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FATCA Creates New Issues for Cross-Border Stock and Other Incentive Compensation Plans

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When a multinational company implements product deployment, research, sales expansion and manufacturing on an international basis, it may want a unified approach to compensation incentives covering both U.S. and other foreign executives. This means a U.S. citizen or resident who works outside the U.S. and is in an incentive program designed by a non-U.S. employer can face surprising, often serious tax problems. A non-U.S. citizen who is assigned to the U.S. but stays in their home country incentive plan may also have U.S. tax problems. And now, new issues are arising from the U.S. Foreign Account Tax Compliance Act.

There are a number of issues around a "mobile" workforce, including pay levels, immigration status, moving families and career planning. One crucial area involves the application of incentive compensation plans based on global business plans, and not national boundaries. There are now new issues, arising from the Foreign Account Tax Compliance Act (FATCA). While Congress and the Treasury/IRS focused on abuse, noncompliance and reporting of foreign income subject to reporting, there are also nonabusive situations involving international operations and executive compensation. This advisory will look at these developments from the perspective of financial institutions administering these incentive plans, the individuals receiving incentive awards and the multinational employers sponsoring them.

Background on U.S. Tax Laws and Non-U.S. Tax Incentive Plans

Unlike most other countries' tax laws, the Internal Revenue Code ("IRC") takes a very aggressive approach to U.S. tax laws by extending their reach to the worldwide income of U.S. citizens and residents (resident either by physical presence in the U.S. or though immigration status – e.g., holding a "green card"), without regard to source or residence. The U.S. thus applies its domestic tax laws to other countries' compensation structures. What this means is that a U.S. citizen or resident who works outside the U.S. and winds up in an incentive program designed by a non-U.S. employer can face surprising, and often serious, tax problems. Correspondingly, a non-U.S. citizen who is assigned to the U.S. and who stays in the home country incentive plan may have significant U.S. tax problems.

If the incentive program is "unfunded," most of the issues around individual taxation have been handled by the IRS in the regulations under IRC section 409A. What this means is that certain deferred compensation programs, executive pensions, and deferred stock unit plans and stock option plans have special rules for non-U.S. plans and the U.S. taxpayers who find themselves covered by these plans. This is not to say that multinational companies can ignore the 409A rules, but there may be additional time to correct these problems, or to comply with special rules for employees who are subject to U.S. tax 409A rules for the first time.

When it comes to plans that are considered "funded," the general rules of IRC section 409A do not apply, and the individual taxpayers, their employers, and in some cases the financial institutions holding the funds or equity have significant problems. For example, a U.S. taxpayer who has an interest in a non-U.S. trust that holds employer stock or other financial assets may face taxation in advance of actual distribution of the assets. The employee may also be facing a non-tax Treasury filing under the Report on Foreign Bank and Financial Accounts (FBAR) requirements. This report has been required for some time, but the U.S. Treasury has indicated there will be increased enforcement of this filing. There have been particular issues with FBAR reports required for foreign accounts over which a U.S. taxpayer has signature authority. These filings can also sweep in some forms of incentive and deferred compensation plans. Reporting for most U.S. taxpayers with only signatory authority was delayed to June 30, 2012, and then again to June 30, 2013.

Enter FATCA

The new twist to this old problem is the 2010 U.S. legislation, the Foreign Account Tax Compliance Act. This legislation is grounded in the strong U.S. policy to enforce its worldwide taxation of U.S. citizens and residents. In attacking what the U.S. views as widespread underreporting of U.S. taxable income related to assets held outside the U.S., the U.S. decided to increase enforcement not only through aggressive monitoring of individuals' non-U.S. assets, but more alarmingly, through forcing "foreign financial institutions" (FFIs) to find and disclose any U.S. taxpayers holding assets in these non-U.S. funds. The penalties on the institutions are severe, to the point that some institutions are considering removing all U.S. taxpayer "customers" from their funds, rather than face the penalty of 30% withholding on all U.S. source income or gross payments to the fund. In addition to the new tax rules applied to FFIs, there were also new statutory requirements for individuals holding "foreign financial assets" under IRC section 6038D.

In addition, FATCA has rules applying to individuals under IRC section 6038D. While this does not give rise to new taxation for the individuals, it does highlight the U.S. tax issue for the individuals. And although the form implementing this IRC section 6038D (Form 8938) is for the individuals holding the assets outside of a financial account and meeting certain threshold dollar amounts, and not the FFIs, there are good reasons for employers sponsoring non-U.S. incentive plans to consider communicating with employees who may be required to file the form and to alert their plan administration providers to the U.S. taxpayer status of some participants.

Key Issue: Is It a Fund?

The typical U.S. incentive compensation program would usually not involve any type of "fund" held by a financial institution. The program might provide for some form of incentive units (e.g., stock appreciation rights or restricted stock units), where the underlying shares would not be held in a separate fund, but rather would be "phantom" units measuring amounts the employer would pay in cash or stock to the employee at a later date. Likewise, a U.S. incentive compensation program may provide for stock options or future grants of stock, which would normally be satisfied by the employer from treasury stock or, occasionally, from newly issued stock. This structure, however, if moved outside the U.S., would be a FATCA problem. FATCA will require an individual U.S. taxpayer to report on Form 8938 (although there is no need for a duplication of filing if Form 3520 or 8891 are filed) the ownership of employer stock issued by a foreign corporation and options and other similar rights on such stock as well as capital and profits interests in a foreign partnership, unless held in a foreign financial account or by a U.S. brokerage account.

Further, there are many countries where it is customary for assets, including employer stock, to be held in trusts, or in non-Anglo-Saxon jurisdictions, to be held in funds such as a *Stichting* (often translated as “foundation” in English). These structures can present significant tax issues for individuals who are “beneficiaries” of such funds. The issues include troublesome reporting, and sometimes taxation on the amounts held in these funds. This has been a problem for some time, and in some situations commentators have concluded that the employer has such control of the funds that the U.S. tax analysis is that the fund is a “grantor trust” of the employer, and is ignored for U.S. tax purposes. Thus the employee is not taxed even on his vested benefit in a rabbi or grantor trust until he receives a distribution.

With FATCA, this problem now spreads to the FFI holding these assets. While the financial institution may view itself as an administrative structure to help the employer, it may be an FFI holding financial accounts. Now the FFI has to worry about whether there is a U.S. taxpayer participating in that incentive program.

Some Practical Examples

Let’s take a look at what employers, employees and FFIs have to worry about with regard to U.S. tax laws and FATCA when dealing with incentive plans.

Start with the situation where a U.S. citizen is hired by a multinational to work outside the U.S., for example in the UK. As part of the compensation package, the individual is covered by a UK equity-based incentive compensation plan. These plans are frequently linked to an offshore (non-UK, and certainly non-U.S.) trust holding the stock, with the trustee being a part of a financial institution which assists in administering the plan. Under U.S. domestic tax law, the surrounding documents may permit the conclusion that the trust is a grantor trust of the employer, and that the employee (including any U.S. taxpayer employee/participant) may not be considered to hold any asset. However, the documents might also lead to the conclusion that the trust is not an employer grantor trust, and that the individual may have an enforceable beneficial interest in that trust. If that is the case, the U.S. will look to its rules around funded compensation plans, and this type of situation is not generally protected by the U.S.-UK income tax treaty. While there may be many other applicable exemptions for the FFI under FATCA, the particular FFI may not meet those exemptions. Of course, the individual will still have the new IRC section 6038D reporting requirement, as well as possible U.S. taxation (if the beneficial interest is vested). The employer will have the traditional issues around reporting and withholding on compensation taxable for employee services.

Let’s look at another situation. Suppose a citizen of the Netherlands is sent by the Dutch employer to work in the U.S.. It may not be clear how long the assignment will last. As is often the case, the employee might stay in the Netherlands-designed incentive program, and that program might be administered through a *Stichting* or some other Civil Law structure. While it is far from clear how the U.S. characterizes the *Stichting* for U.S. tax purposes, the interests of the individual may well be protected from creditors of the Netherlands employer, and all the U.S. tax issues of compensation through a funded plan are on the table.

Conclusion

It would seem that at a minimum, non-U.S. employers and FFIs supporting equity and funded incentive programs will have to look to new procedures to find U.S. taxpayers in their non-U.S.-designed incentive plans. Foreign financial institutions are already facing the huge problem of finding U.S. taxpayers among its customers and investors, and this issue will be just another exercise in detailed process creation. However, unlike the approach of some FFIs in just getting rid of U.S. taxpayer customers, the foreign incentive plan sponsors may find it very difficult to "get rid of" U.S. participants in their incentive compensation programs. The IRS has made compliance with U.S. tax liability for assets held outside the U.S. a high priority. This is evidenced in many areas of newly imposed or enforced tax disclosure, reporting, withholding and assessment. There are many individual tax compliance issues that will probably be addressed outside FATCA. But the story doesn't end there. First, employers and FFI administrators will have to take a closer look at what happens if U.S. taxpayers are in their non-U.S.-designed incentive programs, and mobile executives who are U.S. taxpayers need to consider whether they must file a FBAR report and/or a Form 8938, and second, what that means for the FFI, the employer and the employee.

If you have questions about the content of this publication, please contact the Pillsbury attorney with whom you regularly work or the attorneys below.

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