatriating event]." H.R. Rep. No. 736, supra, ¶ 256. "The net gain, if any, on the deemed sale . . . is subject to U.S. tax at such time to the extent it exceeds $600,000. . . ." Id. The rule "generally applies to all property interests held by the individual [at that time] provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date." Id. ¶ 257. For discussion of earlier versions of this proposal, see Staff of the Joint Comm. on Tax'n, 104th Cong., 1st Sess., Issues Presented by Proposals to Modify the Tax Treatment of Expatriation (JCS-17-95) (1995), reprinted in 37 Highlights & Documents 3351 (June 5, 1995) [hereinafter JCT Report on Expatriation].

130. See H.R. Rep. No. 736, supra note 129, ¶ 257 (noting that the Senate Amendment contained an exclusion for "interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans as prescribed by regulations."). See also JCT Report on Expatriation, supra note 129, at 3367, noting similar exclusion in earlier version.

131. See H.R. Rep. No. 736, supra note 129, ¶¶ 230-51, 280. The conference report follows the House bill, which "expands and substantially strengthens in several ways the present-law provisions" in §§ 877, 2107, and 2501(a)(3). Id. ¶ 230. These existing provisions are applied to "certain long-term residents of the United States," and are applied in some situations "without inquiry as to . . . motive." Moreover, the conference report "expands the categories of income and gains that are treated as U.S. source." Id.

132. For a discussion of the types of income covered in the House Bill, see H.R. Rep. No. 736, supra note 129, ¶¶ 236-42.

133. See, e.g., 1981 U.S. Model, supra note 83, art. 18, ¶ 1. Article 15, dealing with dependent personal services, is made "[s]ubject to the provisions of Articl[e] 18." Id. art. 15, ¶ 1.

Model (although with a new limitation on taxation by the residence country).[134] Thus, in rows 2 and 5 of Table 1, pages 358-59, where a distribution is received by a nonresident alien from a U.S. qualified plan, this treaty rule would bar imposition of U.S. tax on the distribution.[135]

This treaty position is consistent with the 1963, 1977 and 1992 OECD[136] Model treaties,[137] although reservations to this aspect of the

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134. The 1996 U.S. Model provides that "pension distributions . . . beneficially owned by a resident of a Contracting State, whether paid periodically or as a single sum, shall be taxable only in that State, but only to the extent not included in taxable income in the other Contracting State prior to the distribution." 1996 U.S. Model, supra note 2, art. 18, ¶ 1; 1996 Treasury Explanation, supra note 2, ¶¶ 241-46. See infra text accompanying notes 296-301 (discussing the new limitation imposed on the residence country).

135. The savings clause of treaties would, however, generally preserve the U.S. right to tax pension income of a U.S. citizen even if he or she is resident in another country at the time of retirement. See, e.g., 1981 U.S. Model, supra note 83, art. 1, ¶¶ 3, 4(a). This may result in double international taxation of pension income derived by a U.S. citizen resident in another country, even though that country is a U.S. treaty partner. In the recent treaty with France, special provisions are included to avoid such double taxation. Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, art. 24, ¶ 2, reprinted in Tax Treaties (CCH) ¶ 3001.04, 27005-13 [hereinafter U.S.-France Income Tax Treaty]. First, in the case of a pension distribution attributable to services performed while the principal place of employment was in the U.S., France agrees to provide an effective exemption from French tax for a U.S. citizen resident in France. Id. art. 24, ¶¶ 2(a)(i), 2(b)(iv). Second, the U.S. agrees generally that where U.S. tax is imposed solely on the basis of citizenship, the U.S. will provide credit for French tax imposed on the basis of residence (e.g., on pension income derived by a French resident/U.S. citizen with respect to employment outside the U.S.). Id. art. 24, ¶ 1(b). See Treasury Department Technical Explanation of the U.S. France Income Tax Treaty, reprinted in Tax Treaties (CCH) ¶ 3058, 27,197-5, discussing art. 24 [hereinafter Treasury Explanation of U.S.-France Treaty].

136. The model tax treaties prepared under the auspices of the League of Nations varied in their approach to the treatment of pensions. Draft Conventions Ia and Ic provided that "[p]ublic or private pensions shall be taxable in the State of the debtor of such income." League of Nations, Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, (C.562.M.178.1928.II) Oct. 31, 1928, Official Journal, Jan. 1929, at 205, 208, 215. The commentary states that "[i]t appeared both right and practical that all pensions should be made subject to the same rules." Id. at 211. It then explains: "In the special case of private pensions, however, the country of the debtor may be taken to be that in which the activity was carried on within the meaning of article 7 [dealing with salaries], or that in which the parties concerned subsequently established their domicile." Id. By contrast, in Draft Convention Ib, source taxation is limited to income from immovable property, income from a industrial, commercial or agricultural undertaking, fees of managers, salaries and wages, or *public* pensions. Id. at 213. In the "Mexico draft convention" of 1943, the Fiscal Committee of the League of Nations provided that private pensions and life annuities should be taxed exclusively "in the State where the debtor has his fiscal domicile." Fiscal Committee, League of Nations, London and Mexico Model Tax Conventions, Commentary and Text

1992 OECD model were noted by Canada, Finland and Sweden.[138] By contrast the 1980 U.N. Model includes two alternative provisions, one consistent with the OECD model and the other allowing source-based taxation of a pension payment "made by a resident of that . . . State or a permanent establishment situated therein."[139] A U.S. treaty that exempts a pension payment from U.S. tax is viewed as also precluding application of section 72(t) (penalty on premature distributions). However, section 4980A, imposing an excise tax on certain excess distributions from a qualified pension plan, may nevertheless be applicable.[140]

Only two major U.S. treaties, those with Canada and the Netherlands, and a few treaties with less important[141] trading partners (Indonesia,[142]

(C.88M.88.1946.II.A.) Nov. 1946, at 66-67. However, in its 1946 "London draft," the Fiscal Committee provided for exclusive taxation of such items "in the State where the recipient has his fiscal domicile." Id. The commentary explains that the Mexico draft's treatment of private pensions is "according to the principle of taxation by origin" and is consistent with the draft's treatment of income from movable capital as taxable only in the country where the capital is invested. Id. at 28, 62. The commentary states that, in the London draft, jurisdiction to tax pensions is given to "the country of fiscal domicile of the creditor, as in the case of interest from debts." Id. at 28. For further discussion of the history of the "pension" article in treaties, see Albert A. Ehrenzweig and F.E. Koch, Income Tax Treaties, 180 (1949).

137. See 1992 OECD Model, supra note 83, art. 18 (entitled "Pensions"). Article 18 provides that "pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State." Id. art. 18. This provision was also included in the 1963 and 1977 OECD Models. See Organization for Economic Cooperation and Development Model for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, Tax Treaties (CCH) ¶ 201, at 10,525-8; Model Income Tax Treaties 58 (Kees van Raad ed., 1983) (comparing the 1963 and 1977 OECD Model Treaties). This provision is subject to an exception provided for pensions paid in respect of government service in article 19. Id. art. 19, ¶ 2. A pension paid by a Contracting State in respect of services to that State is taxable only by that State; however, where the individual is a resident and national of the other State, the other State is given the exclusive right to tax. Id.

138. The Commentary to the 1992 OECD Model notes that "Canada reserves its position on [article 18]"; its negotiating position is to "propose that the country in which the pensions arise be given a limited right to tax." Commentary on the Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital [1992] [hereinafter 1992 OECD Commentary], at C(18)-12. Finland and Sweden, when negotiating conventions, will attempt to "retain the right to tax pensions paid to non-residents, where such pensions are paid in respect of past services rendered mainly within their respective territory." Id.

139. U.N. Dep't of Int'l Economics & Social Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries at 33-34, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. Model]. The commentary notes that the parties were unable to reach a consensus between the two alternative guidelines. Id. at 171-72.

140. See supra notes 117-118 and accompanying text.

141. The U.S.-U.S.S.R. Income Tax Treaty, signed on June 20, 1973, did not contain a pension article. See Priv. Ltr. Rul. 87-21-006 (Jan. 30, 1987) (noting that the treaty

Jamaica,[143] the Philippines[144] and Poland[145]), depart from the U.S. preferred treaty position on pensions. Under the U.S. treaty with Canada, source-based taxation is permitted (in addition to residence-based taxation) but may not exceed 15% of the gross amount of a periodic pension payment.[146] The new treaty with the Netherlands[147] provides that in the case of a private

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does not provide an exemption or lower rate for private pensions). However, the new treaty between the U.S. and the Russian Federation, signed June 17, 1992, contains a provision (article 17) exempting private pensions from source country tax. See Senate Foreign Relations Comm., Report on the 1992-U.S.-Russia Income Tax Treaty and Protocol Nov. 18, 1993, reprinted in 31 Highlights & Documents 3175, 3192, (Nov. 29, 1993).

142. The U.S. treaty with Indonesia provides that both countries may tax "pensions and other similar remuneration in consideration of past employment derived from sources within one of the Contracting States by a resident of the other Contracting State." 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, ¶ 1. However, the source country's tax is limited to 15% of the gross amount. Id. For source rules, see id. art. 7, ¶ 6, art. 21, ¶ 4. The Treasury's Technical Explanation provides that this "rule . . . is a concession to Indonesia's interest, as a developing country, in preserving source-basis taxation." Tax Treaties (CCH) ¶ 4350, at 31,536-37. The recently signed protocol to the treaty does not affect the treatment of pensions. See Protocol Amending the 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 24, 1996, reprinted in Tax Treaties (CCH) ¶ 4345, 31,523, 31,523-2.

143. The U.S. treaty with Jamaica provides that a pension received by a resident of the one state in consideration of "past employment . . . performed in the other Contracting State while such person was a resident of that other State" may be taxed by the latter as well as the former State. Convention Between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 21, 1980, art. 19, ¶ 1, T.I.A.S. 10206. See also Report of the Senate Foreign Relations Committee, Tax Treaties (CCH) ¶ 5055, at 33,571.

144. The U.S. treaty with the Philippines provides that "pensions and other similar remuneration paid to an individual in consideration of past employment shall be taxable by the Contracting State where the service is 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, ¶ 1, T.I.A.S. 10417.

145. The U.S. treaty with Poland does not contain a pension article. See 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, T.I.A.S. 8486. Article 5 provides, in general, for source country taxation. See id. art. 5.

146. Convention Between the United States of America and Canada for the Avoidance of Double Taxation on Income, Sept. 26, 1980, T.I.A.S. 11087, 27 art. 18, ¶¶ 1, 2, [hereinafter U.S.-Canada Income Tax Treaty]. The treaty does not seek to define the source of a pension, but simply allows taxation of pensions "in the Contracting State in which they arise." Id. art. 18, ¶ 2. This aspect of the treaty is not changed by the March 1995 Protocol.

147. See Treasury Department Technical Explanation of the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of

pension that is not paid in the form of periodic payments, the country where the employment is exercised may tax the payment (with allowance of a credit for residence country tax) provided that the individual was a resident of the source country at any time during the preceding 5-year period;[148] this source-based tax does not apply, however, to certain qualified rollovers of the lump sum into a residence country retirement account.[149]

The contours of the term "pension"[150] have not been established

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Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed Dec. 18, 1992, and Protocol signed Oct. 13, 1993, reprinted in 31 Highlights & Documents 1631, 1653-54, (Nov. 2, 1993) [hereinafter Treasury Explanation of Netherlands Treaty]; Sen. Comm. on Foreign Relations, 103d Cong., 1st Sess., Exec. Rept. 103-19, Report on the Tax Convention with the Kingdom of the Netherlands (1993).

148. See 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, Dec. 18, 1992, S. Treaty Doc. No. 6, 103d Cong., 1st Sess. (1992), art. 19, ¶¶ 1-2, art. 25, ¶ 7 [hereinafter U.S.-Neth. Treaty]; see also Treasury Explanation of Netherlands Treaty, supra note 147, at 1631, 1653. Article 25 of the Convention provides that for purposes of allowing the credit for residence-based tax, the U.S. is to treat the lump sum payment as arising in the Netherlands. U.S.-Neth. Treaty, supra, art. 25, ¶ 7. An example of the application of article 19 is provided in Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996), reprinted in 96 TNI 128-24 (July 2, 1996) ¶¶ 6-13 (LEXIS, FEDTAX library, TNI file).

149. The U.S.-Netherlands Tax Convention exempts from source-country tax "the portion of the . . . lump sum . . . that is contributed to a pension plan or retirement account under such circumstances that, if the . . . lump sum had been received from a payer in the State of the recipient's residence, the imposition of tax on the payment by the State of the recipient's residence would be deferred until the amount of the payment was withdrawn from the pension plan or retirement account to which it was contributed." U.S.-Neth. Treaty, supra note 148, art. 19, ¶ 3. See also Treasury Explanation of Netherlands Treaty, supra note 147, at 1653 (explaining that, for example, a lump sum payment from a Netherlands pension plan that was invested in a U.S. IRA would be exempt from Netherlands tax. In this case, explains the Treasury, "the tax avoidance concerns of the Netherlands would not be present.").

150. The commentary to the 1992 OECD model states that article 18 applies to "pensions paid in respect of private employment" as well as "widows' and orphans' pensions and other similar payments such as annuities paid in respect of past employment." 1992 OECD Commentary, supra note 138, at C(18)-1. It is further noted that "a common solution" was not reached regarding "amounts paid to an employee on the cessation of his employment." Id. These amounts are viewed as "a pension . . ., paid as a lump sum" in some countries, "as the final remuneration for the work performed" by others, and in some cases "as a bonus . . . subjected to a gift tax." Id. at C(18)-1-(18)-2. For a discussion of article 18 of the 1992 OECD Convention, see Manfred Gunkel, The Taxation of Pensions (Article 18), 1992/12, Intertax 690. According to Gunkel, to come within this article "the pension has to be paid by the former employer himself or by a separate organization, e.g. an employer's pension fund." Id. at 691. Gunkel explains that article 18 "does not apply to social security pensions [which] are not paid in consideration of past employment" but rather are dealt with under article 21 pertaining to other income. Id. (citing Klaus Vogel on Double Taxation Conventions, Commentary, December 1991, Article 18, annotation 12 and Article 21, annotation 12).

very clearly in the treaty language itself or in technical explanations of the treaties.[151] Private[152] letter rulings have been an important source of law in this area, an approach disconcerting to taxpayers and withholding agents.[153] The Treasury Department's Technical Explanation of the 1996 U.S. Model provides useful insight into the Treasury's current negotiating

151. See, e.g., 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, Dec. 31, 1975, art. 18, ¶ 1, T.I.A.S. 9682 [hereinafter U.S.-U.K. Treaty] (exempting "any pension in consideration of past employment and any annuity"); Technical Explanation of the [U.S.-U.K. Treaty, supra], Tax Treaties (CCH) ¶ 10,941, at 44,553-54 (stating that "[t]he term 'pension' includes payments from qualified retirement plans as well as other forms of retirement benefits paid for services rendered, or by way of compensation for injuries or sickness incurred in connection with past employment."); U.S.-France Income Tax Treaty, supra note 135, art. 18, ¶ 1 (exempting "pensions and other similar remuneration, including distributions from pension and other retirement arrangements . . . in consideration of past employment, whether paid periodically or in a lump sum"); Treasury Explanation of the U.S.-France Treaty, supra note 135, Tax Treaties (CCH) ¶ 3058, at 27,197-31 (explaining that the provision "applies to both periodic and lump-sum payments" and to "pension payments in consideration of past employment that are paid to a resident of the other Contracting State, whether to the employee or to his or her beneficiary.").

152. For published rulings, see Rev. Rul. 56-446, 1956-2 C.B. 1065, 1066 (lump sum distribution from U.S. qualified pension plan to Canadian resident, paid on death or other separation from service, treated as capital gain under § 402(a)(2), was exempt from U.S. tax under article VI A of U.S.-Canada Income Tax Convention, as a pension, or under article VIII, as a capital gain), modified by Rev. Rul. 58-247, 1958-1 C.B. 623, 24 (treaty exemption in latter situation is under article VIII, and not article VI A); Rev. Rul. 58-248, 1958-1 C.B. 621, 622 (similarly, article XII(1) of the U.S.-Australia Income Tax Convention, dealing with pensions and annuities, does not apply to such a distribution treated as capital gain under § 402(a)(2)); Rev. Rul. 71-478, 1971-2 C.B. 490, 490-91 (the term "pension" as used in the U.S.-U.K. Income Tax Convention, article XII, refers to "a stated allowance or stipend paid by an employer in consideration of services rendered, to a retired employee, payment being conditioned on retirement"; thus, bonuses paid in periodic installments as "compensation for services rendered in specific prior years" did not qualify); Rev. Rul. 72-12, 1972-1 C.B. 440, 441 (under U.S.-Sweden Income Tax Convention, article X, the term "private pension" means a pension paid by a private person (in contrast to a government) either directly or through the medium of a trust); Rev. Rul. 72-460, 1972-2 C.B. 659, 660 (supplemental annuity payments in excess of guaranteed minimum payments under retirement annuity contracts qualify as "pensions" under U.S.-Canada Income Tax Treaty, article VI A).

153. See Bissell, supra note 98, at 77 (noting that "virtually all of the IRS' views [on pension or IRA distributions to nonresident aliens] have been expressed in PLRs, which may not formally be relied upon by anyone except the taxpayer to whom the ruling was issued"); IRPAC Paper, supra note 98, issue 1 (recommending that, "for purposes of promoting certainty and uniformity among payors concerning income tax withholding, the Service publish guidance, upon which payors may rely, concerning the treatment of nonperiodic pension and annuity payments under foreign tax treaties which exempt 'periodic' payments from taxation.").

position regarding the definition of the treaty term "pension";[154] but it is not an authoritative interpretation of any particular treaty.[155] This 1996 Technical Explanation is discussed after analysis of the materials interpreting existing treaties.

There is no direct guidance as to whether a payment from an unfunded deferred compensation plan may qualify as a pension; overall, the failure of the IRS or Treasury[156] to refer to "funding" as a requirement leaves the impression that it is not required.[157] However, if an unfunded plan is not designed to provide benefits that are dependent on retirement, it seems unlikely that the treaty article will apply. If the pension article is not applicable, the entire amount paid to the employee is viewed as compensation, and treaty benefits, if any, are under the provision dealing with dependent services.[158] The "183 day" rule of that provision is applied by

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154. See 1996 Treasury Explanation, supra note 2, ¶¶ 242-245.

155. Id. ¶ 6 (explaining that "a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries," and that "[a]nother purpose . . . is to provide a basic explanation of U.S. treaty policy for all interested parties").

156. Id. ¶ 243. The Treasury states that the term "pension" in the 1996 U.S. Model includes "qualified plans under section 401(a), individual retirement plans . . ., non-discriminatory section 457 plans, section 403(a) qualified annuity plans, and section 403(b) plans." Id. ¶ 243. All these examples are funded plans, except that § 457 plans are required to be "unfunded." See IRC § 457(b)(6); Bittker & Lokken, supra note 7, ¶ 60.2.3. The Treasury then states that "competent authorities may agree that distributions from other plans that generally meet similar criteria to those applicable to other plans established under their respective laws also qualify for the benefits of" the treaty. 1996 Treasury Explanation, supra note 2, ¶ 243. The Treasury then lists a series of criteria for U.S. plans that does not include any requirement of funding. Id. See discussion of these criteria at infra notes 181-186.

157. See Bissell & Giardina, supra note 72, at 282 (stating that payments from an unfunded supplemental executive retirement plan (a "SERP") would often qualify as a pension for purposes of U.S. treaties). Bissell and Giardina consider that a lump sum payment from a SERP that complies with the requirements of IRS private letter rulings, described infra in notes 166-167 and accompanying text, might also qualify. Id. However, they note that "the PLRs only deal with distributions from qualified plans, and the IRS has apparently never been faced with the question of whether to apply the same rules to unfunded plans such as a SERP." Id.

158. See Priv. Ltr. Rul. 93-32-038 (May 18, 1993), reprinted in 94 TNI 22-17 (Feb. 2, 1994) (LEXIS, FEDTAX library, TNI file), where despite a lack of compliance with the model "rabbi" trust format of Rev. Proc. 92-64, 1992-2 C.B. 422, the IRS ruled that contributions made by a Canadian employer to a trust to provide deferred compensation benefits to a U.S. citizen key employee were not includible in the employee's income until amounts are actually distributed or made available to him. The IRS further ruled that payments made by the employer to the employee pursuant to the arrangement "shall be treated as dependent personal services income" under article 15 of the U.S.-Canada Income Tax Treaty. Id.

reference to the year in which the services were performed.[159] Thus, in row 1 of Table 1, page 358, the treaty bars imposition of U.S. tax on unfunded deferred compensation received by a nonresident alien only if the payment qualifies as a "pension" or if the "183 day" rule is met.

The IRS has not indicated that a funded deferred compensation plan must be tax-qualified for distributions to come under the "pension" article of treaties, and the Treasury's September 1996 explanations of the treaties with Luxembourg and Austria state explicitly that these treaties do not contain such a requirement.[160] Thus, in rows 3 and 6 of Table 1, pages 358-59, involving a U.S. nonqualified funded plan, any U.S. tax that would otherwise be imposed on the accretion element at the time of distribution is apparently barred.

In addition, even though some treaties define pensions as "periodic payments" made in consideration for services, the IRS[161] has recently stated in a series of private letter rulings that "the term 'periodic' is simply descriptive of a pension payment generally, not a restriction on the manner of payment."[162] The Treasury's Technical Explanation of the U.S.-Nether-

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159. See Rev. Rul. 86-145, 1986-2 C.B. 297, 298 (ruling that in applying article 15 (dealing with dependent personal services) of the U.S.-U.K. Income Tax Convention to compensation earned in the U.S. by a U.K. resident in 1985 but received in 1986, the "183 day" test applies to 1985, the year in which the services were performed); see also 1996 Treasury Explanation, supra note 2, ¶ 212.

160. See Treasury Department Technical Explanation of the Convention Between the Government of the United States of America and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 96 TNT 185-13 (Sept. 20, 1996), ¶ 184 (LEXIS, FEDTAX library, TNT file); Treasury Department Technical Explanation of the Convention Between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 96 TNT 185-15 (Sept. 20, 1996), ¶ 234 (LEXIS, FEDTAX library, TNT file). See also infra note 178 (discussing the U.S.-Canada Income Tax Treaty).

161. Under the U.S.-Canada Income Treaty, only "periodic" payments qualify for the 15% reduced tax rate. U.S.-Canada Income Tax Treaty, supra note 146, at 21,018. One commentator has noted that Revenue Canada applies a narrower definition of the term "periodic" under the treaty than does the IRS. Peat Marwick Urges Renegotiation of Tie-Breaker Rules in U.S.-Canada Income Tax Treaties, 90 TNI 24-18 (April 30, 1990) (LEXIS, FEDTAX library, TNI file) [hereinafter KPMG Letter].

162. Priv. Ltr. Rul. 90-41-041 (July 13, 1990), reprinted in 90 TNT 211-92 (Oct. 16, 1990) (LEXIS, FEDTAX library, TNT file) (interpreting art. 11, ¶ 3 of the U.S.-Swiss Income Tax Convention, which defines a pension as periodic payments made in consideration for services rendered). The IRS ruled that a distribution from a 401(k) plan (whether in a single lump sum or in equal quarterly installments over two years) would be treated as a pension payment, provided that "it meets general United States pension rules," as described infra in the text accompanying note 166. Priv. Ltr. Rul. 90-41-041; see also Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988), reprinted in 89 TNI 6-5 (Feb. 8, 1989) (LEXIS, FEDTAX library, TNI

lands Income Tax Convention, signed in 1992, states that "[i]t is preferred, though not uniform, U.S. treaty policy not to distinguish in treatment between periodic and lump-sum pensions."[163] The proposed treaty with Turkey refers specifically to a pension "whether paid periodically or in a lump-sum."[164]

In recent letter rulings, the IRS has instead provided its own quite specific guidelines for defining the term "pension" (at least in the case of a qualified plan). For example, Private Letter Ruling 95-41-043, interpreting the pension article of the U.S.-India tax treaty,[165] states that:

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file) (applying exemption for pension amounts, under art. 11, ¶ 2 of the U.S.-Germany Income Tax Treaty, defined in art. 11, ¶ 3 as "periodic payments made in consideration for services rendered"). See discussion in Bissell, supra note 98, at 77 (stating that "[t]he major development in the IRS' interpretation of tax treaties has been the IRS' willingness to treat a lump-sum distribution from a tax-qualified U.S. retirement benefits plan as exempt from U.S. tax under a tax treaty—although it has not taken a consistent stance on which theory to rely on"). Bissell cites Priv. Ltr. Rul. 89-34-025 (interpreting the U.S.-U.K. Income Tax Convention) as well as the rulings listed above. Id. at 77-78. He notes that "these rulings mark a clear change from the prior IRS position, even if they cannot be officially relied upon." Id. at 78. Bissell cites, as an example of the IRS' former position, Gen. Couns. Mem. 37,899 (Mar. 26, 1979), where "the Chief Counsel's Office concluded that a lump-sum distribution from a U.S. plan was fully taxable because it violated the 'periodic payment' requirement in the Denmark-U.S. treaty." Bissell, supra note 98, at 79 n.4. See also IRPAC Paper, supra note 98, issue 1, (further citing Priv. Ltr. Rul. 89-01-053, interpreting the U.S.-Swiss Income Tax Convention, as an example of the new IRS position).

163. Treasury Explanation of Netherlands Treaty, supra note 147, at 1653. The Treasury notes that "[i]t is the policy of the Netherlands, however, to preserve by treaty the right of the Netherlands to tax any lump-sum pension payment made in consideration of employment in the Netherlands." Id.

164. Proposed Agreement Between the Government of the Republic of Turkey and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 18, ¶ 1, reprinted in Tax Treaties (CCH) ¶ 10,103, 43,647-63 [hereinafter Proposed U.S.-Turkey Income Tax Treaty]. However, the recently proposed treaties with Austria and Luxembourg do not contain this language. See Proposed Convention Between the Republic of Austria and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 18, reprinted in Tax Treaties (CCH) ¶ 14,017-033 [hereinafter Proposed U.S.-Austria Income Tax Treaty]; Proposed Convention Between the Government of the Grand Duchy of Luxembourg and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 19, ¶ 1, reprinted in Tax Treaties (CCH) ¶ 5701, 35,021-40 [hereinafter Proposed U.S.-Luxembourg Income Tax Treaty].

165. Article 20(3) of that treaty provides that "[t]he term 'pension' means a periodic payment made in consideration of past services or by way of compensation for injuries received in the course of performance of services." Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, art. 20, ¶ 3, reprinted in Tax Treaties (CCH) ¶ 4203, 31,007-023 [hereinafter U.S.-India Income Tax Treaty]. The explanation of the treaty upon which Senate approval was

It is the position of the Service that distributions from a qualified retirement plan will be treated as pension amounts for treaty purposes provided that:

(1) the employee had been employed for 5 years or more prior to the time the benefit is paid, or, if employed for less than 5 years, first employed by the employer (or a related employer) on or after reaching age 60;
(2) the benefit is:
  (A) paid on or after attainment of Social Security retirement age as defined in section 216(l) of the Social Security Act,
  (B) paid on account of the employee's death or disability,
  (C) paid either 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 his or her beneficiary), or paid for the life of the employee (or for the life of the employee and his or her beneficiary), or
  (D) paid after separation from service after attaining age 55; and
(3) all distributions are made after the employee has separated from service with the employer maintaining the plan, except for distributions made on or after the employee attains age 70 and 1/2.[166]

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based stated that the treaty definition of a pension as a periodic payment "excludes a lump-sum pension benefit, which is generally understood to be covered by the corresponding article of the U.S. model treaty." Staff of Joint Comm. on Tax'n, 101st Cong., 2d Sess., Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Republic of India (JCS-20-90) 59 (Joint Comm. Print 1990). Thus, it seems inconsistent for the IRS to interpret the pension article of this treaty in a way that could apparently allow for coverage of a lump sum distribution.

166. Priv. Ltr. Rul. 95-41-043 (Oct. 13, 1995) (involving application of art. 20, ¶ 1, of the U.S.-India Income Tax Convention to distributions from qualified U.S. retirement plans to a resident of India). The IRS found that the requirements quoted in the text accompanying this note were satisfied because "Taxpayer was employed by Corp X for over five years and the monthly distributions from [the plan] will be paid after Taxpayer separated from service with Corp X after attaining age 55." Id.

The separation from service requirement would be violated if the employee begins work for a related employer within five years.[167]

One commentator has questioned "what basis (if any) these tests may have in the Code, the regulations, or in non-tax statutory law or regulations."[168] The IRS has stated that these tests for classification as a pension[169] "ensure that the Distributions will occur upon retirement after long-continued and faithful service."[170] In the recent *Clayton* decision,[171] the U.S. Court of Federal Claims treated the "pension" article of the U.S.-Canada treaty as inapplicable to the U.S.-sourced "accretion" portion of a 1986 distribution on termination of Chrysler's employee stock ownership plan paid

167. See Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988) (ruling applying U.S.-Germany Income Tax Treaty). This will result in disqualification from the point of rehiring and in retroactive disqualification if the rehiring was intended by the employer at the point of cessation. Id.

168. Bissell, supra note 98, at 78. In a recent private ruling, the IRS noted that requirement (2) described in the text accompanying note 166 is similar to the requirements of § 72(t)(2)(A) of the Code. Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996), at 9-10.

169. The IRS has addressed the treaty definition of a "pension" most recently in Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996), which interprets the U.S.-Netherlands Income Tax Treaty signed in 1992. A provision of that treaty permits the U.S. to tax a lump sum pension distribution in respect of U.S. employment made to a Netherlands resident who had been a U.S. resident within the previous five years. Id. at 6. The IRS determined that this provision applied to a lump sum payment made out of a "pure rollover" IRA, which was created from funds distributed upon the termination of a qualified section 401(a) retirement plan and transferred to a spouse pursuant to a Qualified Domestic Relations Order. Id. at 7-9. In addition, the IRS held that the payment did not qualify for exemption as "other income" under the treaty. Id. at 10-11. The IRS reasoned that "[w]hile a pension is not specifically defined under the Code, it is considered to be a payment in consideration of services rendered and conditioned on retirement." Id. at 7. The IRS further explained that "[a] payment from a qualified retirement plan under section 401(a) of the Code is a payment in consideration of services and is conditioned upon retirement and is commonly referred to as a pension for U.S. tax purposes." Id.

170. Priv. Ltr. Rul. 89-04-035 (Oct. 31, 1988) (ruling applying U.S.-Germany Income Tax Treaty). As support for its ruling, the IRS states: "See Rev. Rul. 71-478, 1971-2 C.B. 490; Staff of Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, 713 (Joint Comm. Print 1987) (explaining Congress' intent not to penalize under section 72(t) distributions the timing or character of which reflect a genuine intent to retire); cf. Schellfeffer v. U.S., 343 F.2d 936, 941 (Ct. Cl. 1965) (employee not 'retired' within the intendment of a law increasing federal pensions, if he or she resigns early in his or her career)." See also Priv. Ltr. Rul. 89-34-025 (May 25, 1989) (applying exemption under article 18 of U.S.-U.K. Income Tax Treaty to lump sum distribution; and providing identical explanation). In Revenue Ruling 71-478, interpreting the term "pension" under article 12 of the predecessor U.S.-U.K. Income Tax Treaty, the IRS explained that payment of a pension is "deferred until after retirement in order to induce 'long-continued and faithful service.' "

171. Clayton v. United States, 95-2 U.S. Tax Cas. (CCH) ¶ 50,391, 76 A.F.T.R.2d (RIA) 95-5197 (Cl. Ct. 1995), aff'd, 96-1 U.S. Tax Cas. (CCH) ¶ 50,314 (Fed. Cir. 1996).

to Canadians employed by Chrysler's Canadian subsidiaries.[172] It agreed with IRS reasoning that "payment of a pension for purposes of the Treaty must be contingent on retirement."[173]

The IRS apparently views a distribution from an IRA as outside the scope of the term "pension" as used in "most treaties."[174] However, distributions from IRA's containing solely rollover distributions from qualified plans (and earnings thereon) may in some cases[175] be treated as a pension,[176] although application of this rule by withholding agents may

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172. The *Clayton* court stated that "[t]he distribution at issue is neither a pension nor an annuity under United States tax law, but a distribution from a stock bonus plan." Id. at 89,240, 76 A.F.T.R.2d at 95-5224.

173. Priv. Ltr. Rul. 86-33-081 (May 27, 1986) (cited in *Clayton*, 95-2 U.S. Tax Cas. at 89,240, 76 A.F.T.R.2d at 95-5224). According to the ruling, the ESOT plan provided that "distributions . . . may be made on the employee's separation from service and are thus not contingent on an employee's age or retirement." Priv. Ltr. Rul. 86-33-081 (May 27, 1986).

174. See IRPAC Paper, supra note 98, (issue (8)) (citing Priv. Ltr. Rul. 92-53-049, Priv. Ltr. Rul. 91-43-067, and Priv. Ltr. Rul. 89-04-036). The IRPAC Paper states that: "it appears that the Service may take the position that an IRA is not a 'pension' within the meaning of most treaties, unless it is a 'pure' pension rollover IRA. . . . [The Service might adopt this position] notwithstanding the fact that such vehicles may be used for retirement savings." Id. In the first of the rulings cited above, the IRS stated: "Generally, an IRA is not a pension. However, in certain circumstances a distribution from an IRA that consists solely of amounts rolled over from a qualified pension plan and earnings thereon will be treated as a pension distribution for purposes of the pension article in a treaty." Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992). In Priv. Ltr. Rul. 91-43-067 (July 31, 1991), discussed in Bissell, supra note 98, at 78, the IRS stated that the treatment of "withdrawals from [IRAs] that do not qualify as a pure rollover IRA is currently under study." See also KPMG Letter, supra note 161 (stating that the IRS interprets the term "pension" in the Canadian treaty to refer to "pensions paid by private employers" or the U.S. or Canada). KPMG concludes that an IRA would not qualify "[s]ince the individual may establish these plans on their own account and receive a distribution from the plan upon demand prior to retirement. . . ."). Id.

175. Recently, the IRS stated its position that the term "pensions" includes a distribution in compliance with requirement (2), quoted in the text accompanying note 166, that is made from a "pure rollover IRA," i.e., an IRA that "contain[s] only distributions from qualified retirement plans (plus earnings thereon) that meet the above requirements and are themselves treated as pensions." Priv. Ltr. Rul. 95-41-043 (Oct. 13, 1995) (applying pension article of U.S.-India Income Tax Convention to periodic distributions from an IRA created by a rollover from two qualified defined contribution plans sponsored by a U.S. employer). See also Priv. Ltr. Rul. 89-04-036 (Oct 31, 1988) (pension article of U.S.-Italy Income Tax Treaty exempted distributions from an IRA, into which lump sum distributions from U.S. qualified retirement plans had been rolled over). In the latter ruling, the IRS stated that "amounts otherwise qualifying as pension payments . . . which are rolled over into a segregated IRA and which qualify as 'rollover contributions' under section 408(d)(3) . . ., will continue to qualify as pension payments under the Treaty, including interest earned while in the IRA." Id.

176. See Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996), where the IRS ruled that a lump sum distribution from a "pure rollover" IRA that had been transferred to a Netherlands resident pursuant to a Qualified Domestic Relations Order was pension income and thus taxable under

be difficult.[177] Moreover, the March 17, 1995 protocol to the U.S.-Canada Income Tax Treaty expands the coverage of the pension article to include an IRA.[178]

In its explanation of the 1996 U.S. Model, the Treasury has set forth its current negotiating position regarding the definition of a "pension" (which is not necessarily its interpretation of existing treaties). The text of article 18 of the 1996 U.S. Model refers to "pension distributions and other similar remuneration . . . whether paid periodically or as a lump sum."[179] The Treasury's Explanation specifies that this provision applies to "qualified plans under section 401, individual retirement plans . . ., nondiscriminatory section

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art. 19, ¶ 2 of the U.S.-Netherlands Income Tax Treaty. See supra note 169. The IRS explained that "certain conditions must be met for a distribution from a 'pure-rollover' IRA to be treated as a pension for purposes of a treaty, in order to ensure that the distribution is made as a retirement benefit." Priv. Ltr. Rul. 96-26-055. "These conditions are similar to those prescribed under section 72(t)(2)(A) . . . for avoiding the 10 percent additional tax upon an early withdrawal. . . ." Id. The Service reasoned that because the "additional tax does not apply in the case of a distribution to a divorced spouse pursuant to a QDRO [by reason of the exception in section 72(t)(2)(C)], such distributions . . . are to be treated as retirement benefits in all events." Id. The IRS will not, it explained, "impose conditions for treaty purposes that are not otherwise required to affect the U.S. tax consequences of the distribution." Id.

177. See IRPAC Paper, supra note 98, issue 8. The IRPAC Paper points out that "[t]he original source of funding for an IRA is not always clear to a payor of IRA distributions, especially where the IRA was established pursuant to a rollover or direct transfer from another IRA at a different institution." Id. Accordingly, the Paper suggests, "the different withholding rules that apply to IRAs, based on the original source of such funds, leads [sic] to confusion and undue administrative burdens to the payor." Id. Bissell recommends that taxpayers "discuss the U.S. tax and treaty rules in advance with the IRA fiduciary, so as to anticipate whether the fiduciary will withhold tax." Bissell, supra note 98, at 80.

178. Revised Protocol Amending the 1980 Tax Convention with Canada, Mar. 17, 1995, art. 9, ¶ 1 (replacing art. 18, ¶ 3 of the U.S.-Canada Income Tax Treaty, signed September 26, 1980) reprinted in Tax Treaties (CCH) ¶ 1946 [hereinafter 1995 Revised Protocol]. The reference in the 1980 treaty to a "superannuation, pension or retirement plan" was changed to a "superannuation, pension or other retirement arrangement." See id. This change "clarifies that the definition of pensions includes, for example, payments from [an IRA or a Canadian registered retirement savings plan or registered retirement income fund]." Joint Comm. on Tax'n, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCS-15-95), May 23, 1995, (Joint Comm. Print 1995). See also Treasury Department Technical Explanation of the Protocol Amending the Convention Between the United States of America and Canada (June 13, 1995), 95 TNT 115-64 (June 14, 1995) (LEXIS, FEDTAX library, TNT file) [hereinafter Treasury Explanation of Revised Protocol to U.S.-Canada Treaty]. The Treasury Explanation further states: "The term 'pensions' also would include amounts paid by other retirement plans or arrangements, whether or not they are qualified plans under U.S. domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the Internal Revenue Code." Id.

179. See 1996 U.S. Model, supra note 2, art. 18, ¶ 1. The Treasury states that "[t]he same result is understood to apply in U.S. treaties that do not make this point explicitly." 1996 Treasury Explanation, supra note 2, ¶ 242.

457 plans, section 403(a) qualified annuity plans, and section 403(b) plans." All these examples of included plans are funded plans, except that section 457 plans are required to be "unfunded."[180]

The Treasury further explains that "Competent Authorities may agree that distributions from other plans that generally meet similar criteria to those applicable to other plans established under their respective laws also qualify for the benefits of" the treaty. The criteria listed for the U.S. by Treasury[181] are that the plan

(a) be "written";
(b) be "nondiscriminatory" in the case of an employer-sponsored plan;[182]
(c) contain restrictions on non-retirement use of assets by participants;[183] and "in all cases be subject to tax provisions that discourage participants from using the assets for purposes other than retirement;" and
(d) require minimum distributions so that death benefits to survivors are merely incidental.[184]

It would seem that the second part of criteria (c) would not be met by most plans that are ineligible for tax-qualified treatment under the Code.

Finally Treasury in its explanation of the 1996 U.S. Model restates the position previously announced in private rulings that "certain distribution requirements" (essentially those set forth in the private rulings)[185] "must be met before distributions from these plans would fall under" the treaty provision.[186]

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180. See IRC § 457(b)(6); Bittker & Lokken, supra note 7, ¶ 60.2.3.

181. See 1996 Treasury Explanation, supra note 2, ¶ 243.

182. Treasury states that "[i]n the case of an employer-maintained plan, the plan must be nondiscriminatory insofar as it (alone or in combination with other comparable plans) must cover a wide range of employees including rank and file employees, and actually provide significant benefits for the entire range of covered employees." Id.

183. Treasury states that "[i]n the case of an employer-maintained plan the plan must contain provisions that severely limit the employees' ability to use plan assets for purposes other than retirement." Id.

184. Treasury states that "[t]he plan must provide for payment of a reasonable level of benefits at death, a stated age, or an event related to work status, and otherwise require minimum distributions under rules designed to ensure that any death benefits provided to the participants' survivors are merely incidental to the retirement benefits provided to the participants." Id. ¶ 243.

185. See supra notes 166-168 and accompanying text.

186. These are that "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"; and "the distribution must be either (A) on account of death or disability, (B) as part of a series of

Payments of funded deferred compensation that do not qualify under the "pension" article of a treaty may come under the "other income" article. For example, in its recent decision in *Clayton*, the U.S. Court of Federal Claims agreed with the IRS position that the "accretion" element of a 1986 distribution to Canadian employees working in Canada in termination of Chrysler's employee stock ownership plan was subject to article 22 of the U.S.-Canada Treaty, dealing with "other income."[187] Similarly, the IRS has ruled that a distribution from a rollover IRA made before age 59-1/2 (and thus not classified as a "pension") was to be classified as "other income" under the U.S.-U.K. treaty; as a result the distribution was exempted from U.S. tax.[188] This treaty classification may not be available, however, to the extent that distributions are subject to section 864(c)(6) (because they are attributable to deductible contributions made with respect to services performed after 1986).[189] In addition, some treaties, such as the U.S.-

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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"; and finally that "the distribution must be made either after separation from service or on or after attainment of age 65." 1996 Treasury Explanation, supra note 2, ¶ 244. And the distribution cannot be "solely due to termination of the pension plan." Id.

187. *Clayton*, 95-2 U.S. Tax Cas. (CCH) at 89,241, 76 A.F.T.R.2d (RIA) at 95-5226. Under art. 22, ¶ 1, other income arising in the U.S. can be taxed by the U.S. Id. The *Clayton* court held that paragraph two of article 22, providing a maximum rate of 15% for distributions from a trust resident in one country to a resident of the other country, was applicable. Id. The taxpayer had unsuccessfully argued that the distribution represented "remuneration" for services rendered outside the U.S., and, therefore, was exempt under article 15 (dependent personal services). Id. at 89,239-40, 76 A.F.T.R.2d (RIA) at 95-5223-24. This argument was also rejected on appeal. See Clayton v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 50,314, 77 A.F.T.R.2d (RIA) 96-2484 (Fed. Cir. 1996).

188. See Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992). The IRS further ruled that the second sentence of art. 22, ¶ 1, denying an exemption for income from trusts, was inapplicable to an IRA trust. See discussion in Bissell, supra note 98, at 79-80. The IRS had applied this article of the U.S.-U.K. Income Tax Convention to a distribution from a non-rollover IRA annuity in a 1984 private letter ruling. Id. (citing Priv. Ltr. Rul. 84-22-069). By contrast, in Priv. Ltr. Rul. 96-26-055 (Apr. 11, 1996), the IRS treated a lump-sum distribution from a "pure rollover" IRA, transferred to a spouse pursuant to a QDRO, as "pension income," and thus rejected the taxpayer's argument that the distribution qualified for a treaty exemption as "other income." See supra notes 169 & 176.

189. Bissell points out that in Priv. Ltr. Rul. 92-53-049 (Oct. 6, 1992), the IRS noted that no U.S. services were performed by the employee after August 1984, for which pension contributions were made, and it concluded that § 864(c)(6) does not apply to distributions from the rollover IRA. Bissell, supra note 98, at 79. Bissell states that "[t]here is an implication in these comments that if the individual had worked in the United States after 1986 . . ., to that extent the Article 22 exemption might not have been available." Id. (footnote omitted). In that case, Bissell concludes, the distributions might have been classified as "the payment of deferred U.S. source compensation under § 864(c)(6) that is subject to U.S. tax under the 'dependent personal services' article of the relevant tax treaty." Id. at 80.

Mexico treaty, do not provide an exemption from source-based taxation for "other income."[190]

2. *Pension Contributions.*—The basic treaty provision providing for exclusive residence taxation of pensions (just discussed) is applicable only to pension *distributions* and not to pension *contributions.* In the 1981 U.S. Model and in most U.S. treaties, there is no limitation on source-based taxation of pension contributions. Thus, in rows 3 and 4 of Table 1, page 358, involving a U.S. nonqualified funded plan and a foreign funded plan, respectively, the 1981 U.S. Model does not block the U.S. source-based tax on contributions in respect of U.S. services performed by a nonresident alien.

The commentary to the 1992 OECD Model Treaty does, however, suggest a provision[191] that would ameliorate the treatment of employee contributions to *home country* pension plans for employees assigned to work abroad.[192]

Such a provision was added to the treaty between the U.S. and France by a 1984 protocol,[193] and was again included in the revised treaty signed on August 31, 1994. Under the 1994 provision, for example, contributions paid by or on behalf of a French citizen who is a U.S. resident to a retirement arrangement established in France and qualifying for tax relief (with respect to contributions) in France is to be treated in the same way by the U.S. as a U.S. retirement arrangement qualifying for tax relief (with respect to contributions) in the U.S. provided that the U.S. competent authority agrees that the French arrangement corresponds to an arrangement qualifying for tax

190. The 1996 U.S. Model does provide for exclusive taxation by the residence country of income not dealt with in other articles of the Model. 1996 U.S. Model, supra note 2, art. 21, ¶ 1.

191. Under the proposed provision in the 1992 OECD Commentary, the host state is to accord the employee relief for contributions made by him to a pension scheme in the home country comparable to that accorded contributions to a pension plan in the host country. To achieve this, the employee must not have been a resident of the host country and must have been contributing to the home country pension scheme before taking up employment in the host country, and the home country scheme must be "accepted by the competent authority" of the host country "as generally corresponding to a pension scheme recognised as such for tax purposes by [the host country]." 1992 OECD Commentary, supra note 138, at C(18)-4. See also Andersen, supra note 1, at 95-96; Sassesville, supra note 83, at 129, 135 (1993); Gunkel, supra note 150, at 690-93.

192. 1992 OECD Commentary, supra note 138, at C(18)-2.

193. See Protocol to the Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property of July 28, 1967, signed Jan. 17, 1984, art. 8, (adding ¶ 5 to article 19 of the 1967 treaty), reprinted in Tax Treaties (CCH) ¶ 3038, 27,073.

relief in the U.S.[194] A similar provision was also included in article 19 of the U.S.-Sweden Tax Convention, signed on September 1, 1994, and in the proposed treaties with Austria and Switzerland, signed in 1996.[195] The Treasury Department's Technical Explanation of the French and Swedish provisions suggests that (as in the Commentary to the 1992 OECD Model[196]) they provide only for deductions of employee contributions, and not an exclusion for employer contributions.[197]

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194. U.S.-France Income Tax Treaty, supra note 135, art. 18, ¶ 2(a), (b)(iii), Tax Treaties (CCH) ¶ 3001.04, 27,005-13; see also Treasury Explanation of the U.S.-France Treaty, supra note 135, Tax Treaties (CCH) ¶ 3058, 27,197-31 (noting that this provision is "based on . . . the suggested provision set forth in the Commentaries to Article 19 of the 1992 OECD Model").

195. Convention Between the Government of Sweden and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 1, 1994, art. 19, ¶ 4, Tax Treaties (CCH) § 8801, 41,505-11 [hereinafter U.S.-Sweden Tax Convention]; Treasury Technical Explanation of 1994 U.S.-Sweden Income Tax Treaty, Tax Treaties (CCH) ¶ 8802A, 41,505-66 [hereinafter Treasury Explanation of U.S.-Sweden Treaty]. Proposed U.S.-Austria Income Tax Treaty, supra note 164, art. 18, ¶ 5. Proposed Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, signed Oct. 2, 1996, art. 28, ¶ 4, 96 TNI 194-41 (Oct. 4, 1996) (LEXIS, FEDTAX library, TNI file). The Swedish provision differs from the provision in the French treaty by requiring that "contributions [be] paid by, or on behalf of, such individual to [the home country] arrangement before [the individual becomes] a resident of the [host country]." U.S.-Sweden Tax Convention, supra, art. 19, ¶ 4(a)(i), Tax Treaties (CCH) ¶ 8801, 41,505-11.

196. The 1992 OECD Commentary states that the proposed provision's reference to "[c]ontributions borne by an individual" is intended to include only an employee's contributions, and that the provision "is silent on the treatment of" an employer's contributions. However, the Commentary suggests that "Member countries may wish to extend" the provision "to ensure that employers contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive." 1992 OECD Commentary, supra note 136, at C(18)-4, C(18)-10.

197. The language of the treaties with Sweden and France refers to "contributions paid by, or on behalf of," an individual to a home country plan being "treated in the same way for tax purposes" as contributions to a host country plan. U.S.-France Income Tax Treaty, supra note 135, art. 18, ¶ 2(a); U.S.-Sweden Tax Convention, supra note 195, art. 19.4(a). But the Treasury's Technical Explanation states that the provision "permits" the employee "to deduct contributions . . . that are made by or on his behalf" to certain home country plans "to the same extent that deductions would be permitted" for contributions to a host country plan. Treasury Explanation of the U.S.-France Treaty, supra note 135 (discussing art. 18); see Treasury Explanation of the U.S.-Sweden Treaty, supra note 195 (discussing art. 19 (similar language)). But cf. Letter of Price Waterhouse to Cynthia Beerbower, International Tax Counsel, dated June 7, 1994, 94 TNI 136-20 (July 15, 1994) (LEXIS, FEDTAX library, TNI file), recommending that a provision like art. 19(5) of 1967 U.S.-France Treaty be added to U.S. Model Treaty [hereinafter PW Letter]; and Section of Taxation, ABA, Comments on Income Tax Treaty Between Finland and the United States, dated Nov. 1, 1990, 90 TNI 48-71, (Nov. 28, 1990) (LEXIS, FEDTAX library, TNI file), recommending inclusion of a provision

The Treasury has now indicated that its policy is to negotiate for inclusion of such a provision in future treaties in order to "ensure that certain differences between the two Contracting States' laws regarding pension contributions and pension plans will not inhibit the flow of personal services between the Contracting States."[198] The 1996 U.S. Model Treaty contains a provision of this nature that is in some ways broader in scope than the provisions in the French and Swedish treaties. Under the provision in the 1996 Model,[199] an individual performing services in the U.S. who has already participated[200] in a pension plan recognized under the legislation of the other country and generally corresponding to a tax-qualified U.S. pension plan is eligible for three treaty benefits:[201] (1) contributions to the plan are deductible (if made by the employee) or excludable if made by the employer, up to the limits applied by the U.S. to U.S. tax-qualified plans;[202] (2) the U.S. may not tax earnings in the plan prior to distribution; and (3) the U.S. may not tax distributions rolled over into a U.S. tax-qualified plan pursuant to U.S. rules.[203] Moreover, the 1996 Model's provision also allows the employer in such a case to deduct contributions in computing taxable income in the U.S., subject to the limits that would be applied to a U.S. plan.[204]

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like art. 19, ¶ 5 of the 1967 U.S.-France Treaty [hereinafter ABA Comments]. Price Waterhouse suggests that this provision would "ensure that employees do not lose the opportunity to continue sharing in benefit programs and are not unduly burdened with income tax on employer contributions during the period of residency in the country in which the employee is not a citizen." PW Letter, supra. The ABA Tax Section suggests that art. 19, ¶ 5 of the 1967 French treaty is an example of "a provision for mutual recognition by each Contracting State of the qualification of a retirement plan under the other Contracting State's rules, both for the purposes of deductions by employers and timing of inclusion by employees." ABA Comments, supra.

198. 1996 Treasury Explanation, supra note 2, ¶ 251.

199. 1996 U.S. Model, supra note 2, art. 18.6.

200. The Treasury states that "the individual . . . must be a visitor to the host country," in that the provision applies "only if he was contributing to the plan in his home country." 1996 Treasury Explanation, supra note 2, ¶ 257.

201. These benefits are not denied by the savings clause to U.S. residents who are neither U.S. citizens nor permanent residents. 1996 U.S. Model, supra note 2, art. 1.5(b).

202. See 1996 Treasury Explanation, supra note 2, ¶¶ 252-254. Treasury explains that "the exclusion of employee contributions from the employee's income . . . is limited to elective contributions not in excess of the amount specified in section 402(g)." Id. ¶ 254. The Treasury further explains that "the benefits [under art. 18, ¶ 6] are limited to the benefits that the host country accords under its law, to the host country plan most similar to the home country plan." Id. ¶ 258.

203. Id. ¶ 256.

204. See 1996 U.S. Model, supra note 2, art. 18, ¶ 6; 1996 Treasury Explanation, supra note 2, ¶¶ 253-254. The Treasury explains that the employer's deduction "is subject to the limitations of sections 415 and 404." Id. ¶ 254.

D. *Rationale for Source-Based Taxation*

1. *Unfunded Deferred Compensation.*—It is clearly within international norms for the U.S. to tax current salary paid to a nonresident alien performing services in the U.S. as effectively connected income. The OECD Model provides for such source-based taxation of compensation for dependent services, subject to a "short-term business travel" exception (which is incorporated in U.S. treaties, as well as in the Internal Revenue Code in a narrower version). Presumably, the host country is viewed as providing valuable benefits to the employee by providing the situs for his employment.[205]

Unfunded deferred compensation is viewed by the U.S. as merely a delayed substitute for current compensation in that it comes directly from the employer. Thus, the U.S. considers it appropriate to apply the same treatment to eventual payments of unfunded deferred compensation as to current payment of compensation. The enactment of section 864(c)(6) (taxing deferred compensation as effectively connected income) apparently does not conflict with any treaty obligations of the U.S.[206]

Presumably, it would be permissible under international norms for the U.S. to adopt a broader concept of constructive receipt or economic benefit that would result in current taxation of the present value of unfunded deferred compensation.[207] The generosity of the U.S. in not taxing currently does not seem a valid reason for precluding it from taxing at a later date more convenient to the employee.[208]

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205. See, e.g., David Gliksberg, The Effect of the Statist-Political Approach to International Jurisdiction of the Income Tax Regime—The Israeli Case, 15 Mich. J. Int'l L. 459, 472 (1994) (proposing that "[j]ustification for imposing [tax on foreign taxpayers on a territorial basis] is centered on the connection between income and governmental expenditure incurred in creating a working environment to enable the production of that income").

206. See ABA, Section of Tax'n, Issues Paper on Technical Corrections to the Tax Reform Act of 1986 Relating to Tax Treaties at nn.63-66 (July 1, 1988), available in 88 TNT 146-39, (July 15, 1988) (LEXIS, FEDTAX library, TNT file) (indicating general agreement that § 864(c)(6) added by the 1986 Act is not inconsistent with any treaties).

207. For example, in 1978, the IRS published proposed regulations providing that "if a taxpayer . . . individually chooses to have payment of some portion of his current compensation . . . deferred and paid in a later year, the amount will nevertheless be treated as received by the taxpayer in the earlier taxable year." Notice of Proposed Rulemaking, Deferral Tax Treatment of Amounts of Compensatory Payments [LR-194-77], 43 Fed. Reg. 4638 (1978) (IRS explanation of proposed regulation). The Revenue Act of 1978 barred the Treasury from implementing this proposal. Pub. L. No. 95-600, § 132(a), 92 Stat. 2763, 2782-83 (1978).

208. This argument has been made in the context of state taxation of pensions of nonresidents. See Walter Hellerstein & James C. Smith, State Taxation of Nonresidents' Pension Income, 56 Tax Notes 221, 224 (July 13, 1992) [hereinafter Hellerstein]. They argue that the fact that the state as "a matter of legislative grace" accorded deferral when pension

2. *Different Treatment of Funded Deferred Compensation.*—A distribution to an employee from a funded pension plan can be conceptualized in the same way as a payment of unfunded deferred compensation, i.e., as a substitute for current compensation.[209] The amount to be received by the employee on a deferred basis should be greater than the amount he would receive on a current basis because the funds can be invested in the interim. Thus, under this approach, the full amount of the deferred payment would be classified as compensation.

Such an approach was advocated by the Chief Counsel in 1975 with respect to a qualified U.S. pension plan,[210] but was eventually rejected by the IRS in favor of a "bifurcated" approach. Under the bifurcated approach, only the amount contributed by the employer (or by the employee on a tax-deferred basis) to a funded plan is viewed as compensation to be sourced on the basis of the place of performance of services. The "accretions" earned in the retirement trust by investment of the contributions is viewed as a separate element of investment income for the employee, which is sourced to the U.S. if the trust has a U.S. situs.

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rights were earned should not be used as a basis for "prevent[ing] a state from taxing income earned within its borders." Id.; see also Jean M. Klaiman, Note: Take the Money and Run: State Source Taxation of Pension Plan Distributions to Nonresidents, 14 Va. Tax Rev. 645, 664 (Winter 1995) [hereinafter Klaiman]. Nevertheless, the recent federal legislation barring state taxation of pensions paid to nonresidents does appear to apply to unfunded deferred compensation that qualifies as an executive excess benefit plan or is paid in periodic installments for at least 10 years. See Pub. L. No. 104-95, 104th Cong., 1st Sess. § 1(a), (1996) (adding 4 U.S.C. § 114); Amy Hamilton, Clinton Signs Source Tax Bill, 96 TNT 8-4 (Jan. 11, 1996) (LEXIS, FEDTAX library, TNT file) [hereinafter Hamilton].

209. Gen. Couns. Mem. 36,344 (July 23, 1975) at *9; Gen. Couns. Mem. 38,007 (July 10, 1979) at *4-5. It was the Chief Counsel's position that "[e]xemptions in treaties for pensions have always been applied to pensions as a whole." Gen. Couns. Mem. 36,344 at *11 (July 23, 1975). In addition, Chief Counsel cited Rev. Rul. 72-3, 1972-1 C.B. 105, for the proposition that a "pension is a substitute for current compensation." Id. As yet further support, Chief Counsel cited Gen. Couns. Mem. 35,894 (July 11, 1974), "in which a lump sum payment from a qualified employee's profit-sharing plan in excess of the employee's own contributions is [treated as] business income for purposes of computing a net operating loss." Id. at *6, *11. Counsel also pointed to: H.R. Rep. No. 2, 70th Cong., 1st Sess. 22 (1927) ("to the effect that distributions from a pension trust are taxed as compensation"); and Rev. Rul. 73-252, 1973-1 C.B. 337 (holding that "supplemental unemployment benefits paid to [a NRA] who performed all his services outside the United States from a tax-exempt trust operated by a domestic voluntary employee's association constitutes income from" foreign sources). Id. at *12-13.

210. Gen. Couns. Mem. 36,344, supra note 209. In 1979, Chief Counsel, although restating the same objections, acquiesced in ITC's approach and concurred in the adoption of Rev. Rul. 79-388. Gen. Couns. Mem. 38,007, supra note 209. See also supra notes 108-111 and accompanying text.

International Tax Counsel criticized the Chief Counsel's approach of sourcing the entire distribution based upon the place of performance of services as:

> represent[ing] an unwarranted transmutation of a provision for tax deferral into one which unilaterally concedes primary tax jurisdiction on certain U.S. source income to foreign taxing authorities.[211]

Thus, International Tax Counsel apparently supported bifurcation as a means to strengthen U.S. source-based jurisdiction: i.e., to allow the U.S. to impose tax on the accretion portion of a distribution to a nonresident alien from a U.S. pension plan even if the employee performed all his services outside the U.S. This situation could occur, for example, when the employer is a U.S. multinational. International Tax Counsel apparently did not believe that an employee should have the advantage of investing in U.S. assets through a tax-exempt U.S. pension trust and at the same time avoid U.S. tax on the distribution of such investment earnings. The statement by International Tax Counsel may also suggest that a strong assertion of source-based jurisdiction over pensions might be a useful tool in bilateral negotiations for a reciprocal source-country exemption for pensions.

These policies are undercut, however, by enactment of section 871(f) exempting from U.S. tax any amounts received as an annuity from a qualified pension trust by a nonresident alien if all of the services were performed outside the U.S. and at least 90% of the employees benefitting under the plan are U.S. citizens or residents.[212] It is hard to explain how the ceding of U.S. jurisdiction with respect to "accretions" earned in a U.S. pension trust becomes more or less warranted in principle depending on what percentage of the beneficiaries under the plan are nonresident aliens.

Overall, it seems advisable for Congress to amend the Internal Revenue Code so as to treat the entire amount of a distribution from a U.S. qualified pension plan as compensation (to be sourced to the place where the services were performed). This change would greatly simplify U.S. source-based taxation of distributions from U.S. qualified pension plans (when there is no treaty bar to taxation); with this change, it would no longer be necessary to separately identify the "accretions" element of a distribution or to determine whether the requirements of section 871(f) are met. The source-based jurisdiction that the U.S. would thereby surrender has already been

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211. Gen. Couns. Mem. 38,007, supra note 209, at *6-7.

212. See supra notes 114-116 and accompanying text. As noted there, a further exemption is provided even though the 90% requirement is not met when the recipient's country of residence grants a substantially equivalent exclusion to residents and citizens of the United States. IRC § 871(f)(2)(A).

largely abandoned as a result of the operation of section 871(f). The simplifying effects of this proposal are depicted in bold print in Table 1-A, rows 2 and 5, pages 362-63.

Whether the IRS should continue to apply a bifurcated approach to distributions from a nonqualified funded plan (domestic or foreign) is a harder question. Since the U.S. treats contributions to such a plan as taxable compensation (at the point of vesting), pursuant to section 402(b)(1), it is harder to conceptualize the eventual distribution from the trust as merely a substitute for current compensation.

In the case of a U.S. secular trust, the bifurcation approach may not add much complexity in that separation of the contributions element from the earnings element may be necessary in any event to determine the proper time for taxing. Moreover, in the case of a foreign retirement trust with a nonresident alien beneficiary, the bifurcation rule has the simplifying effect of treating the accretion element as foreign and thus not subject to U.S. tax; this may be a worthwhile concession to the limits of IRS enforcement ability.

These considerations suggest that bifurcation should be retained in the taxation of a nonresident alien participant in a funded nonqualified retirement plan.[213]

E. *Rationale for Treaty Relinquishment of Source-Based Jurisdiction Over Pensions*

Why does the U.S., while making a strong assertion of jurisdiction over deferred compensation (particularly after the 1986 Act), simultaneously embrace a treaty policy of complete relinquishment of source-based taxation over pension payments (whether or not made in a lump sum)? Somewhat inconsistently, the U.S. does not relinquish by treaty its source-based taxation, on a current basis, of compensation for U.S. services that is contributed (by the employer or employee) to a foreign retirement arrangement or to a nonqualified U.S. funded plan.

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213. See Table 1-A, rows 3, 4, and 6, page 362-63. But cf. infra Part IV.E (proposing a different treatment of foreign *defined benefit* plans). The IRS also applies the bifurcation approach in determining the source of a pension distribution for purposes of computing the foreign tax credit of a U.S. citizen or resident. See supra note 105. If the proposal described in the text to eliminate bifurcation of a distribution from a U.S. qualified plan is implemented for this purpose as well, the aggregate effects are likely to be fairly modest. The only change would be that a U.S. citizen or resident who performed services abroad could treat the entire distribution (and not just the original contribution) from a U.S. qualified plan as having a foreign source. This would simplify the task of the plan trustee, particularly in the case of a defined benefit plan.

The U.S. treaty policy is obviously consistent with international norms, as it is also embodied in the OECD Model Tax Conventions for 1963, 1977 and 1992.[214] However, one commentator from the U.K. has argued that the bar to source country taxation of pensions under the OECD Model is "outdated, having been designed in an era when there were fewer privately funded pensions and less costly tax-deductible pension reserves, . . . and the mobility of individuals not so marked."[215] She notes that "[t]hose states, such as the United Kingdom and the Netherlands, that allow generous deductions to pension reserves, are high-tax, developed nations with strong welfare systems."[216] The author further notes that this tax break is "justified only in relation to keeping down future welfare costs and substituting a stream of taxable income when employment has ceased."[217] She believes that "high-earning 'mobiles' will draw their pensions as (technical) residents of havens where the sun shines and the taxes are low; [while] the mid- to lower-income sector and the poor needing welfare [will] stay behind in high-tax countries."[218]

A main purpose of bilateral tax treaties is to avoid "tax barriers to the free international exchange of goods and services."[219] Thus, a major goal is avoidance of double taxation of cross-border transactions, which obviously is a discouragement to such transactions. However, this goal is generally achieved to a large extent by a country's internal tax rules giving priority to source-based tax; thus, for example, the U.S. allows a credit for foreign taxes paid in respect of foreign source income, while some other countries provide an exemption for foreign source income.[220] By contrast, treaties generally operate by reducing or eliminating source-based taxation.[221]

In some cases, however, the internal rules of the two countries may not be effective to avoid double taxation because of inconsistent treatment

214. In fact, this policy seems to have gained acceptance prior to 1963 since official commentary for the three OECD model treaties do not provide any explanation of the rationale for this treatment. For the treatment of pensions in draft model conventions prepared under the auspices of the League of Nations, see supra note 136. See also Muten, supra note 72, at 750 (noting that "we Swedes have learned by experience that this rule is extremely hard to get prospective treaty partner countries to modify").

215. Jill C. Pagan, United Kingdom: Momentum for Change in Approach to Taxation Gathers Pace, 11 Tax Notes Int'l 802, 805 (Sept. 18, 1995).

216. Id.

217. Id.

218. Id. at 805-06.

219. American Law Institute, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties, 1991 A.L.I. Fed. Income Tax Project 1 (May 13) [hereinafter ALI].

220. See id. at 5-6.

221. See id. at 2.

accorded a transaction by two countries, e.g., in their application of source rules.[222] Moreover, in some cases, source taxation may be considered "burdensome" either in amount or in enforcement, even if "not duplicative."[223] Thus, a treaty provision may be needed to prevent either "double" or "burdensome" taxation.

1. *Eliminating Difficulties Created by Inconsistent Source Rules.*—The pension article of the U.S. model treaty eliminates problems of double taxation that are created if more than one country seeks to impose source-based tax on the same pension income. At least three possible sourcing rules could be applied to a distribution from a pension plan:[224] as under the Code, the distribution could be sourced to the situs of the plan to the extent of the accretion element and to the place of services to the extent of the compensation element; alternatively, the entire amount could be sourced to the situs of the plan (as under the UN Model) or the entire amount could be sourced to the place of services (as for unfunded deferred compensation). The U.S. Model, by providing for taxation of a pension payment exclusively in the residence country, effectively eliminates conflicts between different views of the source of a pension payment.[225]

Another way of achieving this goal, however, would be to specify by treaty which sourcing rule should prevail. This suggests that there may be additional reasons for the U.S. treaty policy regarding pensions payments.

2. *Administrative Difficulties of Source-Based Taxation*

a. *Elimination of Administrative Difficulties by Eliminating Source-Based Taxation.*—The most obvious rationale for U.S. treaty policy

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222. See id. at 6-8.

223. See id. at 9. ALI offers the example of "source-based withholding taxes on investment income." Id. ALI notes the further "objective" of "exempt[ing] income entirely at the source in cases in which the contact of the foreign taxpayer with the jurisdiction is relatively weak and the compliance burden on the taxpayer is large by comparison." Id. at 10. ALI cites as examples "[t]reaty provisions exempting income derived from international shipping and air transport," and the "permanent establishment" limitation on the taxation of business profits. Id.

224. See id. at 8 (noting that "[t]wo countries may assert source jurisdiction to tax the same income of a taxpayer that is not a resident of either country," for example, because of the "application of inconsistent source rules").

225. See Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1311 (1996) (arguing that one "pragmatic" reason "for preferring residence over source taxation for individuals" is that "individuals can only be in one place at any given time," whereas "determining the source of income is a highly problematic endeavor, and in most cases, income will have more than one source").

regarding pensions is the serious administrative difficulties associated with source-based taxation of distributions from U.S. qualified plans. As in the case of unfunded deferred compensation, the withholding agent first must characterize contributions to the plan as made with respect to services performed outside the U.S., services performed within the U.S. before 1987, or services performed within the U.S. after 1986. But also, in contrast to the case of unfunded deferred compensation, the withholding agent for a U.S. qualified plan must allocate each distribution between the amount contributed by the employer (and thus treated as compensation) and the accretion element.[226] Chief Counsel noted the special difficulty of this task[227] with respect to a defined benefit plan[228] in that, for such a plan, "the amount of the pension . . . does not depend on the amount of earnings."[229] These

226. See Gen. Couns. Mem. 38,007, supra note 209, at *4 (referring to the "almost overwhelming administrative difficulty (in many cases) in allocating a trust distribution between employer contributions and trust accretions").

227. The Chief Counsel also viewed identification of the earnings element of a pension payment as inconsistent with the treatment of the trust as a separate entity. He argued that, because of the trust's separate status, "whatever increment may be paid out loses its character in the hands of the distributee"; thus, for example, the employee cannot claim an exemption under § 103 for municipal bond interest received by the trust or a dividends received exclusion for dividends received by the trust. Gen. Couns. Mem. 36,344, supra note 209, at *10. But see Clayton v. United States, 95-2 U.S. Tax Cas. (CCH) ¶ 50,391, 76 A.F.T.R.2d (RIA) 95-5197 (Cl. Ct. 1995), aff'd, 96-1 U.S. Tax Cas. (CCH) ¶ 50,314 (Fed. Cir. 1996). In *Clayton*, the U.S. Court of Federal Claims approved the separate identification of the "increment" in a distribution on termination of an ESOP, while rejecting the argument that capital gains recognized by the trust could pass through to the beneficiary. Id. at 89,231-89,232. The court noted that the conduit rules of subchapter J do not apply to employer trusts. Id. at 89,232 (citing Rev. Rul. 72-99, 1972-1 C.B. 115, and Rev. Rul. 55-61, 1955-1 C.B. 40).

228. A recent report of the IRS Information Reporting Program Advisory Committee states that "it is unclear whether Rev. Rul. 79-388 is applicable to distributions from defined benefit plans and, if applicable, how its methodology would apply." IRPAC Paper, supra note 98, issue 5. The report adds that "[i]t is unclear, for payments made under a defined benefit plan, how a plan administrator would identify contributions from earnings and, with respect to contributions, distinguish between benefits attributable to services performed both [sic] before or after a specified date for a specific employee." Id. The report recommends that "[t]he Service should clarify whether the principles contained in Rev. Rul. 79-388 apply to pensions paid from defined benefit plans"; and, if they do apply, it should "provide guidance that any reasonable method may be used by payors/plan administrators" for making this determination. Id.

229. Chief Counsel noted further that "in many cases it would be difficult, if not impossible, to determine the amount of earnings that are allocated, or should be treated as allocated, to each employee's account." Gen. Couns. Mem. 36,344, supra note 209, at *9. See also Gen. Couns. Mem. 38,007, supra note 209 (Chief Counsel acquiesced to the approach taken in Rev. Rul. 79-388, 1979-2 C.B. 270). In Gen. Couns. Mem. 38,007, Chief Counsel pointed out that "[a] similar allocation problem was involved in the original lump-sum distribution provisions of section 402," requiring identification of "any part of a lump-sum

problems of allocation are compounded when the distribution is made in a series of payments,[230] rather than a lump sum, and have been emphasized[231] in a recent report by the Information Reporting Program Advisory Committee to the IRS.[232]

The U.S. and OECD model treaty provision for pensions allows these administrative difficulties to be completely sidestepped. Because only the state of residence of the recipient may tax a pension payment, there is no need for the plan administrator to make the allocation between compensation and earnings.

Similar administrative concerns are the most convincing justification for federal legislation enacted in 1996 that bars an individual state of the United States from imposing tax[233] on pension payments made to an

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distribution which represented employer contributions accrued after 1969." Id. at *5. Chief Counsel confessed that "[i]t was found difficult if not impossible to administer this provision"; thus, in 1974 ERISA replaced it with "a relatively simple averaging." Id. at *5-6.

230. IRPAC Paper, supra note 98, issue 6 ("It is unclear how the principles contained in Rev. Rul. 79-388 would apply to pensions, other than lump sum distributions, which are attributable to services performed both within and outside the United States.").

231. The IRPAC report also criticized "current rules that may require the application of three distinct withholding methodologies to a single pension payment to a nonresident alien" for promoting "undue hardship" and "confusion." Id. at issue 3. Under the current withholding rules: (1) "[t]hat portion of [a distribution] attributable to pension contributions for U.S. services performed after 1986 . . . is [generally] subject to the 10% withholding requirement under IRC section 3405(b) unless [the beneficiary] elects out of withholding in which case 30% withholding under section 1441 would apply"; (2) however, "the 20% withholding requirement under section 3405(c)" would apply mandatorily to any such amount "in excess of the minimum required distribution under section 401(a)(9)"; and (3) "that portion of [a distribution] attributable to contributions for U.S. services performed before 1987 plus all plan earnings would apparently be subject to 30% withholding under section 1441." Id. The report notes that payors may have to "issue and process several different types of information returns and . . . apply different withholding methodologies with respect to the same payee in any one calendar year" because of the payee's ability to "freely elect in or out of IRC section 3405 withholding." Id. The report recommends that the law be clarified and simplified by a replacement of Temp. Regs. § 1.1441-4(b)(1)(ii); under the proposed replacement, withholding for effectively connected pension payments made to nonresident aliens from qualified pension plans would be exclusively under § 1441, and never under § 3405. Id. The IRPAC Paper's recommendation was adopted in a proposed regulation issued by the Treasury in 1996. Under this proposed regulation, "payments to a nonresident alien individual from a trust described in section 401(a) are subject to withholding under section 1441 and not under section 3405 or 3406." Prop. Regs. § 1.1441-4(b)(1)(ii).

232. See IRPAC Paper, supra note 98, at issues 5 and 6.

233. States have generally conformed to federal income tax rules deferring recognition of pension income. See Hellerstein, supra note 208, at 221, 222; Hamilton, supra note 208; Richard Reichler, State Taxation of Executive and Employee Compensation, 35 Tax Mgmt. J. 275 (Sept. 5, 1994) (LEXIS, FEDTAX library, TMJNL file). In the event that the individual enjoying this deferral becomes a resident of another state before retirement, most

individual currently resident in another state.[234] Because the source-based jurisdiction of a state extends to intangibles only if they have a "business situs" in the state, states that sought to tax pension payments paid to nonresidents had to allow exclusion of an amount "reflect[ing] accumulations after the taxpayer's change of residence."[235] Thus, the pension trust would

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states do not seek to tax the pension income, adopting a "de facto policy of tax forgiveness." Hellerstein, supra note 208, at 223. Reichler notes that "27 states have no explicit statement of policy on this issue," and that "nine states do not impose a personal income tax that would apply to pensions or retirement annuities distributed from qualified plans." Reichler, supra, at text accompanying nn.26-27. Further, eight states do have an explicit policy of not taxing such income. Id. at text accompanying n.28. See also Klaiman, supra note 208, at 647 & nn.3-4 (stating that of 13 states with tax codes authorizing such taxation, five indicated in a 1991 survey that they do not enforce the tax; however, some states, particularly California, have sought to tax pension income of former residents); Hamilton, supra note 208 ("California has been notably aggressive in pursuing source tax . . .; Kansas, Louisiana and Oregon also have the statutory right to tax all types of nonresident pension income."); Reichler, supra, at nn.29 & 30 and accompanying text (stating that California, Idaho and Oregon "explicitly do impose such a tax" and that Kansas, Massachusetts and New York "do so under some circumstances"); Klaiman, supra note 208, at 647 & n.4 (stating that only California, New York and Vermont "have systems in place to pursue nonresidents" receiving such income).

234. See Hamilton, supra note 208 (noting that President Clinton signed H.R. 394 on January 10, 1996). For the statutory language, see 95 TNT 252-50 (Dec. 28, 1995) (LEXIS, FEDTAX library, TNT file). For a description of earlier efforts to pass such legislation, see Klaiman, supra note 186, at 659-662. Professors Walter Hellerstein and James Charles Smith, leading commentators on state taxation issues, label as "ludicrous" the arguments of former Senator Harry Reid of Nevada that state taxation of nonresident pensions is taxation "without representation" and without reciprocal benefits. Hellerstein, supra note 208, at 223-24. See also Letter from Carolyn Joy Lee, Chair, Tax Section, N.Y.S.B.A., to Rep. Sam Gibbons (Nov. 9, 1995) 95 TNT 227-6 (Nov. 21, 1995) (LEXIS, FEDTAX library, TNT file) (criticizing as "not . . . persuasive" the "[a]rgument that the [federal legislation] is necessary to correct unfair State taxation"). For further description of such arguments by Reid and others, see Klaiman, supra note 208, at 663-64. However, Hellerstein and Smith "remain agnostic" as to the desirability of such proposed legislation limiting states' taxation of pension income of nonresidents because of the "serious practical complication[s]" resulting from such taxation. Hellerstein, supra note 208, at 230, 226. See also Letter of Carolyn Joy Lee, supra (stating that "[t]he complexities of multistate compliance and the risks of multiple taxation may be factors that warrant federal intervention"). Ms. Lee suggests that "[i]t also might be fruitful to consider more limited forms of restriction, for example federal rules that allocate deferred income among the States in which an individual has lived or worked." Id.

235. Hellerstein, supra note 208, at 226. Hellerstein and Smith note, however, that in 1989 "a New Jersey court held a nonresident taxable on the payout from a profit-sharing plan from his former New Jersey employer over the objection that New Jersey was taxing dividends, interest, and appreciation in the value of a nonresident's intangible assets." Id. at n.32 (citing McDonald v. Director, Division of Tax'n, 10 N.J. 556 (1989), modified in part, aff'd in part, 589 A.2d 186 (N.J. Super. Ct. App. Div. 1991). Hellerstein and Smith note that the N.J. legislature provided a statutory exemption in that same year. Id. Determining the amount that may be taxed becomes particularly complicated when "[a] taxpayer has worked in more than one state prior to retirement or has earned income in a state other than his state

have to make a separate determination of that amount.[236]

b. *Alternative Means of Easing Administrative Difficulties.*—Recognition of the administrative difficulties of source-based taxation of pension payments does not lead inexorably to the current treaty policy. Instead, the U.S. rules for source-based taxation might be revised in order to ease these difficulties. A statutory change in U.S. source-based taxation would have the advantage of completely freeing withholding agents from the administrative difficulties created by the current rules, even where the recipient of a pension payment is not protected by a treaty.

For example, as urged by the IRS Chief Counsel in 1975 and as recommended above for qualified U.S. pension plans, pension payments could be sourced entirely to the place where the services were performed to avoid the need to separately identify the "accretions" element. This approach would not preclude the need to identify multiple source countries where services are performed in more than one country; however, this same problem also exists for payments of unfunded deferred compensation that are not classified as "pensions," and is not considered unworkable in that context.

A second approach to simplifying source-based taxation would be to treat a pension payment as sourced entirely to the situs of the payor trust. Thus, the entire amount distributed by a U.S. pension trust would be classified as from U.S. sources (even if services were performed abroad as in Table 1, row 5, page 359); no amount distributed by a foreign pension trust would be classified as from U.S. sources (even if services were performed in the U.S., as in Table 1, row 4, page 358). A similar approach is suggested by the U.N. Model Treaty, which contains two alternative provisions for pensions (one allowing source-based taxation and the other precluding it). In the former provision, source-based taxation is permitted when a pension payment is "made by a resident . . . or a permanent establishment situated" within a treaty state. The commentary explains that this approach was directed at avoiding problems in the situation where employees have "performed services consecutively in several different countries." The commentary concluded:

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of residence." Id. at 227. Hellerstein & Smith note that if a resident of New Jersey performs services in Pennsylvania and then moves to Florida upon retirement, "[l]ogically New Jersey has jurisdiction to tax the full amount of the deferred compensation, together with any accumulations thereto up to the date of the taxpayer's relinquishment of New Jersey residence." Id. However, New Jersey's statute would not require filing of a resident return in the year of retirement when the individual is not a N.J. resident. Id.

236. Cf. supra note 226; Letter of Carolyn Joy Lee, supra note 234 (noting that "taxation of deferred income requires the allocation of pension distributions between deferred compensation and deferred investment income, as well as allocation among the States where income was earned or where an individual resided").

> [I]t would be very difficult for the head office of a company to allocate each pension among the various countries in which the pensioner had worked during his years of employment. It was generally agreed, therefore, that taxation of pension at source should be construed to mean taxation at the place in which the pension payments originated, not the place in which the services had been performed.[237]

If the U.S. were to unilaterally redefine the source of a pension payment as the situs of the pension trust, then consistency would seem to require that it disclaim source-based taxation of contributions to foreign pension plans in respect of U.S. services (see Table 1, row 4, page 358). However, for the U.S. to amend the Code to relinquish this claim to source-based tax would seem to create a huge loophole for nonresident aliens performing services in the U.S. Such aliens could avoid U.S. tax permanently by having their employers set up nonqualified pension trusts for them outside the U.S., even though the employees were never subject to a significant home country tax with respect to such plans.

3. *Determination of Overall "Ability to Pay."*—A third rationale for relinquishment of source-based taxation of pensions by treaty is that "the country of residence [is] probably in a better position than the source country to structure its taxation of pensions to the taxpayer's ability to pay."[238] This argument may be based on the concern that source country taxation will lead to hardship.[239] Thus, a country taxing on the basis of source may be unable

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237. U.N. Model, supra note 139, Commentary on Article 18B, at 172.

238. Id. This argument was presented by members from developed companies in connection with drafting of the U.N. Model Treaty. Members from developed countries also argued that "since the amounts involved were generally not substantial, developing countries would not suffer measurably if they agreed to taxation in the country of residence." Id. at 172. See also Julie Roin, Rethinking Tax Treaties in a Strategic World With Disparate Tax Systems, 81 Va. L. Rev. 1753, 1761 (1995). Professor Roin notes that, in general, "[r]esidence-country taxation is thought to be preferable because it enables greater inter-taxpayer equity." Id. at 1761. She explains that this "argument stems in part from concerns about the implementation of a progressive rate schedule when taxation is split between the country of residence and country of source." Id. at 1761 n.27. See also Gliksberg, supra note 205, at 473 (noting that "the principle of ability to pay . . . examines the income of the taxpayer from every source, including that produced abroad").

239. Cf. The Commission of the European Communities, Commission Recommendation of 21 December 1993 on the Taxation of Certain Items of Income Received by Non-residents in a Member State Other Than That In Which They Are Resident, 94 TNI 61-22 (Mar. 30, 1994) (LEXIS, FEDTAX library, TNI file). The Commission recommended that when a resident of one member state derives at least 75% of his taxable income in the form of compensation for dependent or independent services (or from industrial or commercial activities) in another member state in which he is not resident, the latter country should not

to provide remedial measures designed to insure that an elderly individual's sole source of income is not subjected to excessive tax (e.g., a special rate schedule, standard deduction, or credit for retirees). The residence country's mechanism to avoid double tax (whether a credit system or exemption system) will not serve to remedy excessive tax in the source country.[240]

On the other hand, such a concern could be addressed by requiring source countries to exempt a generous amount of pension income received by each recipient. For example, the developing countries participating in discussions of the 1980 U.N. Model proposed exclusive source-based taxation but with an exemption "for amounts equivalent to the personal exemptions allowable in the source country."[241]

Alternatively, this rationale for the current U.S. treaty policy might be based on the concern that source-based taxation may be inappropriately low. Thus, if the pension is the only item of U.S.-source income of a nonresident alien and it is (to the extent of the compensation element) taxed as effectively connected income,[242] the applicable U.S. tax rate may be quite low.[243] However, this concern does not seem very serious as long as residence-based tax is not precluded.[244]

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impose any heavier burden of tax than if the individual were a resident. Id. At the same time, the residence country "may decide not to grant deductions or other tax reliefs which it normally grants to residents" if such deductions would be duplicative. Id. Similarly, some countries have entered into bilateral arrangements providing for taxation of frontier workers by the residence country only.

240. See ALI, supra note 219, at 9-10.

241. See U.N. Model, supra note 139, Commentary to Article 18B, at 172.

242. Ironically, § 864(c)(6) treating deferred compensation as effectively connected income, rather than fixed or determinable income subject to a 30% withholding rate, may have a favorable effect on the treatment of nonresident aliens.

243. Thus, it has been suggested that an IRA might be an attractive investment for U.K. employees working temporarily in the U.S. because the eventual distribution may not be subject to U.K. tax and the rate of U.S. taxation may be low if this is the only effectively connected income. See Koch, supra note 125, at 141-42. Koch notes that a nonresident alien would be eligible for a $2,350 personal exemption, and might well be taxed at a 15% rate. Id. at 141. See also Roin, supra note 238, at 1761 n.27 (noting that "the source country typically treats the income earned by the taxpayer in that country as the taxpayer's only income, and computes the applicable rate starting at the bottom of the rate schedule").

244. But see Avi-Yonah, supra note 225, at 1311-12 (arguing that "because most individuals have only one residence jurisdiction and are part of only one society, distributional concerns can be effectively addressed only in the country of residence"). Professor Avi-Yonah points to the "vertical equity problem in taxing an investor with low domestic earnings and high foreign earnings that are not taxed abroad in the same way that a person with only low domestic earnings is taxed." Id. at 1312. He notes that "[t]his problem can be resolved if the residence jurisdiction is allowed to tax on a residual basis only foreign source income that is not taxed abroad (or is taxed at lower effective rates) and allows a credit for foreign taxes." Id. He concludes, however, that "it is much simpler to address the issue if the residence

4. *Reliance on Residence-Based Taxation.*—Each of the arguments for relinquishment of source-based taxation (described above) rests on the implicit assumption that the residence country will in fact impose a tax on a pension payment derived from another country, and that such a tax will be enforceable. Otherwise, individuals who earn a pension in one country and retire to another would have the opportunity for achieving complete tax exemption by virtue of a treaty. Such complete tax exemption is a concern in the context of state taxation of pensions within the United States. Thus, for example, now that California is barred by federal law from imposing its tax on pensions earned in California and paid to former California residents who retire in Florida, such pensions will be free of any state income tax (since Florida has no income tax).[245] A desire to limit such abuses by the wealthy (who are often more mobile) was behind failed proposals to limit the federal legislation to pensions from qualified plans.[246]

By contrast, in the context of a bilateral treaty relationship, it should be possible for the U.S. and its treaty partner to assure themselves that residence-based taxation at a reasonable rate will in fact be imposed on recipients of pension payments exempted from source-based tax. This assumption is discussed further in Part IV of this article, dealing with residence-based taxation. If so, a country such as the U.S. that (unlike a developing country)[247] could expect to have a fairly balanced position (as a residence country and a source country) with other developed countries, may see no disadvantage to entering bilateral agreements that entail giving up source-based jurisdiction while preserving residence-based jurisdiction over pensions.[248] Therefore, even if the U.S. adopts this article's recommen-

jurisdiction is given the exclusive right to tax all income of its residents." Id. Professor Avi-Yonah further notes that "taxation based on residence is a useful, though far from perfect, proxy for taxation with representation." Id.

245. Some predict that the federal legislation could lead to "substantial abuses of the pension system" on the part of wealthy taxpayers with the ability to shift considerable compensation to the form of a pension and to move to a low tax state on retirement. See Klaiman, supra note 208, at 667-68. This outflow of wealthy taxpayers could lead states to lower their top marginal rates to be more attractive to such taxpayers. Id. at 668.

246. Id.; see id. at 660-62 (describing legislative proposals).

247. In the discussions leading to the U.N. Model Treaty, developing countries "observed that pension flows between some developed and developing countries were not reciprocal and in some cases represented a relatively substantial net outflow for the developing country." U.N. Model, supra note 139, Commentary to Article 18B, at 172. Developed countries responded with the argument that "since the amounts involved were generally not substantial, developing countries would not suffer measurably if they agreed to taxation in the country of residence." Id. at 172.

248. The recent opinion by the Court of Justice of the European Communities in the *Wielockx* case reflects this view. See Case C-80/94, G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen, 95 TNI 216-11 (Nov. 8, 1995) (preliminary ruling) (LEXIS, FEDTAX

dation to simplify the U.S. statutory rules for source-based taxation, there is no great incentive to change the long-standing treaty policy of barring source-based taxation of pension payments.

F. *Proper Scope of Source-Based Exemption*

If the treaty exemption from source-based taxation of pensions is to be maintained, then it seems appropriate to delineate more clearly, and in an authoritative manner, the payments to which it applies.

As the IRS has noted, the term "pension" generally refers to a payment or series of payments that is "contingent on retirement," i.e., a separation from service due to reaching retirement age, death or disability. The IRS may reason that the refinements in measurement of ability to pay that are possible in the residence country (but not the source country) are most important for individuals who are no longer in the workforce and may be completely dependent on a pension. A focus on this aspect of "pensions" suggests that lump-sum payments during retirement are at least as deserving of treaty protection as periodic payments (even though periodic payments may present greater administrative difficulties in respect of segregating the "compensation" and "accretion" elements).

The "contingent on retirement" criterion might further suggest that the treaty exemption for pension payments should apply to payments from unfunded, as well as funded, arrangements, provided that the payments are contingent on retirement. On the other hand, one might argue that only payments from funded plans should qualify for the treaty exemption because only payments from funded plans present the administrative difficulty of separating the "compensation" element from the "accretions" element. To the extent that this administrative problem is eased by eliminating the distinction under U.S. internal law between the "compensation" and "accretions" element of a pension payment, this argument would have less force. Perhaps, most unfunded plans are not "contingent on retirement" in any event; thus, as a practical matter, unfunded deferred compensation (even if not specifically excluded

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library, TNI file); see also Kees van Raad, EC Court of Justice Decides *Wielockx* Case, Restricting the Scope of *Bachmann* Decision, 11 Tax Notes Int'l 779 (Sept. 18, 1995) [hereinafter van Raad]; Jill C. Pagan, United Kingdom: Momentum for Change in Approach to Taxation Gathers Pace, 11 Tax Notes Int'l 802, 803-06 (Sept. 18, 1995). In the *Wielockx* case, the court held that the Netherlands' refusal to allow a Belgium resident working full-time in the Netherlands to establish a deductible pension reserve violated the "freedom of establishment" article of the EC treaty. See van Raad, supra, at 779-80. The court concluded that allowance of such a deduction by the Netherlands would not disrupt the "cohesion" of its tax system, even though the Netherlands had relinquished its right to tax distributions from the pension reserve under its treaty with Belgium. Id. at 780. The court found that overall "cohesion" was achieved through the reciprocity in the obligations under the treaty. Id.

from "pension" classification) would generally not qualify for the treaty exemption.

The IRS should provide guidance in an authoritative form regarding the scope of the term "pension" in treaty provisions being applied to limit the assertion of U.S. tax. The current use of private letter rulings to delineate the term (and even then, only in respect of "qualified plans") creates serious problems for U.S. plan administrators, who face substantial penalties for failure to withhold when required.

Some of the requirements that the IRS has set forth in private letter rulings seem to be appropriate guidelines for determining whether a payment is "contingent on retirement." For example, the IRS requirement that payments be made only after the employee has reached Social Security retirement age, has separated from service after attaining age 55, or has died or become disabled (unless the payments are to be spread over the employee's entire life or life expectancy) may be useful for this purpose. On the other hand, it is not clear why the IRS further requires that payments be made "after the employee has been employed for 5 years or more" or alternatively, if the employee was "first employed . . . on or after reaching age 60." It seems ironic that the source country would condition giving up its jurisdiction to tax a pension upon the pensioner having a long-term relationship with the employer and thus in many cases a longer relationship with the source country.

Distributions from an IRA are not directly contingent on retirement, even though lump-sum distributions prior to age 59 and 1/2 (and absent death or disability) are subject to penalty. However, the age threshold of 59 and 1/2 assures that a large portion of distributions from IRAs are in fact made during retirement. In addition, it seems appropriate for a distribution from an IRA that is attributable to a rollover from a qualified pension plan to qualify for the pension exemption. Creating a different treatment for a distribution from an IRA to the extent not attributable to a rollover would create serious administrative difficulties for the IRA trustee.

Certain types of payments that might otherwise be classified as "pensions" might nevertheless be excluded from this category if the task of ensuring adequate residence-based tax is particularly difficult with respect to such payments. For example, the Netherlands' policy of preserving source-based taxation of lump sum pension payments in its treaties is apparently based upon concern about avoidance of residence-based tax.[249] That the

249. See Treasury Explanation of Netherlands Treaty, supra note 147, at 1653. The treaty allows taxation of a lump sum pension payment by the country where services were performed if the employee was resident in that country at any time in the previous five years. See U.S.-Neth. Treaty, supra note 148, art. 19, ¶ 2. The Treasury explains that the U.S. sought to accommodate the Netherlands "concern . . . that the lump-sum payment might avoid tax

Netherlands is willing to accept the superiority of the residence country's claim to tax is suggested by the fact that the source-country taxing a lump sum pension payment is required to give a credit for residence-based tax.

G. *Source-Based Taxation of Contributions to Foreign Pension Plans*

As just discussed, the U.S. is willing to surrender source-based taxation of pension payments from a U.S. qualified pension plan in the context of a bilateral treaty (where residence country taxation and a relatively balanced movement of employees between the two countries is assured). Should it be equally willing to give up by treaty its source-based taxation of compensation derived by a nonresident alien from U.S. services and contributed by his employer (or by the employee himself) to a plan qualified in a foreign country that is a U.S. treaty partner? (See Table 1, row 4, page 358). In either case, even though services have been performed in the U.S., the combination of such a treaty provision with the applicable provisions of the Code would result in complete elimination (rather than merely deferral) of U.S. tax.

Until recently, a policy of relinquishing source-based tax on contributions to foreign pension plans has had relatively little acceptance among the U.S. and its treaty partners. Such a rule is suggested only in the commentary of the 1992 OECD Model, and the rule suggested is quite limited in scope. The suggested rule applies only to employee contributions (which do not present the valuation issues of some employer contributions), only to an individual who is a *resident* but not a national of the country where services are performed, and only where an employee has previously been contributing to the home country pension plan prior to taking up a work assignment in the other country. The Court of Justice of the European Community has ruled that the Treaty of Rome's provision guaranteeing freedom of movement of workers does not require an EC member country to permit a national of another member country to deduct contributions made to a pension plan entered into in the latter country prior to arrival in the former country.[250]

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altogether, or be subject to only a low rate of tax, even though the contributions on which the payment is based had been deductible for Netherlands tax purposes." Treasury Explanation of Netherlands Treaty, supra note 147, at 1653. Under the treaty, however, taxation of a lump sum payment by the country where the services were performed is barred when the lump sum payment is contributed to a pension plan or retirement account under circumstances that would have qualified for tax deferral in the residence country if the payor were also resident in that state. See U.S.-Neth. Treaty, supra note 148, art. 19, ¶ 3. The Treasury explains that in this case "the tax avoidance concerns of the Netherlands would not be present." Treasury Explanation of Netherlands Treaty, supra note 147, at 1653. See also supra note 163.

250. In the *Bachmann* case, Belgium refused to allow a German national working in Belgium to claim a deduction from his Belgium income for contributions paid to pension

The U.S. has included a rule similar to that in the OECD commentary only in its treaties with Sweden and France and in its proposed treaties with Austria and Switzerland. The French provision applies to an employee who is a U.S. resident but not a U.S. national; but the employee is not required to have previously contributed to the French plan. However, the inclusion of such a provision in the 1996 U.S. Model suggests that such a provision may be included in U.S. treaties more frequently in the future.

The hesitancy of the U.S., until recently, and the hesitancy of other countries to give up imposition of source-based tax on contributions made to a foreign plan seems odd given the disadvantages that may be involved in imposition of such a tax. First, imposition of a current tax under section 402(b)(1) on contributions to a foreign pension plan in respect of U.S. services involves serious administrative difficulties (particularly if the plan is a defined-benefit plan). If the foreign country where the plan is located does not impose an immediate tax on contributions to this type of plan, then the foreign tax authorities may not require the types of computations that would be required to determine the U.S. tax (i.e., determination of the employee's interest in the trust, and determination of the portion of the services performed in the U.S. before or after 1986). It seems questionable whether the U.S. tax in this situation has been uniformly enforced.

Further, imposition of a source-based tax on contributions to a foreign pension plan may create burdens for the employee that discourage his acceptance of a work assignment in the U.S. particularly when the country where the plan is situated accords tax-favored treatment to the plan. For example, the U.S. tax on contributions may create liquidity problems that would have been avoided if the employee had instead continued to work in his home country. In addition, double taxation may result because generally treaties have not barred further taxation by the country where the employee resides at the time of distribution. If that country uses a foreign tax credit mechanism, it may not grant credit for a tax paid to a source-country so many years before. Finally, source-based tax may not provide as accurate a determination of ability to pay as a residence-based tax.

(and other) insurance plans entered into in Germany prior to his arrival in Belgium. Case C-204/90, Bachmann v. Belgian State, 94 TNI 50-15 (Jan. 28, 1992) (LEXIS, FEDTAX library, TNI file). The court found that, notwithstanding provisions guaranteeing freedom of movement of workers in the Treaty of Rome, Belgium's position was "justified by the need to ensure the cohesion of [its] tax system." Id. ¶ 28. That is, the court believed that Belgium should not be required to allow a deduction for contributions to a plan the distributions from which would not be subject to Belgium tax. Id. For a subsequent limitation imposed by the court on the principle of "cohesion," see discussion of the *Wielockx* case, supra note 248. The *Bachmann* case is further discussed in Muten, supra note 72.

The past reluctance of the U.S. to relinquish source-based tax over pensions in this context can perhaps be attributed to the following factors. Because a foreign plan is ordinarily not a qualified plan under the Internal Revenue Code, the appropriate time for the U.S. to impose its tax is when contributions are made (or, if later, when they are vested). Even if the plan situs is a country having a treaty with the U.S., the U.S. may not be able to determine at that time whether any country will ultimately impose a residence-based tax on the pension income. At the time of the contributions, the employee may be a resident of the U.S. for tax purposes. The U.S. cannot be sure that the employee will retire in the country of the plan's situs. That country may impose tax only at the time of distributions from the plan and only if the employee is resident at that time (because the underlying services were performed elsewhere). (By way of analogy, when the only nexus of the U.S. with a pension is the situs of the pension trust, the U.S. taxes only the accretions element of a distribution and forgives that tax in many cases under section 871(f)). It is possible that the employee will retire in the Cayman Islands, or some other country not having a treaty with the U.S. Thus, if the U.S. forbears from immediate imposition of source-based tax, it cannot be assured that residence tax will ever be imposed.

This concern may perhaps be addressed by the U.S. providing merely a deferral of its source-based tax at the time of the contributions to the foreign plan and *only if* the situs of the plan is a U.S. treaty partner and provides for deferral with respect to such a plan. Under this approach, the U.S. would retain jurisdiction to impose source-based tax on an eventual distribution from the plan if residence jurisdiction is not claimed at that time by a treaty partner of the U.S.[251] The country of the plan situs, as a U.S. treaty partner, would be able to facilitate the U.S. obtaining the necessary information to impose tax at the time of distribution. If the U.S. eventually surrenders its source-based tax because the individual retires as a resident of a treaty partner of the U.S., the U.S. is giving up its tax as part of a reciprocal arrangement. Provided that limits on the dollar amounts contributed to the pension plan are similar to those applied by the U.S. for contributions to a U.S. qualified pension plan, some parity in the revenues surrendered is preserved.

Nevertheless, some may question why the U.S. should allow deferral of U.S. tax for contributions to a foreign pension plan that is not subject to U.S. standards for vesting, funding, rank-and-file participation, and fiduciary behavior. Allowing the deduction may be seen as undermining the incentive

251. However, the total amount subject to tax would be reduced in terms of present value unless the U.S. were to treat the entire distribution (including the accretions element) as U.S. source.

effect of the tax-favored treatment of U.S. qualified pension plans because the same U.S. tax advantage can be obtained without all the detailed restrictions of a U.S. qualified plan.

It is not clear whether this concern is valid, however. The true advantage of a tax-favored pension plan (exemption of the investment return from tax in the country where the plan is located) is not being granted by the U.S. in this situation; in fact, the country in which the plan is situated may not even grant complete exemption from tax for investment income of the plan. Moreover, in the case of contributions made directly by the employer, if the U.S. defers the tax on the employee, it would presumably also defer the allowance of a U.S. tax deduction[252] for the employer.[253]

Further, the employee's decision to make contributions in respect of U.S. services to a pension plan situated outside the U.S., but in a country that is a U.S. treaty partner, is more likely to be based upon his expected, continuing relationship with that country, than upon avoidance of the requirements of a U.S. qualified plan. This would seem to be especially true where the employee is a national of (or has been a long-term resident of) the country where the plan is situated. Moreover, if the employee has already contributed to the foreign plan prior to his U.S. work assignment, there may be significant advantages in continuing with the same plan.[254] In addition, it seems reasonable for the U.S. to entrust a country with which the employee has had significant ties with the responsibility to assure the adequacy and safety of his retirement arrangements.

Thus, this innovation in the 1996 U.S. Model is to be commended. The U.S. should provide more generally in treaties for the giving up of source-based tax on contributions to pension plans situated in the other treaty country where the other treaty country also provides employee tax deferral with respect to plan contributions. This treaty policy is especially compelling if limited to cases where the employee is a national (or prior resident) of the

252. The restrictions of § 404(a)(5) would apply because the plan would not be a qualified plan for U.S. tax purposes. The more lenient rules of § 404A are inapplicable to "any item to the extent such item is attributable to services . . . performed in the United States the compensation for which is subject to tax under this chapter." IRC § 404A(g)(1)(B).

253. However, if the employee is treated as receiving compensation and then making a deductible contribution to the foreign pension plan, there would be no deferral of the employer's deduction for U.S. tax purposes.

254. It has been suggested that the "right of deduction [be limited] to persons with legitimate reasons for requesting deductions—say, having moved internationally"; in other words, limited to "cases where it is required to safeguard the principle of mobility of labor." See Muten, supra note 72, at § VIII. Bissell & Giardina point out that "many U.S. plans exclude foreign nationals who retain [home country pension] coverage"; they explain that "because such groups are relatively small, and/or highly compensated, usually no prohibited 'discrimination' results." Bissell & Giardina, supra note 72, at 279.

treaty country where the plan is situated, and the employee has previously contributed to the plan in that country.

IV. RESIDENCE-BASED U.S. TAXATION OF DEFERRED COMPENSATION PAID TO U.S. CITIZENS OR RESIDENTS

If the U.S. treaty policy of relinquishing source-based taxation of pensions is based upon the assumption that residence-based taxation is preferable and will be asserted by the U.S. and its treaty partner, then further examination is warranted of residence-based taxation. Two principal scenarios for U.S.-residence-based tax will be described. In the first, a U.S. citizen performs services in another country in respect of which contributions are made by him or his employer to a foreign retirement arrangement; the individual remains a U.S. citizen (though perhaps resident outside the United States) when distributions are eventually made to him from the foreign retirement arrangement. See Table 2, row 8, page 360. In the second scenario, a nonresident alien performs services in a foreign country in respect of which contributions are made to a foreign retirement arrangement; the individual retires in the U.S. and is a U.S. resident at the time of receiving retirement distributions from the foreign plan. See Table 2, row 10, page 361.

A. *U.S. Citizen Who Works in Foreign Country Before Retirement in the U.S.*

1. *Imposition of U.S. Tax.*—Unlike almost all other countries,[255] the U.S. taxes its citizens on their worldwide income, regardless of where they may be resident.[256] However, a U.S. citizen or resident present in a foreign country for an extended time may exclude from income up to $70,000 of foreign earned income annually pursuant to section 911.[257] Foreign income taxes paid by a U.S. citizen with respect to compensation for services

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255. Apparently, the only other countries taxing worldwide income on the basis of citizenship are the Philippines and Eritrea; however, Mexico had such a regime prior to 1981. See JCT Report on Expatriation, supra note 129, app. at B-1.

256. See supra note 77.

257. Remuneration paid to a U.S. citizen for services rendered abroad to a U.S. or foreign employer are subject to income tax withholding to the extent the remuneration exceeds the allowable § 911 exclusion and is not subject to foreign withholding. Rev. Rul. 92-106, 1992-2 C.B. 258 (situations 1 and 2). The exemption from withholding for the § 911 exclusion amount is not available to a U.S. resident. Id. at 259. If the remuneration is paid by an "American employer," as defined in §§ 3121(h) and 3306(j)(3), it is also subject to FICA and FUTA taxes. Id.; see Bissell, supra note 80, at 146-47; see also supra note 81 and accompanying text. As explained by Bissell, "[i]t is believed that the IRS does not actively enforce [the requirement that a foreign employer perform U.S. wage withholding] except possibly where the foreign employer is a payroll subsidiary owned by a U.S. company and located in a foreign tax haven." See Bissell, supra note 80, at 146.

performed abroad may be creditable against U.S. tax under section 901. However, no credit is allowable with respect to foreign taxes attributable to income excluded by section 911.[258]

A U.S. citizen working overseas may be able to continue making contributions to a U.S. deferred compensation plan.[259] Whereas taxation of contributions to a qualified U.S. pension plan will be deferred for U.S. tax purposes, there may be a current tax in the country where the services are performed.[260] In addition, no exemption is available from U.S. tax under section 911 for the eventual distributions[261] from the plan because section 911 is inapplicable to deferred compensation[262] (although some wish to

258. IRC § 911(d)(6); Regs. § 1.911-6(c)(1).

259. For example, the worker's employer may be a U.S. corporation with a qualified plan who sends the employee to a foreign branch operation. A U.S. multinational employer may arrange for the employee to be "seconded" to a foreign subsidiary (so that the employee's employment relationship and pension plan coverage remain with the U.S. parent company). See Ellis & Navin, supra note 72, at 9, 18-24 (discussing this possibility for an "outbound executive"); see also Bissell & Giardina, supra note 72, at 276-78.

260. See Ellis and Navin, supra note 72, at 24 ("[T]he local tax rules may provide for taxation when the contribution is made to the plan, allocated to a plan account on the executive's behalf or when the executive vests in the contribution." The "vesting date" is "the most likely date" for "a number of countries (e.g., Brazil, Germany and Spain)," whereas in the U.K. it is "when [the executive] first becomes entitled to receive payment under the plan."). See also Bissell & Giardina, supra note 72, at 277-78 ("As a general rule, most foreign countries do not attempt to tax employer contributions to an actuarially-based defined benefit pension plan located in an employee's home country. In contrast, most foreign countries do not respect the salary reduction portion of a U.S. § 401(k) plan, and will tax the employee on his own contributions to the plan if they know about it.").

261. Similarly, it cannot be argued that the employee has an investment in the contract in the amount of employer contributions that would have been excludable under § 911 if paid directly to the employee. See IRC § 72(f); Rev. Rul. 72-149, 1972-1 C.B. 218. This rule applies only to services performed after 1962. Id.

262. Section 911 does not apply to: (1) any compensation "received after the close of the taxable year following the taxable year in which the services are performed;" (2) any amounts "received as a pension or annuity" and (3) any amounts "included in gross income by reason of § 402(b) (relating to . . . nonexempt trusts)." IRC § 911(b)(1)(B)(i), (iii), (iv). These restrictions were added to the Code in 1962. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 54 (1962), reprinted in 1962-3 C.B. 405, 458. Congress denied the § 911 exclusion for an amount paid as a pension because "Congress thought it discriminatory to allow [an employee who worked abroad] to retire in the United States next to another individual who had worked in the United States for the same employer and who was fully taxable on the contributions made by the employer." Gen. Couns. Mem. 36,345 (July 23, 1975) (citing S. Rep. No. 1881, 87th Cong., 2d Sess. 74-75 (1962), reprinted in 1962-3 C.B. 780-81); see also H.R. Rep. No. 1447, 87th Cong., 2d Sess. 54-55 (1962), reprinted in 1962-3 C.B. 405, 458-59. Congress denied the § 911 exclusion for deferred compensation (received after the end of the taxable year following the year of performance of the services) because it saw "no reason . . . to provide [a] special inducement for overseas employment long after the period in which the

change this).[263]

A U.S. citizen working abroad may alternatively[264] participate in a foreign deferred compensation plan.[265] A foreign retirement plan is almost certain to be a nonqualified plan for U.S. tax purposes.[266] As a result, employer contributions to a funded plan are taxed under section 402(b)[267]

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employment occurred." Id. at 55. The committee report further noted that "this will treat deferred compensation under the exclusion the same as qualified pensions." Id.

263. Legislation introduced by Representative Bill Alexander in 1992 would expand the scope of § 911 to reach deferred compensation income. H.R. 4562, 102d Cong., 2d Sess. (1992). Under the proposal, "[a]mounts received after the close of the taxable year in which the services to which the amounts are attributable are performed shall be excluded . . . without regard to the taxable year in which they are received." Id. § 2(a) (adding new § 911(c)(3), and in effect repealing § 911(b)(1)(B)(iv)). Further, the current law's denial of a § 911 exclusion for a pension or amount included in income under § 402(b) is in effect reversed; the § 911 exclusion is not denied for "so much of any amounts received as a pension . . . as is attributable to personal service rendered outside the United States during the periods for which the taxpayer met" the eligibility requirements; nor is the exclusion denied for "amounts received or otherwise includible in gross income under a foreign pension, annuity, or trust (except to the extent that such amounts are attributable to personal services rendered within the United States. . . ." Id. (adding new § 911(c)(5)(A), (B), and in effect repealing current § 911(b)(1)(B)(i) and (iii)).

264. See Ellis & Navin, supra note 72, at 30-31 for a discussion of "reasons" for participating in foreign deferred compensation plans.

265. Assuming that the foreign deferred compensation plan is not a U.S. qualified plan, then an employee's participation in it will not be a barrier to making deductible contributions to an IRA. Id. at 31 (citing IRC § 219(g)(1), (5)).

266. Id. They consider it "highly unlikely that a foreign retirement plan would ever satisfy the tax qualification requirements set forth in IRC § 401(a)." Id. They note that "very few jurisdictions in the world [have] private pension requirements as complicated" as these, and, even though there are "similar schemes" in Canada, U.K., and Australia, "few rules are the same." Id. See also Letter from Raymond J. Wiacek to Leonard B. Terr, International Tax Counsel, (Aug. 10, 1988), reprinted in 88 TNI 38-32 (Sept. 21, 1988) (LEXIS, FEDTAX library, TNI file) [hereinafter Wiacek Letter to Terr] (noting that although Canadian pension arrangements may be "analogous to U.S. retirement vehicles" a Canadian registered pension plan "does not constitute a 'qualified' plan for U.S. purposes, because Canadian requirements are different from those set forth in section 401 of [the] Code."). The fact that the pension trust is not organized under U.S. law is not in itself disqualifying if all of the other requirements of § 401(a) are met. See § 402(e)(5), which was repealed and reinstated as § 402(d), by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1401(b)(13), 110 Stat. 1755 (effective for tax years after December 31, 1999).

267. See Walker & Olson, supra note 22, at 98:

> [Section 402(b) will] generate a tax liability for resident aliens accruing benefits in a foreign plan that is funded, whether or not the foreign plan is a tax-preferred vehicle for accumulating retirement savings in the foreign country. To avoid this result, the foreign employer needs to consider delaying the funding of benefits . . . or make the benefit that is being funded subject to a substantial risk of forfeiture until the individual is no longer a U.S. resident.

when made, if they are vested; otherwise, the value of the employee's interest at the time of vesting is included[268]; the amounts so included are not eligible for section 911 exclusion.[269] One might anticipate problems in applying these provisions when separate accounts are not maintained for each employee, for example in a defined benefit plan.[270] Moreover, if the employee is a "highly compensated employee" and the plan fails to meet certain "participation" or "coverage" requirements of a qualified plan,[271] he or she is taxed currently under section 402(b)(4)(A) on the amount of his vested accrued benefit.[272]

Id. Walker & Olson state that "[w]hile the effect of Section 402(b) on aliens most likely was not considered when the statute was enacted, the provisions do not exclude such employees." Id. at 95 n.28. They suggest that "[i]n an increasingly global economy, the adverse consequences will be more noticeable." Id. See also Letter from Raymond J. Wiacek to Peter Barnes, Associate International Tax Counsel (Jan. 25, 1990), reprinted in 90 TNI 8-54 (Feb. 21, 1990) (LEXIS, FEDTAX library, TNI file) [hereinafter Wiacek Letter to Barnes] ("Because [Canadian] registered plans are not qualified plans under the Code, Canadian citizens resident in the U.S. and U.S. citizens (wherever resident) who are covered by registered plans are required under Section 402(b) to include in their income contributions by their employer . . . to the extent the employees' benefits under the plan are vested"); KPMG Letter, supra note 161 ("Section 402(b) will subject a U.S. citizen to U.S. income tax as the individual becomes vested in the benefits of a Canadian pension . . . plan.").

268. See Regs. § 1.402(b)-1(a)(1), (b) (when interest that was nonvested becomes vested, the employee must include the value of his interest in the trust at the time of change); Ellis & Navin, supra note 72, at 31-32.

269. See IRC § 911(b)(1)(B)(iii) (IRC § 911 is inapplicable to amounts included in gross income under § 402(b)); Ellis & Navin, supra note 72, at 33.

270. See Regs. § 1.402(b)-1(b)(2)(ii) (providing that in such a case "the value of an employee's interest in such trust shall be determined in accordance with the formula described in § 1.403(b)-1(d)(4) or any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan . . . and the method adopted by the employer for funding the benefits. . . ."); Ellis & Navin, supra note 72, at 32; Wiacek Letter to Barnes, supra note 267; Wiacek Letter to Terr, supra note 266. See also infra note 346 for a discussion of Wiacek Letter to Terr.

271. See §§ 402(b)(4)(A), 401(a)(26), 410(b); Ellis & Navin, supra note 72, at 31 (explaining that most foreign retirement plans will attract the application of § 402(b)(4)(A) for an employee who is a "highly compensated employee" as defined in § 414(q)). They comment that:

> Even if a foreign retirement plan covers the lesser of 50 employees or 40% of all employees (§ 401(a)(26)), it probably will not cover a percentage of non-highly compensated employees which is at least 70% of the percentage of highly compensated employees covered by the plan (or satisfy alternative coverage requirements), and there are likely to be several other § 401(a) qualification requirements that will not be met.

Id.

272. In a 1996 amendment to the foreign trust rules, Congress made clear that § 679 (dealing with foreign trusts having a U.S. beneficiary) is not applicable to a trust described in § 402(b). See §§ 679(a) and 6048(a)(3)(B)(ii), amended by Small Business Job Protection Act

If a foreign retirement arrangement is unfunded by U.S. standards,[273] then U.S. tax is delayed until payment of the deferred compensation.[274] See Table 2, row 7, page 360. This may be true of a foreign pension plan meeting the foreign country's requirements for an immediate employer deduction.[275] Although U.S. standards are necessarily applied, the IRS recently showed some flexibility in applying its usual ruling guidelines for classifying a deferred compensation arrangement as unfunded in order to take into account the fact that the arrangement had to "comply with Canadian tax law as well as United States tax law."[276]

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of 1996, Pub. L. No. 104-188, § 1901(a), 1903(b), 110 Stat. 1755, 1904-10 (effective for transfers after Feb. 6, 1995).

273. See Ellis & Navin, supra note 71, at 32 (suggesting that "it may be possible to argue that § 402(b) is inapplicable where the foreign retirement plan is financed through book reserve accruals or other arrangements that do not constitute typical U.S. employee benefit plan trusts"; noting the absence of a definition of "employee's trust" in § 402(b) or the regulations thereunder; suggesting that reference should be made to the definition of a trust in Regs. § 301.7701-4, and further noting that "an outbound executive may be taxable with respect to his interest in a foreign retirement plan pursuant to § 83 if it is funded but not otherwise subject to taxation under § 402 or § 403").

274. See Priv. Ltr. Rul. 93-32-038 (May 18, 1993), where the IRS ruled that a deferred compensation agreement and trust established in Canada (and modelled according to Canada's Income Tax Act as an Employee Benefit Plan Trust) by a Canadian employer for a U.S. citizen employee did not result in any income for the employee until amounts were actually distributed or otherwise made available to the employee. The IRS ruled that there was no transfer of property under § 83, no contribution to an employee's trust under § 402(b), and no inclusion under the economic benefit or constructive receipt doctrine prior to that time. Id. See also Ellis & Navin, supra note 72, at 33 ("[T]o the extent that a foreign retirement plan is unfunded and participants receive benefits on a 'pay as you go' basis, the outbound executive is not taxable on the foreign retirement benefit until receipt.").

275. See Feder, supra note 72, at 43-44 (Most German pension plans are unfunded, with "[a]nnual additions to reserves for pension expenses deductible for German income tax purposes under a precise set of actuarial assumptions."). Feder further notes that a U.S. executive participating in such a plan does not recognize income for U.S. tax purposes "until payment is actually made" to him. Id. at 47.

276. Priv. Ltr. Rul. 93-32-038 (May 18, 1993) (confirming unfunded status for a trust formed by a Canadian sports team for the benefit of a U.S. citizen key employee). The IRS considered that the formation of the trust in Canada and the need to "comply with Canadian tax law as well as United States tax law" was a "rare and unusual circumstance" justifying a ruling notwithstanding failure to follow the model format. Id. The trust agreement provided that the employee "has the status of a general unsecured creditor," and the "material terms and provisions of the Trust ... are enforceable" under Canadian law. Id. The ruling states as a proviso that "the provision in the Trust requiring use of the Trust assets to satisfy the claims of general creditors in the event of insolvency is enforceable by the general creditors of the Employer under Canadian as well as . . . provincial law." Id. (The trust at issue in that ruling followed the IRS's model language but not its model format for a rabbi trust. Rev. Proc. 92-64, 1992-2 C.B. 422.)

When a U.S. citizen or resident working overseas contributes to an individual retirement savings trust organized under foreign law, the consequences are similar to those of participating in a foreign employer-sponsored plan. Contributions to such plans are not deductible for U.S. tax purposes. Moreover, such plans may be viewed as grantor trusts under section 679 of the Code,[277] with the result that trust earnings are taxable to the beneficiary pursuant to section 671.[278]

2. *Foreign Tax Credit Considerations.*—U.S. taxation of deferred compensation of a U.S. citizen who works overseas may be duplicative of the host country's tax. In some cases, the host country will be prevented from imposing source-country taxation by the dependent services article of a treaty (where the "commercial traveler" test is met) or by the pension article of a treaty (if source-based tax would otherwise be imposed at the time of the pension payment). At the same time, the host country may seek to impose a residence-based tax; even if a treaty applies, the treaty tie-breaker rule may classify the individual as a resident of the host country, rather than the U.S.[279] Under the French or Swedish treaties, employee contributions to a U.S. qualified retirement arrangement may be deductible in the host country.[280]

As the residence country, the U.S. undertakes to mitigate international double taxation by the allowance of a credit under section 901 for foreign taxes paid with respect to foreign source income.[281] Assuming that all services are performed abroad, the entire amount of unfunded deferred compensation is treated as foreign source income (when paid); the entire amount of income arising from contributions to a foreign pension plan or from distributions from the plan would also be foreign source. In the case of a distribution from a U.S. qualified pension plan, only the amount represent-

277. See Wiacek Letter to Barnes, supra note 267 (concluding that a Canadian registered savings plan created as a trust by a U.S. citizen or resident would be subject to § 679); see also Wiacek Letter to Terr, supra note 266.

278. See Wiacek Letter to Barnes, supra note 267 (Wiacek notes that if a Canadian citizen with a RRSP trust establishes U.S. residence, the application of § 679 would be triggered. Under the U.S.-Canada Income Tax Treaty, supra note 146, prior to the effective date of the 1995 protocol, the election to defer U.S. tax on the earnings pursuant to art. 29, ¶ 5 was not available to a Canadian citizen.) Wiacek argued that "[n]oncompliance here" is "potentially serious." Wiacek Letter to Terr, supra note 266. On the other hand, "if, before establishing a U.S. residence, the Canadian citizen uses his RRSP/RRIF assets to purchase an annuity contract . . . the U.S. trust taxation rules would never apply," and the purchase price of the contract would be the "investment in the contract" for purposes of § 72. Id.

279. See Ellis & Navin, supra note 72, at 48-49.

280. See supra notes 193-200 and accompanying text.

281. See IRC § 901.

ing contributions in respect of services abroad is foreign source; the amount representing "accretions" is from U.S. sources.[282]

However, effective use of the foreign tax credit may be hindered by timing differences under U.S. and foreign tax rules.[283] Thus, for example, contributions to, or accretions in, a foreign funded pension plan may be eligible for deferral under foreign law;[284] in that case, U.S. taxation of the employee will precede foreign taxation. In the year that foreign taxation is imposed, the employee may have no foreign source taxable income for purposes of the section 904 credit fraction. A carryback of the credit is permitted only to the two preceding years.[285]

3. *Treaty Provisions.*—The recently negotiated treaties with France and Canada provide some relief for such mismatching.[286] Under Canadian tax rules, taxation of the earnings of a Canadian registered retirement savings plan is deferred until distribution; however, the failure of such a savings plan to qualify as an IRA under section 408(a) results in immediate U.S. taxation of the earnings to a beneficiary who is a U.S. citizen or resident. Under article 29, paragraph 5 of the U.S. tax treaty signed with Canada in 1980,[287]

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282. See Rev. Rul. 79-389, 1979-2 C.B. 281 (A distribution to a U.S. citizen from a U.S. pension plan is treated as U.S. source for purposes of § 904 to the extent of "accretions" and contributions made with respect to services performed in the U.S.); Rev. Rul. 78-227, 1978-1 C.B. 242 (Distributions from a Foreign Service retirement annuity that were attributable to current Congressional appropriations were considered to be "employer contributions" and thus sourced for purposes of § 904 on the basis of the place where services were performed.); Rev. Rul. 84-144, 1984-2 C.B. 129 (Amounts withdrawn from an IRA established by a rollover from a qualified pension plan were foreign source, for purposes of § 904, only to the extent attributable to employer contributions with respect to wages earned abroad.). See also Bissell & Giardina, supra note 72, at 277 (noting that § 402(d)(7) creates a separate foreign tax credit basket for a "lump sum distribution from a qualified plan").

283. See Rev. Proc. 89-45, 1989-2 C.B. 596 (implementing provision of U.S.-Canada Income Tax Treaty designed to avoid such a "mismatch"). See also Penny Mavridis, A Cross-Border View: Election to Defer U.S. Income Tax on Earnings of Canadian Registered Savings Plan, 24 Tax Mgmt. Int'l J. 382 (1995).

284. See supra notes 66-71 and accompanying text for a discussion of the tax treatment of pensions in other countries.

285. IRC § 904(c). Section 904(c) also allows carryover to the five succeeding years.

286. See U.S.-France Income Tax Treaty, supra note 135, at ¶ 3001.04, 27005-13; U.S.-Canada Income Tax Treaty, supra note 146, at T.I.A.S. 11087, 27.

287. See U.S.-Canada Income Tax Treaty, supra note 146, art. 29, ¶ 5; see also Treasury Department Technical Explanation of the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital, Signed at Washington, D.C. on Sept. 26, 1980, as amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on Mar. 28, 1984, 1986-2 C.B. 295, reprinted in Tax Treaties (CCH) ¶ 1950, 21,089 (explaining that the intent is to "resolve conflicts between the Canadian and U.S. treatment of individual retirement accounts") [hereinafter Treasury

the beneficiary of an RRSP can make an election[288] to defer U.S. tax on the earnings until distribution[289] to the extent the earnings are attributable to contributions made during a period of Canadian residency.[290] The March 17, 1995 protocol to the Canadian treaty extends this election to allow deferral of Canadian tax by beneficiaries of U.S. retirement plans, and includes any retirement plan exempt from taxation in its residence country and operated exclusively to provide pension, retirement or employee benefits.[291]

Similar relief is provided in the U.S. treaty with France.[292] Article 18, paragraph 2(c) provides that payments received by a beneficiary resident in one Contracting State in respect of a pension or other retirement arrangement established in and recognized for tax purposes by the other Contracting State shall be included in income in the Contracting State of the beneficiary's

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Department Technical Explanation of the U.S.-Canada Income Tax Treaty]; Klein, supra note 72, at 382.

288. See Rev. Proc. 89-45, 1989-2 C.B. 596 (establishing procedure under which beneficiary elects deferral); Mavridis, supra note 283, at 382-84.

289. The eventual distribution is taxed pursuant to § 72. Rev. Proc. 89-45, 1989-2 C.B. 596. Under Rev. Proc. 89-45, the investment in the contract in the case of a "person who is a U.S. citizen in all years for which contributions are made to the plan . . . is the sum of: (i) [e]mployee contributions from after-tax (that is, after U.S. tax) earnings, and (ii) [e]mployer contributions included in the U.S. gross income of the employee. . ." If the person

> is not a U.S. citizen or a U.S. resident in any years for which contributions are made to the plan, the gross investment in the contract . . . is equal to the lesser of (a) the fair market value of the assets in the plan at the time the beneficiary became a U.S. citizen or resident, or (b) the sum of contributions to the plan plus earnings accrued in the plan at the time the beneficiary became a U.S. citizen or resident.

Id.

290. See Protocol Amending U.S.-Canada Income Tax Treaty, June 14, 1983, art. 13, ¶ 4, T.I.A.S. 11087, 72 [hereinafter 1983 Protocol] (stating that the deferral privilege "shall not apply to income which is reasonable [sic] attributable to contributions made to the plan by the beneficiary while he was not a resident of Canada"). But see 1995 Revised Protocol supra note 178, art. 9, ¶ 3, and art. 17, ¶ 2, reprinted in Tax Treaties [CCH] ¶ 1946, 21,043-6, 21,043-11 (eliminating the residence requirement).

291. See 1995 Revised Protocol, supra note 178, art. 9, ¶ 3 (adding new ¶ 7 to art. 18 of the U.S.-Canada Income Tax Treaty) and art. 17, ¶ 2 (replacing art. 29, ¶ 5 of the Treaty); Joint Comm. on Tax'n, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada, supra note 178; Treasury Explanation of Revised Protocol to U.S.-Canada Treaty, supra note 178, ¶ 1952, 21,091-5 (discussing art. 9 of the Protocol); see also Notice 96-31, 1996-22 I.R.B. 1 (May 28, 1996) (specifying that the provisions of the Protocol apply to a RRSP or RRIF).

292. U.S.-France Income Tax Treaty, supra note 135, art. 18, ¶ 2(c). A similar provision was added to the 1967 U.S.-France Income Tax Treaty by a Protocol signed Jan. 17, 1984; the provision originally arose in a "side letter to the 1978 Protocol for the purpose of providing French benefits to U.S. citizens resident in France." Treasury Department Technical Explanation of U.S.-France Income Tax Treaty, supra note 135, ¶ 3058, 27,197-31.

residence "when and to the extent such payments are considered gross income by the other Contracting State." Thus, for example, if a U.S. citizen came to work in France as a French resident,[293] but contributed to a U.S. qualified pension plan, the contribution would be deductible (pursuant to paragraph 2(a) of article 18) for French tax purposes, and France would not tax accrued benefits in the plan until such benefits would be taxed by the U.S.[294]

The treaty with Canada contains a further provision, which is designed to prevent mismatching in the situation where the source country imposes tax *earlier* than the residence country. Under this provision, the residence country must exempt "the amount of any . . . pension that would be excluded from taxable income" in the source country if the recipient were resident there.[295] Thus, if Canada as the source country had imposed a

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293. Staff of the Joint Comm. on Tax'n, Explanation of Proposed Protocol to the Tax Treaty Between the United States and France, JCS 22-84, Apr. 26, 1984, reprinted in 87 TNI 53-44 [hereinafter Staff of the Joint Comm. on Tax'n, Explanation of 1984 Protocol to the U.S.-France Income Tax Treaty]; Report of the Senate Foreign Relations Committee on the Protocol Signed on Jan. 17, 1984 to Amend the Income Tax Treaty with France (CCH) ¶ 3053, 27,163 ("[A] U.S. citizen residing in France . . . may be required to include benefits received from a U.S. retirement plan in income for French tax purposes when distributed since, under U.S. internal law, an employee's benefits from or under a qualified plan . . . generally are includible in income when distributed.") [hereinafter Senate Foreign Relations Comm. Report on the 1984 Protocol to U.S.-France Income Tax Treaty].

294. Paragraph 2, subparagraph (c) of art. 18 refers back to "an arrangement referred to in subparagraph (a) that satisfies the requirements of this paragraph. . . ." This may mean that relief is limited to the situation where, as described in subparagraph (a), a national of one country who is working and resident in the other country contributes to a plan in his country of nationality. However, the provision is apparently potentially applicable to the case of a U.S. citizen who contributes to a U.S. plan while his principal place of employment is in the U.S. and later resides in France; this can be inferred from the fact that the provision is made "subject to" art. 24, which provides in such a case for France to grant a credit (in the amount of the French tax otherwise due) with respect to such pension income. U.S.-France Income Tax Treaty, supra note 146, art. 24, ¶ 2(b)(iv); see also Senate Foreign Relations Comm. Report on the 1984 Protocol to U.S.-France Income Tax Treaty, supra note 293, ¶ 3053, 27,163-64 (stating that if a U.S. citizen residing in France receives benefits from a U.S. retirement plan attributable to services while his principal employment "was in the United States (rather than in France or a third country), then the benefits will not be included in income for French tax purposes because such benefits are exempt from French tax under the treaty's double taxation relief article"). It is not as clear that the provision could be applied to defer U.S. tax for a U.S. citizen who works in France and makes contributions to a French plan, and then resumes residence in the U.S.

295. 1983 Protocol, supra note 290, art. 9, ¶ 1, replacing art. 18, ¶ 1 of the treaty. As signed on Sept. 26, 1980, the provision stated that the "amount of any pension included in income for the purposes of taxation" in the residence country "shall not exceed the amount that would be included" in the source country if the recipient were a resident there. U.S.-Canada Income Tax Treaty, supra note 146, art. 18, ¶ 1. This language apparently left the implication that the residence country would have to grant a "personal allowance" granted by

current tax on contributions or accrued benefits in a pension plan and thereafter granted basis for such amounts, the U.S. could not, as the residence country, impose a tax on such amounts at a later time.

A similar provision has been included as a limitation on the residence country in the 1996 U.S. Model.[296] Article 18, paragraph 1 of this model provides that "pension distributions . . . shall be taxable only in" the residence state, "but only[297] to the extent not included in taxable income in the other Contracting State prior to the distribution."[298] The Treasury explained that "[t]he exclusive residence-based taxation provided under . . . [article 18, paragraph 1] is limited to taxation of amounts that were not previously included in taxable income in the other Contracting State."[299] Thus, "if a Contracting State had imposed tax on the resident with respect to some portion of a pension plan's earnings, subsequent distributions to a resident of the other State would not be taxable in that State to the extent the distributions were attributable to such amounts."[300]

This provision will affect U.S. residence-based taxation of a pension only if U.S. tax is delayed until the time of the pension's distribution. Therefore, this provision's impact will be only on (a) distributions from a U.S. qualified plan or an unfunded pension plan, or (b) in the case of

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the source country. To counter, this language was revised by the Protocol of June 14, 1983, art 9, ¶ 1. 1983 Protocol, supra note 290, art. 9, ¶ 1. Under the revised version, if $5,000 of a $10,000 pension payment arising in the source country "would be excluded from taxable income as a return of capital" in the source country "if the recipient were a resident," then the $5,000 should be exempted by the residence country; at the same time, the fact that the source country "would also grant a personal allowance as a deduction from gross income if the recipient were a resident" would not result in an increase in the amount to be exempted by the residence country. Treasury Department Technical Explanation of the U.S.-Canada Income Tax Treaty, supra note 287, ¶ 1950, 21,069. See also Klein, supra note 72, at 382 (stating that the provision is "believed . . . to make any basis in the pension created in one country recoverable tax-free in the other country.").

296. 1996 U.S. Model, supra note 2. This provision is not exempted from the savings clause. Id. art. 1, ¶ 4; 1996 Treasury Explanation, supra note 2, ¶ 259. This result is perhaps unintended.

297. 1996 U.S. Model, supra note 2, art. 18, ¶ 1. This language is ambiguous due to the double use of the term "only." The language could be interpreted to mean that the residence country can tax the full amount in all cases, but that its jurisdiction to tax is not exclusive when the other country has previously taxed. However, the Treasury's Technical Explanation does not adopt this interpretation. See infra notes 299-300 and accompanying text.

298. 1996 U.S. Model, supra note 2, art. 18, ¶ 1.

299. 1996 Treasury Explanation, supra note 2, ¶ 246.

300. Id. Treasury states that "[i]n determining the amount of a distribution that is attributable to previously taxed amounts, the ordering rules of the residence State will be applied." Id. In particular, "[t]he United States will treat any amount that has increased the recipient's 'investment in the contract' (as defined in Section 72) as having been previously included in taxable income." Id.

distributions from a funded nonqualified plan (U.S. or foreign), only to the extent benefits have avoided earlier U.S. taxation because the benefits are forfeitable or the individual is not a highly compensated individual.

For example, suppose a U.S. citizen, who is resident and performing services in a treaty country, were to participate in a U.S. qualified pension plan and the treaty country were to impose a current tax on contributions and plan earnings (notwithstanding the 1996 Model's rules limiting source taxation of home country pensions[301]); upon retirement, the individual becomes a U.S. resident. Under the 1996 U.S. Model, the U.S. would be barred from taxing the distribution since that amount was already taxed by the other country.[302] A further example would be the case of a U.S. citizen who performs services in a treaty country and participates in a pension plan located there, and who is not a highly compensated employee. The U.S. would impose a current tax on nonforfeitable contributions to the plan, but not on plan earnings. Assume that the foreign country imposes a current tax on plan earnings and that, prior to the time of distribution, the individual becomes a U.S. resident. In that case, the U.S. would not tax any part of the distribution from the foreign plan. The contributions were previously taxed by the U.S.; and, under the 1996 U.S. Model, the U.S. is barred from taxing the earnings because they were previously taxed by the other country.

4. *Possibilities for Manipulation of Timing Differences.*—In an entirely domestic context, deferral of an employee's tax liability with respect to nonforfeitable retirement benefits is conditioned upon compliance with the rules for qualified pension plans (or IRAs) or upon deferral of the employer's deduction for compensation and treatment of the employer as continued owner of the pension assets. These conditions can be avoided in some cases when a foreign employer creates a hybrid retirement arrangement for a U.S. citizen employee.[303]

For example, the foreign employer may establish a Cayman Islands trust to secure the employer's liability to pay deferred compensation to the U.S. citizen employee; the Cayman Islands trust may be viewed as a grantor trust by the U.S., but as a separate taxpayer by the employer's home country. In that case, the employee is not subject to U.S. tax on the deferred compensation until it is distributed to him. Assuming that the employer is not engaged in the conduct of a U.S. trade or business, the employer is

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301. See 1996 U.S. Model, supra note 2, art. 18, ¶ 6; see also supra notes 190-203 and accompanying text.

302. This example and the subsequent example assume an exception to the savings clause. See supra note 296.

303. Ordower, supra note 72, at 322-35 (analyzing this type of arrangement and its tax consequences for employer and employee).

indifferent to the deferral for U.S. tax purposes of the allowance of a deduction for compensation. Nor will the employer be subject to U.S. tax on the investment income derived from the trust assets, provided that the assets are invested outside the U.S. or in bank deposits or bonds yielding portfolio interest.[304] At the same time, the home country of the employer may allow the employer an immediate deduction for assets contributed to the trust, and may not seek to impose any tax on the income of the Cayman Islands trust.[305]

However, the situations where such benefits are fully available may be fairly limited.[306] If the U.S. citizen is employed outside the U.S. (e.g., in the home country of the employer), he may be subject to an immediate foreign tax on the deferred compensation; the employee will subsequently incur the U.S. tax without any possibility of a section 911 exemption and with a risk that the foreign tax credit will be lost because of delay in the inclusion of the foreign source income for U.S. tax purposes.[307]

If the employee performs his services for the foreign employer in the U.S., the employee avoids foreign tax liability. On the other hand, if services are performed by the employee in the U.S. in connection with a U.S. business of the employer, the employer will not be indifferent to the U.S. tax treatment of the trust.[308] Those in the best position to benefit from such a hybrid arrangement may be (a) an offshore investment company employing a U.S. citizen employee to perform services in the U.S. as its investment advisor or broker,[309] or (b) a foreign employer employing a U.S. citizen employee to temporarily provide business or engineering expertise with respect to non-U.S. activities of the employer.[310]

The Clinton Administration's February 1995 proposal[311] to curb

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304. Id. at 322-26. Moreover, the U.S. citizen employee avoids the impact of §§ 551-558, 951, or 1291-1295. Id. at 325, 329 & n.157.

305. Id. at 323.

306. Id. at 328-29.

307. Id. at 329-33.

308. Id. at 333-35.

309. Id. at 329. The employee's performance of services in the U.S. can be arranged in such a way as to avoid "U.S. business" status for the employer. Id. (citing § 864(b)).

310. Id.

311. Treasury Explanation of Clinton's Proposals to "Curb Foreign Tax Avoidance": Tax Responsibilities of Americans Renouncing U.S. Citizenship, 95 TNI 26-24 (Feb. 8, 1995) (LEXIS, FEDTAX library, TNI file). The Treasury stated concern with "[w]ealthy foreign families [who] set up foreign trusts which benefit a U.S. family member." Id. The Treasury explained that "income generated by foreign trust assets frequently is not taxed in any country;" this occurs because "[m]any foreign jurisdictions do not consider the foreign grantor to be the owner of the trust assets, and trusts are normally established in jurisdictions which do not impose tax on trust income." Id. Because the U.S. treats the trust assets as owned by the foreign family, the U.S. views the "distribution of trust income to the U.S. beneficiary . . .

abuses involving foreign trusts might have interfered with the desired effects of such an arrangement. Under the proposal, the grantor trust rules would not be applied unless the effect would be to require current income inclusion by a U.S. citizen or resident or a domestic corporation.[312] However, the version finally enacted in 1996 provides an exception for trusts used to pay compensation.[313]

5. *Lack of Citizenship Jurisdiction in Most Countries.*—As noted, hardly any of the trading partners of the U.S. impose tax on the basis of citizenship.[314] Thus, nationals of other countries who earn deferred compensation while living and working in the U.S. can avoid any risk of current taxation in their country of nationality if they are considered resident in the U.S. For example, Canada does not impose its tax on an individual who is a Canadian citizen-U.S. resident with respect to employer contributions to, or accrued earnings of, a qualified U.S. pension plan or a Canadian registered pension plan because Canadian taxation is based on residency.[315] In many cases, deferred compensation payments made to such individuals after reestablishing residence in their country of nationality may also be exempt from tax in such country.[316]

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as a nontaxable gift." Id. Under the Administration's proposal, the "trust income would be taxed" by the U.S. "when distributed to U.S. beneficiaries." Id.

312. H.R. Rep. No. 981, 104th Cong., 1st Sess. (1995) (Section 204 of the bill amends IRC § 672(f)(1) to provide that subpart E (the grantor trust rules) "only apply to the extent such application results in an amount being included in gross income of a citizen or resident of the United States or a domestic corporation.").

313. Conference Report for Small Business Job Protection Act of 1996, H.R. Rep. No. 3448, 104th Cong., 2d Sess. (1996) (enacted). Under the final version, § 672(f)(2)(B) is amended to state that: "Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered." Id. § 1904(a)(1). Apparently Congress concluded that if the trust distributions are subject to U.S. tax as compensation, the type of abuse of concern to Treasury was not present.

314. See supra note 255.

315. See Letter from Raymond J. Wiacek to Peter Barnes, Office of Int'l Tax Counsel (Oct. 3, 1988), reprinted in 88 TNI 43-40 (Oct. 26, 1988) (LEXIS, FEDTAX library, TNI file). See also Bissell & Giardina, supra note 72, at 282 ("[A] foreign national working in the United States would usually not be subject to foreign tax on current accruals in a U.S.-based SERP because most foreign countries do not impose personal income tax on their citizens who are resident in another country.").

316. See Ellis & Navin, supra note 72, at 88 ("Many foreign countries (e.g., the U.K.) will exempt deferred compensation payments from tax if they were earned during a period of U.S. residence" although "some foreign countries (e.g., Italy and Switzerland) may tax these payments."). See also E.A. Nicholson & Thomas St.G. Bissell, Tax Planning for Foreign Nationals Working in the United States, 1992 Intertax 55, 58 (placing Belgium, Germany and U.K. in the former category and Italy, Switzerland, and Sweden in the second).

B. *Alien Performs Services Outside the U.S. and Receives Payments of Deferred Compensation After Becoming U.S. Resident*

1. *Results Under the Internal Revenue Code.*—Assume that a citizen of Country X spends his working years employed in Country X by a Country X employer who makes contributions for the employee to a Country X qualified pension plan. Assume, however, that this individual takes up permanent residence in Florida at the time of his retirement and is treated by the U.S. as a resident alien and is no longer classified as a resident by Country X tax authorities.[317] See Table 2, row 10, page 361. If the Country X tax rules regarding pensions are the same as in the U.S., then Country X would defer taxation of amounts contributed to the plan until distributed to the employee. Country X tax rules may or may not provide for taxation of the eventual distribution. This would depend upon whether Country X seeks to retain jurisdiction to tax items that have accrued to a long-term resident prior to his departure; it also depends upon whether Country X asserts a source-based tax over pensions by reason of the location of the services or the situs of the trust.[318]

In this situation, even though the U.S. taxes its residents on world-wide income, U.S. taxation of the entire distribution is not assured. If the pension plan in Country X is classified by U.S. standards as an unfunded plan (despite the contrary result under Country X law),[319] then the U.S. will treat distributions from the plan as foreign-source compensation income, taxable in full and ineligible for section 911 relief (because it is deferred). See Table 2, row 9, page 361.[320] If, however, the U.S. agrees with Country X's

317. See, e.g., Tech. Adv. Mem. 89-11-001 (Sept. 27, 1988), reprinted in 89 TNI 13-42 (Mar. 29, 1989) (LEXIS, FEDTAX library, TNI file) (involving a Canadian citizen who receives pre-retirement distributions from a Canadian pension plan after becoming a U.S. resident alien).

318. For example, Norway imposes its income tax on "[a]ll remuneration (including pension distributions) derived from employment in Norway or paid to a manager or member of the Board of Directors of [a] company resident in Norway. . . ." JCT Report on Expatriation, supra note 129, at B-5. "A business . . . distributing pension benefits is responsible for withholding taxes on such income regardless of the individual's country of residence," e.g., even if he is a former resident. Id. Denmark imposes its income tax on "[p]ension distributions received by nonresidents from Danish pension plans, . . . but many tax treaties effectively override this provision of Danish law." Id. at B-8.

319. See supra note 276 and accompanying text. For example, the plan may be a "rabbi trust," for U.S. tax purposes, but Country X may view a plan secured by such a trust as a funded plan.

320. In Priv. Ltr. Rul. 96-28-024 (Apr. 16, 1996), the IRS ruled that an individual, who becomes a resident alien after performance of services and before payment, is taxable as a resident on the compensation paid, regardless of its source. The results in the ruling were not affected by the relevant treaty because of the applicability of the savings clause. Id.

characterization of the plan as funded, then the distribution will be viewed as a return of capital at least to the extent of amounts previously contributed to the plan (by employee or employer). See Table 2, row 10, page 361.

Because the foreign plan would in all likelihood be "nonqualified" for U.S. tax purposes, distributions from the plan would be subject to the rules of section 402(b) and thus the rules of section 72.[321] For this purpose, investment in the contract takes account not only of employee contributions, but also of contributions made by the employer that either (a) were includible in the employee's gross income for U.S. tax purposes at an earlier time or (b) would *not* have been so includible if paid directly to the employee at the time of contribution.[322]

In the example given, the employer contributions do not meet condition (a) since they were not includible in gross income of the employee for U.S. tax purposes when made; however, the employer contributions do meet condition (b); that is, even if the employer contributions had been paid directly to the employee, they would not be includible because the employee was a nonresident alien receiving compensation for services performed outside the U.S.[323] Thus, these contributions are, pursuant to section 72(f), considered part of the investment in the contract (even though not yet taxed in the U.S. or in country X).[324]

Thus, only the portion of the distribution representing "earnings and accretion" is treated as income by the U.S. This income would apparently be foreign source income (as coming from a foreign situs trust) for purposes of determining a foreign tax credit.[325]

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321. See Tech. Adv. Mem. 89-11-001, supra note 317.

322. IRC § 72(f). See Tech. Adv. Mem. 89-11-001, supra note 317 (citing Rev. Rul. 58-236, 1958-1 C.B. 37).

323. See Tech. Adv. Mem. 89-11-001, supra note 317; Walker & Olson, supra note 22, at 98 (discussing exclusion under IRC § 872); Rev. Rul. 58-236, 1958-1 C.B. 37, 38-39.

324. Tech. Adv. Mem. 89-11-001, supra note 317 (citing Rev. Rul. 58-236, 1958-1 C.B. 37). See Walker & Olson, supra note 22, at 98; see also Bissell & Giardina, supra note 72, at 278-79.

Walker & Olson argue that this analysis is supported by the Supreme Court's opinions in Biddle v. Commissioner, 302 U.S. 573 (1938) and United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989) (requiring application of U.S. tax principles in applying the foreign tax credit rules). See also KPMG Letter, supra note 161 ("[A] Canadian citizen resident in the U.S. will be subject to U.S. income tax to the extent vesting [in a Canadian pension plan] occurs after the U.S. residence is established."); Michael J. Canan, Qualified Retirement and Other Employee Benefit Plans § 23.6, at 1094-95 n.3 (practitioner ed. 1995) (noting that the fact that basis is granted for employer contributions made to a foreign pension plan on behalf of a nonresident alien "may open the door for planning opportunities with respect to deferred compensation or retirement income paid while the individual was a nonresident alien.").

325. See supra note 282 and accompanying text.

It has been suggested that the U.S. will in many cases not tax even the "earnings and accretion" portion of the distribution. If the employee is considered under U.S. tax rules to be a "highly compensated employee" and the pension plan does not meet the nondiscrimination rules applied to U.S. qualified plans, then the investment in the contract might include the entire amount of the vested accrued benefits.[326] If the individual had been a U.S. citizen or resident throughout his employment, he would have been taxed annually pursuant to section 402(b)(4)(A) on the amount of his vested accrued benefit (other than his investment in the contract); presumably for this purpose, amounts once included under this provision would thereafter be treated as investment in the contract.[327]

In support of this result, one might argue by analogy to section 72(f) (which deals only with employer contributions) that investment in the contract should also include amounts that would have been taxed annually to an alien under section 402(b)(4)(A) but for his status at the time as a nonresident and the foreign source of the income.[328] More generally, one might argue that under U.S. timing rules, the appropriate time to tax would have been as the vested benefit accrued; thus, as the benefits accrued, basis is created (even though the U.S. was in fact unable to tax because of the individual's nonresident alien status).[329] Under this theory, the fact that the U.S. did not

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326. See Walker & Olson, supra note 22, at 98 (stating that the *Biddle*, 302 U.S. 573 (1938), and *Goodyear*, 493 U.S. 132 (1989), decisions by the Supreme Court "and the enactment of Section 402(b)(2) arguably enable the noncitizen taxpayer who is an HCE participant in a plan that does not satisfy the rules of Sections 410(b) or 401(a)(26) to count as investment in the contract any earnings that accrued during a period of nonresidency.").

327. See Regs. § 1.402(b)-1(b)(5) ("The basis of any employee's interest in a trust to which this section applies shall be increased by the amount included in his gross income under this section."). See also Ellis & Navin, supra note 72, at 32. However, this is not clearly a reference to inclusions pursuant to § 402(b)(4)(A), which are not discussed in Regs. § 1.402(b)-1). As noted above, the IRS is unwilling to rule on the treatment of distributions to a highly compensated employee, in the absence of a technical correction to § 402(b)(4)(A). See supra note 39.

328. See Walker & Olson, supra note 22, at 98 (suggesting that § 72(f)'s "focu[s] on contributions rather than accrued benefits" is due to the fact that "it was enacted before Section 402(b)(2)."). (Section 402(b)(2) was relocated at § 402(b)(4)(A), as a result of the Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 521(a), 106 Stat. 300, 301 (1992)).

329. Walker & Olson, supra note 22, at 98 n.26 (citing Tech. Adv. Mem. 87-49-008 (Aug. 18, 1987)). In that Technical Advice Memorandum, the IRS National Office ruled on the proper determination of the adjusted basis of a foreign corporation's depreciable property that was placed in service in a foreign country in 1967 but then used in a business in the U.S. beginning in 1975. Tech. Adv. Mem. 87-49-008 (Aug. 18, 1987). The National Office concluded that the adjusted basis should reflect depreciation allowable under U.S. principles beginning in 1967, even though no U.S. tax return was required to be filed prior to 1975 and the depreciation was attributable to income not subject to U.S. tax. Id. See also Gen. Couns.

have jurisdiction (either source or residence-based) to tax at that time should not permit it to tax at a later time when it acquires residence jurisdiction.

A similar approach seems to be accepted by the IRS in implementing article 29, paragraph 5 of the U.S.-Canada Treaty, providing for deferral of U.S. tax with respect to certain earnings accrued in a Canadian registered retirement savings plan (RRSP).[330] The IRS has taken the position that when a person becomes a U.S. resident or citizen only after making all contributions to a RRSP, the gross investment in the contract under section 72(c)(1)(A) is "the sum of the contributions to the plan plus earnings accrued in the plan at the time the beneficiary became a U.S. citizen or resident" (or, if lesser, "the fair market value of the assets in the plan at the time the beneficiary became a U.S. citizen or resident").[331]

2. *Results Under Treaties*

a. *Treatment by Country X.*—If a treaty (following the OECD or U.S. model) were in effect between the U.S. and Country X in the above-described situation, Country X would surrender its right to assert source-based tax jurisdiction over the pension payments because its national had become a U.S. resident.

It is possible, however, that Country X would assert a residence-based tax, focusing on the employee's continued citizenship in Country X or on his long-term residence in Country X, and seek to protect this jurisdiction in its

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Mem. 34,572 (Aug. 3, 1971), where the Chief Counsel concluded that when "a nonresident alien acquires property before becoming a U.S. resident and then sells the property after such date . . . the general statutory basis provisions set forth in sections 1001 and 1011 . . . are applicable. . . ." General Counsel acknowledged "that a strictly 'equitable' approach . . . might possibly dictate use of a 'special basis' . . . such as, a basis equal to the fair market value . . . upon taxpayer's initial entry into the United States. . . ." Id. However, it explained that: "the present basis provisions of the Code cannot be so interpreted. . . ." Id. In support of this interpretation, Chief Counsel cited the case of Gutwirth v. Commissioner, 40 T.C. 666 (1963), acq. in result, 1966-2 C.B., where the Tax Court had to determine the loss to be claimed for war damage occurring in 1945 to a factory in Antwerp that was owned by alien individuals who took up U.S. residence in 1939. The court held that the adjusted basis of the property included the original investment made in 1922 and 1923, increased by "subsequent capital additions" notwithstanding that "these additions were treated as expenses in Belgium." Id. at 678. The court held that the basis should also reflect downward adjustment for depreciation so as to avoid "discriminat[ing] in favor of resident aliens owning property abroad as against resident taxpayers in identical situations." Id. at 679.

330. See supra notes 287-291 and accompanying text. The March 17, 1995 protocol has moved this provision to art. 18, ¶ 7 of the treaty. See 1995 Revised Protocol, supra note 290, art. 9, ¶ 3.

331. Rev. Proc. 89-45, supra note 283 (stating "[t]his amount does not include unrealized appreciation in the plan assets."). See Mavridis, supra note 283, at 383-84 n.12.

treaty with the U.S. Such an approach is taken to some extent by Finland, Germany, the Netherlands, Norway, and Sweden.[332] For example, in Finland, a Finnish citizen who is also a permanent resident of that country is taxed by Finland for three years after departing Finland unless he maintains no "essential ties" with Finland.[333]

In addition, a few countries may impose a form of "exit tax" on departing residents.[334] In particular, beginning in 1987, Denmark imposes an exit tax on departing individuals who have been "resident for at least five of the preceding 10 years," with respect to "certain unrealized capital gains" and "certain pension contributions made in the five years prior to" the departure.[335] In addition, since 1995, the Netherlands imposes tax on the "fair market value of pension assets" at any time that they are removed from the Netherlands, unless "the pension distributions will be taxed in the foreign jurisdiction in which a former resident lives at the time of the distribution."[336]

b. *Treatment by United States.*—On the other hand, pension articles in most treaties would not impose any limitation on the pension's taxation by the U.S. as the taxpayer's residence country. The lack of treaty impact is suggested in a 1989 technical advice memorandum, in which

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332. See JCT Report on Expatriation, supra note 129, at B-2 - B-6. For example, "Germany imposes a so-called 'extended limited tax liability' on German citizens who emigrate to a tax-haven country or do not assume residence in any country and who maintain substantial economic ties with Germany. . . ." Id. at B-3. Under this rule, the emigrating citizen is taxed for 10 years "as a German resident on all income that is not treated as foreign source income for German tax purposes." Id. However, "tax treaties generally take precedence" over this rule. Id. Under its treaty with Monaco, France treats its citizens residing in Monaco as residents for French income tax purposes. Id. at B-2. The Netherlands in its treaties seeks "to secure the right to tax the sale of substantial interests in Netherlands' companies for a period of five years after emigration." Id. at B-4. In Norway, "[a] former resident may still be considered resident for purposes of the income tax if he keeps a home in Norway which is not let out and is unable to prove that he is considered resident for tax purposes in the country in which he is living." Id. at B-5.

333. Id. at B-2. However, the treaty with the U.S. precludes application of this rule. Id. at B-2, n.4. A citizen or resident of Sweden cannot shed his resident status if he maintains "essential ties" with Sweden; an individual who has been a resident of Sweden for at least 10 years is presumed to remain a resident for five years after departing, unless he proves that he has not kept "essential ties." Id. at B-6.

334. The Staff of the Joint Committee has identified Australia, Canada, and Denmark as falling in this category. Id. at B-7-B-8. The Australian exit tax applies to the appreciation in non-Australian assets at the time residence is ended. Id. at B-7. An individual giving up Canadian residence "is deemed to have disposed of all capital gain property at its fair market value. . . ." Id.

335. Id. at B-8.

336. Id. at B-5.

section 402(b) and section 72(f) were applied to a distribution from a Canadian pension plan to a Canadian citizen who retired in the U.S. There the IRS stated that the treaty in effect with Canada as of 1983 did not address these issues.[337]

The current U.S. treaty with Canada does, however, provide a limitation on the taxation of pensions by the residence country; i.e., the residence country is required to exempt the amount of any pension that would be excluded from income in the source country if the recipient were resident there.[338] The 1996 U.S. Model contains a similar provision, barring the residence country from taxing a pension distribution to the extent attributable to amounts previously taxed by the other country.[339] But these provisions do not seem relevant to a case where the source country (Country X in the example above) has allowed deferral of tax on contributions and accrued benefits until distribution.

Of possibly greater relevance is article 18, paragraph 2(c) in the U.S.-France treaty.[340] The Staff of the Joint Committee describes this article as "provid[ing] that the timing and extent of taxation of pension benefits is determined under the laws of the source country."[341] This provision clearly applies to delay imposition of U.S. tax when contributions to a French pension plan are made on behalf of a French citizen working and residing in the U.S.[342] It is not as clear, however, that this provision would apply if a French citizen working and residing in *France* and contributing to a French pension plan became a U.S. resident immediately before receiving distributions from the French plan. Absent the treaty, the U.S. would never have imposed a tax on the French citizen, assuming that he or she is a "highly compensated employee" and all contributions are nonforfeitable. In that case, the proper time to tax, under U.S. timing rules, is as benefits accrue. Because the individual was not a U.S. resident at that time and the income is from

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337. Tech. Adv. Mem. 89-11-001, supra note 317. The Treaty signed Sept. 26, 1980, did not go into force until Aug. 16, 1984.

338. See U.S.-Canada Income Tax Treaty, supra note 146, art. 18, ¶ 1.

339. See 1996 U.S. Model, supra note 2, art. § 18, ¶ 1, and supra notes 296-302 and accompanying text.

340. See supra notes 292-294 and accompanying text.

341. Staff of the Joint Comm. on Tax'n, Explanation of Proposed Income Tax Treaty Between the United States and the French Republic, JSC 10-95, ¶ 32 (Joint Comm. Print 1995) [hereinafter Joint Comm. on Taxn's Explanation of Proposed U.S.-France Income Tax Treaty].

342. See supra text accompanying notes 292-294; Staff of the Joint Committee on Taxation, Explanation of 1984 Protocol to the U.S.-France Income Tax Treaty, supra note 293 (stating that the protocol would "make reciprocal rules similar" to those applied to "Americans in France" by the 1978 side note "so that French citizens resident in the United States, as well as U.S. citizens resident in France, can benefit").

French sources, no U.S. tax would be imposed. Thus, if the treaty provision were applied to delay the U.S. tax until the time of distribution, when the individual had become a U.S. resident, the effect of the treaty provision would be to impose a U.S. tax that would never have been imposed by the Internal Revenue Code. Yet the French treaty (like most others) provides that the treaty "shall not restrict in any manner any . . . allowance . . . accorded by . . . the laws of . . . the United States."[343]

C. *The Problems Associated with U.S. Residence-Based Taxation of Participants in Foreign Plans*

The U.S. rules for taxing its citizens and residents who participate in foreign pension plans involve application of U.S. tax concepts to such plans to determine if they are "funded" or "unfunded" and "qualified" or "nonqualified." If the plans are funded but nonqualified, U.S. tax concepts must be applied to determine the amount to be taxed at the time of vesting, whether the employee is a "highly compensated employee," and, if so, the annual amount of accrued benefits. This creates at least four potential problems.[344]

First, particularly if the employer is a foreign person, not affiliated with a U.S. company, it may be difficult for the employee to obtain information about the foreign plan sufficient to categorize the plan under U.S. tax standards and to determine the amount and timing of any income inclusion. The plan documents may not be in English, and the employer may have no need for local tax purposes to draw the distinctions made under U.S. law.[345]

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343. U.S.-France Income Tax Treaty, supra note 135, art. 29, ¶ 1; see 1996 U.S. Model, supra note 2, art. 1, ¶ 2 (referring to the "laws of either Contracting State"). See also 1996 Treasury Explanation, supra note 2 ("[This provision] also means that the Convention may not increase the tax burden on a resident of a Contracting States [sic] beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law."). The Treasury further explains that "a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result." Id. See also ALI, supra note 219, at 81.

344. For a similar catalogue of problems in the context of a U.S. citizen or resident participating in a Canadian registered pension plan, see Wiacek Letter to Barnes, supra note 267, and Wiacek Letter to Terr, supra note 266. See generally Avi-Yonah, supra note 225, at 1336 (noting that "even developed countries find it hard to effectively enforce residence-based taxation on the global income of individuals." He further explains that "[s]ource-based taxation of passive income is much more effective than residence-based taxation because the source country has the information needed to enforce the tax if it wishes to do so.").

345. See Wiacek Letter to Barnes, supra note 267 (making this point with regard to U.S. citizens or residents participating in Canadian registered plans). In this letter, Wiacek states that "determining the correct amount to include in an individual's income can be extremely difficult, especially in the case of a defined benefit plan. Not only can the task be difficult, but Canadian employers simply may not perform the calculations necessary to determine the includible amount, imposing a significant burden on individual employees." Id.

Second, whereas in the case of a U.S. plan, employers ordinarily structure deferred compensation arrangements to obtain desired tax results under *U.S.* tax law for the beneficiaries, such structuring generally would not occur for a pension plan organized in a foreign country with more than a few participants. Most of the participants would generally be nonresident aliens of the U.S. who would not be subject to U.S. tax (assuming services are performed abroad). Moreover, it might not be possible to conform the plan to U.S. tax requirements and local tax requirements at the same time since the two sets of requirements may be inconsistent. Thus, given these factors and the enormous complexity of the requirements for qualification under section 401(a), it is virtually impossible that a foreign plan would meet the U.S. requirements for a qualified pension plan.

Third, the treatment of funded but nonqualified plans under U.S. law will generally be applicable to foreign pension plans, but such treatment is difficult to administer (even in an all "domestic" context), particularly for defined benefit plans.[346] As Zelinsky points out, in arguing that the treatment accorded to qualified plans should be considered the norm,[347] current taxation of accruing pension benefits creates problems of valuation and of liquidity and understandability for the employee.[348]

In a domestic context, difficulties in applying the rules for nonqualified plans may be tolerated since taxpayers have the option of complying with the qualified plan rules. In fact, one commentator suggested that the treatment of nonqualified plans should be "punitive" in order to encourage creation of qualified plans.[349] Even those who favor increasing the present value of tax imposed on qualified plan benefits have generally proposed doing so, not by extending the current rules for nonqualified plans to all plans, but rather by imposing a new flat tax on pension income.[350]

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346. See Wiacek Letter to Terr, supra note 266 (noting the difficulty for Canadian defined benefit plans, "where the employer makes a contribution based on the ages, probability of vesting, and salary levels of the employee group as a whole, and the U.S. rules . . . require a calculation of the 'annual incremental projected normal retirement benefit' as a proxy for the employer contribution per employee.").

347. See supra notes 60-62 and accompanying text.

348. See Wiacek Letter to Barnes, supra note 267 (noting that "includability in income of amounts contributed to a trust from which the employee cannot withdraw the contributions creates a cash flow problem for the employee when the tax is assessed"); KPMG Letter, supra note 161 (noting that a U.S. citizen participating in a Canadian pension plan "may be required to make a cash payment of tax based on a vesting of benefits, even though, by operation of Canadian income tax law or by virtue of the restrictions of the plan, the individual is not yet entitled to a cash distribution.").

349. See Halperin, supra note 8, at 43-44; see also supra note 57 and accompanying text.

350. See supra note 59 and accompanying text.

Fourth, because U.S. taxation of its residents or citizens participating in foreign plans does not take account of foreign tax rules, the potential for inconsistency in the timing of taxation under the two countries' rules is great. This may lead to a situation where no tax is imposed by either country, or two taxes are imposed, but at different times, creating problems for application of the U.S. foreign tax credit. For example, many foreign countries allow participants in local pension plans to defer taxation until distribution (as in a U.S. qualified plan); however, since the U.S. will generally classify the foreign pension plan as nonqualified, deferral of U.S. tax will not be available for a U.S. citizen.[351] Moreover, an alien who retires to the U.S. may avoid taxation in the country where he worked and yet avoid significant U.S.-residence based taxation because the distribution is treated as a return of capital.

D. *U.S. Residence-Based Taxation of U.S. Multinational Employer*

The difficulty of applying U.S. rules for taxing deferred compensation arrangements to foreign plans has been demonstrated very clearly in connection with the U.S. tax treatment of the employer. Although Congress acted in 1980 to make U.S. rules more easily applicable to foreign plans in this context, the Treasury has had difficulty in adopting regulations that would simplify and clarify the rules in this area.

A U.S. corporation with a foreign branch may establish a foreign pension plan for local employees, which is structured to satisfy local tax and labor requirements. The U.S. corporation will wish to currently deduct contributions to the plan on its U.S. tax return. Prior to 1980, U.S. tax rules were applied without modification to this foreign context; thus assuming that the foreign plan did not meet the requirements of section 401(a),[352] a U.S. corporation's deduction was governed by section 404(a)(5), dealing with contributions to nonqualified plans. Under that provision, the deduction must

351. See Wiacek Letter to Barnes, supra note 267 ("[F]or U.S. citizens working in Canada, U.S. income tax liability and foreign tax credits are mismatched twice: first, upon the inclusion of amounts in income for U.S. tax purposes as contributions are made to the plan when there is no corresponding inclusion in income for Canadian tax purposes; and second, upon the full includability in income for Canadian tax purposes of distributions from the plan when there is only partial includability for U.S. tax purposes . . . [due to] . . . the basis recovery rules of Section 72. . . .").

352. If the U.S. employer were to establish a funded pension plan that complied with all U.S. requirements for a qualified pension plan, except that the trust was foreign, then the U.S. employer could deduct contributions to the pension plan under § 404(a) subject to the same restrictions on overfunding applied to a domestic plan. See IRC § 404(a)(4). The beneficiary's treatment would also be the same as for a qualified plan. See supra note 266.

await the year of inclusion by the employee[353] and is conditioned on maintaining separate accounts for each employee (a condition generally not met by defined benefit plans).[354]

A similar issue arises when a U.S. corporation's foreign subsidiary creates a local pension plan for local employees. The proper timing of the subsidiary's reduction of earnings and profits to reflect pension contributions will be a factor in applying section 902 and the subpart F rules to the U.S. parent. The IRS took the position prior to 1980 that the requirements of section 404 were also applicable in this context.[355]

In response to the IRS position in this context,[356] Congress in 1980 enacted section 404A[357] allowing an electing employer to deduct certain contributions to a "qualified foreign plan." A "qualified foreign plan" is not required to meet all the requirements of section 401(a); rather, it is defined simply as "any written plan of an employer for deferring the receipt of compensation" as to which an employer makes an election, provided that the plan is "for the exclusive benefit of the employer's employees or their beneficiaries," and meets a requirement that 90% of the benefits represent compensation to nonresident aliens that is not taxable by the U.S.[358]

Pursuant to section 404A, contributions to qualified foreign plans are deductible when paid, either to a trust (or the equivalent of a trust) meeting section 401(a)(2)'s requirement of exclusive benefit to employees, for a retirement annuity, or to a participant or beneficiary;[359] alternatively, "reserve plan" treatment may be elected so that the employer may take into account "the reasonable addition for such year to a reserve for the taxpayer's liability under the plan."[360] The deduction for funded plans is, in the case

353. It is not clear how this rule is applied when the employee is a nonresident alien not subject to U.S. taxation on the contribution. See Letter from Mark J. Ugoretz, infra note 367.

354. See Priv. Ltr. Rul. 79-04-042 (Oct. 25, 1978) (applying § 404(a)(5) to defined benefit plans maintained by U.S. subsidiaries for local employees so as to permanently deny a deduction for contributions if separate accounts are not maintained).

355. Tech. Adv. Memo. 78-39-005 (June 21, 1978). The IRS ruled that the earnings and profits of an accrual basis German subsidiary could be reduced "only by the amount of payments actually made under its pension plan, and not by the liabilities accrued under its pension plan" in light of the "emphasis of section 404(a) . . . on actual payment. . . ." Id. The subsidiary was entitled to a current deduction for the accrued liability under German tax law even though the plan was not funded. Id.

356. See S. Rep. No. 1039, 96th Cong., 2d Sess. 10-12 (1980) [hereinafter 1980 Senate Report].

357. Act of Dec. 28, 1980, Pub. L. No. 96-603, § 2, 94 Stat. 3503, 3505 (1980).

358. See IRC § 404A(e).

359. Id. § 404A(b)(1), (5).

360. Id. § 404A(c)(1), (f). Some limitations on the determination of the addition to the reserve are set forth in § 404A(c)(1)-(4).

of a defined benefit plan, subject to the limits on overfunding in section 404(a)(1) and in the case of a defined contribution plan, subject to the 15% of compensation limit of section 404(a)(3).[361] In any case, the taxpayer's deduction may not exceed, on a cumulative basis, "the aggregate amount allowed as a deduction under the appropriate foreign tax laws."[362]

The Senate Finance Committee explained its reason for enacting Section 404A as follows:

> The committee believes that the provisions of present law generally applicable to deferred compensation plans are ill-suited to plans maintained for the benefit of foreign employees. These plans must frequently comply with provisions of foreign law which are either inconsistent with U.S. law or can be made consistent only through the surrender of major tax benefits under the foreign system, ... It is unnecessary to burden qualification for these tax benefits with many of the provisions intended to protect employees and their beneficiaries applicable to domestic plans.[363]

Similarly, Congressman Barber Conable, Jr., stated that foreign plans for foreign employees should not have to "comply with those U.S. deduction rules that are motivated by U.S. social policy concerns rather than general U.S. tax policy with respect to the appropriate calculation of taxable income for the period."[364]

Perhaps not surprisingly, the diversity of foreign rules regarding pension plans has made it difficult and controversial to apply even the stripped-down requirements of section 404A to foreign pension plans. Proposed regulations issued in 1985[365] were withdrawn and replaced by

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361. IRC § 404A(b)(3).

362. Id. § 404A(d). In order that the IRS may monitor satisfaction of this requirement, the employer is required to furnish "a statement from the foreign tax authorities specifying the amount of the deduction allowed in computing taxable income under foreign law for such year," a copy of the foreign tax return showing the deduction "as a separate identifiable item," or some other evidence of the amount of the deduction that is viewed as sufficient under regulations. Id. § 404A(g)(2).

363. 1980 Senate Report, supra note 356, at 12.

364. Minor Tax Bills: Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 96th Cong., 2d Sess. 143, 162 (1980) (statement of Rep. Barber Conable, Jr.). See generally Gliksberg, supra note 205, at 472 (noting that "the objects of social policy are, as a rule, local residents or citizens"). Gliksberg argues, for example, that "it is substantially right that redistribution of income within society should apply to all the income of the members of that society, because they, and not foreign residents, are the object of the redistribution." Id. at 473.

365. See 50 Fed. Reg. 13,821 (1985) (to be codified at 26 C.F.R. pt. 1) (proposed Apr. 8, 1985).

new proposed regulations in 1993.[366] Both sets of regulations have aroused considerable criticism from U.S. multinationals.[367] Some have argued that

366. See 58 Fed. Reg. 27,219 (1993) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1993). In September 1996, the IRS supplemented these proposed regulations with proposed regulations specifying the limited circumstances in which an employer is treated as owner of a foreign employees' trust. See 1996 Proposed Rulemaking, supra note 22, ¶¶ 38-54. Generally, these circumstances are (a) when the employer is a U.S. employer or a foreign employer that is a CFC and plan funding is excessive, or (b) where a foreign employer transfer assets to the trust "with a principal purpose of avoiding the PFIC rules." Id. ¶¶ 35-36, 45-46.

367. For criticism of the 1993 regulations at the public hearing on Oct. 5, 1993, see IRS' Proposed Foreign Deferred Plan Rules May Be Costly, Perpetuate "Ugly American," BNA Pensions & Benefits Daily (Oct. 7, 1993) (LEXIS, BNA library, BNAPEN file); Meegan M. Reilly, Imposing U.S. Pension Concepts on Foreign Plans "Smacks of Ugly-Americanism," IRS Told, 93 TNI 194-1 (Oct. 7, 1993); Unofficial Transcript of IRS Hearing on Nonresident Pensions, 93 TNI 197-10 (Oct. 5, 1993) (LEXIS, FEDTAX library, TNI file). For criticism of the 1985 regulations, see e.g., Sam Goodley, IRS Hears Unanimous Criticism of "All or Nothing" Election Rule in Sec. 404A Foreign Plan Regs., 85 TNI 33-4 (Sept. 25, 1985) (LEXIS, FEDTAX library, TNI file).

For further criticism of the 1993 proposed regulations, see, e.g., Comments of Thomas A. Rowley of William M. Mercer, Inc. (Dec. 4, 1994), reprinted in 95 TNI 9-14 (Jan. 13, 1995) (LEXIS, FEDTAX library, TNI file); Comments of Kevin W. Johnson of Dow Chemical Company (Aug. 30, 1994), reprinted in 94 TNI 182-38 (Sept. 15, 1994) (LEXIS, FEDTAX library, TNI file); Draft of Comments on Proposed Regulations Under Section 404A of the Internal Revenue Code of American Bar Association, Section of Taxation (June 23, 1994), reprinted in 94 TNI 156-18 (Aug. 12, 1994) (LEXIS, FEDTAX library, TNI file); Letter from Tom McMahon of Financial Executives Institute on behalf of Committee on Employee Benefits (Apr. 13, 1994), reprinted in 94 TNI 81-28 (Apr. 27, 1994) (LEXIS, FEDTAX library, TNI file) [hereinafter Letter from Tom McMahon]; Comments of Tax Executives Institute, Inc. (Jan. 6, 1994), reprinted in 94 TNI 13-24 (Jan. 20, 1994) (LEXIS, FEDTAX library, TNI file); Letter from Towers Perrin on behalf of a Group of Companies with Foreign Pension Plans (Oct. 5, 1993), reprinted in 93 TNI 198-6 (Oct. 14, 1993) (LEXIS, FEDTAX library, TNI file) [hereinafter Letter from Towers Perrin]; Letter from William L. Sollee of Ivins, Phillips & Barker (Oct. 5, 1993), reprinted in 93 TNI 198-4 (Oct. 14, 1993) (LEXIS, FEDTAX library, TNI file); Comments of American Institute of Certified Public Accountants (Oct. 1, 1993), reprinted in 93 TNI 199-3 (Oct. 13, 1993) (LEXIS, FEDTAX library, TNI file); Letter from Lynn D. Dudley, on behalf of Association of Private Pension and Welfare Plans (Sept. 30, 1993), reprinted in 93 TNI 199-4 (Oct. 15, 1993) (LEXIS, FEDTAX library, TNI file); Comments of E.I. Du Pont De Nemours on the Proposed Regulations Under Internal Revenue Code Section 404A (Sept. 30, 1993), reprinted in 93 TNI 198-5 (Oct. 14, 1993) (LEXIS, FEDTAX library, TNI file); Letter from Mark J. Ugoretz on behalf of The ERISA Industry Committee (Sept. 24, 1993), reprinted in 93 TNI 195-10 (Oct. 8, 1993) (LEXIS, FEDTAX library, TNI file) [hereinafter Letter from Mark J. Ugoretz]; Statement of the United States Council for International Business to the Internal Revenue Service Regarding Proposed Regulations Under Section 404A of the Internal Revenue Code (Sept. 24, 1993), reprinted in 93 TNI 193-16 (Oct. 6, 1993) (LEXIS, FEDTAX library, TNI file) [hereinafter Statement of the United States Council for International Business]; Letter of Joseph W. Tierney, Jr. on behalf of Digital Equipment Corp. (Sept. 23, 1993), reprinted in 93 TNI 193-14 (Oct. 6, 1993) (LEXIS, FEDTAX library, TNI file) [hereinafter Letter from Joseph W. Tierney, Jr.]; Letter the IRS is using section 404A "as the vehicle for exporting U.S. ERISA type rules and protections to employees" of qualified foreign plans;[368] this, it is contended, will "penalize US based multi-nationals and . . . also smacks of ugly Americanism."[369]

Thus, for example, critics argue that the requirements for qualification of a fund as a "trust equivalent" under the Proposed Regulations[370] "are based on Anglo-American trust law," and will lead to "significant confusion because of the different types of funding vehicles utilized throughout the world."[371] They argue that "it might be difficult in many countries to create a legally enforceable duty of prudence in the holder of the fund, or to provide absolute priority for creditors,"[372] as required by the proposed regulations. Some argue that the "strict impossibility of reversion requirement" imposed by the Proposed Regulations may preclude section 404A qualification even with respect to "trusts established under [such] English-speaking countries as the United Kingdom, Canada and Australia, which follow the common law system and recognize the trust concept. . . ."[373] Critics note that in some

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from Marian A. Campbell on behalf of Exxon Corporation (Sept. 22, 1993), reprinted in 93 TNI 193-15 (Oct. 6, 1993) (LEXIS, FEDTAX library, TNI file); Letter from Norbert Rossier on behalf of International Pension Consultants (July 1, 1993), reprinted in 93 TNI 134-16 (July 14, 1993) (LEXIS, FEDTAX library, TNI file).

368. Letter from Joseph W. Tierney, Jr., supra note 367.

369. Unofficial Transcript of IRS Hearing on Nonresident Pensions, supra note 367 (Statement of Robert Heitzman). Barbara Felker from the Office of Associate Chief Counsel, International, asked Mr. Heitzman whether his view could be reconciled with the general "requirement of US law . . . that earnings and profits be computed under US principles," as exemplified in the Goodyear case. Id. Mr. Weitzman replied that "pension law . . . involves balancing . . . social goals versus revenue goals—and every country strikes its own balance." Id. He further explained that "what we're really trying to do, I think, with this law is to prevent manipulation of taxes and not to impose social policy that we in the US seem to have deemed to be correct on foreign jurisdiction." Id.

370. See Prop. Regs. § 1.404A-1(e), imposing four requirements for a fund to be treated as "equivalent of a trust": "(i) The corpus and income [of the fund] is separately identifiable and segregated, through a separate legal entity, from the general assets of the employer; (ii) The corpus and income . . . is not subject, under the applicable foreign law, to the claims of the employer's creditors prior to the claims of employees . . . under the plan; (iii) The corpus and income . . ., by law or by contract, cannot at any time prior to the satisfaction of all liabilities with respect to employees under the plan be used for . . . any purpose other than providing benefits under the plan; (iv) The corpus and income . . . is held by a person who has a legally enforceable duty to operate the fund prudently." 58 Fed. Reg. 27,219, 27,230 (1993) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1993).

371. ABA Section of Tax'n, Foreign Pension Task Force Subcommittee of the Committee on Employee Benefits, Comments on Proposed Regulations Under Code Section 404A (Nov. 2, 1994), reprinted in 94 TNI 232-7 (Dec. 2, 1994) (LEXIS, FEDTAX library, TNI file) [hereinafter ABA Comments].

372. Letter from Towers Perrin, supra note 367.

373. Statement of United States Council for International Business, supra note 367.

countries withdrawals of surplus assets are permitted or even "required" under local law.[374] Among the important pension vehicles that may not meet the requirements of the Proposed Regulations are the so-called Security Contract[375] under German law and funds covering a number of different

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374. Withdrawals of surplus assets are said to be "required," in some cases, in the United Kingdom and Japan and to be permitted in Mexico, the Netherlands and Ontario. See Comments of Tax Executives Institute, Inc., supra note 367 (mentioning UK and Mexico); Comments of The Dow Chemical Company, supra note 367 (discussing Dow plans in Canada and the Netherlands); Letter from Tom McMahon, supra note 367 (in the UK, "surplus reversion is a commonly utilized method of complying with . . . [the] requirement" that surplus assets be reduced; also discussing requirement of returning surplus assets in Japan); Letter from Towers Perrin, supra note 367, ("The laws of some countries, such as the United Kingdom, . . . allow surplus assets to revert to the employer, and in some cases require it."); Letter from C. Frederick Oliphant III, of Miller & Chevalier (Feb. 6, 1995), reprinted in 95 TNT 36-14 (Feb. 23, 1995) (LEXIS, FEDTAX library, TNT file) (under qualified Canadian pension plans subject to the local law of Ontario, the employer may be permitted to withdraw surplus assets even though no settlement has been made of existing pension liabilities). The ERISA Industry Committee stated that "the impossibility-of-reversion requirement is virtually impossible to satisfy in any country except the United States, and in many countries would either be illegal or contrary to accepted business and actuarial practice." Letter of Mark J. Ugoretz, supra note 367. The Committee of ERISA Industry states that "in the United Kingdom, plans that do not permit reversions of surplus assets . . . are at a serious tax disadvantage" because "[f]unding practices are conservative and, should large surpluses result . . ., the Inland Revenue will require them to be eliminated." Id. Moreover, "[s]ettling the liabilities would generally not be permitted, or be practical in terms of the local insurance market." Id. The committee states more generally that "[t]he capital markets in foreign countries are often not sufficiently well-developed to annuitize participants' accrued benefits on plan termination, or even reliably to determine the amount that would be necessary to satisfy those benefits." Id. See also Statement of United States Council for International Business, supra note 367 ("[M]any countries with advanced legal systems generally thought to be protective of employees permit or even require pension trusts or funds to revert money to the employer . . . if the plan is overfunded," including "United Kingdom, Canada, Australia and Holland. . . . [I]t is not clear whether in all these countries an employer can modify the trust instrument to negate this possibility.").

375. In a security contract arrangement, assets funding pension liabilities are transferred to a wholly-owned subsidiary that "pledges its assets to a custodian who then gives a guaranty to the employees." Comments of Tax Executives Institute, Inc., supra note 367. The proposed regulations decline to approve this arrangement because of uncertainty as to whether the pledged assets are in fact "protected from the claims of an employer's creditors in the event of bankruptcy." Preamble to Proposed Regulations, 58 Fed. Reg. 27,219, at 27,221 (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1993). The Tax Executives Institute recommends that the regulations approve such arrangements "perhaps on the basis of an opinion of German counsel that the pension assets are protected from claims of the employer's creditors." Comments of Tax Executives Institute, Inc., supra note 367. See also Letter of Mark J. Ugoretz, supra note 367 ("[I]n Germany, . . . there exists no [other] legal vehicle . . . that can prevent a reversion to the employer without also resulting in the current taxation of plan participants.").

employers under the laws of France, the Netherlands, and Sweden.[376]

One suggestion offered to the Treasury to better accommodate foreign law is to allow a foreign plan to be "qualified" despite gaps in foreign law protections provided that the plan "make[s] certain representations which would have the effect of protecting the integrity of the funded investment vehicle."[377] Others propose that any detailed attempt to apply U.S. concepts to foreign plans should be abandoned; instead the IRS should "publish a list of foreign countries whose laws adequately protect the employees' pension funds," and accept plans "complying with a foreign country's laws and regulations."[378]

The experience with section 404A demonstrates the difficulties of applying U.S. tax rules to foreign pension plans. These difficulties are at least somewhat eased by the fact that the pension plan is created by a U.S. corporation or its foreign subsidiary. By contrast, when the U.S. seeks to tax a U.S. citizen or resident participant in a foreign plan, and the employer has no contact with the U.S., the difficulties of obtaining information about foreign law and the operation of the plan would likely be much greater.

E. *Possible Improvements of U.S. Residence-Based Taxation of Beneficiaries of Foreign Plans*

Present law's approach for taxing U.S. participants in foreign pension plans is to apply U.S. pension standards and, consequently, classify virtually all foreign plans as nonqualified; therefore, current taxation of contributions to the plan and accrued earnings (in the case of an HCE) is required. As noted, this approach presents serious problems of enforcement, valuation,

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376. In these countries, employers "may be required by law or by union agreements, to contribute to a nongovernmental fund covering many different companies under a full or partial cross-subsidies between the various participating companies." Unofficial Transcript of IRS Hearing on Nonresident Pensions, supra note 367 (statement of Thomas Rowley of William M. Mercer, Inc.). Thus, these plans are not "for the exclusive benefit of the employees of the employer. . . ." Id.

377. ABA Comments, supra note 371. The representations, relating to trust equivalence, are that "(A) the corpus and income of the fund shall be segregated from the assets of the employer and shall be separately accounted for;" (B) generally, "the corpus and income shall not, any time prior to the satisfaction of all liabilities with respect to employees under the plan be used for, or diverted to, any purpose other than providing benefits under the plan"; and "(C) the Administrator holding the corpus and income shall agree to operate the fund prudently." Id. There would be further contractual undertakings to insure compliance with the exclusive benefit rule, i.e., "there shall be no reversions of assets from the plan to the employer unless—(i) the reversion shall leave in the plan assets having a fair market value equal to 125% of the accrued benefit obligation under the plan . . .; and (ii) the reversion is permitted under local law or regulation." Id.

378. Comments of Tax Executives Institute, Inc., supra note 367.

liquidity, and mismatching of U.S. and foreign tax (with resulting double or under-taxation).

Yet there are at least two alternative approaches available: (1) The U.S. might treat all foreign pension plans as qualified plans (or, to the same effect, as unfunded). Thus, all taxation of the employee would be deferred until the time of distribution. (2) The U.S. might follow the tax treatment accorded in the place where the plan is situated; that is, if the plan is eligible for deferral of employee tax on contributions, the U.S. would also allow such deferral. Thus, it is worth examining the justifications for the present law.

The logic behind the present law is that deferral of the employee's tax on deferred compensation should depend upon the quid pro quo that either (a) the arrangement satisfies the requirements of section 401, or (b) the employer's deduction is also deferred (as in the case of an unfunded plan).[379] Since foreign plans do not satisfy all the detailed requirements of section 401, this quid pro quo is viewed as not being present. Requirements for pension plans in other developed countries may be designed to achieve similar goals, but are considered to be insufficiently similar to substitute for the requirements of section 401. If a U.S. citizen or resident can achieve the same U.S. tax results in a foreign plan as in a U.S. qualified plan, the incentive to participate in a qualified plan is undermined. As long as an individual is a U.S. citizen or resident, the U.S. has the responsibility to apply its own standards to pension plans in which the individual participates (in part for his or her own protection).[380]

The logic of this "quid pro quo" theory is not, however, as compelling in a cross-border context as in a domestic context.

First, if the employer is a foreign corporation without U.S. business activities or a U.S. affiliate, the employer will not offer the employee the option of participating in a qualified U.S. pension plan. Thus, there is no point in denying deferral to the employee as an incentive to channel his retirement savings to a U.S. qualified plan (unless the intent is to encourage him not to work abroad for a foreign employer).

Second, in many cases, pension plans organized in a foreign country may meet the objectives behind the requirements of section 401 even if the foreign law does not embody all the requirements of section 401. At the same time, it is not realistic to expect a foreign employer to design a plan that is primarily for employees working outside the U.S. so as to meet the precise requirements of section 401.

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379. See supra notes 303-313 and accompanying text.

380. As explained by Professor Gliksberg, residence-based jurisdiction "focus[es] . . . on the connection between the resident and the State, and the taxpayer's general duty to contribute to government expenditure since he or she benefits from the full range of its services, in all spheres of life. . . ." Gliksberg, supra note 205, at 473.

Third, in many cases, deferral of employee taxation by the U.S. may not lead to any overall advantage to the employee. The overall effect will also depend upon foreign law, which is outside the U.S.'s control. Foreign law may tax the employee on contributions to the plan when made. The foreign law may impose a tax on the pension trust's investment income (thereby eliminating the advantage of a qualified plan under U.S. law), or the foreign law may defer the employer's deduction.

Fourth, in a case where an alien's U.S. residence begins only after contributions are made to a foreign pension plan, a deferral of the employee's tax will close an existing loophole rather than opening a new one. In situations where the foreign country defers its tax on the employee and then forgives it if the employee retires abroad, deferral by the U.S. has the effect of insuring that some tax will be imposed on the deferred compensation.

On the other hand, it is not clear that either of the two alternative treatments should be adopted by the U.S. by unilateral action. The first alternative (deferral for all foreign pension plans) has the advantage of eliminating the problems of valuation, liquidity, and understandability entailed by current taxation. Since the actual distribution to the employee is always the taxable event, the employee is in a position to determine the amount subject to U.S. tax without the assistance of the foreign plan administrator or foreign tax authorities. On the other hand, it would not insure much greater coordination with the foreign law treatment than does the current approach. Moreover, especially outside the context of a treaty, the U.S. might be concerned that delaying imposition of tax might make enforcement more difficult. This approach might be viewed as particularly unwarranted in a situation where a U.S. citizen or resident works in a low-tax or tax-haven country, and thus is subject to little or no foreign tax.

The second alternative (following the foreign law treatment) would eliminate current taxation with its associated problems in many cases. Under this alternative, U.S. tax would be imposed currently only to the extent that the situs of the plan would also tax currently. Thus, the plan administrators would be in a position to determine the amount to report as current income for U.S. tax purposes; problems of liquidity and understandability would not be exacerbated by the U.S. treatment. However, this approach would be difficult to administer outside the context of a treaty relationship because it would require characterization of the pension plan under the law of the situs country and would require the cooperation of the plan administrator.

These considerations suggest that unilateral change in U.S. law should be relatively limited, and that, in general, the needed improvements should be by treaty. However, there are two changes that the U.S. should adopt unilaterally. First, the U.S. should unilaterally close off opportunities for a foreign national who retires in the U.S. to avoid all tax on distributions from a pension plan in a foreign country; the other country, where the foreign national previously worked and resided, may not assert jurisdiction to tax such distributions. The U.S. can insure that U.S. tax is imposed in such a case by amending section 72 so that an individual's investment in the contract for pension distributions includes only amounts shown to have been already subjected to tax either by the U.S. or by the country where the services were performed or where the pension fund is located. The U.S. should not in its role of residence country provide a tax haven for foreign nationals, regardless of whether the country of nationality has a treaty with the U.S. To ease administrative burdens for the IRS, the taxpayer should have the burden of establishing that foreign taxation has previously been imposed. See Table 2-A, row 10, page 365.

Second, the U.S. should amend the Code to treat all foreign defined benefit plans as unfunded. Under this change, a U.S. resident or citizen who participates in a defined benefit plan in a foreign country would be taxable only when actual distributions are made from the plan; the distributions, when made, would be sourced entirely to the place where the services were performed. See Table 2-A, row 8, page 364. The U.S. should make this change unilaterally because the current rules applied to foreign defined benefit plans are uncertain in application and too difficult to administer. It seems highly unlikely that a satisfactory level of enforcement is, or could ever be, achieved. If this "unfunded" treatment is considered too alluring an opportunity for U.S. tax planning, then it could be limited to situations where the structure is likely determined by foreign tax or other considerations. For example, this "unfunded" treatment could be reserved for foreign plans for which at least 90% of the benefits accrue to nonresident aliens.

This treatment of foreign defined benefit plans as unfunded should also be applicable to nonresident aliens who participate in a foreign defined benefit plan in respect of services performed in the U.S. See Table 1-A, row 4, page 363. Administrative problems of imposing the U.S. source-based tax on a current basis are equally severe in this context. Allowing income of a nonresident alien to be deferred to the time of retirement when the individual may have no further connection to the U.S. in itself greatly lessens the likelihood of enforcement. Nevertheless, the likely advantage in enforcement from imposing tax while the individual is still conducting activities in the U.S. does not seem sufficient to outweigh the burden of computing current tax with respect to a foreign defined benefit plan.

V. A More Comprehensive U.S. Treaty Policy

The treaty policy for pensions embodied in most existing U.S. treaties, the 1981 U.S. Model and the OECD Model, i.e., that pension payments should be taxed exclusively in the residence country, does not resolve all of the complex issues of coordination presented by the taxation of cross-border pensions.

The term "pension" as used in existing treaties does not have an authoritative and clear-cut definition; this makes the position of a withholding agent extremely difficult. Most existing U.S. treaties address only the treatment of payments from pension plans: they do not address taxation of contributions when made or earnings when accrued in a plan. Thus, apparently, the country where services are performed, the country where the plan is located, or the country where the pensioner resides prior to retirement are all authorized to impose tax on pension benefits prior to distribution (even though such taxation may be very difficult to administer). This creates the potential for overlapping taxation at different times. In addition, there is no attempt to assure that residence taxation will in fact be imposed in situations where source-base taxation is foregone. Thus, further refinements of the U.S. treaty policy are clearly required.

A few treaties entered into by the U.S., i.e., those with Canada, France and Sweden, as well as the proposed treaty with Austria, do contain provisions beyond those contained in the 1981 U.S. Model. Thus, the French and Swedish treaties, as well as the proposed treaties with Austria and Switzerland, include a variation of the provision of the OECD commentary dealing with contributions to a home country plan. The treaties with Canada and France, moreover, provide for some coordination of residence-based tax with the timing rules in the source country.

The 1996 U.S. Model has commendably embraced this kind of broadening of U.S. treaty policy. The 1996 U.S. Model has provided further elaboration of the term "pension" in its Technical Explanation, has adopted a somewhat expanded variation of the OECD commentary provision dealing with contributions to a home country plan, and has provided for the residence country to relinquish tax on distributions to the extent previously taxed in the source country. These provisions should be adopted more widely and be expanded upon to create a more comprehensive treaty policy for pensions.

The following proposal for a new treaty policy attempts to address the concerns described above. Under this proposal,

(a) A pension plan would be defined as an arrangement created by an individual or his employer to provide a separate fund for his retirement, provided that the country where the fund is located treats the fund as a tax-favored pension arrangement with respect to which employee tax is deferred until distribution, and establishes limits on the amount of tax-favored contributions or benefits. Neither the pension article nor the "other income" article would protect any other form of deferred compensation from source-based tax; however, the "dependent services" article would potentially be applicable.

(b) No country having a treaty with the country in which the pension plan has its situs would tax amounts contributed to the pension plan (by employee or employer) or earnings accrued in the plan, prior to distribution to the employee (or beneficiary). See Table 1-A, row 4, page 363; Table 2-A, row 8, page 364. However, the pension plan would be required to report the eventual distribution to tax authorities in the country where the services are performed, the country where the plan is located, and the country in which the employee then resides.[381]

(c) When a pension is distributed in a manner permitted under the laws of the plan's situs (whether by lump sum or periodic payments), any country where the services were performed or where the plan is situated would refrain from taxation if such country has a treaty with the country of the pensioner's then residence. The residence country would be required[382] to tax the full amount of the distribution; except that (as in the 1996 U.S. Model) the residence country would be barred from taxing amounts previously taxed by a country that is its treaty partner. See Table 2-A, row 10, page 365. However, because of paragraph (b) above, the likelihood of previous taxation would be reduced.

The proposed policy (if widely adopted in U.S. treaties) would achieve much greater coordination in the taxation of cross-border pensions. For any particular pension, one country's laws would control the timing of the imposition of tax (including the amount to be taxed at any particular time). The country where the plan is located is the most logical choice to serve in this role. This place (unlike the place of residence) ordinarily would not change over time. Moreover, this rule assures that the plan administrator would be familiar with the controlling law; thus, he would be in a position to issue information reports at the correct time and showing the correct amount. Reliance on the timing rules of the country where the plan is situated

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381. See Avi-Yonah, supra note 225, at 1336-37 (suggesting two ways to make residence-based taxation of passive income more effective: "to enhance the information exchange programs under tax treaties" and "for developed countries to establish a concerted program of withholding taxes at the source of income for the benefit of the residence country."). This withholding tax could be remitted to the residence country if "the investor furnishes documentation showing that the income has been declared in his or her residence country." Id. at 1337.

382. If necessary, an explicit exception could be made to the statement in most treaties, e.g., in 1996 U.S. Model, art. 1, ¶ 2, that the treaty will not restrict a benefit accorded by internal law. See supra note 343. The proposal in text should be viewed as merely providing for a treaty to change the timing of a tax under internal law and not as providing for the treaty to impose a tax that does not exist under internal law.

is already accepted in treaties with France,[383] Canada,[384] and Sweden.[385]

Under this proposal, an employee would not be discouraged from working away from the country of his permanent residence by the prospect of losing favored pension treatment. Thus, for example, a U.S. citizen working abroad would not need to be concerned about immediate U.S. taxation if he participated in a foreign qualified plan; nor would he be concerned about immediate foreign taxation if he participated in a U.S. qualified plan.

This policy (if adopted widely) would also insure that only one country has jurisdiction to tax pension benefits, i.e., the residence country, determined at the time of the distribution. For example, assume that an employee is a participant in a pension plan, located in a country that allows taxation of contributions to the plan to be deferred. If the country where the plan is located has entered into a treaty with the employee's country of then residence and the country where services are performed, then the treaties would prevent current taxation of contributions to the plan or accruals of earnings in the plan. Since the agreed time to tax would be the time of distribution, the country of *residence at the time of distribution* would have exclusive tax jurisdiction (assuming that it had a treaty with each of those countries having potential source-based jurisdiction).

This proposal also seeks to insure that treaties will not have the effect of rendering pension income completely exempt from any significant tax. Thus, this proposal requires that the country of residence at the time of distribution may not decline to tax the distribution received by a resident on the grounds that the distribution is merely a return of capital or income previously earned at a time when residence was not established, except to the extent that the pension benefit has already been subject to tax by a country that is a treaty partner of the residence country. In this way, the countries that relinquish source-based taxation can be assured that the pension benefits will not completely escape taxation.

If the place of the employee's residence at the time of distribution is not a treaty partner of the source countries, source-based taxation would be preserved. Assume that a country X national, residing and working in the U.S., contributes to a country X qualified pension plan and that country X defers employee taxation with respect to a qualified pension plan until the

383. See supra text accompanying note 341 (the Staff of the Joint Committee on Taxation describes the French treaty provision as looking to the "source" country to determine the time and extent of taxation). The "source" country for this purpose seems to be the place where the plan is located, i.e., France, where a French national living and working in the U.S. contributes to a French plan.

384. See supra text accompanying note 295.

385. See supra text accompanying note 195.

time of distribution. Under the treaty between the U.S. and X, the U.S. would defer imposition of tax (whether residence-based or source-based) until the time of distribution (in conformity with country X law). If the employee ultimately received distributions while residing in country X, country X (but not U.S.) tax would be imposed at that time. If, however, the employee retired in the Cayman Islands, neither the U.S. nor X would be precluded by any treaty from taxing the eventual distribution. The plan administrators would have to insure that the plan provides information about distributions to the U.S. and country X tax authorities.

If the country where the plan is located has not entered into income tax treaties (e.g., the Cayman Islands), the special treaty treatment for pensions described above would be inapplicable. Contributions to the pension plan could be taxed as compensation either by the country of the employee's residence and/or by the country where the services were performed (unless taxation by the latter country is precluded under the dependent services article of a treaty between the two countries).

Similarly, the above-described treaty provisions would not apply if the country where the plan is located does not treat the type of plan as eligible for deferral of employee tax (e.g., a U.S. nonqualified plan), whether or not that country actually has a basis for source- or residence-based taxation of the employee. In that case, however, treaties would subject the plan to information-reporting requirements. Thus, the plan administrator would be required to provide information regarding the amount treated as current income (under the situs country's rules) to the tax authorities in the country where services are performed and the tax authorities in the country of the employee's residence.

This proposal may be criticized as surrendering too much of the currently claimed U.S. tax jurisdiction over pensions. In contrast to the 1981 and 1996 U.S. Model, this proposal may block U.S. imposition of a current tax on contributions to a foreign plan by an employee resident in the U.S. or performing services in the U.S., even if the foreign plan is not a home country plan in which the employee has previously participated (as required by 1996 U.S. Model, article 18 paragraph 6). However, this effect may not be as significant as it first appears. The U.S. would retain the opportunity to tax the eventual distribution from the plan unless the participant's residence at that time is in a foreign country that is a treaty partner. Moreover, the savings clause could preserve U.S. taxation at the time of distribution if the participant is a U.S. citizen.

This proposal and the proposals for improvement of U.S. residence-based taxation of beneficiaries of foreign pension plans[386] are depicted in

386. See supra Part IV.E.

bold (to contrast with the depiction of current law) in Tables 1-A, page 362, and 2-A, page 364.

TABLE 1*

NONRESIDENT ALIEN EMPLOYEE: SERVICES PERFORMED IN THE U.S.

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
1. Unfunded deferred compensation	EET.* Entire distribution treated as effectively connected income.	No change (except that distribution is exempt if it qualifies as pension or meets business traveler exemption of dependent services article).
2. U.S. qualified plan	EET.* At time of distribution, compensation element is taxed as effectively connected income, and accretion is taxed at 30% rate.	EEE.* The pension article bars U.S. tax on distribution.
3. U.S. nonqualified funded plan	TET.* Contributions taxed as effectively connected income; accretion taxed at 30% on distribution (or on accrual if highly compensated employee).	TEE.* The pension article may bar U.S. taxation of accretion on distribution.
4. Foreign funded plan	TEE.* Contributions taxed as effectively connected income.	No change under 1981 Model. Under 1996 Model, contributions to home country plan may be exempt, if employee already participated in plan.

* In the terminology of Andrew Dilnot, see supra notes 67-71 and accompanying text, a pension tax regime can be described by a three letter acronym, referring to its status as "exempt" (E) or "taxable" (T) at each of three points in time: the time of contribution, the time when earnings are derived in the plan, and the time of distribution. Thus, for example, "EET" refers to a tax regime of exemption from tax at time of contribution; exemption when earnings are derived, and full taxation at the time of distribution; "EEE" refers to a regime of exemption throughout; "TET" refers to a regime of taxation at the point of contribution and at the time of distribution.

(TABLE 1 CONTINUED)

NONRESIDENT ALIEN EMPLOYEE: SERVICES PERFORMED OUTSIDE U.S.

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
5. U.S. qualified plan	EET.* Accretion taxed on distribution, unless exempted by § 871(f).	EEE.* Treaty bars U.S. taxation of distribution.
6. U.S. nonqualified funded plan	EET.* Accretion taxed on distribution (or on accrual, if highly compensated employee).	EEE.* Treaty may bar taxation of accretion on distribution.

TABLE 2

U.S. CITIZEN OR RESIDENT AT TIME OF DISTRIBUTION; SERVICES PERFORMED OUTSIDE U.S.

U.S. CITIZEN OR RESIDENT AT ALL TIMES

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
7. Unfunded deferred compensation	**EET.*** Distribution is taxable as foreign source compensation.	No change under 1981 Model. Under 1996 Model, any payment classified as pension is exempt to extent previously taxed by other country.
8. Foreign funded plan	**TET.*** Because plan is nonqualified, contributions are taxed; accretion taxed on distribution (or on accrual, if highly compensated employee).	No change under 1981 Model. Under 1996 Model, on distribution U.S. tax is barred to extent of amount previously taxed by other country.

(TABLE 2 CONTINUED)

NONRESIDENT ALIEN AT TIME OF ACCRUAL;
RESIDENT ALIEN AT TIME OF DISTRIBUTION OF BENEFITS

Type of Plan	**Treatment Under Code**	**Treatment Under U.S. Models**
9. Unfunded deferred compensation	**EET.*** Entire distribution is taxable as foreign source compensation.	No change under 1981 Model. Under 1996 Model, any payment classified as pension is exempt to extent previously taxed by other country.
10. Foreign funded plan	**EEE.*** Distribution is exempt as return of capital, except that accretion element is taxed if not highly compensated employee.	No change under 1981 Model. Under 1996 Model, accretion element not taxed to extent previously taxed by other country.

* See footnote to Table 1, page 358.

TABLE 1-A

NONRESIDENT ALIEN EMPLOYEE: SERVICES PERFORMED IN THE U.S.

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
1. Unfunded deferred compensation	**EET.*** Entire distribution treated as effectively connected income.	No change (except that distribution is exempt if it qualifies as pension or meets business traveler exemption of dependent services article).
2. U.S. qualified plan	**EET.*** At time of distribution, compensation element is taxed as effectively connected income, and accretion is taxed at 30% rate. **Proposal: Entire distribution taxed as effectively connected income.**	**EEE.*** The pension article bars U.S. tax on distribution.
3. U.S. nonqualified funded plan	**TET.*** Contributions taxed as effectively connected income; accretion taxed at 30% on distribution (or on accrual if highly compensated employee).	**TEE.*** The pension article may bar U.S. taxation of accretion on distribution. **Proposal: Treaty inapplicable since situs country does not defer employee taxation.**

(TABLE 1-A CONTINUED)

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
4. Foreign funded plan	TEE.* Contributions taxed as effectively connected income. **Proposal: In case of defined benefit plan, treatment in row 1 applies, i.e., EET.***	No change under 1981 Model. Under 1996 Model, contributions to home country plan may be exempt, if employee already participated in plan. **Proposal: EEE.* U.S. does not tax at time of contribution if plan's situs provides deferral of taxation for employee.**

NONRESIDENT ALIEN EMPLOYEE: SERVICES PERFORMED OUTSIDE U.S.

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
5. U.S. qualified plan	EET.* Accretion taxed on distribution, unless exempted by § 871(f). **Proposal: EEE.* Accretion not taxed.**	EEE.* Treaty bars U.S. taxation of distribution.
6. U.S. nonqualified funded plan	EET.* Accretion taxed on distribution (or on accrual, if highly compensated employee).	EEE.* Treaty may bar taxation of accretion on distribution. **Proposal: Treaty inapplicable since situs country does not defer employee taxation.**

* See footnote to Table 1, page 358.

TABLE 2-A

U.S. CITIZEN OR RESIDENT AT TIME OF DISTRIBUTION; SERVICES PERFORMED OUTSIDE THE U.S.

U.S. CITIZEN OR RESIDENT AT ALL TIMES

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
7. Unfunded deferred compensation	EET.* Distribution is taxable as foreign source compensation.	No change under 1981 Model. Under 1996 Model, any payment classified as pension is exempt to extent previously taxed by other country.
8. Foreign funded plan	TET.* Because plan is nonqualified, contributions are taxed; accretion taxed on distribution (or on accrual, if highly compensated employee). <u>**Proposal: In case of defined benefit plan, treatment in row 7 applies.**</u>	No change under 1981 Model. Under 1996 Model, on distribution, U.S. tax is barred to extent of amount previously taxed by other country. <u>**Proposal: EET.* U.S. does not tax at time of contribution if plan's situs provides deferral of tax for employee. As in 1996 Model, on distribution, U.S. does not tax amount previously taxed by other country.**</u>

(TABLE 2-A CONTINUED)

NONRESIDENT ALIEN AT TIME OF ACCRUAL;
RESIDENT ALIEN AT TIME OF DISTRIBUTION OF BENEFITS

Type of Plan	Treatment Under Code	Treatment Under U.S. Models
9. Unfunded deferred compensation	EET.* Entire distribution is taxable as foreign source compensation.	No change under 1981 Model. Under 1996 Model, any payment classified as pension is exempt to extent previously taxed by other country.
10. Foreign funded plan	EEE.* Distribution is exempt as return of capital, except that accretion element is taxed if not highly compensated employee. <u>Proposal: EET.* No basis recovery allowed except for amounts subjected to tax by other country.</u>	No change under 1981 Model. Under 1996 Model, accretion element not taxed to extent previously taxed by other country. <u>Proposal: EET.* Residence country to tax any amount of distribution not previously subjected to tax by other country.</u>

* See footnote to Table 1, page 358.

V. CONCLUSION

The growth in the number of employees who move across national borders makes this an opportune time for the U.S. to examine its tax treatment of deferred compensation paid to such employees. The current U.S. statutory rules governing these transactions together with the U.S. treaty network do not assure a coherent and administrable approach for taxing such compensation.

This article proposes three changes that the U.S. should unilaterally make in its statutory treatment of these transactions to meet these concerns. The first change is to simplify the U.S. assertion of source-based jurisdiction over pension distributions from a U.S. qualified plan by eliminating separate identification of the "accretions" element. The second change is to adjust U.S. basis rules to close off existing opportunities for a foreign national to use the U.S. as a tax haven on retirement. The third change is for the U.S. to relinquish its impractical assertion of current taxation of a U.S. resident's contributions to foreign defined benefit plans.

More generally, this article recommends that the U.S. should promote a more comprehensive treaty policy dealing with these transactions. If this policy were widely adopted, it would lead to better coordination of the taxation of an employee's deferred compensation by the potentially large number of countries that may assert source-based or residence-based jurisdiction. This would prevent employees from suffering unwarranted double taxation or from seeking out unwarranted tax exemption, and would simultaneously assure that the U.S. and its trading partners receive their rightful share of tax revenues.