

focus

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frank hirth plc
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Welcome to all our clients and friends to the autumn edition of Focus. Like our readers, we are struggling to come to terms with the fact that our meagre summer is over and we are quickly heading towards our end-of-year deadlines! We have had an excellent start to our 2006 US tax preparation season and are definitely ahead of the game. We are hoping that our clients will receive their outstanding information or will be recharged from their summer breaks to focus their attention on tax so that we can finalise their 2006 US returns. Our audit and accounting department are also gearing themselves for the big push to make sure that the accounts and tax returns are filed for our corporate clients with a 31 December year-end.

Our main article in this edition outlines the UK offshore disclosure facility and details what needs to happen next for those individuals who have already made a disclosure to HM Revenue & Customs. The article also sets out how this may impact those clients who are non-UK domiciliaries and are remitting funds from non-UK sources to the UK. This edition's other UK article sets out what we consider to be a change of tack in how HM Revenue & Customs may seek to tax stock options granted to a non-UK resident in certain circumstances.



On the US side, the exit tax for expatriating individuals is on the agenda for the third time this calendar year alone and we look at the current proposed rules. We strongly urge any of our clients who are considering relinquishing their green-cards or US citizenship or who are in danger of losing their green-cards to discuss this as soon as possible with their regular Frank Hirth contact or Jemma Baker, our US expatriation specialist.

Over recent months, the exchange rate has steadily remained above £1 = \$2 and this, accompanied by the continued increase in property prices in some parts of the UK, has lead many US taxpayers to realise significant US taxable capital gains when these properties are sold. We cover this problem in depth. Our final article outlines how US taxpayers may be able to claim tax refunds from 2007 onwards as a result of prior year Alternative Minimum Tax Liabilities – something to look forward to!

The news on the firm's front is that Suzanne Willis, one of our senior managers, has temporarily left the firm to travel around the world for a year but is expected back in July 2008. Her colleagues, including David Foster, Iain Younger and James Murray, have stepped in to look after her clients and assist with any complex US trust issues whilst she is away. We have said a sad good-bye to Tameron Elliott, who has returned to her native Australia with her husband after spending three years in the UK. We're crossing our fingers that she will realise that London actually has better weather than Melbourne and return to us soon! We also bid farewell to Chi Lam, Daniel Pierce, David Henderson and James Poynter (our gap year student) and wish them all the best in their future careers.

We are completely committed to our graduate training program and are very excited that we have twelve graduates joining this year's programme from 3 September 2007. Ashleigh Arkless has also recently joined the firm as a senior specialising in UK personal and business tax. We also welcome Philip Hawkins to our team; Philip is a very experienced US and UK personal tax manager. Nicola Warrick, Kathy Davis and Gurpreet Lall are new additions to our audit and IT teams respectively. We welcome all of them to the firm. The new joiners represent yet another exciting stage in the firm's growth as we have now reached over 100 employees!

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OFFSHORE DISCLOSURE FACILITY (ODF) AND REMITTANCES

Background

You may recall we wrote a special “stop press” on the subject of the voluntary disclosure initiative. The HM Revenue & Customs (HMRC) launched this amnesty - officially the “Offshore Disclosure Facility” (ODF) - back in April after obtaining information about holders of offshore accounts from a number of banks. This facility is open to those UK taxpayers who hold or have held an offshore account, either directly or indirectly through companies or trusts, that is in any way connected to a loss of UK tax. The deadline for the intention to disclose was 22 June 2007. A parallel facility exists enabling those with undeclared onshore liabilities to benefit from the same penalty regime if they make their disclosures within the same time limits.

Under the ODF, tax liabilities on previously undisclosed income will be subject to a fixed penalty of 10% of the outstanding tax (in addition to paying the total tax and interest due). Outside of the ODF, penalties of at least 30% and possibly as much as 100% can be imposed.

As well as from UK domiciled resident taxpayers towards whom this initiative was primarily directed, some non-UK domiciled individuals with offshore UK bank accounts have received notifications from their banks of the approach by HMRC for information. As a non-UK domiciled person, income from offshore investment is not subject to UK taxes unless remitted into the UK, and we will highlight later in this article some of the potential pitfalls of the remittance rules.

What Happens Next?

HMRC has said that all disclosures will be acknowledged as soon as possible, and in any event, within four weeks of 22 June 2007. They will also issue a Disclosure Reference Number (DRN) which should be used for any correspondence with regard to the disclosure facility.

Those who are notified are required, by 26 November 2007, to make a full disclosure of all previously undisclosed income and gains, not just those connected with their offshore accounts. The disclosure can be a personal one or one made on behalf of another, for example a director on behalf of a company. The tax, interest and penalty must be calculated by the taxpayers and paid in full by the November deadline.

On the assumption that the individual has complied with the 26 November 2007 deadline, he will not hear, potentially until 30 April 2008, whether his disclosure has been accepted by HMRC or whether HMRC will investigate further. The guidance notes do

not explain the criteria which will determine whether or not further investigation will be required, but it seems likely that where large amounts of tax have been underpaid an investigation will follow. However, HMRC has stated that it expects the majority of disclosures to be accepted. If the disclosure is not accepted, HMRC will open an enquiry in the normal way before 30 April 2008.

Remittances

As mentioned above, individuals who are not UK domiciled and have not remitted overseas investment income to the UK, probably have no UK tax liability to disclose. However, the remittance basis, whilst an apparently simple concept, is far from straightforward in practice as is borne out by the significant body of case law on the question of what actually constitutes a remittance.

It is often clear whether money remitted to the UK represents capital, income or capital gain, particularly if the appropriate arrangements have been made to segregate capital and income into separate accounts before coming to the UK, and those arrangements are correctly operated. But it is not always so; for example, when a remittance is made from an account containing capital, gains and income (referred to as a “mixed” or “tainted” account) – and there are complex rules to identify the nature of the funds remitted to the UK. Then there is the possibility of “constructive” remittance, for example, when a credit card is used to purchase goods or services in the UK and the credit card bill is subsequently settled by payment from an offshore account, or the purchase of a property in the UK financed by an offshore repayment mortgage.

Please contact your usual Frank Hirth representative should you have any questions regarding the above.

STOCK OPTION – HMRC UPDATED GUIDELINES

HM Revenue & Customs (HMRC) have recently updated their guidelines with respect to stock options, and it appears they have revised the guidance with respect to the taxation of stock options granted to individuals when they were not resident in the UK.

Prior to the update, the guidelines detailed that typically there would be no UK tax charge on the grant of share options to an individual considered non-resident of the UK, unless the grant was in connection with UK employment. In addition, there would be no UK income tax on the subsequent exercise even if the individual were resident of the UK at that time (either not ordinarily or ordinarily resident).

The new guidance suggests that, under certain circumstances, the exercise of the options granted to a non-resident may be subject to UK income tax.

Whilst HMRC have always considered that there would be a UK tax charge on exercise in the case of an individual who was non-UK resident at grant, but UK resident at exercise if there was a **direct link** to UK employment (previous HMRC Q+A states that a grant

must not be in “prospect of taking up UK employment or otherwise in respect of duties performed in the UK”), the new guidelines are much wider than this.

The revised guidelines relate to UK-based employees who are seconded outside the UK and are granted stock options whilst non-resident of the UK. HMRC argues that if, at the point when the options are granted it is known to the employer that the individual will return to the UK prior to the date in which the options could be vested, such options have arguably been granted in respect of a future UK employment, and as such will be subject to UK income tax on exercise.

Consequently, employers will need to determine at the time of grant whether the employee will be returning to the UK prior to the date of vesting. This will also have implications with respect to PAYE withholding and Form 42 reporting.

HMRC, however, have argued that this is not in fact a change of policy but is a question of fact and that this has always been HMRC’s view; clearly, this is contradictory to the treatment by most employers and the view of professional service firms.

It is important to note that this does not appear to be a change in practice with respect to individuals granted options whilst non-resident under their non-UK employment, prior to any secondment to the UK, and it is still arguable that this has not been granted in respect of a future UK employment.

US DOLLAR RATES AND THE US TAX IMPACT ON THE SALE OF A UK PRINCIPAL RESIDENCE

We would like to briefly highlight the US tax implications of selling a UK principal residence and the methods used to calculate such a gain under US tax principles. We hope that this article will raise awareness of the effect the US dollar depreciation and the UK property market appreciation could have on a US taxpayer’s Federal tax liability.

The consequences and examples below are based on the disposal of a UK residence that has been the taxpayer’s main home during the entire ownership period and the taxpayer has not disposed of another principal residence in the previous two years. If your personal circumstances are at all different, the tax treatment in both the UK and US may differ to that set out below and you should contact your usual Frank Hirth advisor to discuss.

The sale of an individual’s principal residence is fully exempt from UK capital gains tax if the individual has lived in the property as his main residence for the full period of ownership.

Under US tax principles, the US dollar gain is calculated by converting the original cost basis, improvements and proceeds into dollars using the exchange rates at the dates of purchase, improvements made and disposal. The gain is not calculated by converting the gain in British pounds into dollars at the exchange rate on the date of sale, as is often believed to be the case.

As an example, a UK property purchased on 1 June 2002 for £1 million which is sold on 1 June 2007 for £1.2 million will produce a gain of \$900,000 for US tax purposes (per the computation below):

Cost	- £1 million x 1.5 = \$1,500,000
Proceeds	- £1.2 million x 2.0 = \$2,400,000
US taxable gain	- \$900,000

[Note – exchange rates rounded for illustration purposes and are not exact].

Each individual US taxpayer is able to claim an exclusion against the gain of \$250,000 (i.e. \$500,000 for those filing joint returns) as long as he has owned the property and lived in it as his main home for at least two out of the five years leading up to the date of sale. The remaining capital gain will be subject to US income tax at 15% (if property was held for longer than 12 months), unless there are other capital losses that can be utilised against it, or an excess of foreign tax credits in the passive income basket. As there is no UK tax due on this disposal, there is no foreign tax credit to frank the US tax due on the gains, so there is likely to be a US tax liability due to both the US dollar depreciation and the UK property appreciation.

In contrast to the above, if the exchange rates had been the other way round and a US dollar loss was computed the loss would not be allowed on the individual’s US tax return because a residence is personal in nature.



EXPATRIATION

Unfortunately, the spectre of an “exit tax” on expatriating US citizens and long-term residents has once again reared its ugly head. The House Ways and Means Committee has recently approved a bill which, although focused on

tax collection techniques, includes a number of provisions targeting certain expatriating persons.

The proposal, in its current form, would affect any person who relinquishes their US citizenship or any long-term resident who ceases to be a US person on or after the enactment date (collectively, a “covered expatriate”). In general, the term “long-term resident” means any person who has been a lawful permanent resident (i.e. green-card holder) during at least eight of the fifteen tax years ending in the year of expatriation.

The fundamental principle of the proposed exit tax is that all of the assets of a covered expatriate would be deemed to have been sold at their fair market value on the day prior to expatriation. To the extent that the resulting gain exceeds \$600,000 it would then be subject to US taxation. There is a provision in the bill allowing for the deferral of the payment of such a tax charge, which would alleviate the potential for significant cash-flow issues, but to do so would mean the imposition of an interest charge.

Around this principle, there are a number of provisions contained within the bill dealing with specific items. Firstly, certain deferred compensation arrangements are specifically exempt from the exit charge. In these cases, the payer of any taxable payment to a covered expatriate would have to withhold tax at a rate of 30% from the payment. If a deferred compensation arrangement does not meet the requirements for the exemption from the exit tax, the expatriate would be deemed to have received a distribution of their entire interest under the plan on the day before their expatriation. It should be noted that the definition of what constitutes a deferred compensation arrangement is drawn very widely, and includes, for example, interests in non-US pension schemes.

Similar provisions are also included in the bill to deal with interests in trusts. For non-grantor trusts, there is an exemption from the exit tax, but the 30% withholding on taxable payments would apply in the same way as for deferred compensation. In addition, if the market value of the property distributed exceeds its basis, the trust would recognise a gain equal to the amount of the excess.

The bill goes further to make the tax affairs of expatriating citizens and long-term residents more onerous by also imposing a new gift tax regime to apply to gifts and bequests made by covered expatriates. The proposed legislation imposes a tax on the receipt of such gifts by a US person calculated at the highest gift tax rate in operation at the time of the gift to the extent that the gift exceeds \$10,000. It should be noted that there is no wording in the bill to suggest that the lifetime exemption or marital deduction would apply to this tax.

Similar rules apply to gifts made to US trusts. For gifts made to foreign trusts, the tax would apply to any distribution from the trust to a US person which can be attributed to those gifts.

These proposals are clearly very draconian in nature, both in terms of the tax burden that they would impose, and also because of the administrative and reporting obligations that they would create.

Unlike previous attempts at introducing legislation in this area, these latest proposals have originated in the Ways and Means Committee, suggesting that there is a greater chance that they will be enacted, either in whole or in part. However, Congress has risen, so no further developments are expected before October of this year. Anyone who is thinking of expatriating from the US in the near future should give careful consideration to the potential impact of doing so, or consider going through the expatriation process as soon as possible in order to try to finalise everything before any such law is passed.



US & UK ORGANISERS

As the holiday season draws to an end and for those of you have not already done so, it is time to complete the 2006 US tax organiser and 2006/07 UK tax organiser.

For US filers living in the US, the final deadline is 15 October 2007, and therefore is fast approaching. For those individuals residing outside the US, you still have until 15 December 2007 to file, but remember interest will run on any outstanding liability from 17 April 2007.

Although the UK return deadline is not until 31 January 2008, we encourage you to return your completed organisers to ensure timely filing.

THE MINIMUM TAX CREDIT

The Alternative Minimum Tax (AMT) has run parallel to regular income tax since its introduction in 1969. Its purpose was to stop taxpayers with high incomes from paying little or no income tax by taking advantage of various preferences in the tax code. It is currently not indexed to inflation (unlike regular tax) and, as a result, each year more and more taxpayers are finding themselves faced with an AMT liability. The 2003 report to Congress of the Internal Revenue Service's National Taxpayer Advocate went so far as to describe AMT as, "the most serious problem faced by taxpayers." Inevitably there have increasingly been calls for the whole system to be revisited but given the level of revenue produced, such a wholesale reassessment is politically sensitive. Instead various sunset provisions have been introduced over recent years.

One such provision, which applies for calendar year taxpayers from 2007 and ceases after 2012, was introduced by the 2006 Tax Relief and Health Care Act (2006 TRHCA). This allows a refundable credit for a prior year minimum tax liability after a period of years (the Refundable Long-Term Unused Minimum Tax Credit). The period of years is three, the liability having arisen "before the third taxable year immediately preceding the taxable year at issue" (so 2003 or earlier for a 2007 return).

The amount of the allowable credit can be summarised as follows: if the total long-term credit is less than \$5,000 then the full amount will be allowed; between \$5,000 and \$25,000 the allowable credit is \$5,000; over \$25,000 then 20% of the credit.

There is a phase-out for taxpayers whose Adjusted Gross Income (AGI) is above a threshold of \$150,000 for joint filers (half that if married filing separately) and \$100,000 for single filers. When looking at AGI for these purposes, any deduction for foreign housing or earned income is not considered. The allowable credit is reduced by 2% for every \$2,500 (\$1,250 for separate filers) over the threshold.

Many of our clients will have accrued minimum tax credits because of the 90% limit that until 2005, applied to foreign tax credits under AMT. For those with the appropriate AGI, this provision allows an opportunity to release credits carried forward on Form 8801.