Administors of tax-qualified retirement plans (or their delegated payor) are responsible for both withholding on distributions and for reporting the tax withheld. If taxes are under-withheld, the administrator/delegated payor may be subject to penalties.

Although the rules governing withholding on distributions to US citizens and resident aliens are clear and generally well-understood, administrators may not be aware of the rules applicable to distributions to individuals who are (at the time of distribution) non-resident aliens (NRAs). As a result, an administrator could end up under-withholding on NRA distributions, since NRAs are subject to a higher rate of withholding than US persons (unless a treaty exemption applies, as discussed below).

By way of background, NRAs might participate in a plan either because they spent all or part of their career with the plan sponsor working in the United States before returning to their home country, or because the sponsor’s plan allows NRAs to participate. In either case, the NRA withholding rules apply based on the status of the payee at the time of distribution—i.e., the individual is an NRA at the time of distribution, the NRA withholding rules apply, even if the individual spent all or part of his/her related service working in the United States.

Assuming the NRA withholding regime applies, a flat 30% withholding rate generally is imposed on the portion of the distribution that is attributable to (i) all earnings that accrued on the participant’s benefit, and (ii) contributions made with respect to the participant’s period of service in the United States. Any contributions made with respect to the NRA’s period of service outside of the United States are not subject to US income tax withholding. The IRS has provided special guidance on applying this concept to defined benefit plans.

If, however, the NRA resides and pays taxes at the time of distribution in a country that has a treaty with the United States that prevents double taxation, the NRA may avoid US taxation and withholding on the distribution altogether. The participant generally needs to provide the administrator (or delegated payor) a Form W-8BEN to claim the treaty exemption, but the administrator should consult the text of the treaty and relevant IRS guidance to confirm that the exemption actually applies. For example, the exemption under certain older treaties may not apply to lump sums, and certain countries deny the exemption in limited circumstances (e.g., the United States-United Kingdom treaty generally does not exempt from US taxation any lump sum distributions from US qualified plans made to UK residents).

The rules governing withholding on distributions to NRAs are complex, ambiguous in certain respects, and are still being refined and developed by the IRS. Accordingly, plan administrators making distributions to NRAs should carefully review the rules and seek appropriate tax advice as necessary.