Foreign Investments By Governmental Pension Plans: Special Reporting Obligations To Consider

By
Terry A.M. Mumford & Sarah Funke
Ice Miller, LLP, Indianapolis, IN

Many governmental pension plans invest in foreign securities through funds structured as limited partnerships. These pension plans customarily establish and manage their investments through third party advisers such as registered investment advisors, money managers, and custodians. These advisers assist with making and managing investments but they are not, unless contractually obligated to do so, focused on ensuring the plan complies with its investment-related tax and reporting obligations. These obligations often are referenced generally in Form 1065 Schedule K-1s or other fund-related reports a plan receives with respect to an investment, but many times those references are not tailored to the plan's unique status as a tax-exempt governmental plan. Furthermore, a plan's advisers might not even be attuned to the special considerations of the plan as a result of that status.

Consequently, a governmental pension plan must stay informed of and understand the reporting obligations that foreign investments have the potential to create, in order to ensure that the plan either complies with those obligations or makes appropriate contractual arrangements with its advisers to provide those services. This is particularly important because penalties for failure to comply often are substantial. This article briefly describes some of the federal tax and other reporting requirements that apply to foreign investments and the applicability of these requirements to governmental pension plans.

Is The Plan Subject To Unrelated Business Income Tax?

Alternative investments, such as a fund investing in foreign securities, may create a greater potential for unrelated business taxable income, and the federal tax on unrelated business taxable income ("UBIT"), than traditional investments do. The approach a plan takes with respect to unrelated business taxable income could, for some of the reporting obligations discussed below, affect whether the plan takes the position that it is not required to comply with those obligations.

Governmental pension plans generally follow one of two approaches:

1. The plan takes the position that it is not subject to UBIT liability pursuant to one or all of the following rationales: (a) that it is exempt from UBIT pursuant to intergovernmental tax immunity doctrine;[1] (b) that it is exempt from UBIT pursuant to Internal Revenue Code Section 115 as an alternative basis for exemption to Internal Revenue Code Section 501(a)[2]; or (c) pursuant to News Release IR 1869 (August 10, 1977).[3] While taking the position that they are exempt from UBIT, some plans also establish policies and procedures to avoid engaging in UBIT-generating activities.
2. The plan concedes that it is subject to UBIT. Under this approach, any potential investment, as well as any tax-related reporting requirements, must be analyzed with the assumption that any UBIT liability will be paid by the plan, and the plan's investment advisers must factor potential UBIT liability into their analysis of investment options. This approach has the potential to eliminate some investment opportunities because of their potential for UBIT liability.

Regardless of which approach a governmental pension plan follows, it should educate its advisers about its status as a tax-exempt governmental entity and its position and policies regarding UBIT. Such actions will help the plan ensure that its investments are appropriate and that, if contractually required to do so, the plan's advisers help the plan comply with any applicable tax and other reporting requirements.

The position that a governmental pension plan takes with regard to UBIT is very important with respect to other reporting obligations that are discussed below.

Reporting Requirements

<u>FBAR - Report of Foreign Bank and Financial Accounts:</u>

Generally, a U.S. person must file a Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1, commonly referred to as an "FBAR") with the Department of the Treasury ("Treasury") if that person has a financial interest in, or signature or other authority over, any foreign financial accounts (including bank, securities, or other types of financial accounts) in a foreign country, and if the aggregate value of those financial accounts exceeds $10,000 at any time during the calendar year.

On February 24, 2011, Treasury's Financial Crimes Enforcement Network (FinCEN) issued final regulations addressing the reporting of foreign financial accounts and FBAR form. The final regulations were effective March 28, 2011 and apply to FBARs required to be filed by June 30, 2011, for foreign financial accounts maintained in 2010 and for reports required to be filed for all subsequent years. In addition, filers who properly deferred their filing obligations under Internal Revenue Service ("IRS") Notice 2010-23 (which extended the FBAR filing due date from June 30, 2010 to

June 30, 2011 for certain groups) may, but are not required to, apply the provisions of the final rule in determining their FBAR filing requirements for reports due June 30, 2011, for foreign financial accounts maintained in years beginning before 2010.

The final regulations provide a filing exemption for the accounts of governmental pension plans, both with respect to the plan itself and with respect to the plan's employees with signature authority over foreign investments. The exemption is applicable for accounts held during 2010 and subsequent years. In addition, both pension plan employees with signature authority over accounts but no financial interest in those accounts who took advantage of the extension provided in IRS Notice 2010-23, and pension plans having commingled funds, none of which were mutual funds, who did not file an FBAR for prior years in reliance on Notice 2010-23, may rely on the final regulations to determine whether a delayed filing is now required.

Treasury International Capital Form SLT:

Treasury International Capital Form SLT gathers information on U.S. securities holdings by foreign residents and on long-term foreign securities held by U.S. residents. The form is filed with the Federal Reserve banks, and information gathered will be shared among Treasury, the Board of Governors of the Federal Reserve System, and the Federal Reserve banks.

All U.S. persons who are U.S.-resident custodians, issuers, and end-investors who meet or exceed the reporting threshold must file Form SLT. A "U.S. person" includes any "individual, branch, partnership, associated group, association, estate, trust, corporation, or other organization (whether or not organized under the laws of any State), and any government (including a foreign government, the United States Government, a State or local government, and any agency, corporation, financial institution, or other entity or instrumentality thereof, including a government-sponsored agency)" resident in the United States or subject to the jurisdiction of the United States. Therefore, a governmental pension plan potentially is subject to these reporting requirements.

Only U.S. persons whose holdings exceed the exemption level of $1 billion of consolidated reportable holdings and issuances, including those held for the entity's own account and for customers, are required to file Form SLT. An entity must file Form SLT for the first month in which it exceeds the exemption level and for every month thereafter in the calendar year. Form SLT will be filed quarterly during 2011 and monthly beginning in 2012. The filing deadline is the 23rd day of the month following the reporting date. The first reporting date is June 30, 2011, making the first filing due date July 23, 2011. The form can be filed electronically using the Federal Reserve System's Internet Submission Electronic Submission System, by U.S. mail, or by facsimile.

A "custodian" includes a bank or other entity that manages or administers the custody or safekeeping of securities or other assets for investors. Custodians must complete Part A, showing all U.S. securities held for the account of foreign residents and all foreign securities held for the account of U.S. residents. Governmental plans should confirm with their custodian that the custodian is complying with this requirement. An "issuer" is a legal entity that has the power to issue and distribute a security, including a corporation, municipality, foreign or domestic government or its agencies, and investment trusts. An issuer must report in Part B all securities issued directly to foreign residents by any U.S.-resident parts of the entity. An "end-investor" is an entity that acquires or relinquishes securities for its own account (for trading, investment, or any other purposes) or invests on behalf of others, including asset pools, such as managers of mutual funds, managers of insurance company policyholder assets, and pension fund managers. A governmental pension plan, for example, could be an "end-investor" with respect to securities it acquires. End-investors are required to report in Part B investments in foreign securities for their own portfolio or those of their clients. However, if such foreign securities are held by a U.S.-resident custodian, reporting will be handled by the custodian and the securities should not also be reported by the end-investor. Governmental plans should confirm with their custodian that the custodian is complying with this requirement.

Form 8865 – Return of U.S. Persons With Respect to Certain Foreign Partnerships:

Form 8865 is filed with the IRS to disclose investments in foreign partnerships that exceed certain thresholds. Generally, a U.S. person who owns more than a 50% interest in a foreign partnership, or who owns 10% or more in a foreign partnership that is controlled (more than 50% collective ownership) by U.S. persons each owning at least 10% interests, must file the Form. A U.S. person who contributes property to a foreign partnership in exchange for an interest also must file Form 8865 if that person either owns at least a 10% interest after the contribution or the value of the property contributed (when added to the value of any other property contributed to such partnership during the 12-month period ending on the date of the transfer) exceeds $100,000. In addition, U.S. persons must file Form 8865 if they acquire or dispose of a foreign partnership interest which changes their ownership percentage by 10% or more or causes their ownership to meet or exceed (or to fall below) the 10% threshold. If a domestic partnership contributes property to a foreign partnership, the partners of the domestic partnership are considered to have contributed a proportionate share of that property, but are not required to file Form 8865 with respect to their contribution if the domestic partnership, itself, properly reports the required information on Form 8865. If required, Form 8865 must be filed with the filer's income tax return or exempt organization return.

Some investment managers may report to a governmental pension plan that the plan may have a reporting obligation on Form 8865. However, the regulations implementing Code Sections 6038, 6038B, and 6046A provide that trusts relating to state and local

government employee retirement plans are not required to report on Form 8865 unless otherwise provided by the Instructions to Form 8865, and those Instructions state that no reporting is required by state and local government employee retirement plans.

Form 926 – Return by a U.S. Transferor of Property to a Foreign Corporation:

Form 926 is used to report certain transfers of cash or other property to a foreign corporation. Generally, a U.S. citizen or resident, a domestic corporation, or a domestic estate or trust is subject to the reporting requirement. If the transferor is a partnership, the domestic partners of the partnership, not the partnership itself, must report.

For transfers of stock or securities to a foreign corporation, the applicable Treasury Regulations provide an exemption from this reporting requirement if the U.S. transferor is a tax-exempt entity and the income was not unrelated business taxable income. Based upon these provisions, a tax-exempt governmental plan that takes the position it is not subject to UBIT could assert that, with regard to such transfers, it is not subject to Form 926 reporting because the transfer does not constitute unrelated business taxable income.

Treasury Regulations governing the transfer of cash to a foreign corporation provide that the transfer must be reported if, after the transfer, the person holds directly, indirectly, or by attribution at least 10% (by voting power or value) of the corporation or if the amount of cash transferred to the corporation during the 12-month period ending on the date of transfer exceeds $100,000. Unlike the regulations governing transfers of stock or securities, these regulations do not provide an exemption for tax-exempt entities. Therefore, unless the 10% or $100,000 threshold exemptions apply, a plan would either have to file Form 926 or would have to assert that it is not required to file because of its status as a tax-exempt governmental pension plan that does not file income tax returns or informational returns. If a plan chooses to assert the latter position, it should remain alert for contrary IRS guidance, as there is no express governmental plan exemption for this filing.

Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporations:

Persons who must file Form 5471 include, among others: (1) a U.S. person who acquires 10% or more (by votes or value) of a foreign corporation's stock; (2) a U.S. person who disposes of stock in a foreign corporation sufficient to reduce the person's interest to less than 10% (by votes or value); (3) a U.S. person who had control (i.e., more than 50% by votes or value) of a foreign corporation for an uninterrupted period of at least 30 days during the corporation's annual accounting period; and (4) a U.S. shareholder who owns stock in a CFC for an uninterrupted period of at least 30 days during the corporation's tax year and who owned the stock on the last day of that year. For purposes of this reporting obligation, a "U.S. person" includes domestic trusts, and there is no specific exemption for governmental plans. A "U.S. shareholder" is a U.S. person who owns 10% or more by voting power of a CFC or who owns any stock of a CFC that is a captive insurance company. A "CFC" is a foreign corporation that has U.S. shareholders who own more than 50% (by votes or value) of the corporation. Form 5471 should be filed with the person's income tax or exempt organization return.

Therefore, if a governmental pension plan falls within one of the categories of required filers, it will need to file Form 5471 unless it chooses to assert that it is not required to file because of its status as a tax-exempt governmental pension plan that does not file income tax returns or informational returns. If a plan chooses to take this position, however, it should remain alert for contrary guidance from the IRS, as there is no express governmental plan exemption for this filing.

Passive Foreign Investment Company/Qualified Electing Fund Reporting:

A foreign corporation is a passive foreign investment company ("PFIC") if either 75% or more of its gross income for the taxable year is passive income (as defined in Internal Revenue Code Section 1297(b)) or if at least 50% of the average percentage of assets that it held during the taxable year are assets that produce, or that are held for the production of, passive income. Prior to enactment of the Hiring Incentives to Restore Employment Act (the "HIRE Act") in 2010, U.S. persons who were direct or indirect shareholders of a PFIC were required to file Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) for each tax year in which such person (1) recognized gain on a direct or indirect disposition of PFIC stock; (2) received certain direct or indirect distributions from a PFIC; or (3) was making certain elections with respect to the PFIC. The instructions to Form 8621 provide that a U.S. person that is an interest holder of a pass-through entity (such as a U.S. partnership) is required to file Form 8621 if the pass-through entity does not do so or if the U.S. person is required to recognize any income under Internal Revenue Code Section 1291. Form 8621 is filed with the IRS, with the person's tax return or, if the person is not required to file a tax return, is to be filed directly with the IRS. If a plan takes the position that it is not subject to UBIT, the plan generally would not be required to file Form 8621.

Effective March 18, 2010, the HIRE Act amended the Code by adding a new Section 1298(f), pursuant to which "[e]xcept as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require." This new provision does not include any exemption for governmental plans or trusts.

The IRS is developing further guidance regarding this new reporting obligation. In the meantime, pursuant to IRS Notice 2010-34, persons that were required to file Form 8621 prior to the enactment of Section 1298(f) must continue to do so as provided in the instructions to that Form. The regulations implementing Sec-

tion 1298(f) could impose reporting obligations that are broader than what is required under Form 8621. Therefore, even if a plan does not file Form 8621, it should nonetheless continue to monitor developments with respect to the Section 1298(f) reporting obligations.

Form W-9:

Pursuant to Code Section 6109 and Treasury Regulation 301.6109-1(b), a governmental plan must provide its federal employer identification number ("EIN") when it is required on a return filed by another entity (such as a fund, for example) that makes payments to the plan. For this purpose, a fund in which the plan invests may ask the plan to submit to the fund a completed Form W-9, stating the plan's EIN. Plans should comply with this request. Penalties may apply for failure to do so and could range from $100 to $25,000 or more, depending on the type of return at issue and whether the IRS believes the failure to comply was due to intentional disregard of the requuirement. Based on guidance recently issued by the IRS, the EIN that should be reported is the EIN for the plan's trust, not that of the plan sponsor. On the Form W-9, the plan should check for "Expempt Payee."

Conclusion

Foreign investments present a host of potential reporting obligations, and failure to comply creates the potential for substantial penalties. Governmental pension plans should consider and discuss these obligations with their advisers, to ensure that the plan has procedures in place to satisfy all applicable requirements, and (where appropriate) document a position that the plan is exempt from a particular obligation. Plans also must stay alert to regulatory developments as additional reporting requirements are enacted, to keep their compliance procedures up-to-date.

This publication is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader must consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

Circular 230 Disclosure: To ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that any federal tax advice contained in this communication is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

Endnotes

1. Section 115 provides that "[g]ross income does not include—

   (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or

   (2) income accruing to the government of any possession of the United States, or any political subdivision thereof."
2. Section 501(a) states that "[a]n organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503."
3. Pursuant to this News Release, the Internal Revenue Service indicated that trusts under governmental plans would, until further notice, be treated as nontaxable.

2012 Winter Section Meetings

The Dupont Hotel
Washington, DC

Wednesday, February 8th – Friday, February 10th

NAPPA Legal Education Conferences

2012 – Hyatt Regency – Philadelphia, PA
June 19 – 22, 2012

2013 – Hilton Santa Fe at Buffalo Thunder, NM
June 25 – 28, 2013

2014 – Sheraton – Nashville, TN
June 24 – 27, 2014