Alarming U.S. Tax Rules and Information-Reporting Duties for Foreign Retirement Plans: Problems and Solutions

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The IRS generally taxes contributions to foreign plans, the accumulated yet undistributed income in foreign plans, and distributions from foreign plans. If the lack of tax deferral is not enough to get your attention, the long list of information-reporting duties and the steep penalties for violations should.

More Americans than ever before will have the chance to work abroad at some point in their careers. The responsible ones will gain valuable professional experience, learn the local language, and save for the future, likely by participating in a foreign workplace retirement plan, which they believe to be similar to a Section 401(k) plan in the United States. Putting money aside for old age can have unexpected downsides in the international context because most U.S. taxpayers, and way too many U.S. tax advisors, make the crucial mistake of thinking that the IRS treats foreign retirement plans just like domestic ones. It does not. Indeed, the IRS generally taxes contributions to foreign plans, the accumulated yet undistributed income in foreign plans, and distributions from foreign plans. If the lack of tax deferral is not enough to get your attention, the long list of information-reporting duties and the steep penalties for violations should. Based on a recent study by the U.S. Government Accountability Office ("GAO Report") criticizing the IRS and Congress for allowing the perpetuation of a complex, obscure, and inconsistent system, this article analyzes the surprising rules for U.S. individuals with interests in foreign workplace retirement plans and proposes solutions for solving unintentional violations.[1]

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Background

How does one get into a mess with the IRS with respect to a foreign retirement plan? Here is a typical scenario.

Expat Ernie, a U.S. citizen by birth, gets a new job in and moves to a foreign country. On securing his first job there, he inquires about the company's retirement plan, arranges to contribute the maximum allowed each year to the plan, and opens a local savings account to squirrel away yet more funds for his old age.

Ernie retains tax advisors in the foreign country to confirm that the accumulated yet undistributed income that the plan generates is not subject to annual taxes in the foreign country and that he is generally not permitted to withdraw funds from the plan until he reaches the specified retirement age. The local tax advisors verify his understandings and help him file all necessary forms and make all necessary payments, either directly or through withholding, to ensure full tax compliance in the foreign country.

Intent on maintaining U.S. tax compliance while abroad, Ernie also consults with his accountant back in the United States and provides him with all the relevant data about his new job, retirement plan, and savings account. The U.S. accountant lacks extensive experience with international tax matters but does his best to help Ernie adhere to all U.S. rules by (1) filing timely Forms 1040 (U.S. Individual Income Tax Return) reporting the wages from the foreign company; (2) disclosing the existence and location of the foreign savings account on Form 1040 Schedule B (Interest and Ordinary Dividends); (3) reporting the interest income from the foreign savings account on Schedule B; (4) claiming the foreign earned income exclusion on Form 2555 (Foreign Earned Income); and (5) filing electronically an annual FinCEN Form 114 (Report of Foreign Bank and Financial Accounts) (FBAR) to notify the IRS about the foreign savings account.

The U.S. accountant believes mistakenly that the foreign retirement plan is similar to a Section 401(k) plan in the United States, such that Ernie will not have any U.S. tax or reporting issues until he starts receiving distributions upon retirement. The accountant explains this to Ernie, who, equally ignorant about U.S. international tax matters, does nothing to reveal the foreign retirement plan to the IRS for many years. Ernie continues to make the maximum annual contribution to the plan and the amount in the plan continues to grow thanks to contributions and gains on passive investments.

Ernie receives news that his parents have serious medical problems and decides to return to the United States. He resigns from the foreign company, closes his foreign account and transfers the funds back to a U.S. account, and assumes that he can simply move the large balance in the foreign retirement account as a tax-free transfer (rollover) to an existing Section 401(k) plan or IRA. Ernie consults with his U.S. accountant to validate his understanding about the U.S. tax effect of the proposed transfer.

This question is novel to the U.S. accountant so he does some research and after a few clicks realizes that Ernie has violated U.S. tax law inadvertently with respect to his foreign retirement plan and that he cannot transfer the funds to a Section 401(k) plan or an IRA tax free. The U.S. accountant is concerned about a malpractice lawsuit, of course, but is smart enough to comprehend that he should not compound his problems so he contacts Ernie, explains the situation, and recommends that he hire U.S. international tax attorneys to analyze the options for rectifying matters on the best terms possible.

Summary of Information-Reporting Duties

U.S. individuals generally have three main duties when they hold a reportable interest in a foreign financial account: (1) check the "yes" box in Part III (Foreign Accounts and Trusts) of Form 1040 Schedule B to disclose the existence and location of the foreign account; (2) report the account on Form 8938 (Statement of Specified Foreign Financial Assets), which is enclosed with Form 1040; and (3) file an FBAR electronically.[2] If the U.S. person holds an interest in a foreign workplace retirement plan, he likely will need to file additional international information returns with the IRS.

Below is an overview of the main information-reporting duties of U.S. individuals with foreign workplace retirement plans. This initial information is important because one must understand these duties before appreciating the problems and solutions discussed in this article.

Form 1040—duty to report foreign accounts and related income

Part III of Form 1040 Schedule B contains an FBAR inquiry and a cross-reference. The IRS has modified and expanded this language slightly over the years, with the 2017 Schedule stating the following:

> At any time during 2017, did you have a financial interest in or a signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions.
>
> If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See Fin-

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[1] U.S. Government Accountability Office (GAO), "Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings," GAO-18-19 (1/31/2018), www.gao.gov/products/GAO-18-19 ("GAO Report"). See also Murthy, "Selected Cross-Border Equity and Deferred Compensation Issues With Fund Foreign Plans," 42 Comp. Planning J. 67 (April 2014); Chastang and Yeager, "Foreign Pensions and Florida Practitioners," Florida CPA Today (May/June 2013); Blum, "Migrants with Retirement Plans: The Challenge of Harmonizing Tax Rules," 17(1) Florida Tax Review (2015).

[2] For a detailed analysis of the Form 8938 filing requirement, see Sheppard, "The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance," 38(3) Int'l Tax J. 11 (2012); Sheppard, "Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules After IRS Issues Final Regulations," 41(2) Int'l Tax J. 25 (2015); Sheppard, "Specified Domestic Entities Must Now File Form 8938: Section 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting," 42(3) Int'l Tax J. 5 (2016); and Sheppard, "Unlimited Assessment Period for Form 8938 Violations: Ruling Shows IRS's Intent to Attack Multiple Tax Returns," 95(5) Taxes 31 (2017).

> CEN Form 114 and its instructions for filing requirements and exceptions to those requirements.
>
> If you are required to file a FinCEN Form 114, enter the name of the foreign country where the financial account is located.

FBAR—duty to report foreign financial accounts

Congress enacted the Bank Secrecy Act in 1970.[3] One purpose was to require the filing of certain reports, like the FBAR, when doing so would help the U.S. government carry out criminal, tax, and regulatory investigations.[4] The relevant statute, in conjunction with the corresponding regulations and FBAR instructions, generally require the filing of an annual FBAR when (1) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (2) had a direct or indirect financial interest in, or signature or some other type of authority over, (3) one or more financial accounts (4) located in a foreign country (5) the aggregate value of which exceeded $10,000 (6) at any point during the year at issue.[5]

Concerned with widespread FBAR noncompliance, the U.S. government has taken action in recent years. Notably, Treasury transferred authority to enforce FBAR duties to the IRS in 2003.[6] The IRS has been empowered since then to investigate potential FBAR violations, issue summonses and administrative rulings, assess civil penalties, and take "any other action reasonably necessary" to enforce the FBAR rules.[7]

Congress enacted new FBAR penalty provisions in 2004.[8] The IRS may now penalize any U.S. person who fails to file an FBAR when required, period.[9] For non-willful violations, the maximum penalty is $10,000, but the IRS cannot assert this penalty if the violation was due to "reasonable cause."[10] Higher penalties apply when willfulness exists. Specifically, when a taxpayer deliberately fails to file an FBAR, the IRS can assert a penalty equal to $100,000 or 50% of the balance in the account at the time of the violation, whichever is larger.[11] Given the astronomical balances in some unreported accounts, FBAR penalties can be enormous.

Form 8938—duty to report foreign financial assets

Section 6038D, which mandates the filing of Form 8938, was enacted as part of the Foreign Account Tax Compliance Act (FATCA).[12] The general rule can be divided into the following parts: (1) any specified person (SP), which term now includes U.S. citizens, U.S. residents, certain domestic entities, and others (2) who/that holds an interest (3) during any portion of a tax year (4) in a specified foreign financial asset (SFFA) (5) must attach to a timely tax return (6) a complete and accurate Form 8938 (7) if the total value of all SFFAs (8) is more than the applicable filing threshold.[13]

Holding an interest in an asset means different things in different contexts. For Form 8938, an SP generally holds an interest in an SFFA if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the SFFA are (or should be) reported, included, or otherwise reflected on the SP's annual tax return.[14] The Regulations clarify that an SP has an interest in the SFFA even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the SFFA for the year in question.[15] The Regulations also indicate that an SP must file a Form 8938 even though none of the SFFAs that must be reported affect the U.S. tax liability of the SP for the year.[16]

For purposes of Section 6038D, SFFA includes two major categories: foreign financial accounts[17] and other foreign financial assets that are held for investment purposes.[18] The concept of "financial account" for purposes of Form 8938 is complicated for several reasons, one of which is that the definition is not found in the applicable statute, Section 6038D, or the corresponding Regulations. Instead, it is in the Code's international tax withholding provision, Section 1471, and its ultra-dense Regulations.[19] For purposes of this article, it suffices to confirm that the tax-favored foreign retirement accounts and foreign pension accounts are generally treated as "financial accounts" on Forms 8938.[20] Notably, even if these retirement items have been excluded from the definition of "financial account" under an inter-

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3 P.L. 91-508, Title I and Title II (10/26/1970).

4 *Id.* section 202.

5 31 U.S.C. section 5314; 31 C.F.R. section 1010.350(a).

6 68 Fed. Reg. 26489 (May 16, 2003).

7 31 C.F.R. section 103.56(g), 68 Fed. Reg. 26489 (May 16, 2003).

8 American Jobs Creation Act. P.L. 108-357 (10/22/2004).

9 31 U.S.C. section 5321(a)(5)(A).

10 31 U.S.C. section 5321(a)(5)(B)(ii).

11 31 U.S.C. section 5321(a)(5)(C)(i). As of May 2018, there was uncertainty regarding the maximum FBAR penalty, as a district court issued an opinion stating that the willful FBAR penalty was capped at $100,000 per violation because the IRS failed to update the operable Regulations after Congress amended the law to increase penalties. See *Colliot*, Cause No. AU-16-CA-01281-SS (DC TX, 5/16/2018).

12 P.L. 111-147, Hiring Incentives to Restore Employment Act (3/18/2010), section 511.

13 Section 6038(a).

14 Reg. 1.6038D-2(b)(1).

15 *Id.*

16 Reg. 1.6038D-2(a)(8).

17 Section 6038D(b)(1); Reg. 1.6038D-3(a)(1).

18 Section 6038D(b)(2); Reg. 1.6038D-3(b)(1).

19 Reg. 1.6038D-1(a)(7).

20 Regs. 1.1471-5(b)(2)(i)(A), (B), and (D); See also Reg. 1.6038D-3(a)(7).

21 See Reg. 1.1471-5(b)(2)(vi); Reg. 1.6038D-1(a)(7); Preamble, 76 Fed. Reg. 73819-73820 (12/12/2014); instructions to Form 8938 (October 2015), page 5.

22 Section 6038D(d)(1); Reg. 1.6038D-8(a).

23 Section 6038D(d)(2); Reg. 1.6038D-8(c).

24 Section 6038D(g); Reg. 1.6038D-8(e)(1).

25 Sections 6048(a)(1) and (4). "Responsible party" means (1) the grantor when an inter vivos trust is created; (2) the transferor in cases involving a "reportable event," other than a transfer by reason of death; and (3) the executor of a decedent's estate.

26 Section 6048(c)(1).

27 Section 6677(a).

28 Section 6677(d).

29 Section 6048(b)(1). The grantor trust rules are in Sections 671-679.

30 Section 678(a)(1).

31 Section 679(a)(1).

32 Section 6677(b).

33 Section 6677(d).

34 Section 6114(a); Regs. 301.6114-1(a)(1), (d)(1).

35 Section 6712(a); Reg. 301.6712-1(a).

36 *Id.*

37 Section 6712(b); Reg. 301.6712-1(b).

38 GAO Report, page 3.

governmental agreement between the United States and a foreign country to implement FATCA, they will still be considered "financial accounts" for purposes of Form 8938. In other words, while certain foreign governments and financial institutions are not required to provide data to the IRS pursuant to FATCA about certain retirement-type accounts, U.S. individuals holding these accounts will not benefit from such an accommodation.[21]

If an SP fails to file the Form 8938 timely, the IRS generally will assert a penalty of $10,000 per violation.[22] The penalty increases to a maximum of $50,000 if the SP does not rectify the problem quickly after contact from the IRS.[23] An SP who unintentionally fails to file a timely, accurate, complete Form 8938 can avoid penalties if the SP can demonstrate that the violation was due to reasonable cause and not willful neglect.[24]

Forms 3520 and 3520-A: duty to report foreign trusts

Taxpayers must file a Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) or Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner), or both, in certain situations involving foreign trusts.

Form 3520. In the context of foreign trusts, Form 3520 generally must be filed in two circumstances. First, the responsible party generally must file a Form 3520 within 90 days of certain "reportable events," such as the creation of any foreign trust by a U.S. person; the transfer of any money or other property (directly or indirectly or constructively) to a foreign trust by a U.S. person; and the death of a U.S. person if the decedent was treated as the "owner" of any portion under the grantor trust rules, or if any portion of the foreign trust was included in the decedent's gross estate.[25] Second, a U.S. person ordinarily must file a Form 3520 if he receives during a year (directly or indirectly or constructively) any distribution from a foreign trust.[26]

The penalty for not filing a Form 3520 is equal to $10,000 or 35% of the "gross reportable amount," whichever is larger.[27] However, the IRS will not assert penalties when there is "reasonable cause" for the violation.[28]

Form 3520-A. Form 3520-A normally must be filed if, at any time during the relevant year, a U.S. person is treated as the "owner" of any portion of the foreign trust under the grantor trust rules.[29] A person other than the grantor is treated as the owner of any portion of a trust with respect to which he has "a power exercisable solely by himself" to vest the assets or income from the trust in himself.[30] Moreover, a U.S. person who transfers property, directly or indirectly, to a foreign trust will generally be treated as the owner during the year of the transfer for his portion of the trust attributable to such property if there is a U.S. beneficiary of any portion of such trust.[31]

IRS may now penalize any U.S. person who fails to file an FBAR when required, period—given the astronomical balances in some unreported accounts, FBAR penalties can be enormous.

The normal penalty for Form 3520-A violations is the higher of $10,000 or 5% of the "gross reportable amount."[32] Penalties will not be asserted when there is "reasonable cause" for the violation.[33]

Foreign trust issues on Form 1040. Part III to Form 1040 Schedule B presents the following question about foreign trusts:

> During 2017, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back.

The instructions to Schedule B expand on the foreign trust concept:

> If you received a distribution from a foreign trust, you must provide additional information. For this purpose, a loan of cash or marketable securities generally is considered to be a distribution. See Form 3520 for details. If you were the grantor of, or transferor to, a foreign trust that existed during 2017, you may have to file Form 3520. Don't attach Form 3520 to Form 1040. Instead, file it at the address shown in its instructions. If you were treated as the owner of a foreign trust under the grantor trust rules, you are also responsible for ensuring that the foreign trust files Form 3520-A. Form 3520-A is due on March 15, 2018, for a calendar year trust. See the instructions for Form 3520-A for more details.

Form 8833—duty to report positions taken pursuant to treaty

Taxpayers taking a position that a U.S. tax treaty overrules or otherwise modifies U.S. tax law generally must reveal such position to the IRS on Form 8833 (Treaty-Based Return Position Disclosure).[34] Corporate taxpayers that fail to disclose treaty-based return positions are subject to a penalty of $10,000 for each violation.[35] The penalty for individual taxpayers is lower, at $1,000 per omission.[36] However, the IRS will waive the penalty if the taxpayer shows that there was reasonable cause, the taxpayer acted in good faith, and the failure was not due to willful neglect.[37]

GAO Report Identifies Numerous Reporting Problems

The U.S. tax and information-reporting problems of U.S. persons with foreign retirement instruments are well documented in the GAO report issued in January 2018.[38]

Distinct U.S. tax treatment of domestic and foreign plans

The GAO Report starts by underscoring the size of the problem: there are nearly nine million U.S. citizens living abroad, many of whom have interests in local

retirement instruments. It then describes the distinct way that the U.S. tax system treats domestic versus foreign retirement plans. The GAO Report says that, in the United States, contributions by employees, contributions by employers, and passive earnings (such as interest, dividends, and capital gains) within a "qualified" retirement plan generally are not taxed until the employee receives actual distributions from the plan.[39]

By contrast, the GAO Report says that foreign workplace retirement plans are not ordinarily considered "qualified" plans under the Internal Revenue Code, so American expatriates working as employees do not receive the same benefits as their counterparts with "qualified" domestic plans. Depending on several factors, including the characteristics of the plan, local law, and the provisions in the applicable bilateral treaty, U.S. individuals who participate in foreign retirement plans might be taxed currently on (1) contributions to the plans, by themselves or their employers; (2) the accrued-but-undistributed earnings in the plans; and (3) distributions from the plans that they have not actually received, such as transfers of assets between or among various foreign plans.[40]

IRS guidance is insufficient and unclear

The GAO Report acknowledges that the IRS has provided some limited guidance about foreign workplace retirement plans, such as the International Tax Gap Series and Publication 54 ("Tax Guide for U.S. Citizens and Resident Aliens Abroad"). However, the GAO Report says that neither of these "describes in detail how taxpayers are to determine if their foreign workplace retirement plan is eligible for tax-deferred status, or how to account for contributions, earnings, or distributions on their annual U.S. tax return, particularly whether and when contributions and earnings should be taxed as income."[41] The GAO Report also indicates that, while the IRS directs taxpayers to review the relevant bilateral tax treaties for any provisions related to foreign pensions, even IRS officials admit that "these treaties can vary from country to country and … can be difficult for nonexperts to understand."[42]

Consistent with IRS rulings discussed elsewhere in this article, the GAO Report confirms the IRS positions that foreign workplace retirement plans are not generally considered "qualified" plans for U.S. tax purposes and thus are not entitled to the corresponding tax benefits. The GAO Report says in this regard:

> IRS officials told us that U.S. tax law generally does not recognize foreign retirement plans as tax-qualified and IRS does not recognize any retirement accounts outside the United States as having tax-qualified status. IRS officials we spoke to said that only plans meeting the specific requirements of [Section] 401(k) or other requirements describing retirement plan qualification may achieve tax-qualified status in the United States. As a result, according to IRS guidance, U.S. individuals participating in foreign workplace retirement plans generally cannot deduct contributions to their account from their income on their U.S. tax return. This is true even if the retirement account is considered a tax-deferred retirement account in the country where the individual works, and even if the account is similar in nature to those found in a U.S.-type retirement plan, such as a [Section] 401(k) plan.[43]

Everybody has an opinion, and this is certainly true in the tax community, fueled too often by unfounded theories posted on endless blogs, chat rooms, webpages, client alerts, and the like. Such a high rate of information dissemination, coupled with the lack of clarity from the IRS, has created disagreement among U.S. tax practitioners about how to treat foreign plans. According to the GAO Report, some practitioners advise their clients to report them as passive foreign investment companies (PFICs) on Forms 8621 (Return by U.S. Shareholder of a Passive Foreign Investment Company). Others recommend disclosing them as foreign financial accounts on FBARs and Forms 8938, while still others suggest that they should be treated as foreign trusts and reported on Forms 3520 and 3520-A.[44]

To exacerbate matters, the GAO Report, citing warnings from the National Taxpayer Advocate, says that the IRS might abate penalties related to erroneous treatment of foreign plans in situations involving reasonable reliance by a taxpayer on a qualified, informed, U.S. tax professional. However, "receiving incorrect tax advice from a foreign tax preparer may not be a sufficient mitigating circumstance to avoid penalties for reporting a foreign retirement account incorrectly on a tax return [because] tax preparers in other countries are usually not considered qualified preparers by IRS."[45] The GAO Report also says that the IRS sticks to its normal mantra when it comes to international tax issues, which is that taxpayers are ultimately liable for getting things right, notwithstanding the complexity of the issues, lack of IRS guidance, and the confusion among tax professionals about how to treat foreign retirement plans: "IRS officials told us that individual taxpayers are responsible for understanding their filing requirements and for determining how to correctly file their tax returns, regardless of whether they live in a foreign country or the United States."[46]

Transfers generally trigger immediate taxation

A major issue that the GAO Report addressed, but one unknown to many U.S. individuals and tax practitioners, is that changing jobs and transferring ("rolling over") savings from one foreign workplace retirement plan to another likely triggers

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39 *Id.* pages 11-12.
40 *Id.* pages 12-14.
41 *Id.* page 37.
42 *Id.*
43 *Id.* pages 38-39.
44 *Id.*
45 *Id.* page 39.
46 *Id.* pages 39-40.
47 *Id.* page 46.
48 *Id.* pages 47-48.
49 *Id.* page 49.
50 *Id.*
51 *Id.* page 50.
52 *Id.*
53 *Id.* page 51.
54 *Id.* page 52.
55 *Id.*
56 *Id.* page 53.
57 *Id.* pages 55-56.
58 See "Foreign Retirement Account Is Subject to OVDP Penalty," 2017 WTD 224-26 (Tax Analysts), 11/21/2017.

immediate U.S. taxation.[47] The IRS acknowledges that such movements of money generally do not undermine tax-deferred status in the foreign country where the plan is located, but this does not alter that the U.S. tax system views it differently:

> IRS officials told us the [Internal Revenue Code] does not recognize foreign retirement plans as tax-qualified plans, and because these plans are not able to meet the criteria for qualification, tax-deferred transfers or rollovers may not be possible, unless a tax treaty provides otherwise. IRS generally considers routine administrative transfers of retirement assets that occur between or within foreign retirement plans to be distributions to the participant and therefore taxable income…. [T]he transfers would generally constitute a "constructive receipt of funds" by the participant and would be reportable and taxable. As a result, a U.S. individual who participates in a foreign retirement plan could owe U.S. tax on the entire amount of their retirement savings when they separate from their employer and their account is transferred to another account within the plan or to a different workplace retirement plan.[48]

The GAO Report says that Treasury officials have been aware of this issue for many years, raised it during treaty negotiations with other countries, and included in the most recent U.S. model income tax treaty a clause that would generally exempt from immediate U.S. income tax transfers between foreign workplace retirement plans, provided that such transfers preserve tax-deferred status under local law.[49] Positive news indeed, but the reality remains that, as of today, many countries lack tax treaties with the United States or they have outdated treaties that do not address specifically the impact on U.S. individuals of making transfers among retirement plans.[50] The GAO Report contains more detail about the U.S. tax effects under current law lest anyone be unclear about the harshness:

> IRS officials told us that if no treaty exists between the United States and the country where the U.S. individual is participating in a foreign workplace retirement plan, or the treaty does not specify how to treat these transfers, there is generally no form of transfer that will receive U.S. income tax-deferral. In these situations, IRS officials said, there is no way that the plan can structure the transfer to prevent the U.S. individual who is transferring assets within or between foreign plans from receiving a distribution and being subject to tax liability. Even in cases where a tax treaty is in place, the treaty may not provide special treatment for the transfer of retirement assets. This would be the case in at least two of the five case study locations we examined, where despite a tax treaty in place, we were unable to identify any provisions that address these types of transfers. In these cases, according to IRS, the U.S. individual must fall back on the [Internal Revenue Code], which does not provide tax-deferral on such transfers. As a result, a U.S. individual who participates in a foreign workplace plan would lose any tax-deferrals on the transfer.[51]

The concept of "financial account" for Form 8938 purposes is complicated for several reasons, one of which is that the definition is in Section 1471 and its ultra-dense Regs.

Solutions are sparse, at least in the short term. The GAO Report points out that renegotiating a tax treaty is a slow process and generally will not occur to rectify just one issue, such as the U.S. tax treatment of foreign workplace retirement funds.[52] It suggests that the best way to provide "more immediate relief" would be to have Congress enact appropriate legislation. Unless and until that occurs, the Report says that "U.S. individuals who participate in foreign workplace retirement plans must follow current law, which does not provide tax deferral for transfers within or between foreign plans, even those that may be eligible for tax-deferred contributions and earnings in the foreign jurisdiction."[53]

Suggestions and future actions

The GAO Report contained several suggestions, three of which focused on the complexity of international tax compliance and the perceived unfairness of U.S. tax treatment of foreign workplace retirement plans. First, the Report recommended that the IRS provide clear guidance about U.S. tax and information-reporting requirements to minimize the compliance burden and avoid unintentional violations.[54] Second, it proposed that the IRS conduct a systematic analysis of data about foreign retirement plans now disclosed on Form 8938 to determine whether it would be appropriate to waive such information-reporting duty in the future.[55] Third, it suggested that Congress consider assisting U.S. individuals who participate in foreign workplace retirement plans by allowing them to be treated as "qualified" retirement plans in the United States, such as a Section 401(k) plan.[56]

The IRS did not agree with everything in the GAO Report but there were some positive signs for taxpayers, perhaps the most important of which is the following:

> IRS also stated that U.S. individuals participating in foreign retirement plans often do not know how to correctly report foreign retirement accounts and associated income due to complex federal requirements and treaty provisions governing the taxation of foreign retirement accounts …IRS agreed with our recommendation to clarify how U.S. individuals are to report their foreign retirement accounts, which could include how the taxpayer should report contributions, earnings, and distributions made from the account.[57]

Examples of IRS Treatment of Foreign Retirement Plans

The GAO Report painted a bleak picture for U.S. individuals with foreign workplace retirement accounts. Lest anyone think that hyperbole was involved, a couple of examples are examined below.

Swiss retirement plans

The IRS released a legal memo in November 2017 dealing with retirement instruments in Switzerland.[58] The taxpayer in the memo:

- Worked in the United States and had an employer-established U.S. pension.
- Was terminated from her job and accepted a new position and moved to Switzerland.
- Transferred the funds from the U.S. pension to a Swiss "libre passage" account (which she argued was analogous to a tax-deferred IRA in the U.S.).
- Did not report on Forms 1040 any accumulated but undistributed gain within the Swiss retirement account or any distributions from the account.
- Presumably did not report the account on all necessary U.S. international information returns including Form 8938 and FBAR.

The IRS concluded the following in the memo:

1. The transfer from the U.S. pension to the Swiss libre passage account was not a tax-free, qualified rollover, such that the taxpayer should have been taxed on the total amount relocated.
2. The taxpayer should have reported on her annual Forms 1040 all accumulated but undistributed gains within the account and all distributions from the account.
3. The U.S.-Switzerland tax treaty "provides no exceptions or relief."
4. Because the Swiss libre passage account was not in compliance with U.S. law, the taxpayer must include the highest value of the account in the "offshore" penalty calculation as part of her participation in a voluntary disclosure program with the IRS.

In what tax practitioners might label as one the biggest understatements in recent memory, the legal memo concludes that "[t]he facts of this case are sympathetic in that the rules relating to foreign pension accounts are not intuitive, and we anticipate that the taxpayer's representatives will not be pleased with the conclusion in this memorandum."

Australian retirement plans

U.S. individuals with Australian retirement plans have fared no better than those in Switzerland. Taxpayers and practitioners have sought guidance and a remedy from the IRS for many years with respect to a common retirement vehicle, the Australian Superannuation Fund (ASF), by sending letters underscoring the inconsistent tax treatment by the U.S. and Australian tax authorities, and the lack of specific language in the U.S.-Australia treaty to correct the issue.[59] One letter from the American Chamber of Commerce in Australia sums up the issues (and the outrage) nicely:

> I have recently been advised that under current treaty arrangements the annual income of my Australian superannuation funds is subject to 39.6% U.S. tax (in excess of $21,000 AUS for my 2013 return). As Australian taxpayers are not able to draw on their superannuation funds to pay U.S. tax before they reach preservation age, this can cause significant financial hardship. In addition to U.S. taxation of the annual income of Australian superannuation funds, there is U.S. taxation on the transaction when they roll over into an allocated pension stream and taxation on the annual annuity/pension, thus causing further financial strain. The treaty does not recognize that Australian superannuation funds meet Australian regulatory requirements and are similar in purpose and structure to American retirement funds which are not similarly taxed. Nor does it account for the fact that the taxation of Australian superannuation funds by the United States amounts to double taxation; Australian superannuation funds are already taxed, albeit at different intervals and different time frames than retirement funds in the United States.[60]

Based on the available data, it appears that neither Congress nor the IRS is heeding the call for change. In 2017, the IRS was obligated to release a portion of the written guidance that it provides to personnel tasked with answering calls from taxpayers on the "voluntary disclosure hotline."[61] The IRS guidance instructs personnel to say the following with respect to ASFs: (1) unlike certain retirement plans in Canada, ASFs are not covered by a favorable treaty provision; (2) the IRS's voluntary disclosure programs do not have special provisions for ASFs; (3) the highest value of ASFs that are not compliant with U.S. tax or information-reporting obligations will be subject to the "offshore" penalty; and (4) ASFs must be reported on various international information returns including, but not limited to, Forms 3520 and 3520-A related to foreign trusts.

Ability to Standardize U.S. Tax Treatment of Foreign Retirement Plans

The situations above involving Switzerland and Australia illustrate what can happen when a U.S. individual has an interest in a workplace retirement plan in a foreign country that does not have a favorable treaty with the United States. It is critical, though, that when the United States and a foreign country put their collective minds to it, they are capable of inserting provisions in a treaty that essentially standardize U.S. tax treatment of workplace retirement plans, foreign and domestic. One example is the treaty with the United Kingdom, the relevant aspects of which are summarized below.[62]

Article 18 of the treaty deals with issues related to "pension schemes." Before analyzing the substantive rules in Article 18, it is first necessary to define the key term. The definition of "pension scheme" is in Article 3(1)(o):

> The term "pension scheme" means any plan, scheme, fund, trust or other

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[59] "Remedy Sought for Taxation of Retirement Funds in Australia," 2016 Tax Notes Today 178-29 (Tax Analysts), 8/26/2016.

[60] "Dual Citizen Concerned about Australian Superannuation Funds," 2014 Tax Notes Today 166-14 (Tax Analysts), August 11, 2014.

[61] "IRS Releases OVDP, Streamlined Program Hotline Guide," 2017 WTD 160-16 (Tax Analysts), August 21, 2017.

[62] See Treasury Technical Explanation of the U.S.-UK treaty and related report by the Joint Committee on Taxation (JCS-4-03), March 3, 2003.

[63] JCS-4-03, supra note 62, page 43.

[64] Section 6501(c)(8)(B) contains a limitation—the assessment period will remain open only with respect to "the item or items" related to the late international information return if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not willful neglect.

[65] This article discusses only the five main methods that the IRS has approved publicly. Taxpayers use other techniques, such as making a "quiet disclosure" with the IRS, doing nothing, and beginning U.S. tax compliance in future years only. The author does not endorse these and other techniques.

> arrangement established in [the United States or the United Kingdom] which is (i) generally exempt from income taxation in [the United States or the United Kingdom]; and (ii) operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

The general rules regarding the taxability of accumulated but undistributed earnings in retirement plans are in Article 18(1), which provides the following guidance:

> Where an individual who is a resident of [the United States or the United Kingdom] is a member or beneficiary of, or participant in, a pension scheme established in the other Contracting State, income earned by the pension scheme may be taxed as income of that individual only when, and … to the extent that, it is paid to, or for the benefit of, that individual from the pension scheme (and not transferred to another pension scheme).

The Treasury Technical Explanation of Article 18(1) gives additional clarity regarding the concept of current or deferred taxation:

> [Article 18(1)] provides that if a resident of [the United States or the United Kingdom] participates in a pension scheme established in the other Contracting State, the State of residence will not tax the income of the pension scheme with respect to that resident until a distribution is made from the pension scheme. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in the United Kingdom, [Article 18(1)] prevents the United Kingdom from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension scheme, that distribution may be subject to tax in the State of residence, subject to paragraphs 1 and 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).

The Joint Committee on Taxation report also contributes to the guidance, explaining the taxation concepts in plain English:

> The proposed treaty provides that neither country may tax residents on pension income earned through a pension scheme in the other country until such income is distributed. For purposes of this provision, rollovers to other pension plans are not treated as distributions. When a resident receives a distribution from a pension plan, such distribution is generally subject to residency country taxation in accordance with Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).[63]

The apparent benefits of certain provisions of a treaty, like Article 18(1), are often trumped by other provisions in the same treaty, such as the infamous "savings clause." Many U.S. accountants and attorneys who do not regularly deal with international tax issues often fail to consider the impact of the clause.

Until there is parity in tax treatment for domestic and foreign retirement plans and IRS clarifies all applicable tax and information-reporting rules, unintentional violations will abound.

Below is an analysis of the savings clause in the treaty and its impact on the tax-deferral benefits that Article 18(1) grants.

The treaty savings clause is in Article 1(4). It says generally and ominously that the United States and the United Kingdom may each tax their own residents and citizens as if the treaty had never come into effect. For U.S. citizens residing in the United Kingdom, the savings clause normally would have the effect of subjecting them to annual U.S. income taxes on all worldwide income, including the accumulated but undistributed income in a workplace retirement plan in the United Kingdom.

Fortunately, there are certain exceptions to the harshness of the savings clause for U.S. persons and one of these preserves the tax-deferral benefits on retirement plans. Article 1(5)(a) of the treaty says expressly that the savings clause will not affect Article 18(1). In short, the treaty functions in the following complicated manner: Article 18(1) provides a benefit to U.S. citizens or U.S. residents holding an interest in an acceptable "pension scheme" in the United Kingdom. The savings clause in Article 1(4) ordinarily takes away that benefit because the IRS has reserved the right to tax U.S. citizens and U.S. residents as if the treaty did not exist. But Article 1(5)(a) revives the tax-deferral benefit rooted in Article 18(1), acting as an exception to an exception. Any doubt remaining on this point is resolved by the Treasury Technical Explanation to Article 18:

> [Article 18(1)] is not subject to [the savings clause] by reason of the exception in [Article 1(5)(a)]. Accordingly, a U.S. citizen who is a resident of the United Kingdom will not be subject to tax in the United States on the earnings and accretions of a U.K. pension fund with respect to that U.S. citizen.

Everyone loves a multi-step analysis, requiring review of domestic tax laws in two countries, the potential for superseding tax treatment by a treaty, and the interplay between a general rule, an exception, and exception to an exception!

Potential Solutions

Many U.S. retirement plans are tax deferred. Taxpayers who have worked abroad (either before or after becoming U.S. persons) often do not distinguish between U.S. "qualified" retirement plans and foreign "nonqualified" plans. Only a few bilateral treaties offer favorable treatment to U.S. persons with foreign plans and, as the GAO Report confirms, the IRS has not developed or published clear guidance regarding the U.S. tax treatment of, and information-reporting duties related to, foreign workplace retirement plans. This is a recipe for widespread noncompliance.

Violations keep assessment periods open

Why must U.S. individuals with violations related to their foreign workplace retirement plans approach the IRS proactively to resolve them? One of the biggest reasons is that they cannot simply put their head in the sand, as they say, and run out the clock on the IRS.

A relatively obscure procedural provision, Section 6501(c)(8)(A), contains a powerful tool for the IRS. It says generally that when a taxpayer fails to file timely a long list of international information returns (e.g., Forms 926, 3520, 3520-A, 5471, 5472, 8621, 8858, 8865, and 8938) the assessment period remains open "with respect to any tax return, event, or period" to which the information return relates, until three years after the taxpayer ultimately files the return.[64] Thus, for example, if a taxpayer never files the information returns that might apply to foreign workplace retirement plans, such as Forms 8938 and 3520, the general three-year assessment period never starts. This would allow the IRS to gather information about the taxpayer and later audit at its leisure, assured of its ability to assess additional taxes, penalties, and interest related to the foreign retirement plan.

Main options available to taxpayers now

What options are available for taxpayers with foreign plans who have unintentionally violated the rules? As of the writing of this article, there are five main options acceptable to the IRS:[65]

1. Participating in the Streamlined Foreign Offshore Procedure (SFOP).
2. Participating in the Streamlined Domestic Offshore Procedure (SDOP).
3. Participating in the 2014 Offshore Voluntary Disclosure Program (OVDP).
4. Filing late FBARs penalty free pursuant to the Delinquent FBAR Submission Procedure (DFSP), which is generally limited to taxpayers who previously reported all income and paid all taxes related to foreign accounts but failed inadvertently to file FBARs.
5. Filing late information returns (other than FBARs) penalty free according to the Delinquent International Information Return Submission Procedures (DIIRSP), which is open only to taxpayers who reported all income and paid all taxes related to foreign entities and assets but neglected to file information returns, such as Forms 5471 (for foreign corporations), 8865 (for foreign partnerships), 8938 (for foreign financial assets), or 3520 (for foreign trusts).

Importantly, the IRS announced that the OVDP would end permanently in September 2018, thereby warning taxpayers with outstanding international issues to rectify them quickly or lose the chance.[66] To create more urgency and public anxiety, the IRS reminded everyone in the relevant news release that it intends to continue using a long list of enforcement tools after the close of the OVDP and that it has criminally indicted more than 1,500 taxpayers for international violations since the OVDP began in 2009.[67]

Dozens of articles have been written about the preceding five options, and there is no need to get into that level of detail here. It is enough for purposes of this article to underscore the order in which taxpayers likely would choose to resolve their matters, if they were to meet the relevant eligibility criteria. Most taxpayers would prefer to settle things through the SFOP, DFSP, or DIIRSP because each of these options calls for penalty-free treatment.

If these top three choices are unfeasible, taxpayers would logically attempt to conclude matters through the SDOP because participants are only required to file Forms 1040X (Amended U.S. Income Tax Returns) for the past three years; the IRS does not assert penalties on the additional tax liabilities shown on the Forms 1040X; and the one-time "offshore" penalty that the IRS imposes to sanction broadly all past international tax violations is set at just 5% of the highest aggregate value of the noncompliant foreign assets. The OVDP occupies the lowest rung on the ladder for most taxpayers because it requires filing Forms 1040X for eight years (as opposed to three years); the IRS obligates the taxpayer to pay taxes, penalties, and interest with respect to the Forms 1040X (instead of just taxes and interest); and the "offshore" penalty is either 27.5% or 50% of the highest value of the noncompliant foreign assets (instead of 5%).

Conclusion

The GAO Report describes the current situation as follows:

1. For decades, Treasury has been aware of the problems that U.S. tax treatment of foreign workplace retirement plans causes but it can only rectify matters very slowly, if at all, as existing treaties are renegotiated or new treaties are implemented.
2. Congress is capable of rectifying matters swiftly but it has not yet enacted appropriate legislation.
3. The IRS claims that its hands are tied, such that it must enforce current U.S. tax and information-reporting obligations regardless of how unjust they might seem in some cases.

Until there is parity in tax treatment for U.S. individuals with domestic and foreign retirement plans (either through bilateral treaties or changes in U.S. law), and until the IRS fulfills its promise to clarify for the public all applicable tax and information-reporting rules, unintentional violations related to foreign plans will abound. Taxpayers who discover the problem before the IRS contacts them will likely attempt to resolve matters proactively on the most favorable terms available, through one of the voluntary disclosure programs described above. On the contrary, taxpayers who get caught by the IRS must present their strongest possible case, first to the IRS and later to a court, about how their violations were "nonwillful" and due to "reasonable cause." Either way, taxpayers with unreported foreign retirement plans should seek assistance from tax professionals with experience in international compliance, treaties, IRS disclosure programs, and tax litigation. ●

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[66] IR-2018-52, "IRS to End Offshore Voluntary Disclosure Program; Taxpayers With Undisclosed Foreign Assets Urged to Come Forward Now," March 13, 2018.

[67] *Id.*