

FATCA COMPENSATION REPORTING: NEW RULES MAY REQUIRE REPORTING OF NON-U.S. SOURCED COMPENSATION TO THE IRS

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To Our Clients and Friends:

In an effort to shake out hidden assets and prevent tax avoidance, Section 6038D of the Internal Revenue Code requires specified individuals — including executive officers, employees, directors, and partners — to disclose their interests in “specified foreign financial assets” on a new Form 8938, which must be attached to the person’s annual tax return. Rather than merely shaking the branch, however, the required disclosure is tantamount to a clearing of the entire forest — with many ordinary and innocuous compensation arrangements seemingly getting swept up in the definition of “specified foreign financial assets,” even for individuals employed in the United States. The current guidance is sparse, but because of the adverse consequences of not properly reporting (described below), until the IRS provides clarity or an exemption from reporting, the following compensation arrangements may be treated as “specified foreign financial assets” that must be disclosed:

- interests in retirement plans and deferred compensation plans maintained by non-U.S. entities;
- options to acquire the stock of non-U.S. entities and stock appreciation rights in respect of non-U.S. entities;
- restricted stock and performance stock of non-U.S. entities as well as restricted stock units, performance stock units in respect of a non-U.S. entity’s stock; and
- compensatory partnership and LLC interests in a non-U.S. entity.

Any individual who participates in such foreign compensation arrangements should consult with his or her return preparer to ensure the arrangements are disclosed as and to the extent required.

Penalties: Any individual who fails to properly disclose his or her interests in “specified foreign financial assets,” other than for “reasonable cause,” will be subject to a fine of at least \$10,000. The penalty can be as high as \$60,000 if the failure to disclose continues after the IRS notifies the individual that he or she should have, but failed to, disclose his or her interest in the assets.

In addition to these fines, under Section 6662 of the Code, the individual will be subject to an additional 40% tax on the amount of any underpayment of tax (that is, if the individual failed to timely pay a tax that is due) that is attributable to any “specified foreign financial asset” that is not properly disclosed.

Deadlines and Statute of Limitations. The Form 8938 must be filed with the individual’s income tax return on the due date for the return, together with any extensions (that is, generally April 15, 2012 for the 2011 tax year or October 15, 2012, if a request for an extension is timely filed).

Under Section 6501(c) of the Code, in the case of any information that is required to be reported on the Form 8938, the statute of limitations for assessing a tax with respect to any event or period to which the information relates will not expire until three years after the IRS is provided the information required to be reported on the form. Technically, the statute of limitations for a tax year will not begin to run if an asset that is required to be reported on Form 8938 for that year has not been reported.

Who Has to File? A U.S. citizen, a resident alien of the United States for any part of the tax year, a nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint income tax return, and a nonresident alien who is a bona fide resident of American Samoa or Puerto Rico, in any case who has an interest in specified foreign financial assets that meet the following reporting thresholds is required to file a Form 8938:

- For taxpayers living in the U.S., unmarried taxpayers and married taxpayers filing separate returns must file a Form 8938 if the total value of the taxpayer’s specified foreign financial assets is more than \$50,000 on the last day of the tax year or more than \$75,000 at any time during the tax year, and married taxpayers filing a joint income tax return must file a Form 8938 if the total value of the couple’s specified foreign financial assets is more than \$100,000 on the last day of the tax year or more than \$150,000 at any time during the tax year.
- For taxpayers living abroad, the thresholds increase to \$200,000 on the last day of the tax year or more than \$300,000 at any time during the year for individual filers and \$400,000 on the last day of the tax year or more than \$600,000 at any time during the year for taxpayers filing a joint return.

What is a Specified Foreign Financial Asset? A “specified foreign financial asset” is (a) any “financial account” maintained by a foreign financial institution or (b) any other foreign financial asset that is held for investment that is not in an account maintained by a U.S. or foreign

financial institution, including stock or securities issued by someone other than a U.S. person, any interest in a foreign entity, and any financial instrument or contract that has as an issuer or counterparty that is other than a U.S. person.

A “financial account” is any depository or custodial account maintained by a foreign financial institution and any equity or debt interest in such an institution, other than interests that are regularly traded on an established securities market, and includes an account that is maintained by a financial institution that is organized under the laws of a U.S. possession. While a person must report an interest in a foreign financial account, the person does not have to disclose the assets that are held in the account. Foreign mutual funds, foreign hedge funds and foreign private equity funds are “foreign financial institutions.” Importantly, a financial account that is maintained by a U.S. payer (such as a domestic financial institution, a domestic branch of a foreign bank or foreign insurance company, or a foreign branch or foreign subsidiary of a U.S. financial institution), is not considered a specified foreign financial asset and does not have to be reported on a Form 8938.

Examples of “specified foreign financial assets” other than a “financial account” include stock issued by a foreign corporation, a capital or profits interest in a foreign partnership, debt obligations issued by a foreign person, deferred compensation payable by a foreign person, and an option or other derivative interest in any of the foregoing. Generally, a person is not considered as owning an interest in a specified foreign financial asset held by a partnership, corporation, trust or estate, merely because the person is a partner, shareholder or beneficiary.

While it seems odd that rights to future compensation payable by a non-U.S. entity that would, when paid, be reported as compensation income on an employee’s Form W-2 should be considered a specified foreign asset required to be reported, the IRS has not provided any compensation exemptions.

Must Unvested Awards be Reported? There is no guidance on how to treat unvested awards. Only foreign financial assets in which a person has an “interest” must be reported. The proposed and temporary regulations provide that a person has such an interest “if any income, gains, losses, deductions, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included or otherwise reflected by the specified person on an annual return,” whether or not there are in fact “any income, gains, losses, deductions, gross proceeds, or distributions” for that year. A good argument can be made that a person does not have an “interest” in unvested awards, provided the person does not have a right to “income, gains, losses, deductions, gross proceeds, or distributions attributable to” in respect of the award. Moreover, under Section 83 of the Code, an employee is not considered the tax owner of restricted property until it has

vested. But until the IRS clarifies that this analysis is correct, there remains a risk that the IRS views unvested compensation as reportable.

What Must be Reported? Taxpayers must provide a description of the specified foreign financial asset as well as the maximum value of the asset during the year.

Valuation. A taxpayer may rely on periodic statements for the tax year to report the value of a financial account, and may value other foreign financial assets at their fair market value as of the last day of the year, unless the person knows or has reason to know based on readily accessible information (such as is available for publicly traded stock) that the statements or value do not reflect a reasonable estimate of the maximum value for the year.

Special valuation rules apply to retirement plans and deferred compensation arrangements, which generally value these interests at the fair market value of the person's beneficial interest in the retirement plan or deferred compensation plan on the last day of the year. If the person does not know or have reason to know based on readily accessible information what the fair market value is on the last day of the year, then the value is deemed to be the fair market value of the cash and property distributed to the person during the year or, if no distributions were made, zero.

There is no guidance as to how equity compensation is to be valued. Until further guidance is provided, the most logical path would appear to be to value stock awards based on their fair market value, and stock options and stock appreciation based on their spread value (the excess of fair market value over the exercise of base price of the award), as this would be how the amount of income associated with the award would be measured.

If the asset is denominated in a foreign currency, the value must be determined in that currency, and converted to U.S. dollars based on the exchange rate on December 31 (whether or not the asset was disposed of prior to December 31).

Unanswered Questions. The new rules leave many questions unanswered in addition to the questions raised above. Moreover, whether a particular compensation arrangement must be reported (or, due to the lack of clarity in the rules, it would be advisable to report the arrangement) may very well depend on the facts and circumstances of the arrangement.

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Please feel free to contact us if you would like to discuss whether a compensation arrangement should be reported or if you would like to discuss any of the forgoing.

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