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Proposed IRS Regulations Exempt Some Non–US Retirement Plans from FATCA

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On February 8, 2012, the US Internal Revenue Service (IRS) proposed detailed new regulations under Internal Revenue Code §1471 through §1474 to implement the Foreign Account Tax Compliance Act, known as FATCA. These proposed regulations include important exemptions for some, but not all, foreign (non-US) retirement plans. In this article, we will highlight key aspects of the proposed rules.

BACKGROUND

FATCA Impact on Non-US Retirement Plans

FATCA, which became law in March, 2010, is a prominent part of US efforts to make US taxpayers disclose and pay tax on earnings in financial accounts outside the USA. It includes a requirement under which an individual US taxpayer owning certain foreign financial accounts must file a tax form disclosing those accounts. FATCA further imposes a controversial reporting obligation on certain foreign financial institutions (FFIs) to search for and disclose their US customers to the IRS and to withhold on certain payments (known as "pass-through withholding"), or be subject to punitive 30% withholding on most US-source investment income.

In addition, the proposed regulations indicate that the Treasury Department is considering, in consultation with certain foreign governments, an alternative approach to implementation whereby an FFI could satisfy the reporting requirements if it collects the information required by the IRS and reports this information to its residence country government; the residence country government then would enter into an agreement to report this information annually to the IRS. A Treasury press release names the UK, France, Germany, Italy, and Spain as the countries currently in discussions, but the goal of the Treasury is presumably to add more countries to that list.

The key issue for non-US retirement plans – including those sponsored by US multinationals – has been that they fall within the broad statutory definition of an FFI, and unless exempted by IRS guidance, will have to engage in an extensive overhaul of their recordkeeping systems, make reports to the IRS, and perform secondary withholding – or face punitive tax withholding on income from their US investments. From soon after enactment, the IRS indicated that it would provide an exemption for certain non-US retirement plans. These new proposed regulations are the first thorough effort by the IRS to flesh out that exemption. While this proposed regulation is broader than initial IRS indications, the proposed exemptions are complex, with several different criteria. The exemptions are not without limits, so non-US retirement plans will need to analyze how the exemption applies to their specific structure.

The FATCA Implementation Timeline for FFIs

Generally, unless there is an exemption, an FFI may apply with the IRS to be a "participating" FFI (not subject to 30% withholding) through an electronic submissions process beginning in 2013. This is also the time by which the proposed regulations are expected to be finalized. The FFI would then be required to enter into an agreement with the IRS by June 30, 2013, to ensure that it will be identified as a participating FFI in sufficient time to allow US withholding agents to refrain from withholding beginning on January 1, 2014. Due diligence requirements for identifying new and preexisting US accounts (including certain high-risk accounts) would

begin in 2013 and reporting requirements would then begin in 2014. Withholding on US source dividends and interest payments to non-participating FFIs would begin on January 1, 2014 and withholding on all other withholdable payments, e.g., pass-through payments by participating FFIs, would then be phased in on January 1, 2015. Certain transition rules apply where there are local legal prohibitions on compliance with the IRS rules. The proposed regulations would also phase in the information on accounts required to be reported, beginning with only a few items, but with a requirement for fuller information to be reported by 2017.

FATCA Exemptions under the Proposed Regulation

The exemption under the regulation for non-US retirement plans is actually several separate exemptions for different types of plans. Though not labeled in the proposed regulations as such, for clarity we will describe these exemptions as the Defined Contribution Plan Exemption, the Retirement Savings Account Exemption, the Tax Treaty Exemption, and the Defined Benefit Plan Exemption, based on the types of arrangements each primarily seems to cover.

It is important to keep in mind that these exemptions apply to the withholding and reporting regime for FFIs. They do not apply for purposes of a US individual account owner's or a plan participant's obligation to report his or her interest in a non-US plan in connection with his or her individual US income tax return.

The Defined Contribution Plan Exemption

One exemption would apply primarily to plans with multiple individual accounts, such as defined contribution plans. This exemption provides that a retirement fund will be a "certified deemed-compliant" FFI if the FFI is organized for the provision of retirement or pension benefits under the law of the jurisdiction in which the account is established or in which it operates.

For larger account plans:

(i) all contributions to the FFI (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described below) are employer, government, or employee contributions that are limited by reference to earned income;

(ii) no single beneficiary has a right to more than 5% of the FFI's assets; and

(iii) contributions to the FFI that would otherwise be subject to tax under the laws of the jurisdiction where the FFI is established or operates are deductible or excluded from gross income of the beneficiary; the taxation of investment income attributable to the beneficiary is deferred under the laws of such jurisdiction; or 50% or more of the total contributions to the FFI are from the government and the employer (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described).

Alternatively, for smaller individual account plans:

(i) the FFI has fewer than 20 participants;

(ii) the FFI is sponsored by an employer that is not itself an FFI or a passive non-financial foreign institution;

(iii) contributions to the FFI (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described) are limited by reference to earned income;

(iv) participants that are not residents of the country in which the FFI is organized are not entitled to more than 20% of the FFI's assets; and

(v) no participant that is not a resident of the country in which the FFI is organized is entitled to more than US$250,000* of the FFI's assets.

Observation. This exemption would generally apply to plans that are based on employer, government or employee contributions, provided that there are limits on contributions based on earned income, and that any contributions either are tax deferred or are more than 50% from the government or the employer. Plans with 20 or fewer participants cannot be sponsored by FFIs or passive entities, however, and they also have limits on participation by individuals not resident in the country in which the FFI is established and the account value of the nonresidents must be less than US$250,000. Thus, some smaller plans may have difficulty passing this test.

This exemption still requires that the FFI certify its status as a deemed-compliant FFI by providing the withholding agent with supporting documentation that it meets these requirements. For certain purposes, an FFI that is organized in a European Union (EU) member state may treat account holders that are residents of other EU member states as residents of the country in which the FFI is organized for certain purposes. However, it does not appear that this DC Plan Exemption is one of those purposes; interested plans might wish to comment to the Treasury on this point.

Retirement Savings Account Exemption

Another exemption applies to individual retirement savings accounts. Under the RSA Exemption, a financial account does not include an account that satisfies one of the following criteria:

– the account is held by a retirement or pension fund that meets the DC Plan Exemption; or

– the account is subject to government regulation as a personal retirement account or is registered or regulated as an account for the provision of retirement or pension benefits under the

* £1 = US$1.59; €1 = US$1.32 as at 16 March 2012

laws of the country in which the FFI that maintains the account is established or in which it operates.

In addition, the account must meet the following requirements:

(i) the account is tax-favored with regard to the jurisdiction in which it is maintained;

(ii) all of the contributions to the account are employer, government, or employee contributions that are limited by reference to earned income under the law of the jurisdiction in which the account is maintained; and

(iii) annual contributions (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described) are limited to US$50,000 or less, and limits or penalties apply by law of the jurisdiction in which the account is maintained to withdrawals made before reaching a specified retirement age and to annual contributions exceeding US$50,000 (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described).

Observation. Importantly, this exemption applies to the definition of "financial account". It does not extend to the FFI holding the account which may be receiving US income subject to withholding. Thus, the FFI may still have to become a participating FFI if it wishes to be exempt from FATCA withholding. This may be a simpler process, however, if all or most of its financial accounts meet the RSA Exemption (or if the country involved enters into an alternative arrangement with the USA). FFIs and executives with individual retirement accounts in non-US jurisdictions would look to this exemption to decide whether the account is treated as a financial account by the FFI. Again, the FFI may still need to become a participating FFI to avoid withholding, and this would not affect whether the executive may have an individual reporting obligation in connection with his or her US personal income tax return with respect to that account under FATCA.

The Tax Treaty Exemption

The proposed regulation provides a fairly broad exemption for corresponding plans under tax treaties with the USA to be treated as an exempt beneficial owner of the withholdable income. This means that the fund itself, not merely an account, is exempt from withholding. A fund meets this exemption if it:

– is established in a country with which the United States has an income tax treaty in force and is generally exempt from income taxation in that country;

– is operated principally to administer or provide pension or retirement benefits; and

– is entitled to benefits under the treaty on income that the fund derives from US sources as a resident of the other country that satisfies any applicable limitation on the benefits requirement.

Observation. The third prong of this exemption will generally limit its application to plans that are exempt from dividend and interest withholding under applicable tax treaties. This should operate to exempt most of the plans in treaty countries that the Treasury has determined are equivalent to US tax-qualified plans, such as "corresponding plans". Such plans typically have benefit and contribution limits.

The Defined Benefit Plan Exemption

In addition, the proposed regulation provides an exemption for certain foreign retirement funds to be treated as exempt beneficial owners of income. A fund is an exempt owner if it is the beneficial owner of the payment and the fund:

– is formed for the provision of retirement or pension benefits under the law of the country in which it is established;

– receives all of its contributions (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described) from government, employer, or employee contributions that are limited by reference to earned income;

– does not have a single beneficiary with a right to more than 5% of the entity's assets; and

– is exempt from tax on investment income under the laws of the country in which it is established or in which it operates due to its status as a retirement or pension plan, or receives 50% or more of its total contributions (other than transfers of assets from other accounts or other plans that were exempt under this or one of the other retirement plan exemptions described) from the government and the employer.

An example in the proposed regulation illustrates that this exemption generally will not apply to defined contribution plans because, in this case, the participant and not the retirement fund is the "beneficial owner" of the investments. The example indicates that the plan may instead separately satisfy the exemptions noted above for retirement savings accounts, or, presumably, for defined contribution plans.

Under the example, it is assumed that the country in which the plan is resident does not have a treaty with the USA, that employees are allowed to make contributions to the trust based on a percentage of compensation income, and that such contributions are credited to the employee's account as well as interest accrued on such contributions. Retirement benefits will reflect the amounts credited to the individual accounts. No single beneficiary is entitled to more than 5% of the trust's assets. The example provides that, in this case, the pension plan is acting as an investment conduit and is not the

beneficial owner of the amounts credited to the individual accounts. As a result, the example provides that such a plan is not a foreign employer-sponsored retirement plan that meets the exemption from being treated as an FFI. However, the example goes on to illustrate that the defined contribution plan exemption (described above) may provide for an exception for certain accounts that are part of such a retirement plan that acts as an investment conduit, if the requirements of that exemption are met.

Observation. If a non-US retirement plan meets one of these exemptions to be an "exempt beneficial owner", the proposed regulations indicate that the payee will have to provide a withholding certificate and certain documentation or statements supporting the exemption. It is expected that the IRS will issue a form for this withholding certificate, probably part of the W-8 series, and that the instructions to that form will indicate the supporting evidence required for the exemption.

SUMMARY AND NEXT STEPS

These proposed IRS regulations substantially expand the foreign retirement plan exemption from FATCA withholding beyond what had initially been indicated. On the one hand, they appear to exempt many broad-based non-US retirement plans that have limits on benefits or contributions, including multiemployer and paritarian plans, and "corresponding plans" under a tax treaty. On the other hand, some individual retirement savings arrangements that are not corresponding plans – and small plans with large contributions or participants resident in other countries – may not meet the exemptions. In any case, the exemptions are very specific, and plans that wish to avoid 30% withholding on US investments should review how the exemptions apply to their specific facts – and keep in mind that, even where exempt, certification of that exemption will often be required.

These rules could be revised prior to finalization, and there is also the possibility of additional guidance under FATCA in various forms, so FFIs should continue to monitor the area.

During 2012, non-US retirement plans should review the availability of the applicable exemptions under FATCA with US employee benefits counsel and, if an exemption applies, begin to prepare the supporting documentation and statements necessary to avoid withholding. Where an exemption does not clearly apply, the plan should consider its alternatives. Among other options, it may be possible to seek further changes or other relief from the Treasury, including by submitting comments (by April 30) or by requesting to testify (on May 15) at the hearing in Washington, DC. Ω

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