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What You Need to Know About Foreign Account Tax Compliance Act's (FATCA) Impact on Non-U.S. Retirement Plans

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On the Subject

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On January 17, 2013, the **Internal Revenue Service** (**IRS**) published final regulations under the Foreign Account Tax Compliance Act (FATCA), which are effective immediately. Congress enacted FATCA in 2010 to make it more difficult for U.S. taxpayers to conceal assets held in offshore accounts. In order to discover information about offshore accounts, FATCA imposes significant reporting obligations on both non-U.S. foreign financial institutions (FFIs) and U.S. taxpayers holding foreign financial accounts. A non-U.S. retirement plan may be subject to FATCA reporting responsibilities as an FFI unless there is an available exemption. Failure to comply with applicable reporting requirements may trigger substantial withholding taxes and penalties. This On The Subject summarizes what employers need to know about FATCA for both plans and participants.

Plan-Level Requirements

Foreign Financial Institutions

An FFI must register with the IRS by October 25, 2013, and formally agree to implement procedures for identifying and disclosing information about financial accounts held by its U.S. customers. Unfortunately, a non-U.S. retirement plan is generally included in the broad definition of an FFI, which means it will be required to register and disclose information about its U.S. taxpayer participants if it is not exempt from FATCA. Complying with FFI reporting rules requires significant due diligence to identify account holders who are U.S. taxpayers. Failure by a non-exempt FFI to comply will subject it to a 30 percent withholding tax on certain U.S. source income and on the gross proceeds from the sale of certain assets that generate U.S. source income (such as debt and equity instruments).

Exemptions for Retirement Plans

The final regulations provide important exemptions from FATCA's reporting and withholding requirements for some, but not all, non-U.S. retirement plans. In response to public comments, the final regulations revised certain exemption requirements under the proposed regulations to broaden the types of retirement plans that will be exempt from FATCA. Important exemptions include the following categories.

Broad Participation Retirement Plans. A non-U.S. retirement plan established to provide retirement, disability and/or death benefits for current or former employees and designated beneficiaries will be exempt from FATCA if these qualifications are met:

- No single beneficiary has a right to more than 5 percent of the plan's assets.
- It is subject to government regulation and provides annual information reporting about its beneficiaries to the tax authorities in the country in which it is established or operates (its home country).
- It satisfies at least one of the following requirements:
    - It is exempt from tax on investment income in its home country because of its status as a retirement or pension plan.

- It receives at least 50 percent of its contributions (other than certain transfers) from sponsoring employers.
- Distributions or withdrawals (other than certain transfers or rollovers) are only allowed upon the occurrence of specified events related to retirement, disability or death, or penalties apply to distributions made prior to such specified events.
- Employee contributions (other than certain make-up contributions) are limited by reference to earned income or may not exceed $50,000 annually

Narrow Participation Retirement Plans. A non-U.S. retirement plan established to provide retirement, disability and/or death benefits for its current or former employees and designated beneficiaries will be exempt from FATCA if these qualifications are met:

- The plan has fewer than 50 participants.
- The plan is sponsored by one or more employers that are not investment entities or passive non-financial foreign entities.
- The plan is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in its home country.
- Participants not resident in the plan's home country are not entitled to more than 20 percent of the plan's assets.
- Employee and employer contributions to the plan (other than transfers from certain retirement savings accounts or other exempt retirement plans) are limited by reference to earned income and compensation, respectively.

Treaty-Qualified Retirement Plans. A non-U.S. retirement plan established in a country with which the United States has an income tax treaty in force will be exempt from FATCA reporting and withholding if it is entitled to benefits under such treaty on income derived from U.S. sources as a resident of that country that satisfies applicable benefit limitation requirements and is operated principally to administer or provide pension or retirement benefits. Tax treaties typically include specific definitions regarding when a person is treated as a resident of a country. Note that this exemption does not require a non-U.S. retirement plan to qualify for favored tax treatment either in the United States or in the country subject to the tax treaty with the United States.

401(a)-Type Plans. A pension plan that would meet the requirements of Section 401(a) of the Code if it were funded by a trust created or organized in the United States is exempt from FATCA reporting and withholding.

Investment Vehicles Designed Exclusively for Retirement Plans. Investment vehicles that exclusively invest funds of one or more types of retirement plans described above or of certain types of retirement savings accounts are exempt from FATCA reporting and withholding.

Even if exempt from FATCA reporting, a non-U.S. retirement plan is required to certify its status on an IRS Form W-8BEN (or suitable substitute) in order to avoid withholding and, in some cases, must also provide documentary evidence supporting the exemption. The IRS has not yet published revisions to W-8BEN that reflect the final regulations, so it remains to be seen what type of general documentary evidence will be required.

Intergovernmental Agreements

FATCA raises many compliance issues for a non-exempt FFI and can pose a catch-22 for an FFI, requiring it to either violate local law restrictions relating to the disclosure of account information or bear the risk of FATCA liability exposure. An intergovernmental approach to FATCA solves these compliance issues, significantly reduces FFI costs and simplifies tax administration. In order to implement FATCA's information reporting requirements, the U.S. Treasury Department (Treasury) worked with several countries to develop model intergovernmental agreements (IGAs). Under one such model, an FFI reports information about financial accounts held by U.S. taxpayers directly to its government, and the foreign government then provides such information to the United States (a Model 1 IGA). In order to comply with any laws impeding a foreign government's ability to report information directly to the United States, another model allows the signing country's FFIs to report directly to the Treasury (a Model 2 IGA).

Each of the model IGAs includes an annex in which the signing countries may list categories of entities that will be exempt from FATCA reporting requirements. Annex II typically lists the retirement plans that will be exempt from FATCA's withholding and reporting requirements irrespective of whether any of the other exemptions described above are available. For example, it was unclear under the FATCA proposed regulations whether certain pension plans established under UK law would have been exempt from FATCA; however, the IGA signed by the United Kingdom and the United States in September 2012 clarifies that most UK pension plans will be exempt from FATCA reporting requirements.

As of March 15, 2013, Denmark, Germany, Ireland, Italy, Mexico, Norway, Spain, Switzerland and the United

Kingdom have initialed or signed IGAs with the United States. It is likely that other countries will adopt IGAs, as the Treasury is engaged with more than 50 countries and jurisdictions to implement the reporting and withholding provisions of FATCA. It is anticipated that IGAs will be entered into with the following countries in the coming months: Canada, Finland, France, Guernsey, Isle of Man, Japan, Jersey and the Netherlands.

Impact of Intergovernmental Agreements on U.S. Retirement Plans

The model IGAs are generally structured to be "reciprocal" in nature, meaning that the United States would agree to provide the same type of information about financial accounts held in the United States by the signing country's taxpayers to the signing country. For example, the IGA with the United Kingdom requires the United States to report information about certain depository accounts and certain narrowly defined financial accounts held in the United States by residents of the United Kingdom. In addition, it commits the United States to adopt regulations to ultimately achieve an equivalent level of information being provided by the United States and the United Kingdom. Thus, under such reciprocal IGAs, it is not unlikely that a U.S. retirement plan eventually will be required to disclose information about non-U.S. taxpayer participants if the plan is not otherwise exempt from FATCA reporting. It remains to be seen what new reporting requirements may be imposed upon U.S. retirement plans.

Next Steps

Employers should evaluate whether their non-U.S. retirement plans qualify for a FATCA exemption under the final regulations. With respect to any non-exempt plans, employers should contact plan trustees regarding steps being taken to address potential FATCA coverage and monitor developments that may affect reporting obligations, including whether the home country appears likely to sign an IGA with the United States.

Individual-Level Requirements

In addition to the plan-level reporting for certain non-U.S. retirement plans, U.S. taxpayers participating in a non-U.S. retirement plan often have reporting obligations to the IRS under FATCA. In general, Section 6038D of the Internal Revenue Code requires U.S. citizens, resident aliens and certain nonresident aliens with U.S. source income to report beneficial ownership of "foreign financial assets" with an aggregate value of more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year (although higher thresholds apply to U.S. taxpayers who file joint tax returns or reside abroad). "Foreign financial assets" have been interpreted to include interests under a foreign pension or deferred compensation plan, and may also include foreign equity awards. Covered individuals are required to report these interests on IRS Form 8938 (as an attachment to the annual income tax return). Section 6038D reporting currently is effective and was required beginning in the 2012 tax filing season (*i.e.*, by April 17, 2012, unless an extension was granted). Click here for a helpful set of Q&As published by the IRS addressing basic questions under IRS Form 8938. The FATCA final regulations do not change any reporting obligations that apply to individuals.

There is no exemption for a covered individual with an interest in a non-U.S. retirement plan from filing Form 8938 merely because the plan that is a foreign financial interest itself falls into one of the FATCA exemptions described above. In addition, the obligation of a covered individual to report under Form 8938 is separate from and in addition to reporting under the Report of Foreign Bank and Financial Accounts (FBAR). A U.S. individual may have FBAR filing obligations merely by having signature authority over foreign financial accounts with an aggregate value above $10,000. In contrast, Section 6038D and Form 8938 focus on equitable ownership of interests in certain foreign assets with different reporting thresholds depending upon the individual's filing and residency status.

Covered individuals who fail to meet the Form 8938 reporting requirements are potentially subject to steep penalties. Section 6038D provides for to up to $50,000 in penalties. In addition, a 40 percent understatement penalty applies to any tax attributable to the non-disclosed assets. While there is currently no IRS correction program for failure to file a Form 8938 for 2012, covered individuals who have failed to meet such reporting requirements with respect to an interest in a plan that is a foreign financial asset may wish to consider amending their prior tax returns.

Next Steps

Employers should consider providing assistance to their employees who may be subject to Section 6038D reporting obligations. Assistance involves identifying foreign plans that may be subject to this reporting requirement and providing information on what values may be reported on Form 8938. Although it is the individual's responsibility to meet any reporting requirements under FATCA, there are also related corporate governance risks for the multinational employer if executive and other employees are not properly reporting U.S. taxes on plan interests outside the United States. In this regard, it is important to keep in mind that the IRS has identified foreign funded retirement plans as a potential area of tax avoidance and is working on guidance with respect to the taxation of these plans.

Compliance with FATCA obligations is an important part of providing employee benefits outside of the United States for a multinational employer. Failure to take these obligations into account as part of compliance and risk management activities can result in adverse exposure to the company and its executive, particularly if there is a related significant underpayment of U.S. income tax.