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U.S. TAX-QUALIFIED PLANS: SELECTED INTERNATIONAL ISSUES

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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.

Furthermore, 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 this concern, the expatriate's U.S. employer can choose among a number of planning alternatives. Which one is selected ultimately depends on a number of different factors, including whether the outbound executive will be employed by a foreign branch or subsidiary of the U.S. employer, the U.S. employer's desire to include other U.S. persons who work abroad in the plan and the length of the foreign assignment.

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. 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.[3] 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 would 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. For these purposes, a "controlled group" is defined as a "controlled group of corporations," or "trades or businesses under common control."[4] 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.[5] 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.[6]

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.[7] 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.[8]

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.[9]

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).[10] 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.[11] With respect to outbound executives who 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.[12] Thus, the plan sponsor may cover only the outbound executives who work for the controlled group member and may or must 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, respectively.

C. Loss of Deduction.

Unfortunately, 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 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.[13] 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, that contribution will not be deductible. Further, nondeductible contributions give rise to a special 10% excise tax.[14] Accordingly, the U.S. employer will have to measure the financial cost of making contributions to the plan on behalf of such an executive.

If a U.S. employer makes a non-deductible contribution to a plan on behalf of employees of one of its controlled group members, the contribution may be treated as a contribution to capital by the U.S. employer.[15] However, if the U.S. employer and its controlled group member enter into a reimbursement agreement (in some foreign jurisdictions a written reimbursement agreement may be required) whereby the controlled group member agrees to reimburse the U.S. employer for the plan-related costs of the employees, then the U.S. employer may have no net tax consequences. This is because the reimbursement will offset the U.S. employer's nondeductible contribution. The controlled group member — depending on local tax laws — should have a claim for a local tax deduction (as an ordinary business expense related to its employees).[16] If the U.S. employer is the parent of the foreign controlled group member, a local tax deduction at the foreign subsidiary level may enable the U.S. employer to obtain a tax advantage through a reduction in the foreign subsidiary's earnings and profits.

D. Treat Assignment As A Leave of Absence.

If the outbound executive will be abroad on a temporary assignment, he may also be able to remain a participant in the tax-qualified retirement plan if his assignment is characterized as a "leave of absence." The relevant Regulations provide that a tax-qualified retirement plan must be established for the exclusive benefit of employees or their beneficiaries, even though it may cover employees who are temporarily on leave.[17] Certain Regulations also provide that a tax-qualified retirement plan must credit a participant with up to 501 hours of service for which he is entitled to be paid because of a leave of absence.[18] This service credit provision could be used to continue an outbound executive's status as a plan participant while on a brief foreign assignment, such as one which lasts six months or less. The relevant Regulations do not define "leave of absence," so there may be some discretion on the employer's part to design an appropriate plan provision. However, a plan will not fail to qualify under Code Section 401(a) so long as it has a provision that credits service for participation and vesting purposes to employees on leaves of absence pursuant to an established leave policy which is applied in a uniform and nondiscriminatory manner.[19]

E. Code Section 406.

Another way to continue the outbound executive's participation in the U.S. employer's tax-qualified retirement plan is pursuant to Code Section 406. U.S. citizens or residents employed by an entity in which an American employer[20] has a 10% or more interest (i.e., a "foreign affiliate"), will be treated as employed by the American employer for purposes of the American employer's tax-qualified retirement plan, if certain requirements are met:

(i) The American employer agrees to extend U.S. Social Security coverage to all of the foreign affiliate's employees who are U.S. citizens or residents by means of a Section 3121(l) agreement filed with the IRS;[21]

(ii) The tax-qualified retirement plan expressly provides for contributions or benefits for U.S. citizen and resident employees of the foreign affiliate to which a Section 3121(l) agreement applies; and

(iii) No contributions are made to any other (including non-U.S.) funded deferred compensation plan (whether or not tax-qualified) on behalf of the employees who are U.S. citizens or residents based on the compensation of such employees from the foreign affiliate. This requirement is not violated, however, if the foreign affiliate is required by local law to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.[22]

The foreign affiliate, not the U.S. employer, is allowed a U.S. federal income tax deduction for the contributions made on behalf of its U.S. citizen or resident employees, even though the U.S. employer actually makes the contribution to the tax-qualified retirement plan.[23] This deduction may accordingly be worthless unless the foreign affiliate is subject to U.S. income taxes.

NOTE: Section 406 is available only if the U.S. employer owns a 10% or more interest of the foreign affiliate. Thus, U.S. subsidiaries of foreign parent corporations which transfer their outbound executives to work for the foreign parent may not be able to use Code Section 406 to continue contributions on behalf of such executives since a subsidiary typically does not own a 10% or more interest in its parent corporation.

Section 406 has a number of disadvantages. Since all of a foreign affiliate's U.S. citizens or residents must be covered by a Section 3121(l) agreement, the U.S. employer may have to pay