Sec. 894: U.K. - U.S. Income Tax Treaty: Taxation of Pension Distributions

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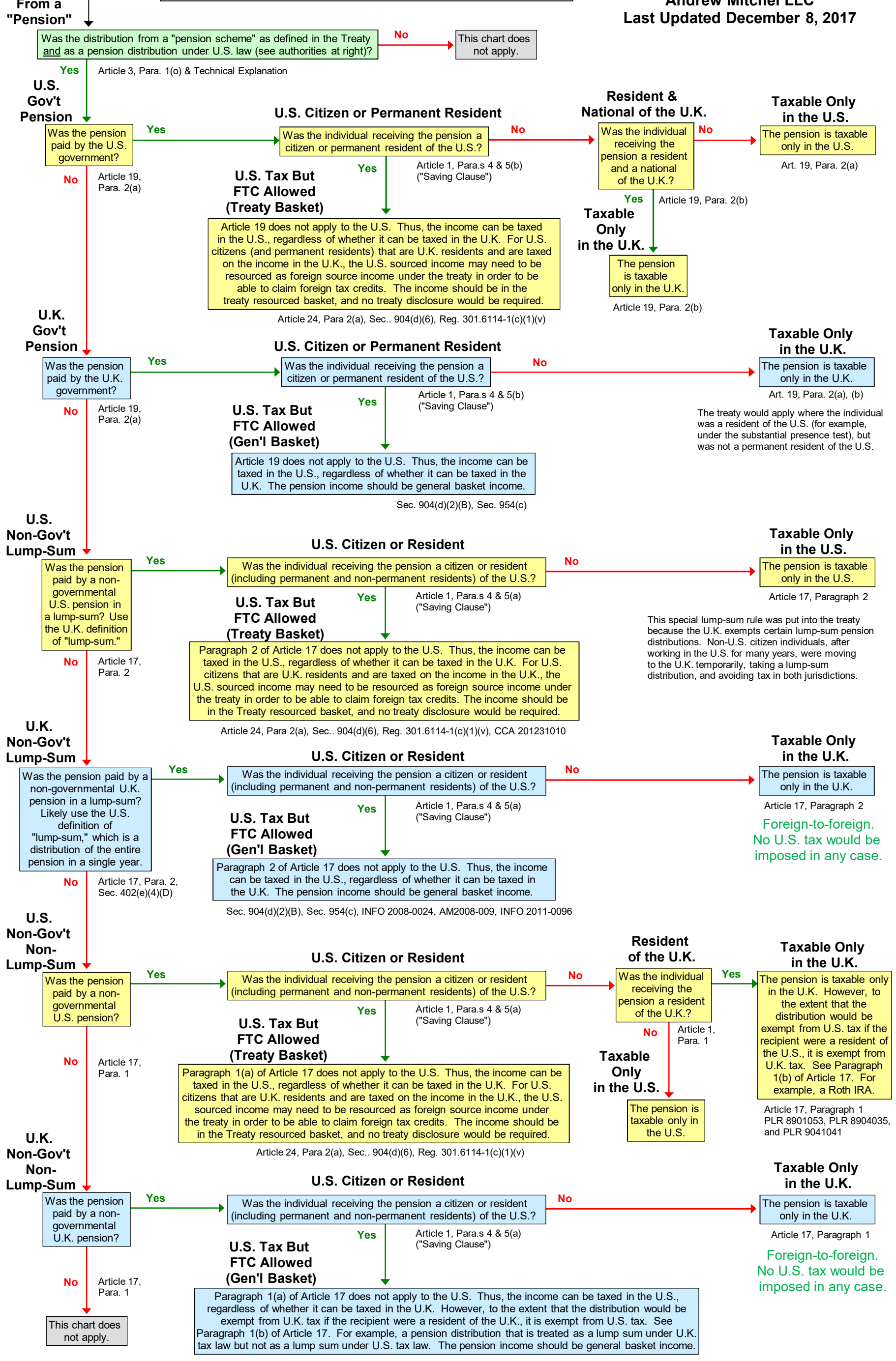

Disclaimer

This flowchart has been extensively reviewed to be as complete and accurate as possible. However, due to the complexity of these rules, this flowchart undoubtedly includes errors and omissions. You should consult a tax professional for individual advice regarding your own situation. This flowchart is not updated for changes in the tax laws and should not be relied upon for any purpose whatsoever.

Net Investment Income Tax - The net investment income tax does not apply to U.S. or foreign pension income. Section 1411(c)(5) provides that net investment income does not include any distribution from a qualified pension, stock bonus, or profit-sharing plan under section 401(a). The preamble to the final regulations (T.D. 9644) states that in response to a "comment asking whether distributions from foreign pension plans are included in net investment income, the definition of 'annuity' * * * in the final regulations clarifies that the term annuitities * * * does not include amounts paid in consideration of services rendered even if such amounts are subject to the rules of section 72." Treas. Reg. §1.1411-1(d)(1) provides in part "* * * The term gross income from annuities does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i)."

Excise Tax - The excise tax under section 4980A was repealed in 1997.

Pre-Immigration Basis in Foreign Pensions - Prior to 2004, employer contributions to retirement plans for services performed outside the U.S. by an NRA were includible in the employee's basis / investment in the contract and were not taxed by the U.S. if a distribution was made when the employee was a U.S. citizen or resident. Rev. Rul. 58-236. In contrast, earnings on contributions were not included in basis unless previously includible in income.

In 2004, Congress enacted section 72(w), which provides that employee or employer contributions are not included in basis if: (1) the employee was an NRA at the time the services were performed with respect to which the contribution was made; (2) the contribution is with respect to compensation for labor or personal services from sources without the U.S.; and (3) the contribution was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were rendered) under the laws of the U.S. or any foreign country. Additionally, earnings on employer or employee contributions are not included in basis if: (1) the earnings are paid or accrued with respect to any employer or employee contributions which were made with respect to compensation for labor or personal services; (2) the employee was an NRA at the time the earnings were paid or accrued; and (3) the earnings were not subject to income tax under the laws of the U.S. or any foreign country.

PMTA 2007-00881 - **Basis Allowed for Contributions to UN Pension --- Would Have Been Excluded From Income Under §893 If Paid As Cash Compensation.** The taxpayer was a Canadian citizen and a nonresident alien who worked for the United Nations. The taxpayer participated in the United Nations Joint Staff Pension Fund (the Plan). The taxpayer made employee contributions to the Plan and the UN made employer contributions into the Plan. Neither the employee nor the employer contributions were taxable by Canada at the time contributions were made. "Section 72(w) provides that, notwithstanding any other provision of §72, for purposes of determining the portion of any distribution that is includible in gross income of a distributee who is a citizen or resident of the United States, the investment in the contract does not include any applicable nontaxable contributions or applicable nontaxable earnings. For this purpose, the term 'applicable nontaxable contributions' means any employer or employee contribution which was made with respect to services performed by an employee who, at the time the services were performed, was a nonresident alien, and which is treated as from sources without the United States, and which was not subject to income tax (and would have been subject to income tax if paid as cash compensation) under the laws of the United States or any foreign country. The employee contributions paid by [the taxpayer] constitute investment in the contract pursuant to §72(c) because they were paid by him and are not excluded from investment in the contract by any provision (§72(w) does not apply to [the taxpayer] because he is not a U.S. citizen or resident). Pursuant to §872 (which generally excludes from gross income foreign-earned compensation of nonresident aliens) and §893 (which generally excludes from gross income compensation of nonresident alien employees of international organizations), employer contributions to the Plan * * * would not have been included in [the taxpayer's] gross income if received in cash at the time the contributions were made. Accordingly, employer contributions * * * are also investment in the contract under the rules of §72(f)."

Withholding on Pension Distributions - Section 3405 provides special withholding rules for pensions. Section 3405(e)(1)(B)(ii) provides that pension distributions that are subject to withholding under section 1441 are not subject to withholding under section 3405. As long as the pension distributions are U.S. source income (which is typically the case), the pension distribution would be subject to withholding under section 1441. Reg. 1.1441-4(b)(1) provides certain exceptions to withholding under section 1441 but only if subject to wage withholding under section 3402. Since pensions are not considered wages (section 3401(a)(12)), they are not subject to wage withholding. Thus, section 1441 withholding will generally apply. If a treaty applies to reduce or eliminate U.S. tax, it may be possible to avoid withholding by providing the pension trustee with a Form W-8BEN. See Reg. 1.1441-6. Special rules may apply if the beneficiary has tax basis in the pension or if the distribution is foreign source income.

Rev. Rul. 79-388 - **Source of Employer Contributions and of Earnings & Accretions**. The ruling provides rules for determining the source of distributions from a private employer's qualified pension plan that is located in the U.S. and pays benefits to a retired NRA who earned the right to the payments by performing services both within and without the U.S. The ruling provides that such pension distributions must be allocated between U.S. and foreign source income as follows: (i) the portion of each distribution attributable to employer contributions with respect to services performed within the U.S. is income from U.S. sources; (ii) the portion of each distribution attributable to employer contributions with respect to services performed without the U.S. is income from foreign sources; and (iii) the portion of each distribution attributable to earnings on or accretions to employer contributions is income from U.S. sources.

PLR 8901053 - **A lump sum distribution from a pure rollover IRA to a 63 year-old NRA resident in Switzerland was not subject to U.S. tax under the Swiss Treaty**. "The definition of a pension as a periodic payment is not viewed as precluding a lump sum payment from qualifying as a pension. If the Convention had provided for the treatment of a lump sum pension payment, however, such language would control. In those instances where a Convention is silent on the treatment of lump sum payments, the term periodic will be treated as a term descriptive of a pension payment generally and not a restriction on the payout. We conclude that a pension payment in the form of a lump sum payment is made in consideration for services rendered and is in the nature of a periodic payment as intended by the Convention."

PLR 8904035 - **Distributions from a U.S. 401(k) plan to an NRA resident in Germany were treated as pension distributions under the treaty.** To be treated as pension distributions: "(1) the Employee must either have been employed by X for five years or must be aged 62 or older at the time the Distribution is made; (2) the Distribution must be made (A) on account of the Employee's death or disability, (B) paid 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 (C) paid on account of the Employee's retirement under the Plan after attaining age fifty-five; and (3) all Distributions are made either after the Employee has separated from service with X or on or after attainment of age 70 and 1/2. The above requirements ensure that the Distributions will occur upon retirement after long-continued and faithful service. See Rev. Rul. 71-478 , 1971-2 C.B. 490; STAFF OF JOINT COMM. ON FINANCE, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 713 (Joint Committee 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)." See also PLR 8904036 for similar analysis regarding Italy treaty.

PLR 9041041 - **Lump sum distribution from a U.S. 401(k) plan to an NRA resident in Switzerland was treated as a pension payment**. "The definition of a pension as a periodic payment does not preclude a lump sum payment from qualifying as a pension. In the absence of a specific provision covering lump sum payments, the term 'periodic' is simply descriptive of a pension payment generally, not a restriction on the manner of payment. A pension payment in the form of a lump sum payment is made in consideration for services rendered and is in the nature of a periodic payment as intended by the Convention. A Distribution from the Plan will be treated as a pension payment within the meaning of Article XI(2) of the Convention if it meets general United States pension rules: (1) At the time the Distribution is made the Participant must either have been employed by Employer for five years or if employed for less than 5 years, have been first employed by Employer (or a related employer) on or after reaching age 60; (2) the Distribution must be (A) made on account of the Participant's death or disability, (B) paid as part of a series of substantially equal payments over the Participant's life or life expectancy or the joint lives (or joint life expectancies) of the Participant and his or her beneficiary, or (C) paid on account of the Participant's retirement under the Plan after attaining age fifty-five; and (3) all Distributions are made either after the Participant has separated from service with Employer or has attained age 70 and 1/2."

PLR 9253049 – **Under the old U.K. treaty, an early distribution from an IRA was "other income" and was not taxed in the U.S.** "The Taxpayer * * * did not perform services in the United States after August 31, 1984 * * *. Accordingly, section 864(c)(6) * * * does not apply * * *. * * * Article 18(1) (Pensions) of the Treaty provides, in general, that pensions shall be taxed based on the residence of the recipient of the pension. Although the Treaty does not define the term "pension", the Technical Explanation * * * states that the term includes payments from qualified retirement plans. 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. Nonetheless, a payment from an IRA before the Taxpayer attains age 59-1/2 is not a pension payment. Therefore, Article 18(1) of the Treaty does not apply. The Technical Explanation states that payments that are not covered by any other more specific article of the Treaty are taxable in accordance with Article 22 (Other Income). Article 22(1) of the Treaty provides that items of income of a resident of a Contracting State, wherever arising, not dealt with elsewhere in the Treaty shall be taxable only in that State. Early distributions from an IRA are not dealt with anywhere else in the Treaty. Therefore, Article 22(1) is the appropriate article of the Treaty that applies to a distribution from an IRA to a recipient who is younger than 59-1/2 years of age. * * * Section 72(t)(1) of the Code imposes a ten percent additional tax on amounts received from qualified retirement plans that are includible in United States gross income. Section 72(t)(2) has certain exceptions to the additional tax. However, since the amount distributed from Account M is excluded from the Taxpayer's United States gross income under Article 22(1) of the Treaty, the ten percent additional tax imposed by section 72(t) does not apply."

PLR 9806012 - **Distributions from a pure rollover IRA and another IRA to an NRA resident in Germany were treated as pension distributions**. "On September 20, 1996, the new U.S. Model Income Tax Treaty (Model) was published, along with a Technical Explanation. One of the purposes of the Model, according to the Technical Explanation, is 'to provide a basic explanation of U.S. Treaty policy for all interested parties. . . .' The phrase 'pension distributions and other similar remuneration' in paragraph 1 of the Model is intended to encompass payments made by private retirement plans and arrangements in consideration of past employment. In the United States, the plans encompassed by Paragraph 1 include, among others, qualified plans under section 401(k) and section 408. Accordingly, distributions received by the Beneficiary under the Pure Rollover IRA and the Second IRA are pensions under Article 18(1) of the Treaty. Under the Model, certain distribution requirements must be met before distributions from qualified plans qualify as pension distributions under the Treaty. To qualify as a pension distribution or similar remuneration from a U.S. plan the employee must have been either employed by the same employer for five years or be at least 62 years old at the time of the distribution. In addition, the distribution must be made either (A) on account of death or disability, (B) as part of a series of substantially equal payments over the employee's life expectancy (or over the joint life expectancy of the employee and a beneficiary), or (C) after the employee attained the age of 55. Finally, the distribution must be made either after separation from service or on or after attainment of age 65."

Rev. Proc. 2004-37 - **Source of distributions from U.S. defined benefit plans.** This revenue procedure provides a method for determining the source of a pension payment to an NRA from a U.S. defined benefit plan.

CCA 200604023 - **Australia Superannuation Fund distribution taxable in the U.S.** Payment of a decedent's member benefits from an Australian superannuation fund to a U.S. citizen residing in Australia was subject to U.S. tax under the Australia-U.S. Income Tax Treaty. The Saving Clause overrode the pension article.

AM 2008-009 - **No tax free rollover from U.K. pension to U.S. pension**. "The parenthetical language merely provides that a transfer of earnings and accretions from one pension scheme to another pension scheme will not be treated as a distribution for purposes of Article 18(1) if the transfer qualifies as a rollover. To qualify as a rollover, a transfer must satisfy the rollover requirements under the domestic laws of both the transferor pension scheme and transferee pension scheme. A transfer from one pension scheme to another pension scheme established in the same Contracting State would have to satisfy only the rollover requirements under the domestic law of that Contracting State. However, a transfer from a pension scheme established in one Contracting State to a pension scheme established in the other Contracting State would have to satisfy the rollover requirements under the domestic law of both Contracting States. If a U.S. resident transfers his or her account in a U.K. scheme to another U.K. scheme in accordance with the applicable provisions of U.K. law, Article 18(1) of the Treaty would require the United States to refrain from treating the income earned by the first mentioned U.K. scheme as a distribution that is currently subject to U.S. tax. However, if the U.S. resident transfers his or her account in the U.K. scheme to a U.S. plan in accordance with the applicable provisions of U.K. law then, because the transfer is not an "eligible rollover distribution" within the meaning of section 402(c)(4), Article 18(1) would not be applicable and the transfer of income earned by the U.K. scheme (together with pre-tax contributions to the U.K. scheme) may be treated as a taxable distribution in the United States."

INFO 2008-0024 - **Lump sum distribution from U.K. pension to U.S. citizen was taxable in the U.S.** "Although Article 17(2) provides that the Contracting State in which the pension scheme is established has the exclusive right to tax a lump-sum payment, Article 1(4) of the Treaty contains a "saving clause" that allows the United States to tax its residents and citizens as if the Treaty had not come into effect. * * * Article 1(5) of the Treaty provides a number of exceptions to the saving clause, but there is no exception for Article 17(2). Therefore, the saving clause overrides Article 17(2) and allows the United States to tax a lump-sum payment received by a U.S. resident from a U.K. pension plan."

INFO 2010-0151 - **Tax free rollover from one U.K. pension to another U.K. pension**. "If an employer pension scheme in the United Kingdom and an SIPP are both pension schemes within the meaning of Article 3(1)(o), then a transfer of income earned by the employer pension scheme to the SIPP would not be a taxable event in the United States. * * * You also asked about transfers of income earned by either an employer pension scheme in the United Kingdom or an SIPP to a pension scheme in a third country. The definition of "pension scheme" requires a plan, scheme, fund, trust or other arrangement to be established in one of the Contracting States -- i.e., the United States or the United Kingdom -- in order to be considered a pension scheme for purposes of the Treaty. A plan, scheme, fund trust or other arrangement established in a third country will thus not be considered a pension scheme for purposes of Article 18(1)."

INFO 2011-0096 - **Transfer from U.K. Pension to Malta Pension.** "If an individual is a resident of the United States under Article 4 (Residence) of the U.K. Treaty and a member or beneficiary of, or participant in, a pension scheme established in the United Kingdom, then a transfer of income earned by that pension scheme to another pension scheme established in the United Kingdom would not be taxed currently as income of the individual provided that each pension scheme qualifies as a "pension scheme" within the meaning of Article 3(1)(o) of the U.K. Treaty. However, a pension scheme established in a third country, e.g., Malta, would not be a pension scheme within the meaning of Article 3(1)(o) of the U.K. treaty because it is not established in one of the two Contracting States (the United Kingdom and the United States). Therefore, if the transfer were to a pension scheme established in a third country, instead of to another pension scheme established in the United Kingdom, the transfer could be treated as a distribution that would be subject to taxation as income of the individual under paragraphs 1 and 2 of Article 17 of the U.K. Treaty."

CCA 201231010 - **No tax free rollover from U.S. pension to U.K. pension**. "The parenthetical language of Article 18(1) of the Treaty merely provides that a transfer of earnings and accretions from one pension scheme to another pension scheme will not be treated as a distribution for purposes of Article 18(1) if the transfer qualifies as a rollover. It does not provide an independent basis for treating a transfer as a tax deferred rollover distribution; * * * A transfer from one pension scheme to another pension scheme established in the same Contracting State would have to satisfy only the rollover requirements under the domestic law of that Contracting State. However, a transfer from a pension scheme established in one Contracting State to a pension scheme in the other Contracting State would have to satisfy the rollover requirements under the domestic law of both Contracting States. * * * In Taxpayer's case, the transfer of funds from U.S. Plan to U.K. Plan did not satisfy the rollover requirements under the domestic law of the United States because U.K. Plan is not an eligible retirement plan described in section 402(c)(8)(B). Therefore, Article 18(1) is not applicable, and the transfer is a lump-sum distribution from U.S. Plan to Taxpayer that is taxable in the United States pursuant to Article 17(2)."