

Employee Benefits Corner

FATCA Compliance Challenges for Employee Benefit Plans

By Elizabeth Thomas Dold and David N. Levine*

Under U.S. law, U.S. citizens and U.S. resident aliens are generally subject to taxation on their worldwide income. While in theory this requirement sounds simple, as events of recent years have highlighted,¹ the IRS's ability to gather knowledge on income and accounts outside the United States has been limited at times. While there have long been existing procedures and processes for obtaining information about foreign financial accounts,² there has also been a long-held perception by some that these programs have been insufficient at ensuring tax compliance. As such, in 2010, the Foreign Account Tax Compliance Act (FATCA) (P.L. 111-147) was enacted.

In the context of retirement plans, FATCA has three potentially significant areas of impact:

1. Reporting and withholding obligations for non-U.S. retirement plans
2. Reporting and withholding obligations for non-U.S. investments made by U.S. retirement plans
3. Individual participant reporting obligations

In this month's column, we first provide a brief overview of "the Basics" of FATCA and then briefly summarize how these rules can impact the both non-U.S. and U.S. retirement plans.

A. The Basics

FATCA and the regulations are complex in nature. However, there are several key concepts that are relevant to retirement plans.

1. How FATCA Can Apply

FATCA can impact a person (whether an individual or an entity) in many ways, including the following:

- *U.S. Person with A Non-U.S. Account.* A U.S. person with a non-U.S. account (as defined below) can be impacted by FATCA by (1) having to directly report their non-U.S. account to the IRS, (2) having an interest in a U.S. account that is subject to reporting by a foreign financial institution (FFI), and/or (3) becoming subject to 30-percent default withholding if the U.S. person fails to provide necessary disclosure information to a FFI.



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- *Non-U.S. Person That Is a Foreign Financial Institution.* A non-U.S. person that qualifies as a FFI can be required to report on U.S. accounts it holds for U.S. persons. Failure to properly register and report can result in the FFI's own U.S. income becoming subject to U.S. tax implications as described below.

2. Foreign Financial Institutions

At the center of FATCA compliance is the concept of an FFI.³ An "FFI" is broadly defined⁴ as a foreign entity that:

- accepts deposits in the ordinary course of a banking or similar business;
- as a substantial portion of its business, holds financial assets for the account of others; or
- is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities.

This definition is broadly interpreted by the IRS and Treasury to include both (1) a non-U.S. retirement plan, and (2) non-U.S. investment vehicle that may be used as an investment vehicle for the assets of a U.S. retirement plan.

An entity that is an FFI, unless otherwise exempted⁵ must provide information to the IRS about U.S. accounts it holds for U.S. persons and, if it fails to do so (subject to special rules governing the FFI's "recalcitrant account holders"), it will be subject to 30-percent withholding on amounts subject to U.S. withholding.

3. U.S. Accounts

A U.S. account is subject to FATCA reporting by an FFI. "U.S. account" generally means "any financial account which is held by one or more specified United States persons or United States owned foreign entities."⁶

"Financial account" generally means⁷:

- any depository account maintained by such financial institution,
- any custodial account maintained by such financial institution, and
- any equity or debt interest in such financial institution (other than interests which are regularly traded on an established securities market).

Notably, under applicable regulations,⁸ there are a few exceptions from this definition of financial account that, if satisfied, result in an account not being considered a U.S. account and thus not subject to disclosure by an FFI.⁹

First, there is an exception for a retirement and pension account if:

- the account is subject to regulation as a personal retirement account or is part of a registered or regulated retirement or pension plan for the provision of retirement or pension benefits (including disability or death benefits);
- the account is "tax-favored" (*i.e.*, contributions to the account that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of the account holder or taxed at a reduced rate or taxation of investment income from the account if deferred or taxed at a reduced rate);
- annual information reporting is required to the relevant tax authorities with respect to the account;
- withdrawals from the account are conditioned on reaching a specified retirement age, disability or death, or penalties apply to withdrawals made before such specified events; and
- either annual contributions are limited to U.S. \$50,000 or less, or there is a maximum lifetime contribution limit to the account of U.S. \$1,000,000 or less.

Second, there is an exception for a nonretirement savings account if:

- the account is subject to regulation as a savings vehicle for purposes other than for retirement;
- the account is "tax-favored" (as described above);
- withdrawals from the account are conditioned on meeting specific criteria related to the purpose of the savings account (*e.g.*, the provision of educational or medical benefits), or penalties apply to withdrawals made before such criteria are met; and
- annual contributions are limited to U.S. \$50,000 or less.

Third, there is an exception for rollovers to a retirement and pension or nonretirement savings account if:

- the funds are transferred from a retirement and pension or nonretirement savings account;
- the funds are transferred from a retirement or pension fund that meets the requirements of being an exempt beneficial owner as explained below; or
- the funds are transferred from a nonreporting financial institution that is a retirement or pension fund under an applicable Model 1 or Model 2 Intergovernmental Agreement (IGA) as explained below.

4. Exempt Beneficial Owner

When FATCA was enacted, Congress recognized that despite concerns about funds related to U.S. persons flowing through foreign financial institutions not being reported for purposes of U.S. taxation, certain persons were likely to pose a low risk of tax evasion, and, accordingly, amounts otherwise subject to 30-percent default withholding with respect to these beneficial owners should not be subject

to this default withholding. These entities are generally referred to as “exempt beneficial owners.”

There are several ways to be classified as an exempt beneficial owner—from the Code,¹⁰ as set forth in Regulations,¹¹ or pursuant to an IGA that sets forth a framework for FFI reporting between the United States and another country and FFI’s located in that country.¹²

The Regulations establish six categories of exempt beneficial owners that relate to retirement funds:

1. *Treaty-Qualified Retirement Fund.* A fund that is established in a country with which the United States has an income tax treaty in force, the fund is entitled to benefits under such treaty on income that it derives from sources within the United States (or would be entitled to such benefits if it derived any such income) as a resident of the other country that satisfies any applicable limitation on benefits requirement, and the fund is operated principally to administer or provide pension or retirement benefits.
2. *Broad Participation Retirement Fund.* A fund that is established to provide retirement, disability or death benefits, or any combination thereof, to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, provided that the fund:
 - does not have a single beneficiary with a right to more than five percent of the fund’s assets;
 - is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which the fund is established or operates; and
 - satisfies one or more of the following requirements:
 - The fund is generally exempt from tax on investment income under the laws of the country in which it is established or operates due to its status as a retirement or pension plan.
 - The fund receives at least 50 percent of its total contributions (other than transfers of assets from a retirement savings account described above or from other retirement funds treated as exempt beneficial owners under the retirement fund exemption) from the sponsoring employers.
 - Distributions or withdrawals from the fund are allowed only upon the occurrence of specified events related to retirement, disability or death (except rollover distributions to retirement and pension accounts or other retirement funds treated as exempt beneficial owners), or penalties apply to distributions or withdrawals made before such specified events.
3. *Narrow Participation Retirement Fund.* A fund established to provide retirement, disability or death benefits to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for prior services rendered, provided that:
 - the fund has fewer than 50 participants;
 - the fund is sponsored by one or more employers that are not investment entities or passive nonfinancial foreign entities (NFFEs);
 - employee and employer contributions to the fund (other than transfers of assets from a retirement savings account described above or from other retirement funds treated as exempt beneficial owners under the retirement fund exemption) are limited by reference to earned income and compensation of the employee, respectively;
 - participants that are not residents of the country in which the fund is established or operated are not entitled to more than 20 percent of the fund’s assets; and
 - the fund is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which the fund is established or operates.
4. *Fund Formed Pursuant to a Plan Similar to a Code Sec. 401(a) Plan.* A fund formed pursuant to a pension plan that would meet the requirements of Code Sec. 401(a), other than the requirement that the plan be funded by a trust created or organized in the United States.
5. *Investment Vehicles Exclusively for Retirement Funds.* A fund established exclusively to earn income for the benefit of one or more retirement funds covered in this and the preceding four situations, a retirement and pension account carved out from the definition of “financial account” as described above or a retirement and pension plan that is listed as such in Annex II of the relevant IGA.
6. *Pension Fund of Governmental and International Organization Employers.* A fund established and sponsored by an exempt beneficial owner which is a foreign government, a political subdivision or wholly owned agency or instrumentality of a foreign government, an international organization or wholly owned agency or instrumentality of an international organization, a non-U.S. government central bank, or a government of a U.S. territory to provide retirement, disability or death benefits to beneficiaries or participants that are current or former employees of the exempt beneficial

owner (or persons designated by such employees), or that are not current or former employees, but the benefits provided to such beneficiaries or participants are in consideration of personal services performed for the exempt beneficial owner.

B. Applying FATCA to Non-U.S. Retirement Plans and Investment Vehicles

As highlighted above, the key features of FATCA intertwine amongst themselves making the determination of FATCA compliance potentially very complex. Although each non-U.S. retirement fund or investment vehicle should complete its own analysis, there are some basic steps that can be taken in almost all cases.

1. Non-U.S. Retirement Plans

First, is whether the non-U.S. retirement plan is an FFI. Given the broad reading of FATCA adopted by the IRS, the answer is normally “yes.”

Second, does an exemption apply to the non-U.S. retirement plan such that it does not have to report to the IRS as an FFI? If the non-U.S. retirement plan’s country of residence has an IGA in force, it is very possible that the non-U.S. retirement plan may not have to report to the IRS and will be exempt from withholding (though it will still have to file a Form W-8BEN-E as explained below).

Third, if the non-U.S. retirement plan invests in investment vehicles that are subject to U.S. withholding (*e.g.*, a U.S.-based investment vehicle that makes payments to the non-U.S. retirement plan), has it determined that its assets are exempt from the 30-percent default withholding? A non-U.S. retirement plan may be exempt because (1) its assets are held in a retirement or savings account, which presumes that the FFI holding the account is either complying with or exempt from FATCA, or (2) it is an exempt beneficial owner (whether because of the exemptions in the relevant Regulations or an IGA). In all events, it may be necessary to provide the U.S. payor of withholding income a Form W-8BEN-E to ensure that the exemption from the 30-percent default withholding is recognized.

2. Non-U.S. Investment Vehicles in Which a U.S. Retirement Plan Invests

First, is the non-U.S. investment vehicle in which a U.S. plan invests (*e.g.*, an offshore investment fund) an FFI?

Given the broad reading of FATCA adopted by the IRS, the likely answer is “yes.”

Second, does an exemption apply to the non-U.S. investment vehicle such that it does not have to report to the IRS as an FFI to avoid U.S. withholding on its U.S. income? Unlike in the non-U.S. retirement plan context, there may not be an exemption, thus requiring the non-U.S. investment vehicle to report its U.S. retirement plan investor. Accordingly, many investment management and other subscription agreements will require a non-U.S. fund to represent and agree that it will comply with FATCA so that income from the investment will not be reduced by withholding. However, it may be necessary to provide the non-U.S. investment vehicle with information to ensure that an exemption from the 30-percent default withholding is recognized.

C. Individual Reporting Requirements

Separate and distinct from FFI and fund and/or investment vehicle disclosure or reporting are the rules that apply to U.S. individual taxpayers (*i.e.*, U.S. citizens or resident aliens).¹³ Unlike the many exemptions that can apply to limit the regulatory burden on funds or investment vehicles, other than certain baseline dollar thresholds, individual taxpayers are generally subject to reporting their non-U.S. retirement plan interests on Form 8938.¹⁴ Notably, the instructions specifically highlight the failure to report foreign pension benefits as disclosable items in its provisions discussing the penalties for failure to make proper FATCA disclosures.¹⁵ As more non-U.S. retirement plans become more visible to the IRS, proper reporting to the U.S. employees participating in these plans may become more important.

D. Conclusion

FATCA has many twists and turns. Thankfully, for many non-U.S. retirement funds and U.S. funds investing in non-U.S. investment vehicles, there may be exemptions or other relief that significantly reduce its administrative burden. However, to ensure compliance, these same funds and investment vehicles should carefully evaluate and document their compliance with FATCA’s myriad requirements. Lastly, although individuals are responsible for their own tax reporting, companies with a mobile workforce may also want to work to ensure that there are clear communications made to members of the mobile workforce regarding their own individual FATCA reporting responsibilities.

ENDNOTES

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¹ See www.irs.gov/uac/Offshore-Tax-Avoidance-and-IRS-Compliance-Efforts.

² See www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-FBAR.

³ Code Sec. 1471(d)(4) and Reg. §1.1471-5(d).

⁴ Reg. §1.1471-5(e).

⁵ See discussion regarding intergovernmental arrangements.

⁶ Code Sec. 1471(d)(1)(A).

⁷ Code Sec. 1471(d)(2).

⁸ Reg. §1.471-5(b)(2).

⁹ Notably, these exceptions do not apply to the individual reporting requirements under Code Sec. 6038D described below.

¹⁰ Code Sec. 1471(f). Retirement plans are not specifically listed, but this provision gives authority to the Secretary of the Treasury to exempt entities "posing a low risk of tax evasion."

¹¹ Reg. §§1.1471-6(f) and 1.1471-6T(f).

¹² See www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx. Annex II of the model IGAs specifically details the other

country's retirement funds that are treated as exempt beneficial owners. Such funds are also treated as "Non-Reporting Financial Institutions" under the terms of the model IGAs and are generally not subject to the reporting requirements that normally apply to an FFI.

¹³ Code Sec. 6038D.

¹⁴ Available online at www.irs.gov/pub/irs-pdf/f8938.pdf.

¹⁵ Available online at www.irs.gov/pub/irs-pdf/i8938.pdf, page 7.

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