Covering Expatriate Employees in Qualified Plans  
(both inbound and outbound) 

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I. Extending U.S. Tax-Qualified Plans to Executives Working Abroad

A common concern of many outbound executives is whether they can continue to participate in a U.S. tax-qualified retirement plan while they are working outside of the United States on a foreign assignment. A U.S. tax-qualified retirement plan may provide certain U.S. tax advantages that a foreign retirement plan cannot, such as a pre-tax contribution feature (as in the case of a plan under Section 401(k) of the Internal Revenue Code (the “Code”), no current U.S. income tax on the contributions made to the plan on the executive’s behalf, no current U.S. income tax on earnings of the plan prior to distribution and favorable U.S. income tax treatment upon distribution (such as tax-free rollover treatment).

An outbound executive may be reluctant to part with these tax benefits, unless a substantial expatriation bonus or other “gross-up” allowance is offered. Further, depending on the executive’s compensation package and his length of stay in the foreign jurisdiction, he may not be able to obtain a meaningful retirement benefit from any foreign retirement plan. And even if can obtain a sizeable benefit, he may be taxable under U.S. income tax law on the contributions made to such a plan or on the vesting or accrual of such benefits.\(^1\)

To address these concerns, the U.S. employer can choose among a number of planning alternatives. Which one is selected ultimately depends on a number of different factors, including: (i) the length of the executive’s foreign assignment, (ii) whether the outbound executive will be employed by a member of the same controlled group as the U.S. employer, (iii) the plan sponsor’s desire to include other U.S. persons who work abroad in the plan, and (iv) the number of transferring executives employed worldwide.

A. A Tax-Qualified Retirement Plan Must Cover “Employees”.

As a first step, the U.S. employer should review the terms of the plan document and determine whether the outbound executive’s employment abroad is covered under the plan. In other words, does the plan cover employees working outside of the United States in that particular location? If not, the plan may need to be amended so that by its terms it covers the outbound executive’s situation.

The most critical aspect for plan participation purposes is the employer-employee relationship. The sponsor of a tax-qualified retirement plan must maintain the plan for the exclusive benefit of its own employees.\(^2\) In general, a tax-qualified retirement plan may not cover individuals who are not technically “employees,” that is, common-law employees of the plan sponsor or adopting employer. For these purposes, a person is in general an “employee” if...
the employer has the right to direct and control the activities of the person. Failure to limit plan participation to employees only may result in disqualification of the plan.

Accordingly, if the outbound executive transfers to a foreign branch of a U.S. employer, the outbound executive can continue to participate in the U.S. employer’s tax-qualified retirement plan if the plan’s provisions so permit because the foreign branch is merely an unincorporated association and thus is treated as an extension of the U.S. employer. Further, if the outbound executive is seconded to the foreign company, then he will also continue to participate in the retirement plan because he technically remains a common-law employee of the U.S. employer.

However, where the outbound executive transfers employment to a foreign parent or subsidiary organization, or to a U.S. subsidiary doing business in a foreign jurisdiction which has not adopted the plan, he technically would no longer be an “employee” of an entity that sponsors the plan, and thus could be ineligible for participation.

B. Controlled Group Coverage.

Notwithstanding an outbound executive’s transfer of employment to a separate entity which has not adopted the plan, his participation in a U.S. tax-qualified retirement plan can be preserved where he is transferred to employment with a member of the same controlled group as the plan sponsor or adopting employer of the plan. For these purposes, a “controlled group” is defined as a “controlled group of corporations,” or “trades or businesses under common control.”

A “controlled group of corporations” is a parent-subsidiary group, in which the parent owns at least 80% of the stock of the subsidiary, or a brother-sister group, in which five or fewer individuals own at least 80% of the stock in two or more corporations, and at least 50% of such ownership is identical with respect to each corporation. Similar rules exist for “trades or businesses under common control,” (which include unincorporated entities), affiliated service groups and entities that the Secretary of the Treasury through regulations deems should be treated as one employer for employee benefit purposes.

For purposes of applying the various nondiscrimination rules applicable to U.S. tax-qualified retirement plans, all employees of all members of a controlled group are aggregated and treated as employees of one employer. For purposes of plan qualification, coverage, vesting and contribution limits, but not tax deduction rules, all employees of all members of the controlled group are aggregated.

NOTE: The controlled group rules, for purposes of tax-qualified retirement plans, include non-U.S. entities in the definition of “controlled group,” even though non-U.S. entities are technically excluded from the definition of an “affiliated group of corporations” eligible to file a U.S. consolidated group income tax return.

The IRS has ruled that because of the application of the controlled group rules, employment is tested on an entity-wide basis. That is to say, employment with any member of the controlled group will be considered to be employment with the U.S. employer for testing
purposes under Section 401(a) of the Code (other than for deduction purposes, discussed below). Accordingly, the U.S. employer may preserve an outbound executive’s participation in the plan as long as he transfers employment to a member of the same controlled group, even if the controlled group member does not itself adopt the plan. The plan document would have to be amended to reflect the extension of participation to an employee who continues employment with a controlled group member.

The plan sponsor can be selective about the employees who participate in its tax-qualified retirement plan in this manner. There is no requirement that the plan sponsor extend coverage to all employees of its controlled group members, so long as it meets certain minimum participation and minimum coverage tests measured on a controlled group basis.

Where outbound executives are transferred to work for controlled group members, they can continue to participate in the U.S. employer’s plan the same as before. Their transfer to employment with a controlled group member will have no impact on the results of the minimum participation or minimum coverage tests for that plan since the executive is counted as a participant in both cases. Further, depending on the relevant test, the plan sponsor may or must exclude all nonresident aliens with no U.S. source income from the plan. Thus, the plan sponsor may cover only the outbound executives who work for the controlled group member and may exclude its other employees who are nonresident aliens with no U.S. income from consideration when performing the plan’s minimum participation and minimum coverage tests.


Even if the participation of the outbound executive can be continued under the U.S. plan because he is transferring employment to a controlled group member, the U.S. employer is not automatically entitled to a U.S. federal income tax deduction for its contributions on behalf of such employee, since the employer may only deduct contributions made on behalf of its own employees. In other words, the controlled group rules and the income tax deduction rules are not completely synchronized. A U.S. employer can make a contribution to a U.S. tax-qualified plan on behalf of an outbound executive who works for a controlled group member outside of the United States without disqualifying the plan. However, the availability of the income tax deduction depends on whether the controlled group member adopts the plan. In PLR 8422142, a plan sponsor of a defined benefit pension plan and a money purchase pension plan made contributions on behalf of all employees of another company in the same controlled group that had adopted the plans. The IRS referred to the second sentence of §414(b) that provides that with respect to a plan adopted by more than one corporation in a controlled group, the minimum funding standard of §412, the tax imposed by §4971, and the applicable limitations provided by §404(a) shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary. The IRS also looked at the legislative history of §414(b), which provides:

In the case of a plan adopted by more than one corporation which is a member of controlled group of corporations … the new rules with respect to maximum deduction limits are to be determined as