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INTERNATIONAL BENEFITS ALERT

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Treasury Issues Proposed FATCA Regulations and Expands Foreign Retirement Plan Exemption

As mentioned in our February 10, 2012, *Benefits Byte*, the Internal Revenue Service (IRS) on February 8, 2012, proposed detailed new regulations under the Foreign Account Tax Compliance Act, known as "FATCA". These proposed regulations include important exemptions for some, but not all, non-US retirement plans. We highlight key aspects of the proposed rules below.

FATCA generally imposes a 30% withholding beginning in 2014 on most US-source investment income of foreign financial institutions (FFIs) unless the FFI agrees to search for and disclose their US customers with financial accounts to the IRS and to withhold on certain payments (known as "pass-through withholding"). Foreign retirement plans would come within the basic definition of an FFI, and thus any exemptions from the FATCA rules for foreign retirement plans are quite important to many companies.

The proposed regulations also indicate that the Treasury Department is consulting with certain foreign governments on an alternative approach to FATCA implementation for those countries. A press release names the UK, France, Germany, Italy, and Spain as the countries currently in discussions, but the number may expand.

Types of Exemptions

The proposed FATCA regulations are complex and over 389 pages. They essentially provide a set of exemptions for foreign retirement plans with different characteristics. Though not labeled in the proposed regulations as such, for clarity, we will describe these exemptions as the Defined Contribution (DC) Plan Exemption, the Retirement Savings Account (RSA) Exemption, the Tax Treaty

Exemption, and the Defined Benefit (DB) Plan Exemption, based on the types of arrangements each primarily seems to cover.

1. The DC Plan Exemption

One exemption would apply primarily to plans with multiple individual accounts, such as defined contribution plans. That exemption provides that a retirement funds 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; and either:

(1) 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 five percent 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 percent or more of the total 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 from the government and the employer; or

(2) 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 a FFI or a passive non-financial foreign institution (passive NFFE);

(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 percent 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 $250,000 of the FFI's assets.

Observations: This DC Plan 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 any contributions are either 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, though, and such plans also have limits on participation by individuals not resident in the county in which the FFI is established and the account value of the nonresidents must be less than $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 that point.

2. <u>Retirement Savings Account (RSA) Exemption</u>

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

(1) The account is held by a retirement or pension fund that meets the DB Plan Exemption discussed below; or

(2) 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 laws of the country in which the FFI that maintains the account is established or in which it operates, and meets the following requirements –

(i) The account is tax-favored with regard to the jurisdiction in which the account 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 $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 $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 exempt the FFI holding the account itself, and 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 exemption, like the other exemptions discussed in this memo, also does not apply for purposes of whether the executive may have an individual reporting obligation in connection with their personal tax return with respect to that account under FATCA

3. The Tax Treaty Exemption

The proposed regulation provides a fairly broad exemption for corresponding plans under tax treaties with the US to be treated as an exempt beneficial owner of the withholdable income. A fund meets this exemption if it:

(1) Is established in a country with which the US has an income tax treaty in force and is generally exempt from income taxation in that country;

(2) Is operated principally to administer or provide pension or retirement benefits; and

(3) 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 benefits requirement.

Observations: The third prong of this exemption will generally limit its application to plans which 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.

4. The DB Plan Exemption

The proposed regulation also 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:

(1) Is formed for the provision of retirement or pension benefits under the law of the country in which is established;

(2) 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;

(3) Does not have a single beneficiary with a right to more than five percent of the entity's assets; and

(4) 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 percent 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 that case the participant and not the retirement fund will often be the "beneficial owner" of the investments. The example indicates that the plan may instead separately satisfy the RSA Exemption, or, presumably the DC Plan Exemption, discussed above.

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 promulgate a form for that withholding certificate, probably part of the W-8 series, and that the instructions to that form will indicate the supporting evidence required for an exemptions.

Summary/Next Steps

These proposed IRS regulations substantially expand the foreign retirement plan exemption from FATCA withholding beyond what had initially been indicated. In particular, 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. However, exempt plans will still need to provide certification of their exemption and supporting documentation.

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 requesting to testify at the hearing in Washington, DC on May 15. The ABC can assist with this, and you can contact Lynn Dudley, Senior Vice President, Policy at 1.202.289.6700 for more information. In addition, 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.

New European Commission White Paper on Pensions Published – Personal Pension Plans, Gender Neutrality, Cross Border Arrangements Encouraged

The long-awaited European Commission White Paper on European pensions was finally issued on February 16. It can be found on the europa.eu website. Generally, the paper calls for a strengthening of the second (employer-based) and third (individual savings) pillars of the European pension systems. The paper is critical of pay-as-you-go pension systems, and more favorable towards personal pension plans, including defined contribution plans, which some believe may encourage more financial institutions to enter that market. As expected, it also includes proposals to increase the length of working lives and encourage cross-border labor movement, both controversial.

The proposal also aims at reducing the gender gap in European pensions. (Recently, the European Court of Justice (ECJ) ruled that insurers cannot charge different premiums to men and women because of their gender. The requirement for unisex insurance premiums and benefits applies beginning December 21, 2012, giving national governments and the European insurance industry time to adjust.)

The White Paper indicates that the Commission will undertake a new legislative proposal on transferability of pensions. The Commission will consider, in the context of the ongoing revision of the IORP directive (expected to be issued later in 2012 or 2013, with implementation in 2014-2015) and the proposal for a portability directive, how the provision of the required information for pensions tracking across borders can be ensured, and it will support a pilot project on cross-border tracking. However, the report recognizes that tax obstacles remain one of the main issues for the development of cross-border pension vehicles, and the Commission intends to continue to investigate tax rules and would initiate litigation where necessary, as it has done with some success in recent years.

The Commission further indicates that it plans to develop a code of good practice for pension schemes, dealing with the payout phase, risk-sharing and risk mitigation, cost-effectiveness, and dealing with financial volatility and counter-cyclicality in investing.

The White Paper is not self-executing, but the paper indicates that the Commission intends to support its legislative implementation (including financially) by individual countries through it's Community Programme for Employment and Social Solidarity (PROGRESS) and the future Programme for Social Change and Innovation.

France Exempts Certain Foreign Pension Trusts from New Wealth Tax

A tax law enacted in July, 2011 by France as Article 14 of the 2011 Amended Finance Act created a new system of taxation for foreign trusts of which the beneficiaries or settlors were either physically present in or fiscal residents of France. This was an interesting development to students of civil law, because civil law generally does not have a concept of trusts. A new Article 990 J of the CGI (the French tax code) imposes a wealth tax which must be reported and paid by the foreign trustee, with substantial penalties for noncompliance. This new law was something of a concern to pension trusts in other countries such as the US, which seemed initially to be covered by the law. In Rescrit N° 2011/37, a ruling issued on December 23rd, 2011, however, the DGI (the French tax authority) exempted trusts subject to the law of a country that has a tax treaty with France if the trust is established to manage the pension rights acquired, in respect of their professional activity, by the beneficiaries in a pension plan established by a company or a group of companies. Thus, US qualified plan trusts are off the hook, but multinational companies may wish to consider whether there are any other plan trusts in other jurisdictions with French taxpayer beneficiaries but where there is no French tax treaty and they may have an issue.

Update on the Status of Puerto Rico Plan Guidance

Notice 2012-06, published at the end of 2011, extended (1) the deadline for spinning off a Puerto Rico (PR) only plan investment in a group trust "until a deadline to be set forth in future published guidance" for PR-only plans invested in group trusts as of January 10, 2011, and (2) the separate deadline for spinning assets out of a US qualified plan trust attributable to PR residents to a PR-only trust until December 31, 2012 (a one-year extension) for all US qualified plans. The reason given for the latter extension is to give plan sponsors time to evaluate the newly revised Puerto Rico code (which made significant changes to retirement plan requirements) and determine whether to spinoff the PR employees into a PR-only plan. For more information, please see a summary of the new guidance prepared by Groom Law Group.

In a recent meeting with Treasury, representatives indicated that they extended the transition relief (allowing spinoffs to PR-only plans without immediate tax consequences and continued participation in group trusts for the PR-only plans) because they are still grappling with certain issues. One of their primary concerns is an international tax issue. Basically, they have represented to US treaty partners that the group trusts are US trusts and are concerned that allowing PR-only plans to continue to participate in US group trusts indefinitely would cause international tax problems for the government. They are also concerned about a sourcing of income problem upon distribution to participants. There was a good discussion of these issues, both the practical concerns as well as technical legal points. In response to our suggestion for a possible approach to sidestep the treaty hurdles, Treasury/IRS representatives asked for the average percentage of PR plan assets in a group or master trust and indicated that if the percentage is very small (which everyone from the private sector thought it would be), that might help validate a potential decision to allow the plans continued access to group trusts. However, they seemed skeptical of simply treating the PR plans like US 401(a) qualified plans (under ERISA Section 1022(i)(1), which essentially states that for purposes of 501(a) a PR plan can be treated as a 401(a) qualified plan). They seem to think of 1022(i)(1) as a limited purpose statute (relating to the tax-free status of the trust) that would not cover the treaty representations.

Clearly in response to their request for comments in Notice 2012-06, they are looking for alternative arguments which would allow the PR plans to invest in the group trusts (other than the 401(a) argument) and even mentioned possibly allowing other entities into these trusts (specifically mentioning VEBAs). The comment letters are due April 16.

In other news, the Puerto Rico Treasury Department ("PR Treasury") recently issued Circular Letter No. 12-02 ("CL 12-02") giving the option to certain trusts funding PR qualified retirement plans (including "dual-qualified" plans - plans that are qualified both in the US and PR) to file a copy of a plan's Form 5500, Annual Return/Report of Employee Benefit Plan, or Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan (hereinafter, collectively referred to as "Form 5500"), instead of PR Treasury Form 480.70(OE), Informative Return for Income Tax Exempt Organizations, in order to comply with the annual filling requirement imposed by the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 PR Code").