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New FATCA Regulations Solve Some Issues for Pension Plans, But Other Problems Remain

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For multinational companies, it is increasingly common to move key employees in and out of different countries – a practice that can trigger a variety of issues. New regulations proposed in February offer some relief for companies with an international workforce, as they indicate that most non-U.S. pension plans will be treated by the U.S. as "deemed compliant" with Foreign Account Tax Compliance Act (FATCA). But multinational employers still have reasons to look closely at pension-based U.S. tax liabilities affecting mobile employees.

There are many issues around a "mobile" workforce, including pay levels, immigration status, moving families and career planning. One small, but increasingly troublesome aspect of a company's international operations and employee mobility problems involves pensions and retirement plans. The issues in this area have existed for a long time, but will not go away, notwithstanding treaty changes and favorable regulatory developments. But in at least one area, the application to pension and retirement plans of the Foreign Account Tax Compliance Act seems to have settled on a reasonable approach for some entities, based on the proposed regulations that came out in early 2012 under this Act. While this is a development to be applauded, other issues will remain. This advisory looks at the developments in this area from the perspective of financial institutions supporting pension plans, as well as from the perspective of the individuals participating in these plans and the multinational companies sponsoring them.

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

The U.S. takes a very parochial view of pensions under U.S. tax law. It starts with the internationally unusual position that U.S. citizens and residents (resident either by physical presence in the U.S. or though immigration status – holding a "green card") are taxable on worldwide income, without regard to source or residence. The U.S. then applies its domestic tax laws to other countries' pension and deferred compensation plans. What this means is that a U.S. citizen or resident who works outside the U.S. and is covered by a non-U.S. pension or a supplemental executive retirement plan or "SERP" (a type of nonqualified deferred compensation plan) has to apply U.S. tax laws to the taxation of that pension. For unfunded pensions and SERPs, there are a number of important exceptions under U.S. tax law for foreign plans (for example, under section 409A of the Internal Revenue Code of 1986, as amended ("IRC") and the regula-

tions). But unfunded plans are not the only retirement plans found in those countries that are the major trading partners to the United States.

For funded plans, the rules are very harsh: the U.S. views all foreign pension plans, including ones registered or approved by the local tax authority, as “nonqualified” for favorable U.S. taxation. This means that if the employee has a “vested” (nonforfeitable) interest in the plan, then the employee has current income while earning the pension, taxable well before anything is paid out. This rule has extremely complicated tax aspects to it, and for many years was not diligently enforced by the IRS. There are some U.S. income tax treaties that reduce, or in some cases eliminate U.S. tax, but these treaty provisions require careful analysis, as well as intricate procedural hurdles for both the employee and the employer in order to get the favorable tax results. The result is that the employees participating in non-U.S. pension plans may well face current tax without any cash and the employer may have reporting and withholding requirements.

FBAR and Pensions

The U.S. has a great concern about U.S. taxpayers' underreporting of non-U.S. situs income. Over the years, the U.S. has approached compliance in a number of ways. A longstanding approach has been to have U.S. persons with a financial interest in or signature authority over foreign financial accounts file a Report on Foreign Bank and Financial Accounts (FBAR). This is not a tax return, but a report to the U.S. Treasury on the existence of the account and a description of it. This report has been required for some time now, but the U.S. Treasury has indicated there will be increased enforcement of this filing. There have been particular issues over reports required for financial accounts over which a U.S. taxpayer has signature authority. These FBAR filings can also sweep in some pensions and deferred compensation plans. The reports for most taxpayers with signature authority were delayed to June 30, 2012, and then delayed 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 (FATCA). 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 also, through forcing “foreign financial institutions” (FFIs) to find 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 that face the U.S. 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.

Exit FATCA?

There was considerable concern about the application of FATCA to non-U.S. pension plans. The fear was that any non-U.S. funded pension plan that had any U.S. taxpayers as participants would be exposed to the new FATCA rules on FFIs. Many comment letters were sent to the U.S. Treasury and IRS on this issue, and in response, the new regulations (proposed in February 2012) take a very sensible position that most foreign pension plans would be treated by the U.S. as “deemed compliant” with the FATCA rules. There are separate requirements for certain foreign retirement plans and corresponding plans covered by U.S. tax treaties with other countries (“Corresponding Plans”) to obtain “certified deemed compliant status” and to be treated as an exempt beneficial owner under the FATCA rules.

In general, in order for a foreign retirement plan to obtain certified deemed compliant status it must (i) be organized for the purpose of providing retirement or pension benefits under the law of each country in which it is established or operates, (ii) contributions must consist of only employer, employee or government contributions and must be limited by reference to earned income, (iii) no single beneficiary may have a right to 5% or more of the FFI's/plan's assets, and (iv) (a) 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, (b) the plan's investment income must be exempt from tax under the laws of the country in which it is established or operates due to its status as a retirement plan or (c) the pension plan or the FFI/plan must receive 50% or more of its total contributions from the government or employers. The retirement/pension plan must certify its status as a deemed compliant FFI by providing the withholding agent with supporting documentation that it meets these requirements.

Corresponding Plans are those which are recognized under U.S. tax treaties and will be treated as exempt beneficial owners if they (i) are established in a country with which the U.S. has an income tax treaty, and are generally exempt from income taxation of that country, (ii) are operated principally to administer or provide retirement or pension benefits, and (iii) are entitled to benefits under the treaty on income that satisfies any applicable limitation on contributions or benefits requirement.

There are also special rules for individual accounts held by a foreign pension or retirement plan meeting the above requirements, small plans and retirement savings accounts.

These exemptions should relieve many non-U.S. pension plans from the burdensome requirement to find any U.S. taxpayers who happen to be in the plan. In that way, the pension plan will not have to worry about the very significant "club" of the U.S. imposing a 30% withholding on all U.S. source payments, but it does not relieve the individuals from their U.S. tax burden under U.S. tax laws relating to participation in a funded, nonqualified plan, nor does it relieve their employers from reporting and withholding on these taxable amounts.

Even though FATCA will provide this relief to many foreign retirement plans, the FATCA rules applying to individuals under IRC section 6038D were not relaxed, and indeed, the IRS released a new Form 8938 in late 2011. Form 8938 (IRS version) specifically requires reporting by U.S. taxpayers who participate in foreign pension plans (although there is no need for duplicative filing if Forms 3520 or 8891 are filed). While this is a form for the individuals participating in a foreign pension plan, and not the FFIs holding the assets, there are good reasons for employers sponsoring non-U.S. pension plans to consider communicating with employees who are required to file the form.

Application to Employees and Employers

Let's take a look at what employers and employees have to worry about with regard to U.S. tax laws and non-U.S. pension plans. Here are some examples.

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 UK compensation package, the individual is covered by a UK pension plan. These plans are generally funded, and vest quickly. Under U.S. domestic tax law, that individual is taxable on the annual contributions or accruals in that pension plan to the extent vested. It is true that the U.S. and the UK have an income tax treaty that protects some U.S. taxpayers from U.S. taxation on these contributions or accruals, but there are a number of complex details and procedures for claiming that protection, and the protection is limited to the amount that the U.S. permits for U.S. tax qualified plans. So even in a "treaty protected" situation, the individual may have U.S. taxable income attributable to participation in the foreign pension plan.

So what are the FATCA results for this situation? It would appear that the FFI holding the foreign pension plan assets has relief (although some commentators are still questioning this), but under the new 2011 IRS Form 8938, the individual must declare this interest. In most situations, it is likely that the interest is U.S. taxable income. And while this new IRS Form does not add to the individual's U.S. tax liability (it exists independent of FATCA), it does add another layer of compliance to this situation. As a technical matter, the employee has taxable income, and the employer has reporting and withholding requirements. Even if a treaty protects 100% of the interest from U.S. tax, this is not automatic and requires compliance with the procedures for treaty relief.

Let's look at another situation. Suppose an Australian citizen is sent by the Australian employer to work in the U.S. It may not be clear when sent how long the assignment will last. As is often the case, the Australian would stay in the Australian-funded, mandatory "superannuation" plan. Under complex U.S. tax rules, that Australian may become a U.S. resident on an unpredictable (unpredictable by the employer) date. Once a U.S. resident, the Australian will become taxable by the U.S. on the superannuation plan (without any distribution). There is a U.S.-Australian income tax treaty, but it does not protect tax in this situation. It appears that the FATCA issue is solved for the Australian superannuation plan, but not the problems of reporting, withholding and paying tax that fall on the employer and employee.

Employer Response

It would seem that at a minimum, employers will have to establish new procedures to find U.S. taxpayers in their non-U.S. pension plans. FFIs are already facing the huge problems of finding U.S. taxpayers among their customers and investors, and this pension 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 pension plans may – depending upon local laws – find it very difficult to "get rid of" U.S. participants in their pension plans.

Conclusion

The U.S. has made compliance with its view of 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. However, there are many individual tax compliance issues that will probably be addressed outside FATCA. The hoped-for IRS result of an exemption from FATCA for many non-U.S. pension plans has occurred, but multinational employers have other reasons to look closely at the pension-based U.S. tax liabilities associated with its mobile workforce.

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