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Defining 'Pension or Retirement Benefits' for Tax Treaty and Other Purposes

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Nearly all bilateral tax treaties contain special rules relating to pension funds or arrangements. These rules generally fall into three categories. First, there are rules treating pension arrangements as resident of a particular country for treaty purposes, including for purposes of any limitation on benefits article. Second, there are rules prescribing how an individual beneficiary of a pension arrangement is subject to tax in cross-border cases; in other words these rules cover income received *from* pension funds. Finally, many treaties provide special exemptions from tax for certain income earned by a pension fund from sources in the other country, that is, cross-border income received *by* pension funds.

These provisions require that the term ''pension fund'' (or some variation thereof) be defined, which is usually done in the general definitions article of the treaty. Because these three sets of rules have different policies, ''pension fund'' as used in each may not be identical. For example, Article XVIII of the tax treaty between the United States and Canada, titled ''Pensions and Annuities,'' provides a general definition of the term ''pensions'' in paragraph 3, but also provides, in paragraph 15, a special definition of a ''qualifying retirement plan'' that is relevant only for purposes of paragraphs 8 through 14 of Article XVIII. The main feature that distinguishes a qualifying retirement plan from any other pension plan covered by that Article is that the former does not include ''an individual arrangement in respect of which the individual's employer has no involvement.'' It must also be determined to generally correspond to a pension or retirement plan established in and recognized for tax purposes by the other treaty partner. The reason that the concept of a qualifying retirement plan is narrower than the definition of a pension plan is that the rules in paragraphs 8–14 were intended to deal with the deductibility and exemption of contributions and accruals in cross-border pension contributions, which had not been addressed in the pre-2007 version of that treaty.

Most tax treaties define the term ''pension fund'' or ''arrangement'' (or, in the United Kingdom, ''scheme'') by using another undefined term, ''pension or retirement benefits.'' For example, in the U.S.-U.K. treaty, a ''pension scheme'' is ''any plan, scheme, fund, trust or other arrangement established in a Contracting State which is: (i) generally exempt from income taxation in that State; 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 circularity and lack of precision suggests that treaty partners make certain common, unstated assumptions about what a pension fund is and how it operates.

What, exactly, are ''pension or retirement benefits''? This phrase is used in §897(l) of the Internal Revenue Code, relating to the FIRPTA exemption for qualified foreign pension funds, without definition. A recent Competent Authority Arrangement entered into

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by the United States and Malta ("the CAA")[1] suggests that the term should be interpreted narrowly, but that may be due to Malta's generous interpretation of the scope of the term pension fund itself. Proposed regulations under §897(l) also seem to define "pension and retirement benefits" narrowly, but in a way that commentators have criticized as unrealistic. These developments suggest that the United States and its treaty partners need to step up their game and fashion a workable definition of "pension or retirement benefits."

First let's examine the hot-off-the-presses CAA. The CAA refines the definition of the term "pension fund" under the U.S.-Malta tax treaty. The original treaty definition in Article 3(1)(k) of that treaty was fairly standard: "a pension fund means: any person established in a Contracting State that is:

> i) in the case of pension funds established in the United States, generally exempt from income taxation, and in the case of pension funds established in Malta, a licensed fund or scheme subject to tax only on income derived from immovable property situated in Malta; and
>
> ii) operated principally either: A) to administer or provide pension or retirement benefits; or B) to earn income for the benefit of one or more persons meeting the requirements of subparagraph i) and clause A) of this subparagraph.

There is nothing particularly strange about this definition, including its reference to "pension or retirement benefits." However, last July the IRS published its 2021 "Dirty Dozen" list of what it calls tax scams, and a technique involving Maltese pension funds was featured on the list. Under the heading "Potentially abusive use of the U.S.-Malta tax treaty," the IRS explained that:

> Some U.S. citizens and residents are relying on an interpretation of the U.S.-Malta Income Tax Treaty (Treaty) to take the position that they may contribute appreciated property tax free to certain Maltese pension plans and that there are also no tax consequences when the plan sells the assets and distributes proceeds to the U.S. taxpayer. Ordinarily gain would be recognized upon disposition of the plan's assets and distributions of the proceeds. The IRS is evaluating the issue to determine the validity of these arrangements and whether Treaty benefits should be available in such instances and may challenge the associated tax treatment.

In the CAA, the treaty partners announced that "It has come to the attention of the competent authorities that U.S. citizens and residents are establishing personal retirement schemes in Malta under the Retirement Pensions Act of 2011 with no limitation based on earnings from employment or self-employment, and are making contributions to these schemes in forms other than cash (e.g., securities). *Questions have arisen in the United States about whether these personal retirement schemes are "pension funds" for purposes of applying the Treaty*. (emphasis added). The CAA states that the two countries have agreed that (except with respect to rollovers) a pension fund that "(a) is allowed to accept contributions from a participant in a form other than cash, *or* (b) does not limit contributions by reference to earned income from personal services (including self-employment) of the participant or the participant's spouse, is not operated principally to administer or provide *pension or retirement benefits* within the meaning of paragraph 1(k) of Article 3 of the Treaty, and is therefore not a "pension fund" (emphasis added).

Both prongs (a) and (b) of the above new definition of pension fund illustrate that U.S. assumptions about how pension funds operate were not shared by the Kingdom of Malta. What is interesting about the CAA is that it does not truly revise the definition of "pension fund" itself. Rather, the CAA says that when a pension fund permits prong (a) or (b) to occur, it is not operated to provide "pension or retirement benefits," and "therefore" is not a pension fund. This result seems correct. But the circularity of the Treasury's reasoning does not help to define the "pension or retirement benefits."

Next, let's turn to the proposed regulations under §897(l), which exempts a "qualified foreign retirement fund" ("QFPF") from Foreign Investment in Real Property Tax Act (FIRPTA) tax. The statute itself requires only that a QFPF be formed to provide "retirement or pension benefits." As mentioned, the proposed regulations nowhere define the term "retirement or pension benefits" (comments were requested on this issue). Yet they provide that the statutory requirement is satisfied only if (1) all of the benefits that the fund provides are "qualified benefits" and (2) at least 85% of the present value of those qualified benefits are retirement or pension benefits.[2] Under the proposed regulations, retirement or pension benefits are a subset of what the regulations call qualified benefits, which also include what the regulations refer to as "ancillary benefits."[3] Ancillary benefits are defined as "benefits payable upon the diagnosis of a terminal

[1] Announcement 2021-19, 2021-52 I.R.B. 912; 2021 TNTI 247-9; 2021 TNTG 247-11; 2021 TNTF 247-15; 2022 TPR 1-10; Doc. 2021-47866.

[2] Prop. Reg. §1.897(l)-1(c)(2)(ii)(B).

[3] Prop. Reg. §1.897(l)-1(d)(8).

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illness, death benefits, disability benefits, medical benefits, unemployment benefits, or similar benefits.''[4] This means that the drafter did not believe that benefits such as death or disability benefits could be retirement or pension benefits. Absent a definition of retirement or pension benefits, the proposed regulations mandate that taxpayers solve an unsolvable equation.

An example in the proposed regulations appears to assume that benefits payable under a standard pension or retirement plan prior to retirement — that is, upon death or disability — are *not* pension or retirement benefits.[5] That conclusion is at odds with many treaties and with common sense. Moreover, if such benefits have to be estimated for purposes of meeting the 85% test, it is completely unclear how such an estimate would be undertaken. Since by definition no one knows when a service provider covered by a pension plan is going to die or become disabled, the use of a precise percentage is strange to say the least.

What explains the odd approach of the proposed regulations? The first step was probably the conclusion by the IRS regulation drafter that Congress did not intend that plans providing medical and unemployment benefits be encompassed within the meaning of a pension plan, since U.S. pension plans do not generally provide such benefits. From there the drafter may have leapt to the unfortunate (and incorrect) conclusion that because death and disability benefits are not provided upon *retirement* (they are provided earlier, of course), they somehow do not qualify as pension or retirement benefits. But because U.S. pension plans provide such early benefits — indeed, it would be bizarre if they did not — this interpretation is almost certain wrong.

Representatives of German pension funds recently wrote a letter to the IRS suggesting changes to the proposed regulations.[6] They described completely standard foreign pension funds and asked that the IRS define retirement or pension benefits in a manner that would include pension payable on disability or death. They suggested that ancillary benefits be limited to reimbursement for incidental costs. Importantly, they suggested that the definition of pension or retirement benefits be generally consistent with tax treaties. They noted that the tax treaty between the United States and Germany specifically includes within the definition pension fund a fund that provides ''pensions or other similar remuneration, including social security payments, disability pensions and widow's pensions.''

As the German letter pointed out, the preamble to the proposed regulations specifically rejected adoption of a rule that would allow a pension fund that qualifies as such for treaty purposes (or for FATCA exemption purposes) to automatically qualify as a QFPF for purposes of §897(l). The preamble stated that:

> There is no indication in the legislative history that Congress intended the Treasury Department and the IRS to *expand* the exemption to entities that met the definition of a pension fund under a U.S. income tax treaty or IGA. Furthermore, the definitions of pension fund under a U.S. income tax treaty or IGA were designed with policy goals that are unrelated to section 897, and therefore pension funds as defined in those agreements are not necessarily the types of entities for which an exemption from section 897(a) is appropriate. Thus, a foreign pension fund that qualifies for other benefits under an income tax treaty or IGA must make a separate determination as to whether it is a qualified foreign pension fund under section 897(l)(2) (emphasis added).

This is a puzzling passage, as it assumes that the definition of ''pension plan'' in treaties is more expansive than what is provided for in §897(l). As noted already, tax treaties don't really define what is a pension fund, except in a circular way. Even if they did, there is no reason to believe that a particular treaty definition is broader than that encompassed in §897(l). While an entity treated as a pension fund under a treaty might not meet all five prongs of the definition set out in §897(l)(2), the question here is whether it meets only the second test in (2)(B), which requires that it provide retirement or pension benefits to qualifying persons. There is no reason to believe that this requirement means anything different in a treaty from what it means in §897(l)(2)(B).

This passage also implies that tax treaties define ''pension fund'' in a single way for a single purpose, which is demonstrably incorrect. In the interest of coherence and sound administration, the final regulations should incorporate a presumption that if a pension plan is covered by a treaty, it meets the requirement of §897(l)(2)(B).

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[4] Prop. Reg. §1.897(l)-1(d)(1).

[5] Prop. Reg. §1.897(l)-1(e) *Ex.* (2) states: ''Fund will pay a death benefit to the beneficiary's designee (or deemed designee under local law if the beneficiary fails to identify a beneficiary). It is reasonably expected that such death benefits will account for less than fifteen percent of the present value of the qualified benefits that Fund expects to provide in the future.''

[6] ''Regs on Foreign Pension Funds Create Uncertainty for Germans'' (Dec. 20, 2021), DOC 2021-47532, 2021 TNTF 245-21 (Dec. 23, 2021). The letter cited a previous letter from Universal Investment GmbH dated Feb. 25, 2020 as well as New York State Bar Association Tax Section Report No. 1421, ''Report on Proposed Regulations relating to Section 897(l) (Exception for Interests Held by Foreign Pension Funds)'' (Sept. 4, 2019).

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