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Richard Phillips
Pensions and Tax Policy Director
United States Senate Committee on Health, Education, Labor and Pensions

Via email to Richard_Phillips@help.senate.gov

RE: OVERSEAS AMERICANS' LACK ACCESS TO RETIREMENT PLANS

Hello Richard,

In July you suggested that we list for you the priority changes that we would like to see added to a retirement or tax package.

The problem is that Americans who work abroad and aspire to participate in a workplace retirement plan where they live and work face challenges under U.S. tax legislation, which decimates the accumulation stage because tax deferred contributions and earnings are lost. Further, neither overseas non-retirement funds nor U.S.-based retirement plans are an effective solution. This makes it extremely difficult for overseas Americans to save for retirement.

We believe that it is only fair that overseas Americans should be able to have plans where they live whose tax attributes mimic the 401(k)s and IRAs that resident Americans enjoy. The goal of this letter is to show you how we think that this could be achieved.

Below are specifics on the three problems we have identified, along with our proposed solutions.

The central problem

Most common defined contribution pension plans in the United States are governed by Section 401 of the tax code, which deems them to be a "qualified trust." A qualified trust under 401(a) is generally exempt from taxation under Section 501(a). In contrast, plans created or organized outside the United States, generally do not "qualify" and, therefore, are governed by Section 402. Tax treatment of, and reporting requirements for, retirement plans under Section 402 are highly punitive in comparison with the tax-advantaged treatment under Section 401. Notably:

1. Employer contributions to a foreign workplace retirement plan must be included in the gross income of the employee [Section 402 b (1)], and employee contributions generally aren't deductible from income on U.S. tax returns even if the foreign retirement account is considered as tax-deferred in the country where the individual works, and even if the account is similar to a 401(k) plan. That is in contrast with the taxation of contributions to 401(k) accounts, in which neither employee pre-tax contributions nor employer matching contributions are taxed as income at the time of contribution.

2. Reporting requirements are excessive. In addition to reporting any vested contributions to the nonqualified trust on their U.S. tax return, overseas Americans must provide information reports on Form 3520 as well as a separate annual report (Form 3520A). The IRS estimates that record-keeping, preparing the forms and filing them require more than 100 hours!

3. Overseas Americans face taxation on transfers of retirement savings, whether initiated by them or the employer because U.S. tax law doesn't provide for tax-deferral in the case of transfers from one foreign retirement plan to another. Rather, the IRS generally considers transfers of retirement assets between or within foreign retirement plans to be distributions to the participant and therefore taxable income. So, overseas Americans may owe U.S. taxes, possibly on the entire amount of their retirement savings, when their account is transferred. In the United States transfers of retirement savings from one qualified plan to another are exempt from U.S. tax.

Our proposed solutions

We believe that the first approach below would resolve the issue:

A. Modify the U.S. tax code to designate foreign retirement plans which resemble 401(k) plans as "qualified trusts" under Section 401. Eliminate Forms 3520 and 3520A [note: FATCA reporting would still apply so plans would still be reported on both Form 8938 and 8966]. The various conditions listed in 401(a) would be subordinated to the laws, rules and regulations governing the plan in the host country. Scope could be restricted to countries with which the U.S. has tax treaties.

If foreign retirement plans could not be treated as "qualified" as suggested above, we propose the following alternative solution:

B. Support and build on the approach of H.R. 6057 from the 117th Congress ("Tax Simplification for Americans Abroad Act," to be reintroduced shortly by Rep. Beyer (D. VA)). This bill would simplify reporting requirements (and eliminate Forms 3520 and 3520A) for many qualified overseas Americans. It would also redefine the Foreign Earned Income Exclusion (FEIE) regime to allow foreign pension/retirement income to be excluded from U.S. taxable income. We suggest to build on this legislation to (i) eliminate Section 911, subsection (b)(1)(B)(iii), which would exclude employer contributions to foreign retirement plans from U.S. taxable income, (ii) exclude

investment earnings on foreign retirement plans from U.S. taxable income, (iii) raise the FEIE threshold as it affects retirement assets and related income (leaving foreign retirement plans to be governed by host laws, rules and regulations); and

Permit routine account transfers within the same foreign workplace retirement plan or between two foreign workplace retirement plans in the same country, free from U.S. tax.

A related problem:

Many savers rely on collective investments such as mutual funds, hedge funds, money market accounts, and insurance products to supplement their retirement savings. Such investments are also commonly held by workplace retirement plans. When such pooled investments aren't registered in the United States, they are classified as passive foreign investment companies (PFICs).[1] This means that:

1. Form 8621 must be filed every year for each PFIC. This form requires complex record keeping and accounting, and is time consuming to complete. The IRS estimates 49 hours for a single PFIC!

2. Tax rates for PFICs are punitive compared with similar investments in the United States; PFIC income distributions and capital gains are taxed at the highest marginal rate and an interest charge is applied to deferred gains for the entire time that they are in the PFIC, which for some investments can add up to taxation of more than 50 percent.

Our proposed solution

Exempt non-U.S. collective investments held by a U.S. citizen with bona-fide residency outside the U.S. from taxation as a PFIC. Eliminate the requirement of reporting on Form 8621. [Note: FATCA reporting would still apply so PFICs would still be reported on both Form 8938 and 8966.]

A final problem:

Given the constraints and costs described above, one would think that a logical choice for Americans living overseas would be to find solutions in the United States. Unfortunately, they cannot simply rely upon U.S. based funds. The Financial Action Task Force Recommendations, which are reflected in anti-money laundering regulations (i.e., KYC rules), deem Americans overseas to be "higher risk" simply because they are non-resident. This makes them unattractive clients from a cost-benefit standpoint to many U.S. financial institutions. The result is financial exclusion.

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[1]A PFIC is generally defined as a foreign corporation for which (a) 75 percent or more of its gross income for the tax year is passive income, or (b) at least 50 percent of the average percentage of assets held by the corporation during the tax year produce passive income, or are held for the production of, passive income.

1. Middle aged and elderly Americans abroad with existing accounts frequently face account closure, asset liquidation, restrictions on activity and/or excessive fees by U.S. institutions for hosting their U.S. retirement assets (IRAs for example); and

2. Younger expats (with fewer assets to attract the fee-based asset managers) cannot even open such U.S. accounts.

Our proposed solution

Failing a meaningful revision of the KYC rules, legislation should be enacted to establish that all U.S. citizens (i.e., including non-residents), absent probable cause relating to illicit activity, have a right to at least basic banking services and access to savings vehicles such as mutual funds in the United States, creating a sort of "host of last resort." It would be akin to the way the European Payments Directive [2014/92/EU] works. One of the bank regulatory agencies could be charged with designating banks to act as hosts of last resort, and it could, for example, choose those banks who benefitted from government financial support during the last crisis.

In summary, overseas Americans need access to retirement plans somewhere, preferably where they live and work. Because changes in residence are normal elements of a person's life cycle, U.S. citizens moving overseas shouldn't be penalized on their retirement funds simply for not being resident in the United States.

We hope that this letter clearly explains our positions and propositions. Of course, we are available for any questions or comments you may have.

We thank you very much for your attention to our issues, Richard!

Sincerely,

Doris

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