

# Individual Retirement Accounts (IRA) and US Deferred Compensation Programs in Transatlantic Cases – The German Perspective

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## Agenda

A. Introduction

B. Application of Art. 18A DTT

C. Taxation of payments from pension plans

D. Summary

## A. Introduction (1)

### ■ Taxation of pension plans – overview of the general principles

- If an employee is beneficiary of/participant in a pension plan, the taxation of the contributions usually corresponds to the taxation of the pensions.
- There are two ways of taxation of pensions:
  - If contributions to a pension plan result from taxed income, the reimbursement of capital remains tax-exempt; only the revenues from the invested capital are subject to taxation.
  - If contributions to a pension plan are deductible from income, the pensions are fully taxable.
- In case of secondment of an employee these principles are not considered as the pension plans of each state and the taxation principles are different.
- **Risk of double taxation** if e.g. contributions to a pension plan are taxable in one state and the pensions are also taxed in the other state.
- Investment in pension plans may have disadvantages if due to a secondment/employment in another state two states have taxation rights.

## A. Introduction (2)

### ■ Taxation of pension plans – Art. 18A DTT

- **Art. 18A DTT** has been introduced to ensure that an individual who pays into a national pension plan does not have any tax disadvantages if he is employed in the other state for a certain period of time.
- **Before the introduction of Art. 18A DTT** a US pension plan had to be qualified according to German tax law.
- Qualification as intransparent investment fund pursuant to Sec. 1 German Investment Tax Act (“InvStG”).
- Foreign investment funds usually do not fulfill the notification obligations of the InvStG. As a consequence, the revenues are subject to a severe taxation:
  - Distributions, the unrealized profit and the difference between the first repurchasing price and the last repurchasing price of the fund share have to be taxed; at least 6% of the last repurchasing price (cf. Sec. 6 InvStG).

## A. Introduction (3)

### ■ Taxation of pension plans – Art. 18A DTT

- In the event that the pension plan is structured as a trust, the special provisions of pension plans do not apply either. If the employer pays into the trust in favor of the employee who will receive distributions one day, Sec. 15 AStG may apply as the employee is beneficiary of the trust.
- The income of the trust is attributed to the beneficiary even if he has not yet received income from the trust. Art. 18 A Para. 1 DTT (deferred taxation) does not apply.
- Distributions from the trust are revenues from capital investment according to Sec. 20 Para 1 No. 9 EStG if the relevant income has not yet been subject to Sec. 15 AStG.
- Distributions may also be subject to gift tax in tax bracket III.
- **Due to the introduction of Art. 18A DTT the application of the German Investment Tax Act or Sec. 15 AStG is not relevant anymore for qualified pension plans.**

## A. Introduction (4)

### ■ Definitions of US pension plans

#### ■ 401(k)-plan

- Sec. 401 of the Internal Revenue Code (IRC) governs the taxation of qualified pension, profit sharing and stock bonus plans.
- The employer establishes a trust whose beneficiaries are only employees. Usually employees are not allowed to receive payments from the trust before the age of 59,5 and have to begin to receive payments at the latest by the age of 70,5, at which time payments are made evenly over the employee's remaining life expectancy and are subject to tax at the ordinary income tax rate (max. 39.6%).
- Premature payments are subject to an exise tax at 10 % and later payments are subject to an exise tax of 50 % of the amount that had to be paid out earlier.

## A. Introduction (5)

### ■ Definitions of US pension plans

#### ■ 401(k)-plan

- The salary of the employee is reduced in a certain amount and is paid into the retirement account for the employee. According to US tax law contributions to the 401(k)-plan remain tax-free. The same applies to built-in-gains.
- Usually the 401(k)-plan is structured as a trust which means that the employer is the settlor and the employee is the beneficiary (equitable owner). The estate of the trust is administered by a trustee.
- The payment of contributions to the trust is not a taxable event according to US tax law.

## A. Introduction (6)

### ■ Definitions of US pension plans

#### ■ Individual Retirement Accounts („IRA“)

- Private retirement benefit plan which is structured like a trust and set up by the employee at a bank or brokerage firm: The contributions are administered by the trustee as individual retirement account or as pension insurance. An IRA can only be established by persons that have salaries/compensations (not persons who have revenues from capital investments or from rent and lease).
- An IRA can also qualify as a company pension plan if the trust is established only by an employer in favor for its employees.
- Assets of a 401 (k)-plan can be transferred to an IRA after the employee leaves an employer for a new job or retires. In this way an IRA can also be established.
- An employee may contribute up to \$ 5,500 to an IRA each year and the amount which is contributed is deductible for US income tax purposes.

## A. Introduction (7)

### ■ Definitions of US pension plans

#### ■ Individual Retirement Accounts („IRA“)

- Built-in-gains remain tax-exempt until the beneficiary receives payments from the IRA.
- Payments from an IRA by the trustee are taxed according to US law as ordinary income, but remain tax-exempt if no tax privileges have been made use of.
- Payment age restrictions are the same as with a 401 (k)-plan.

## B. Application of Art. 18A DTT (1)

### ■ Taxation of contributions to a qualified pension plan

#### ■ Art. 18A para. 2 DTT

- According to Art. 18A para. 2 lit. a DTT contributions to a pension plan paid by or on behalf of an individual who exercises an employment in the other state are deductible or excludable from income.
- Further, any benefits from or contributions to the pension plan by or in behalf of the individual's employer are not qualified as taxable income (Art. 18A para. 2 lit. b DTT).
- Non qualified deferred compensation plans: Even if a deferred compensation is agreed on, the contributions are immediately taxable.
- Contributions shall be deductible from the business profits of the employer (Art. 18A para. 2 lit. b DTT).
- The tax-privileges of Art. 18A para. 2 DTT shall not exceed the relief that would be allowed in the other state to residents for contributions to pension plans established in that state.

## B. Application of Art. 18A DTT (2)

### ■ Taxation of the contributions to a qualified pension plan

#### ■ Art. 18A para. 3 DTT – requirements

- Contributions by or on behalf of the individual/his employer were made **before** the secondment to the other state (Art. 18 para. 3 lit. a DTT).
  - In the event of a secondment the employee shall continue the pension plan of the other state without any disadvantages.
- Pension plan **is accepted for tax purposes by the competent authority** (Art. 18A para. 3 lit. b DTT).
- The competent authority is only allowed to accept plans that correspond to Art. 18 A Para. 4 DTT.
- Pension Plan means an arrangement which is operated principally to administer or provide pensions or retirement benefits or to earn income for the benefit of one or more such arrangements (Art. 18A para. 4 DTT).
- Para. 16 of the Protocole enumerates the pension plans that are qualified to be subject to Art. 18A DTT. This enumeration is not exclusive. If a pension plan is enumerated in Para. 16 there is no qualification necessary.

## B. Application of Art. 18A DTT (3)

### ■ Taxation of the contributions to a qualified pension plan

#### ■ Art. 18A para. 4 DTT – qualified pensions plans

- Qualified plans under sec. 401 (a) of the Internal Revenue Code (IRC) which also comprises 401 (k)-plans
- Individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies sec. 408 (k),
- Individual retirement accounts
- Individual retirement annuities
- Section 408 (p) accounts
- Roth IRA under Sec. 408A
- Sec. 403 (a) qualified annuity plans
- Sec. 403 (b) plans and
- Sec. 457 (b) governmental plans

## B. Application of Art. 18A DTT (4)

### ■ Taxation of the contributions to a qualified pension plan

#### ▪ Consequences in Germany

- Para. 16 lit. b) aa) of the Protocole provides that the enumerated plans are subject to the tax-privileges with exception of Roth IRA.
- Sec. 3 No. 63 German Income Tax Act („EStG“) shall apply; the maximum amounts have to be considered.

## B. Application of Art. 18A DTT (5)

### ■ Taxation of the contributions to a qualified pension plan

#### ■ Art. 18A para. 5 DTT – scope of application

- Art. 18A para. 5 DTT provides the tax-privileges of para. 2 if the following requirements are fulfilled:
  - **A citizen of the US** is resident in Germany where he exercises an employment;
  - The US citizen receives revenues **from a German employer** or by a permanent establishment situated in Germany;
  - He is beneficiary of/participant in a pension plan **established in Germany**.

#### ■ Consequences:

- According to Art. 18A para. 5 lit. a) aa) DTT contributions to a pension plan paid by or on behalf of an individual who exercises an employment in the other state are deductible or excludable from its income.
- Further, any benefits from or contributions to the pension plan by or in behalf of the individual's employer are not qualified as taxable income (Art. 18A para. 5 lit. a) bb) DTT).

## B. Application of Art. 18A DTT (6)

### ■ Taxation of the contributions to a qualified pension plan

#### ■ Art. 18A para. 5 DTT – scope of application

##### ■ Consequences:

- The tax-privileges of Art. 18A para. 5 DTT shall not exceed the relief that would be allowed in the US to residents for contributions to pension plans established there (Art. 18A para. 5 lit. b) DTT).
- The pension plan has to correspond to a pension plan established in the US which has to be confirmed by the competent authority in the US (Art. 18A para. 5 lit. d) DTT).
- This does not apply if a **German citizen** who has an employment in the US is beneficiary of/participant in an US pension plan. Art. 18A para. 2, 3 DTT does not apply as the requirement of para. 2 lit. a) is not fulfilled (payment of contributions before secondment).

## C. Taxation of payments from a pension plan (1)

### ■ Example:

*The German couple A (German citizens) is resident in the US as Mr. A works for a US corporate group for ten years. During the employment, Mr A has the possibility to participate in several US pension plans. His employer pays for him into a 401 (k)-plan, further he is invested in an IRA that also his employer has established for all employees. Further, he is beneficiary of a governmental plan pursuant to Sec. 457 (b) IRC. The contributions to the pension plans are tax privileged in the US.*

*After ten years, he moves back to Germany and works for a affiliated company of the US corporate group for about two years. During this time, there are no further payments into the pension plans. Then, he has reached the age of 65 and intends to assert the claims from the US pension plans. He intends to claim a payment of capital and no payment of annuities.*

*How are the payments from the US pension plans taxed in Germany? What are the tax consequences if Mr. A dies and his wife becomes heir of the pensions?*

## C. Taxation of payments from a pension plan (2)

### ■ Deferred taxation of payments from a pension plan

- **Art. 18A Para. 1 DTT** provides that if a person is a resident in one state and participant in/beneficiary of a pension plan in the other state income earned by the pension plan may only be taxed **when it is paid to this person**.
- Roll-over of assets from a 401 (k)-plan to an IRA is not a taxable event.
- If a pension plan does not comply with Art. 18A DTT, there is generally no deferred taxation (contributions to the pension plan may be taxable).

## C. Taxation of payments from a pension plan (3)

### ■ Taxation of payments from a pension plan in German tax law

- Art. 18A DTT does not govern the taxation of payments from a pension plan. The general provisions may apply.
- Sec. 22 No. 5 EStG governs the taxation of payments from company pension plans in Germany which may be subject to tax-privileges.
- As Art. 18A DTT provides that contributions remain tax-exempt. Also payments from foreign pension plans may be subject to the provision of Sec. 22 No. 5 EStG.
- The taxation of the payments depend on the tax treatment of contributions.

## C. Taxation of payments from a pension plan (4)

### ■ Taxation of payments from a pension plan in German tax law

#### ■ The contributions have not been subject to tax-privileges:

- **Payment of capital:** Sec. 22 No. 5 S. 2 lit. b) EStG refers to Sec. 20 Para. 1 No. 6 EStG for the tax consequences which provides that the **difference between the payment of capital and the contributions** is subject to taxation. Only **half of the difference is taxed** if the individual is 60 years old (conclusion of contract after 31 december 2011: 62 years) and the conclusion of the insurance contract have been 12 years before the payment. The **flat tax rate** would be applicable (26,375% incl. solidarity charge).
- **Sec. 22 No. 5 S. 2 lit b) EStG** only concerns pension plans from the German point of view; it is not entirely clear whether it also applies to US pension plans due to its different structure.
- **Sec. 22 No. 5 S. 2 lit. c) EStG** may be applicable as it concerns “**other payments**”: difference between the payment of capital and the contributions is subject to taxation; Sec. 20 para. 1 No. 6 **S. 2** EStG applies (difference to Sec. 22 No. 5 S. 2 lit. b) EStG!).

→ **Consequence:** No application of the flat tax rate, **but individual progressive tax rate**

## C. Taxation of payments from a pension plan (5)

### ■ Taxation of payments from a pension plan in German tax law

#### ■ The contributions have not been subject to tax-privileges:

- **Payment of annuities:** Sec. 22 No. 5 lit. a) refers to Sec. 22 No. 1 lit. a) bb) EStG with the consequence that the pensions are taxable in the amount of its profit share (*Ertragsanteil*), cf. chart of Sec. 22 lit. a) bb) (If an individual receives the pensions at the age of 60, only 22% is subject to tax, at the age of 75:11%).

#### ■ The contributions to the pension plan have been subject to tax-privileges:

- **Germany had the right to tax the contributions:** Taxation of revenues with the individual progressive tax rate (Sec. 22 No. 5 **S. 1** EStG; cf. internal directive Revenue Service Thuringen 30 October 2012)
- **US had the right to tax the contributions:** Due to the modification of the DTT, it has to be distinguished in the following way:

## C. Taxation of payments from a pension plan (6)

- **Taxation of payments from a pension plan in German tax law**
  - **The contributions to the pension plan have been subject to tax-privileges**
    - **Contributions have been paid before 1.1.2008:** Sec. 22 No. 5 S. 2 EStG; either lit. b) oder lit. c) (not entirely clear: internal directive of Revenue Service Thueringen 30 October 2012).
    - **Contributions have been paid after 1.1.2008:** Due to Art. 18A DTT the contributions are considered to be fully tax-privileged so that the payments are taxable according to Sec. 22 No. 5 S. 1 EStG.

## C. Taxation of payments from a pension plan (7)

### ■ Application of the DTT

- According to Art. 18 DTT only applies to pensions, annuities, alimony, child support and social security.
- Pensions and annuities are payments due to a **former employment**. It is decisive that the payment is the result of a former employment. These are usually payments because of a company pension plan.
- **Application of Art. 15 DTT:** Art. 15 DTT refers to revenues from salaries, etc. For the decision whether Art. 18 oder Art. 15 DTT applies **the character of the payments is important**, not the moment of payment. The character of a pension is that it is paid out as provision for one's old age (*Versorgungscharakter*) while Art. 15 DTT refers to salaries paid for his job. Pensions are payments to safeguard the existence of an employee in a time when he will not receive any salary for his work due to his age. The duration of payments is unforeseeable (*Ismer*, IStR 2011, 537).
- **Payments from a US pension plan according to the DTT:**
  - The payments result from a former employment.

## C. Taxation of payments from a pension plan (8)

- **Taxation of payments from a qualified pension plan according to the DTT**
  - **Payments from a US pension plan according to the DTT:**
    - The 401 (k)-plans and IRA qualify according to Art. 18A para. 4 DTT as company pension plans.
    - Pursuant to Art. 18A para. 2 DTT the contributions are not taxed (e. g. as salary of the employer). In this context, it is consequent to qualify these payments as pensions of Art. 18 DTT.
    - This also applies if assets of a 401 (k)-plan are transferred to an IRA; the payments are also subject to Art. 18 DTT.
    - Art. 18 DTT provides that the resident state has the right of taxation (Germany).
  - **Withholding tax:**
    - In the explanations to the DTT USA and Germany intended to introduce a withholding tax for the pensions of the state that is source of the pensions (this would be the US in case of the mentioned pension plans), but not before 1.1.2013. Currently, there does not exist a withholding tax.
    - A withholding tax of 15% shall be applicable if an individual worked for an “important period of time” in the other state which would be a period of time of at least 15 years.<sup>23</sup>

## C. Taxation of payments from a pension plan (9)

### ■ Taxation of payments from a pension plan – Solution

- During the two years in Germany, there is no taxation of pensions as there is no payment to Mr. A (Art. 18A para. 1 DTT).
- The payments from qualified pension plans are subject to Art. 18 DTT.
- As the contributions have been subject to tax-privileges in the US, it has to be distinguished between payments that result from contributions before the modified DTT (1.1.2008) and after the modified DTT.
- Payments that result from contributions **before 1.1.2008**: Sec. 22 No. 5 S. 2 EStG applies (either lit. b) or lit. c)) so that the difference between the payment of capital and the contributions is base of taxation. It is not entirely clear whether the US pension plans qualify as pension plans according to Sec. 22 No. 5 S. 2 lit. b) EStG. However, the tax-privileges of Sec. 20 para. 1 No. 6 S. 2 EStG apply. According to lit. b) the flat tax rate is applicable, in case of lit. c) the individual progressive tax rate applies.

## C. Taxation of payments from a pension plan (10)

### ■ Taxation of payments from a pension plan – Solution

- Payments that result from contributions **after 1.1.2008**: Sec. 22 No. 5 **S. 1** EStG applies as the contributions have been subject to tax-privileges. From the German perspective they are treated as if they had been subject to the tax-exemption of Sec. 3 No. 63 EStG (tax-exemption with regard to contribution to German pension plans).

### ■ Inheritance taxation

- **German tax law:**
  - According to Sec. 3 para. 1 No. 4 German Inheritance Tax Act (“ErbStG”) it is a taxable event if a person receives a payment due to a contract that the decedent has entered into (e.g. employment contracts, insurance contracts).
  - However, for pensions to a spouse due to an employment contract the German Federal Court has decided that such pensions are not subject to inheritance tax (cf. *Troll/Gebel/Jülicher*, § 3 Rz. 300 ff.; R E 3.5. para. 2 ErbStR). These are those pensions that result from German company pension plans (e.g. *Direktzusage*, *Pensionsfonds*, etc.).

## C. Taxation of payments from a pension plan (11)

- It is questionable whether these principles apply if the spouse inherits claims from US pension plans. Generally, there are no arguments for a different treatment.
- Should the tax-exemption does not apply to foreign pension plans, the inheritance of the spouse would be a taxable event.
- Annuities: Evaluation corresponding to the life expectancy of the heir (Sec. 14 German Evaluation Act, “BewG”), for the taxation there is the option either to tax the capital value immediately or to opt for an annually taxation of the annual value of the annuitites (cf. Sec. 23 ErbStG). However, it is not entirely clear whether the surviving spouse has this option right as the employee is owner of the pensions (immediate taxation).
- Payment of capital: value of the payment is base of taxation
- **Application of the DTT with regard to inheritance and gift tax:**
  - Claims from pension plans are not explicitly mentioned in the DTT so that they are subject to Art. 8 DTT.
  - Only Germany as resident state of the decedent would have the taxation right.

## C. Taxation of payments from a pension plan (12)

### ■ Taxation of payments from a non-qualified pension plan

- It is questionable whether Art. 18A DTT applies to a private IRA as scope of application of Art. 18A DTT is to privilege company pension plans (in Germany only the pension plans according to the BetrAVG are subject to the tax privileges; vgl. *Debatin/Wassermeyer*, Doppelbesteuerung, Art. 18A Rz. 1; *Portner*, BB 2013, 2083, 2092).
- Tax-privileges according to Art. 18A DTT only apply to contributions to IRA if they are company pension plans, not to pension plans in general.
- If a pension plan is not subject to Art. 18A para. 4 DTT, for taxation purposes it has to be qualified according to German tax law.

## C. Taxation of payments from a pension plan (13)

### ■ Taxation of payments from a non-qualified pension plan

- The qualification as a pension plan requires that the beneficiary is protected against a biometric risk (age, death, invalidity) and that it is unforeseeable in which amount and how long he has to pay into the “pension plan”, otherwise the pension plan can be considered as a capital investment.
- In case of an IRA, the beneficiary can claim the pension before a certain age, but he has to pay an exise tax. However, he does not have the risk to lose his claims completely (no biometric risk).
- The possibility to bequeath the claims should not exclude the qualification as pension plan.
- However, according to German law it is only possible to bequeath the claims to spouses or children to comply with the requirements of a pension plan (German Revenue Service 31 March 2010, No. 247 f.).
- There are arguments that a private IRA does not qualify as a pension plan, but as a capital investment.
- As often pension plans are structured as trusts, also Sec. 15 AStG can apply to non-qualified pension plans. According to Art. 1 para. 6 DTT the AStG remains applicable notwithstanding the DTT.

## C. Taxation of payments from a pension plan (14)

### ■ Taxation of payments from a non-qualified pension plan – Application of the DTT

- For the taxation, it has to be considered when the pensions are taxed. According to the general provisions, it has to be decided whether the contributions are subject to tax or only the payments (deferred taxation). Payments from a pension plan usually are taxed in the moment of payment to the individual except the employee has the right to dispose about the payments earlier.
- The taxation of payments from an employer to an employee can be deferred for tax purposes by an agreement (cf. German Federal Court of 11 November 2009 IX R 1/09, DStR 2010, 106: with regard to indemnities).
- The payments from a non-qualified pension plan may be subject to Art. 15 DTT and qualify as salary that is paid as deferred compensation.
- According to Art. 15 DTT generally, the resident state of the employee has the taxation right which would be Germany. However, Art. 15 para. 1 DTT provides that also the state where the employment is exercised has the taxation right. This would be the US.

## C. Taxation of payments from a pension plan (15)

### ■ Taxation of payments from a non-qualified pension plan – Application of the DTT

- Due to practical reasons the resident state should have that taxation right (cf. *Portner*, BB 2013, 2083, 2095). Otherwise the attribution of taxation right could be difficult if an employee worked in several other states. Further, it has to be considered that between the employment in the other state and the payment of pensions there may be a long period of time.
- If e. g. German law provides that the contributions are subject to an immediate taxation and qualify as salary, Art. 21 DTT (Other revenues) may apply. In this case, Germany would have the taxation right as resident state.
- Sec. 22 No. 5 lit. b) or c) EStG, Sec. 20 para. 1 No. 6 EStG may apply so that the difference between the payments and the contributions is subject to taxation.
- If the non-qualified pension plan according to the DTT is qualified as a pension plan according to German tax law, the payments would also be subject to Art. 18 DTT (Germany as resident state would have the taxation right).

## D. Summary (1)

- Art. 18A DTT prevents that beneficiaries of pension plans have tax disadvantages if they are employed in the other state for a certain period of time.
- A 401 (k) plan is a pension plan accepted by German law as qualified pension plan pursuant to Art. 18A DTT. Contributions of a German resident remain tax-exempt.
- Payments from a qualified pension plan are taxed if they are paid to the beneficiary (deferred taxation).
- A German resident who receives payments from a US pension plan does not have to tax pensions before the payment. The payments are subject to tax privileges in Germany corresponding to the tax treatment of the contributions. Base of taxation is the difference between the payment and the contributions to the pension plans.
- Also the tax privileges due to Sec. 20 para. 1 No. 6 EStG may apply.
- An IRA structured as company pension plan may also qualify as pension plan that is subject to the tax principles of Art. 18A DTT.

## D. Summary (2)

- According to Art. 18 DTT payments from a qualified US pension plan are taxed by the resident state (Germany) if the beneficiary is resident in Germany in the moment of payment.
- A private IRA does not qualify as a company pension plan pursuant to Art. 18A para. 4 DTT. Therefore, it has to be qualified from the German perspective in application of the general rules. It can be qualified as a capital investment or be subject to Sec. 15 AStG if it is structured as a trust.
- Investments into US pension plans have to be carefully analyzed in order to safeguard the tax advantages of Art. 18A DTT. In other cases, the general provisions of German tax law may apply.

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