

U.S. Cross-Border Tools

Foreign Pension Advice for US Ex-Patriates

Most people are familiar with the treatment of pension income in the US if the pension is paid by a US employer. The confusion arises when the pension is paid by a foreign employer. There are special rules relating to foreign pensions that can significantly reduce the amount of the pension that is taxable for US purposes.

Generally, US taxpayers may recover a certain portion of their retirement pension income tax free. The amount represents the total of their contributions into the plan that were included in taxable income during those years. If the client's contributions were "before tax" or resulted in a reduction in their gross taxable wages, then they have a zero cost. Those with a zero cost experienced immediate tax savings throughout the period that they were contributing to their retirement plan. This results in 100% of their pension income being subject to tax.

If the client's contributions did not reduce their gross taxable earnings then they can recover this amount over the period that they expected to receive payments. For US employment, pension recipients receive a Form 1099-R, which should show the total gross and taxable portions of their pension. However, through changes in plan administrators and trustees, this information can be lost or incorrectly reported. For foreign employment, pension recipients receive other forms of reports that comply with that country's tax rules but not the US tax rules. So the first step is to determine the total amount of their after-tax contributions.

The next step is to determine the period to use in recovery of their cost basis. A divisor is found in tables provided by the IRS that is based on their age at the time the pension started.

The number from the table is then divided into the total cost and results in the monthly amount of their pension, which is, recovered tax-free. Multiplying by the number of months during the year that they received their pension, results in that year's total cost recovery. The amount calculated for a full 12 months remains constant until the total amount of their cost has been recovered.

If the pension benefit increases with inflation or age, their taxable portion will increase as well. This is because once the recovery amount has been calculated it remains constant.

The above method is known as the Simplified Method and applies to most pensions started after November 18, 1996. Those whose pension started before that date, but after July 1, 1986 may choose to use this method. Once a choice is made, it must be continued.

An alternative method, known as the General Rule, applies under certain circumstances and is a bit more complicated. If the client is eligible to choose the method of calculation, be sure to try both methods to test for the most favorable results.

As mentioned, foreign pensions may be eligible for even more favorable treatment. If they were participating in a pension plan while working outside the United States before 1963 or the plan provided by the employer existed prior to March 12, 1962, and the work was performed after 1962, then both the client's contributions and those of their employer are considered their cost in the pension. As an added bonus, the client's contributions are considered part of the pension cost even if they were not included in their taxable wages.

This special treatment can result in significant tax savings that are just waiting to be determined. As noted above, forms such as the T4A or NR4 from Canada do not indicate the tax-free basis for US reporting. The result is that the client is likely paying taxes on more income than they should.

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