FATCA — Foreign Account Tax Compliance Act impact on employers: An overview and practical considerations for employers' benefit programs

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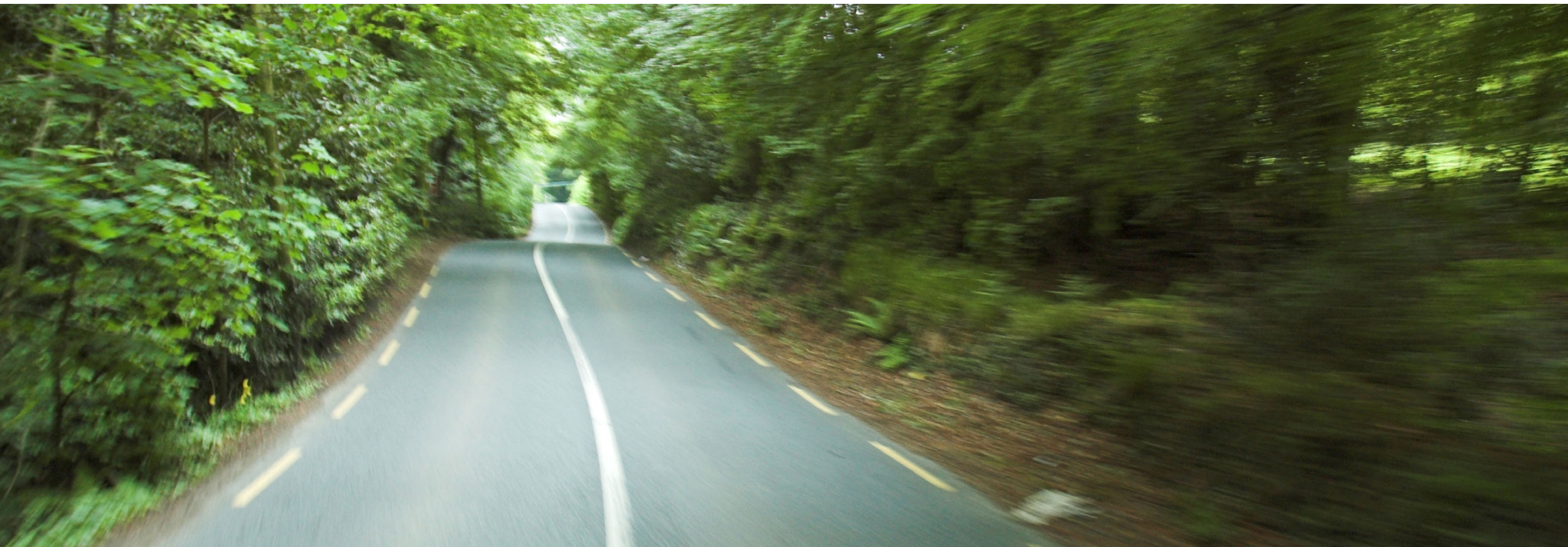
FATCA overview

The Foreign Account Tax Compliance Act ("FATCA") is a new set of tax reporting rules that the U.S. government intends to use to prevent U.S. taxpayers from avoiding their U.S. tax obligations by holding financial assets in non-U.S. institutions. FATCA requires Foreign Financial Institutions ("FFIs") to identify U.S. taxpayers with financial accounts in these FFIs, and provide this information to the U.S. Internal Revenue Service ("IRS"). Given that many FFIs have little nexus to the U.S. and may not otherwise be subject to U.S. tax law, FATCA imposes a significant withholding tax on certain U.S. sourced payments made to FFIs that cannot document FATCA compliance as a means of enforcing these reporting rules.

Why do non-U.S. companies that are not financial service organizations need to be concerned with FATCA? One of the reasons is that almost all employers maintain employee benefit programs, such as retirement plans. Many of these employee benefit programs may fall within the broad regulatory definition of an FFI, and thus need to either: (1) register with the IRS and start reporting information annually, or (2) document their status as exempt from FATCA on IRS Form W-8BEN-E. In our integrated world, it is common for non-U.S. benefit plans to have a global portfolio including at least some U.S. based investments. These investments can be subject to a 30% withholding tax in the absence of proof of FATCA compliance. More practically, foreign benefit plans often deposit their accounts with an institution that does business globally, and many financial service providers may not continue to do business with entities that are not taking the proper steps to demonstrate FATCA compliance. Lastly, FATCA simply stands at the vanguard of what may be coming; many countries outside the U.S. have adopted similar requirements to report foreign financial assets or are sharing information with other governments.



FATCA in a nutshell

Objective	Address perceived abuses by U.S. taxpayers with respect to offshore accounts and investment income from non-U.S. entities
Incentive	30% withholding on certain U.S. source payments to non-participating Foreign Financial Institutions ("FFI")
Action required	Register with IRS or certify status as exempt and document justification for exempt status

FATCA including certain non-U.S. benefit plans as FFIs

Many employers are not aware that FATCA may reach non-U.S. benefit plans. However, FATCA regulations define the term FFI very broadly. Most "funded" non-U.S. benefit plans will fit within the definition of an "investment type" FFI because the funds associated with these plans earn more than half of their annual gross income from investing and the associated assets are managed by financial professionals. "Funded," for purposes of this discussion, generally refers to the fact that assets are set aside and held in a funding vehicle, such as a trust, that cannot be reached by the sponsoring employer's creditors in a bankruptcy proceeding. If the non-U.S. benefit arrangement is not "funded," then such arrangement will typically not need to comply with the FATCA requirements as there are no assets set aside in an FFI.

It is especially common to see funded arrangements within retirement plans. Employers will often set aside assets for investment in order to satisfy their future retirement benefit obligations. Typical examples include defined benefit or defined contribution plans. Other examples of potentially affected non-U.S. benefit plans include long term incentive plans, short term incentive plans, equity awards (e.g., stock options), severance plans, and even some medical plans.

Although many U.S. companies (and most global financial services companies) with foreign subsidiaries have started to determine whether their foreign benefit plans are FFIs and assess FATCA's implications for these non-U.S. benefit plans, many multinational companies with corporate headquarters outside the U.S. have been less focused on FATCA. These multinationals are now beginning to realize the potential impact of tax withholding on certain U.S. sourced income. Additionally, even if a non-U.S. benefit plan is exempt from FATCA reporting (see below), it is still required to certify its status on an IRS Form W-8BEN-E in order to avoid withholding and, in some cases, may be asked to provide documentary evidence supporting its exemption. While the IRS has indicated that 2014 and 2015 will be treated as a transition period for FATCA enforcement (meaning that it will not add additional penalties to any withholding in the event of noncompliance), an institution must be able to demonstrate a "good faith" effort to comply. If no FATCA review has been undertaken, the company will not be in a position to confirm that any required actions have taken place, provide appropriate documentation for audit purposes, or be able to demonstrate a "good faith" effort to comply with FATCA to avoid additional sanctions.

FATCA exemptions for benefit plans

The first step in determining how FATCA will apply to a non-U.S. benefit arrangement is to understand which party is responsible for complying with the FATCA registration requirements. There are often multiple parties associated with these benefits arrangements, including insurance companies, investment managers, trustees, custodians and recordkeepers. An employer may not have any obligations associated with its non-U.S. benefit plan where the employer does not bear any responsibility for, or control over, the management of the assets. If the employer simply turns over the funds to a third party, such as a governmental entity, certain multiemployer arrangements, or certain insurance arrangements, the manager/recipient of the funds may bear the FATCA registration and/or reporting responsibilities.

Once an employer has determined that it has a "funded" benefit plan arrangement for which it is responsible for the FATCA compliance, the next step is to determine whether a FATCA exemption applies. While the general rule is that FFIs must register with the IRS, FATCA does contain meaningful exemptions, particularly for retirement plans. If an exemption applies, the plan must provide U.S. withholding agents with a Form W-8BEN-E, but the plan can avoid registration with the IRS and subsequent reporting responsibilities.

The FATCA regulations provide three pertinent, categorical exemptions for non-U.S. benefit plans:

- Treaty-qualified retirement funds
- Broad participation retirement funds
- Narrow participation retirement funds

The devil, of course, is in the details, and each category has significant limitations.

Another common way that non-U.S. benefit plans that are FFIs have been able to avoid registration is if the plans are located in a country with which the U.S. government has signed an Intergovernmental Agreement ("IGA").

These agreements generally help confirm that FFIs in the jurisdiction can provide information (directly or indirectly) to the IRS without violating local laws. More importantly for purposes of this discussion, Annex II of these IGAs specifies certain non-U.S. benefit plans that are exempt from registration because the U.S. has recognized that these types of plans are unlikely to be abused as shelters for U.S. taxpayers. For example, registered pension schemes in the U.K. are generally exempt from registration.

Practical FATCA considerations and potential implications

While FATCA imposes certain new tax reporting requirements on FFIs, it has also caused employers and individuals to focus on many of the existing tax rules associated with these foreign benefit arrangements.

FATCA effectively adds an additional dimension to the already stringent reporting requirements for U.S. taxpayers; including, but not limited to, the submission of a Form 8938 (Statement of Specified Foreign Financial Assets), and the Report of Foreign Bank and Financial Accounts (FBAR). These disclosures of non-U.S. assets require U.S. taxpayers to self-identify, value, and report all foreign financial assets. Much in the way U.S. Forms W-2 provide an external validation of the amounts employees report on their tax returns, FATCA now requires FFIs to provide information about account holders to the IRS, which can then be used to monitor and enforce compliance with the U.S. reporting and income inclusion requirements. The cumulative effect of these provisions may be onerous to U.S. taxpayers with foreign assets.

As a result of this additional scrutiny, many employers are starting to place more of a focus on the taxation of amounts accruing in these pension plans. From an individual standpoint, oftentimes, amounts accruing in these foreign benefit programs can be currently taxable to these employees, even before such amounts are ever paid to these employees. In such cases, employers are taking the steps to make sure that they are complying with the proper reporting requirements. From a corporate standpoint, companies are reviewing the tax deductions associated with these pension accruals.

Benefit plan review process

Catalogue

- Perform an analysis of all non-U.S. employee benefit plans to determine whether plan is an FFI under FATCA

Analyze

- Determine whether non-U.S. benefit plans that are classified as FFIs meet an exemption under an Inter-Governmental Agreement (IGA), treaty, or other FATCA regulatory provision

File

- If not exempt, register as FFI and report U.S. taxpayer account holders
- 2014 and 2015 are transition years, but companies must demonstrate good faith compliance to avoid penalties

Document

- If exempt, certify status with IRS and develop/retain documentation to substantiate exempt status

In addition to the tax focus, the additional administrative responsibilities associated with these filings are compelling certain foreign banks to decline to open accounts for U.S. taxpayers (including employees abroad). This is especially a concern for expatriate employees who are working overseas and have an overseas bank account. In some cases, the banks are actually closing these accounts leaving employees with few options.

Staying ahead of FATCA

FATCA appears just to be the beginning of increased global coordination of identifying and reporting global sources of income. The reach is far enough to sweep in benefit plans, such as retirement plans, so it will be necessary for employers to have a better understanding of not only the types of benefits their employees receive, but the tax reporting considerations as well.