SHOULD FOREIGN NATIONALS PARTICIPATE IN YOUR COMPANY'S U.S. BASED 401(K)?

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In our increasingly global economy, it is becoming more common that employers hire talented employees from every corner of the world. However, once your employees arrive in the United States and start working for you, questions about whether or not they should participate in your retirement plan typically start to come up.

Here are some things to keep in mind when assisting a foreign employee with your retirement plan:

Each Employee's Situation is Different | There are no universal rules for figuring out whether a foreign employee should participate in your retirement plan. It's important to realize that how a participant's account will be treated from a tax perspective depends on a number of factors, including:

- *Whether your employee has a Green Card*
- *How long the employee will live in the United States*
- *The age of the employee*
- *An employee's country of origin, the tax laws of that country, and their tax treaties with the U.S.*

Every employee should be considered individually with regard to whether or not it makes sense to participate in a U.S.-based 401(k) plan. In most cases, however, foreign employees who intend on staying in the U.S. for more than 2 years will benefit. Those employees who will not be considered "*resident aliens*" of the U.S., and who will only work here part time, will likely not see a benefit to participating in your plan. For the remainder of this article, we will assume that the foreign employees we are talking about are resident aliens (have a Green Card) and intend on staying for a minimum of 2 years.

Taxes and U.S.-Based 401(k) Plans | Your employee's country of origin probably has a tax treaty with the United States. You might find that tax treaties from certain parts of the world are similar, but there's no guarantee that they will be exactly the same. As a result, it's important for the employee to research whether or not the tax-deferred nature of the U.S. 401(k) will be honored later, after they return home.

While your employee is living in the United States, taxes are levied on their compensation, just like any other resident. Therefore, just like a U.S. citizen, contributing to a U.S.-based 401(k) can reduce the amount of taxes the employee pays. There is no different in tax treatment for Resident Aliens. Given that many plans also offer matching contributions, there is an additional incentive for foreign employees to participate.

Where it gets tricky is when your foreign employee withdraws money from the 401(k). Just as there are no differences in how contributions are handled for Resident Aliens vs U.S. Citizens, there are no differences in how distributions are taxed either. More specifically, distributions are taxed at the normal income tax rate. Further, if a participant takes a distribution before they are age 59½, an additional penalty of 10% will be charged. This makes the timing of distributions very important to consider. We will discuss this more later in this article.

First, let's look at a simple scenario to show why it typically makes sense for a foreign employee to participate in your retirement plan:

	WITHOUT 401(k)	WITH 401(k)
Gross Earnings	$ 65,000	$ 65,000
401(k)	$ 0	$ (3,900)
Taxable Earnings	$ 65,000	$ 61,100
Tax (25%)	$ (16,250)	$ (15,275)
Net Take Home	**$ 48,750**	**$ 45,825**
401(k)		
Employee Contribution	$ 0	$ 3,900
Employer Match	$ 0	$ 1,950
Total 401(k) Balance	**$ 0**	**$ 5,850**

In the example above you can see that in one year, the participant saved $975 in Income Tax and picked up $1,950 in employer matching funds, for a total gain of $2,925.

Now, let's assume a worst case scenario that the participant immediately returned to their country of origin at the end of the year, had no tax deferred growth in the market, was not 59½, and paid 30% taxes (inclusive of the 10% penalty) to take the funds from their plan.

30% on $5,850 would mean taxes of $1,755. This means that the participant would still have benefited $1,170 by participating in the plan.

So as the example above illustrates, despite the fact that the money will be taxed when its removed (and there are even ways around that, which we will cover) it still can make sense for your foreign employee to participate.

Minimizing Taxes on Distributions | The most important part of a foreign employee's interaction with your retirement plan will be when they withdraw their money. And here, patience is the name of the game. While it will be attractive for an employee to want to cash out their balance before they move home, this can be really costly for a few reasons.

First, assuming the employee didn't move home on January 1st, it's likely that they had U.S. wages for that year. Their 401(k) withdrawal will be taxed on top of those wages. In addition, if the employee is not 59½, they will pay an additional 10% early withdrawal penalty on top of the taxes. A better approach would be for the employee to leave their money either in the plan, or rolled to an IRA, and then draw that money down slowly when they retire.

In fact, there is a way that your foreign employees can avoid all taxes on this money. There is a tax exemption for Non-Resident Aliens, which your employee would be the year after they move home. Currently that exemption is $4,050. So if your non-resident foreign employee returns home and withdraws less than $4,050 per year, they can avoid taxes all together.

(It is important to note that 30% is automatically withheld from the amount withdrawn from a U.S.-based 401(k) or IRA to an out-of-country address. In order to recoup some (or all) of the taxed amount, your employee will need to file a non-resident tax return. Non-Resident Aliens who move back home can get the amount up to the exemption back through this process.)

What about a Roth Contribution? | Roth 401(k) options are growing in popularity. This allows employees to take advantage of retirement savings that grow completely tax-free. Contributions are made after tax, and when withdrawals are made, they aren't taxed at all. Unfortunately for foreign nationals who move back home, this benefit might not transfer. Some tax treaties haven't been updated to account for Roth accounts. This increases the chance of being double-taxed later. Carefully consider the situation before you steer a foreign employee toward Roth contributions. In many cases, the traditional 401(k) contribution is a better choice.

What About Transferring Funds Between U.S.-Based and Foreign Retirement Accounts? | Depending on the tax treaty, it can get tricky to move funds between retirement accounts. If your employee's country offers a tax benefit to the retirement account, there's a good chance the status will be lost by moving it into a U.S.-based 401(k). It's likely that the money would be taxed leaving the country of origin, and then the earnings would be taxed in the United States. A similar situation can arise if your employee tries to move money from a U.S.-based 401(k) into a retirement account in their home country.

Instead, it often makes sense to keep the accounts separate. A foreign employee can benefit from participating in the U.S.-based account as long as they are living in the United States. After leaving, though, it is often a good idea to keep the account and carefully plan withdrawals in coordination with the home-based retirement account.

Consult with a retirement plan specialist as you help your foreign employees understand their options for retirement plan contributions.

For more information, please call **407.585.1160**