

## New FATCA Reporting Obligations Applicable to Compensation—Action Required for 2011 Tax Returns

The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010. One of the purposes of the new law was to strengthen enforcement of those US tax rules that provide for taxation of worldwide income (including income relating to another country's compensation programs) in response to the government's perception that US taxpayers were underreporting assets held outside of the United States.

FATCA added section 6038D to the Internal Revenue Code. The provisions of section 6038D, which are effective for tax returns filed for tax years beginning after 2010, require specified persons who have an interest in a specified foreign financial asset (SFFA) to attach to such persons' individual US tax returns (Form 1040; Form 1040-NR) certain information relating to such holdings. The reporting is to be done on Form 8938.

The definition of an SFFA is broad enough to include certain elements of compensation provided by companies to US taxpayers and very little definitive guidance has been issued as to the reporting requirements. Nonetheless, even though there are still many open questions relating to the reporting requirements, the obligation to report has not been suspended or deferred. The reporting obligation falls on the individual and the actual reporting is based on facts and circumstances that are unique to the individual.

A company has no reporting obligation even though it is likely that a significant portion of an employee's or director's non-US assets may come from, or be attributable to, compensation. Therefore, although companies have no obligation to do so, they may want to remind their employees and directors about the reporting obligations and provide them with some assistance in determining what types of company-provided compensation may need to be reported. It is important, however, for companies to avoid providing tax advice and for their employees and directors to consult their own tax advisors.

### What is an SFFA?

For purposes of the new reporting rules, an "SFFA" is defined as (i) any financial account maintained by a foreign financial institution and (ii) any of the following assets that are held for investment and are not held in an account maintained by a US financial institution (Other SFFAs): (a) stock or securities issued by a non-US person, (b) any financial instrument or contract that has as an issuer or counterparty a non-US person, or (c) any interest in a foreign entity. Reporting is required only if the aggregate value of all of the SFFAs in which the person has an interest exceeds the threshold applicable to the reporting person as discussed below.

An asset is an Other SFFA only if it is held for investment. An asset is held for investment for purposes of the new reporting rules if the asset is

not used in, or held for use in, the conduct of a trade or business of a specified person (the “trade or business test”). An asset meets the trade or business test and, accordingly, is not held for investment, and so would not be an Other SFFA, if it is (i) held for the principal purposes of promoting the present conduct of a trade or business, (ii) acquired and held in the ordinary course of business, or (iii) otherwise held in a direct relationship to the trade or business. Normally, items of compensation would not meet the trade or business test and so, to the extent applicable, would be treated as an Other SFFA.

The following are examples, set forth in the limited IRS guidance available, of the types of interests that be considered to be an SFFA:

- Financial Accounts: any depository or custodial account maintained by a foreign financial institution (other than interests regularly traded on an established securities market); an equity or debt interest in a foreign financial institution; and a financial account maintained by a financial institution that is organized under the laws of a US possession.
- Stock issued by a foreign corporation.
- Capital or profits interest in a foreign partnership.
- Note, bond or debenture or other form of indebtedness issued by a foreign person (e.g., deferred and incentive compensation arrangements maintained by foreign persons, severance arrangements or agreements maintained by a foreign person or any other compensatory arrangements where the entity responsible for payment is a foreign person).
- Interest in a foreign trust or estate.
- Interest in a foreign retirement plan or deferred compensation plan.

- Options or other derivative instrument with respect to the foregoing (e.g., stock units or phantom stock units with respect to stock of a foreign company).

Reporting of SFFAs is not required if a reporting exception applies, including the following:

- Assets held in a financial account that is a US payer, such as a US financial institution or, in most cases, a US branch of a foreign bank.
- Assets held in a financial account maintained by a securities broker or dealer if certain requirements are met.
- Assets for which other specified reporting is required (but the values reported on such other forms must be taken into account for purposes of determining whether the thresholds are met).

### Who Needs to Report/Thresholds?

Generally, the reporting obligations are applicable to specified persons who have an interest in SFFAs with values in excess of the applicable reporting threshold. For purposes of the reporting rules “specified persons” are: (i) US citizens, (ii) resident aliens, (iii) non-resident aliens who make an election to be treated as a resident alien for purposes of filing a joint tax return, and (iv) nonresident aliens who are *bona fide* residents of American Samoa or Puerto Rico. Special rules may apply to resident aliens.

Reporting is required only if the value of the SFFAs in which the specified person has an interest exceeds the threshold amount applicable to such person. Generally, the threshold varies depending on whether the person files a single or joint tax return and whether or not the person is living the United States as noted in the following table:

| FILING STATUS                            | LOCATION WHERE SPECIFIED PERSON LIVES | AGGREGATE VALUE OF SFFAs    |                             |
|--|---------------------------------------|-----------------------------|-----------------------------|
|  |                                       | ON THE LAST DAY OF THE YEAR | AT ANY TIME DURING THE YEAR |
| Single or Married Filing Separate Return | US                                    | \$50,000                    | \$75,000                    |
| Married Filing Joint Return              | US                                    | \$100,000                   | \$150,000                   |
| Single or Married Filing Separate Return | Outside US                            | \$200,000                   | \$300,000                   |
| Married Filing Joint Return              | Outside US                            | \$400,000                   | \$600,000                   |

A specified person is treated as living outside the United States if that person is either (i) a US citizen who has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire tax year or (ii) a US citizen or resident who is present in a foreign country or countries at least 330 full days during any period of 12 consecutive months that ends in the tax year being reported.

### How is Value Determined?

If a specified person has a reportable interest in an SFFA, the maximum value must be reported on Form 8938. Generally, the maximum value is a reasonable estimate of the highest fair market value (FMV) of the asset during the reporting year. Of course, with respect to certain types of compensation that constitute SFFAs, the FMV is not clear or readily determinable. The following principles govern valuation:

- A third-party appraisal is not required.
- If an asset has no positive value, the reporting value for the asset is zero.
- If the asset's value is denominated in foreign currency, the maximum value has to be determined in the foreign currency and then converted to US dollars.

- Generally, assets are valued as of the last day of the year (unless there is reason to believe that such value does not reflect a reasonable estimate of the maximum value of the asset during the year).
- The value of an interest in foreign pension plans and foreign deferred compensation is the FMV of the person's beneficial interest in the assets of the plan as of the last day of the year; however, if the person does not know or have reason to know (based on readily accessible information) the FMV as of the last day of the year, the maximum value is the FMV of the amount of cash or other property distributed during the year.

### Penalties

The penalties for failure to report are significant. The failure to file Form 8938 (including penalties for incomplete filing or late filing) can result in a penalty of up to \$10,000. If the IRS issues a notice of failure to file, an additional \$10,000 penalty applies for each 30-day period (or part thereof) during which a continued failure continues, up to a maximum of \$50,000.

Although the reporting on Form 8938 does not, itself, affect the amount of taxes payable with respect to SFFAs, if a person underpays tax as a

result of a transaction involving an undisclosed SFFA, a penalty of 40 percent of the underpayment may be imposed.

Fraud and criminal penalties may also apply.

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*For more information about the issues raised in this Legal Update, please contact the member of our Employment and Benefits Department who regularly advises you, or one of the lawyers listed below.*

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