



Welcome to the December issue of Focus

2008 has seen a lot of changes, with Frank Hirth leaving Coldbath Square and moving a short distance to Gray's Inn Road and opening an office at One Penn Plaza in New York.

On a wider level it has been a year of change amidst turbulent economic conditions globally. The US has elected a new President in Barack Obama with promise of change and apparently "he can", and with Democratic majorities in Congress this may well be true. In this edition we take a look at what the impact of this is likely to be within our area of taxation.

Before we get ahead of ourselves, the current US administration is not yet quite over and on 3 October, the Emergency Economic Stabilization Act of 2008 was signed into law as a response to the financial crisis, but which also included a number of far reaching tax changes which will affect Americans overseas. We take a look at the provisions in this issue and highlight the main areas of concern.

The US appetite for information gathering shows no sign of letting up. We are grateful to our friend Scott D. Michel of Caplin & Drysdale in Washington who has contributed an article for this edition detailing the changes to the Foreign Bank Account Reporting or "FBAR" regime, and this will become a major issue for clients in 2009.

Elsewhere we draw your attention to the "ramping up" by the IRS of the assessment and collection of penalties for failure to file Form 5471, Information Return for US Persons with Respect to Certain Foreign Corporations. We have seldom seen these imposed in the past but at \$10,000 per corporation

The next few weeks are the last opportunity for clients to consider US/UK year-end tax planning

failure to make a timely filing will be costly going forwards. We can expect a similar approach to be taken for filings such as Form 8865 and similar forms dealing with non-US business operations.

With 31 December being the end of the US tax year, the next few weeks are the last opportunity for clients to consider US/UK year-end tax planning. We include an article that goes through some of the things to consider before the tax year closes.

In particular the new UK tax law changes for non-domiciled individuals may mean that consideration will have to be made whether to pre-pay their UK tax liabilities for 2007/08 and possibly payments on account for 2008/09 to ensure the matching of credits in the US and UK. Please discuss any year-end concerns with your usual Frank Hirth contact.

The recent "Pre-Budget Report" is the subject of a separate Focus "special edition", and for everyone's sake, we all hope the various measures undertaken by fiscal authorities worldwide will make a real difference and we look forward to a very busy 2009!

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TAX POLICY OF THE OBAMA ADMINISTRATION

"If you were more liberal in your card playing and more conservative in your politics, we'd get along much better." This comment by one of President-Elect Barack Obama's former sparring partners within the Senate sums up some popular sentiment; beyond "change", do the fiscal cards Mr Obama hold contain a joker in the form of a radical fiscal agenda?

The headline policy consists of the intention to reverse the Bush tax cuts of 2001 and 2003 on the top two rates of income tax, replacing the present rates of 33% and 35% with new rates of 36% and 39.6% for those reporting taxable income in excess of \$160,850 and \$349,700 respectively (\$195,850 and \$349,700 for those filing jointly). Complementing this is a commitment to restore the phase-out of personal exemption (the PEP provision) for high-income taxpayers, together with enforcing stricter limitations for certain itemised deductions.

Finally, Mr Obama proposes to introduce a new Social Security payroll tax of between 2 – 4% on wages in excess of \$250,000. This has the hallmark of a "headline grabber" as most people reporting Adjusted Gross Income (AGI) in excess of \$250,000 per year receive the bulk of their income in forms other than wages or salary. The IRS further estimates that little more than \$1 billion is earned in wages by persons with annual gross income exceeding \$250,000; as such, the proposed additional levy of between 2 – 4% might be at least partially considered as a political exercise in smoke-and-mirrors.

Notwithstanding the protests of "Joe the Plumber" during the election campaign, Mr Obama has pledged to provide measures of tax relief for entrepreneurs; a policy headline dominated by the manifesto commitment to eliminate capital gains tax for start-ups and small enterprises, although the definition of what Mr Obama understands to constitute one of these entities remains vague. Other significant policy proposals affecting entrepreneurs include a refundable credit of \$3,000 for firms that hire additional US citizen workers during 2009 and 2010. Note that this echoes a similar scheme previously enacted with limited success by the Carter Administration in 1977.

Domestic US based entrepreneurs should also benefit from an additional "Making Work Pay Credit" of up to \$500, which, though available to all workers, will particularly help alleviate the current 'double-tax' suffered by self-employed small business owners who are required to pay both the employee and employer side of payroll taxes. A small business health tax credit, providing a refundable credit of up to 50% of employer contributions made on behalf of their employees is also in the policy pipeline.



Partners and owners of flow-through businesses – sole proprietorships, partnerships and S.corps – will see their tax burden rise. As these sources of business income are not subject to corporation tax, but instead 'flow-through' to the owner's individual income tax return, so they will become subject to the proposed new top graduated rates of 36% and 39.6%.

In addition, Mr Obama's tax agenda advocates the closure of the current loophole surrounding Publicly Traded Partnerships (PTPs) that are presently exempt from corporation status by virtue of generating in excess of 90% of their income from passive sources.

Reclassification of these entities as C.corps raises the spectre of double-taxation, as income is taxed both at the entity level and subsequently at the individual level after distribution.

Long term capital gains and qualified dividend tax rates are also set to rise. These are likely to rise from 15% to 20% for those earning in excess of \$200,000 (\$250,000 for those filing jointly) from 2011. Similarly, the top rate on qualified dividend income is set to lose its current special status, and become taxable at marginal rates. Given the current economic malaise, these changes could be placed on hold if it was felt the economy needed the boost.

There are also proposals to change the tax treatment of "carried interests" received by private equity fund managers as ordinary income as opposed to capital gains. This is an extension of recent developments in this area, particularly the addition of s.457(A) under the Emergency Economic Stabilisation Act (EESA), which alters the treatment of deferred compensation from "non-qualified entities" (see article in this edition of Focus for more detail).

Although this policy shift is likely to cause problems for fund managers, the net gain to the US Treasury is likely to be small in terms: "carried interest is a small source of income ... compared to the economy at large, it is trivial, and its prominent role in the current tax debate is unwarranted".

Mr Obama has in the recent past shown support for specific legislation targeting perceived abuses using non-US "offshore" tax havens and entities. The evocatively named "Stop Tax Havens Abuse Act" sponsored by Mr Obama with Senators Levin and Coleman perhaps gives some insight into the current thinking of the President-Elect.

Here, the proposed legislation introduces a rebuttable presumption that a US person who transfers property to a foreign entity incorporated or operating in one of 34 listed countries (including Switzerland, a fellow OECD member and full Treaty Partner) controls that foreign entity and would therefore be taxable on all income associated with the transfer.

It would also require that the IRS be informed of any financial account opened by a US financial institution on behalf of a US person in any one of the 34 countries. How much of this will be given political impetus by the recent UBS undisclosed accounts case as well as the Lichtenstein LTG Bank case remains to be seen, but based on prior performance, there is every likelihood of tightening up of the reporting regulations and of enforcement activity by the IRS under the new administration.

Mr Obama will have a lot of work to do to convince both Houses of Congress, and the election has produced increased Democratic majorities in both Houses, albeit without the 60 seats required for a "filibuster proof" majority in the Senate. The new administration will inherit a budget deficit of approximately \$450 billion, together with the potential exposure to additional financial liabilities under the provisions of the EESA. This will no doubt limit his ability to borrow so heavily compared to the practices of the outgoing Administration.

Time will tell if, in the words of Mr Obama, this is "change we need".

Summary of the Obama tax policy proposals:

- Increase the top two rates of income tax to 36% and 39.6%.
- New Social Security payroll tax between 2 – 4% on wages over \$250,000.
- Refundable \$3,000 credit for firms hiring additional workers in 2009/10.
- "Making work pay" and small business health tax refundable credits.
- Increase long term capital gains rate to 20%.
- Qualified dividends to become taxable at marginal rates.
- Treatment of PTPs as C.corps.
- Tax "carried interest" as ordinary income rather than as capital gains.

The FBAR has been the focus of increasing practitioner attention as a result of IRS efforts to publicise its filing requirements

Among other things, it is referenced on every taxpayer's Form 1040, Schedule B, Part III, line 7a, requiring taxpayers to answer whether they have signature authority or a financial interest in any foreign account. Federal tax prosecutors frequently use a false answer to this question, the non-filing of the FBAR, and the failure to report income on a foreign account as the basis for tax evasion indictments.

There are criminal sanctions and severe civil penalties for any "willful" failure to comply with FBAR filing requirements, up to as much as 50% of the balance of an undeclared account, per year, for forms due after October 2004. As it has ramped up enforcement activity against Americans with undeclared offshore accounts, the IRS has made it a point to publicise the filing requirement.

The new form notes that it has been revised as of October 2008 and states that it, as opposed to the older form, must be used for any filing after 31 December 2008. This article will identify substantive changes in the FBAR form and instructions:

1. The IRS has clarified the definition of a "financial" account to include "debit card and pre-paid credit card accounts". This clarification is undoubtedly a result of recent IRS enforcement efforts, including reams of data obtained by the IRS earlier this decade after serving John Doe summonses on US credit card processors identifying Americans who used credit and debit cards issued on foreign accounts.
2. The new instructions waded into the problem area of foreign trusts. The instructions provide that a US person has a financial interest in any foreign account "for which the owner of record or holder of legal title is a trust, or a person acting on behalf of such a trust, that was established" by that person, "and for which a trust protector has been appointed".

Trust protector is defined as "a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee". Many undeclared foreign accounts are associated with trusts where a trust protector is in place. These instructions now make it clear that the FBAR filing requirement applies to a US person who has established such a foreign trust.

In an unanticipated development, the IRS posted on its website on 30 September 2008, a new version of Treasury Department Form 90-22.1, named Report of Foreign Bank and Financial Accounts (FBAR). The FBAR has been the focus of increasing practitioner attention as a result of IRS efforts to publicise its filing requirements, and of ongoing investigations involving Americans who have undeclared foreign accounts at LGT Bank of Liechtenstein, UBS, and other institutions.

This recent activity has included the service of a "John Doe" summons on UBS for a list of American account holders, the plea agreement of a Geneva-based UBS private banker, and hearings held by the Senate Permanent Sub-Committee on Investigations into the problem of undeclared accounts.

The FBAR is not a tax form. It is a creation of the Bank Secrecy Act, which, with its associated regulations, requires any US person with signature authority or a financial interest in a foreign bank or financial account to file an information return with the Treasury Department by 30 June of the succeeding calendar year. The filing requirement applies to corporations and individuals.

The FBAR gathers information for the database of the Financial Crimes Enforcement Network in support of federal efforts against terrorism, money laundering and narcotics, but it also has significant implications in the tax world as well.



IRS ISSUES REVISED FOREIGN ACCOUNT REPORTING FORM



Interestingly, however, the filing requirement applies only to the US person who has established the trust, not that person's heirs. Many situations involving undeclared accounts emerge after the death of the person who created the account.

Under the new FBAR instructions, such heirs or beneficiaries do not appear to have an FBAR filing requirement. Having said that, the new instructions include the previous rule whereby any US person who is more than a 50% beneficiary in a foreign trust must file the FBAR.

3. In a number of important respects, the new form asks for more detailed information:

- The definition of a US person required to file the form has been expanded beyond US citizenship, residency, or, as to entities, domicile. The filing requirement now extends to anyone "in and doing business in the United States". Moreover, the FBAR now requires a foreign identification number, such as a foreign passport number.
- The new form demands the reporting of the exact "maximum value" of the account, and there are specific instructions for calculating this amount, including directions as to the impact of foreign currency holdings.
- And where one has signature authority over a foreign account in which a non-US person has a financial interest, that person must now be identified. Thus, where a US person holds a power of attorney, for example, over an account owned by a foreign family member, the relative must be identified, including, per the instructions, his or her "identifying number".

4. The IRS has clarified a provision involving corporate filings. The FBAR requirement applies not just to corporations but for most small and mid-sized companies; to individual employees who hold signature authority over corporate accounts even where, as in most cases, those employees have no financial interest in the account.

The new instructions clarify that the employee of a subsidiary need not file a separate form where the parent's CFO makes the proper certification to the subsidiary's employees and the account has been included in the parent company filing.

5. Of great interest to practitioners who counsel US persons on voluntary disclosures involving undeclared accounts, the new form and the instructions provide for a specially designated amended filing by including a box on the form noting that it is in fact an amendment.

The instructions request that the filer "attach a statement explaining the changes". Similarly, the instructions note that for delinquent filings the filer should "attach a statement explaining the reason for the late filing".

Voluntary disclosures offer some general assurance that the IRS will not proceed criminally, but given the size of the potential civil penalties (possibly 50% of the account balance per year), these statements should be drafted with care, as they will undoubtedly be important factors in any IRS decision to seek any such penalties for prior non-compliance.

There are other changes in the form and the instructions:

- The instructions make it clear that one has "signature or other authority" if he or she can exercise authority over an account "directly or through an agent, nominee or attorney ... either orally or by some other means".
- The new FBAR now permits a consolidated filing by spouses. The instructions add an explicit five year record retention requirement.
- And the instructions make clear that individual stocks or other instruments, in and of themselves, are not separate "financial accounts", and that an unsecured loan to a foreign business (not a financial institution) does not trigger the filing requirement.

All in all, although the new form demands much more information, the new instructions make significant clarifications. Preparation of the new form will be more complicated. The new instructions will also affect the advice practitioners give to the growing number of US persons who are seeking to make voluntary disclosures arising from previously undeclared foreign accounts. The issuance of the new form and instructions is a significant event, and tax advisors should study the new rules carefully.

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EMERGENCY ECONOMIC STABILISATION ACT OF 2008

The so called bailout act passed on 3 October 2008 included a large range of provisions that assist taxpayers in these difficult economic times. Many of the provisions were approvals of extensions to previously expiring tax credits and small business tax incentives.

The bill also included another so called Alternative Minimum Tax (AMT) patch to ensure the exemption threshold keeps pace with inflation. However, there was a good degree of political capital invested in this bill which, in its initial form was only a few pages long, but turned out to be hundreds of pages.

The main areas of debate focused around how to sell the cost of the package to the public which inevitably included some so called revenue raisers. These provisions were aimed at curtailing the perceived abuses of fat-cat CEOs and hedge-fund managers. This summary focuses mostly on these revenue raising provisions, since they have particular application in the international tax world.

Troubled Assets Relief Program (TARP)

Any senior executive that is employed by a company that has taken the government up on their offer to buy up troubled assets is potentially affected by these provisions or at the very least the employer is affected as this targets the ability of the employer to deduct compensation paid. These extend the already existing rules contained in Internal Revenue Code (IRC) Section 162(m).

The employer first has to be an applicable employer. An applicable employer is one which has assets acquired under TARP that exceed \$300million. It includes subsidiaries and related parties to prevent any abuse by splitting contracts.

An applicable employer is denied a deduction for any remuneration paid that exceeds \$500,000 of a covered executive (under section 162 this is usually \$1 million and for publicly held companies only). This also includes deductions for deferred compensation relating to prior years where TARP applied if the company has over \$300million of troubled assets.

A covered executive is one that is the CEO, CFO or one of the three highest compensated officers. These rules will continue to apply in future even if the individual is no longer a covered executive but the employer remains in the TARP program.

Remuneration for these purposes follows the broad definition in existing IRC section 162(m)(4) where there are relatively limited exceptions for 401(k) or other qualified pension contributions, commissions, normal non-taxable compensation and certain very strict performance based compensation.

Golden Parachutes

The golden parachute rules of section 280G are widely expanded to include covered employees of applicable employers in the TARP program and to capture severance pay and payments resulting from bankruptcy, liquidation or receivership of the employer. The employer receives no deduction for such payments.

It is worth having a recap of the golden parachute rules of 280G to understand the context of the expanded provisions.

- Applies to employees of publicly traded companies.
- More widely drawn than the 162 rules includes the top 1% or 250 highest paid individuals.

- Applies as a result of mergers or changes of control.
- Applies to severance payments.
- Is generally applicable if the payment is in excess of three times base compensation.
- Possibility to prove exceptional circumstances to be exempt.

Deferred Compensation and Carried Interest Arrangements

New section 457A has been added to the code to expand the provisions of 409A and section 83 to further limit the ability to defer compensation. It is effective from 1 January 2009. However, any previous arrangements that did qualify for deferrals that would now be caught out by this new section will expire in 2017. This section particularly targets the hedge fund industry making use of offshore vehicles in tax in different jurisdictions and carried interest vehicles where payouts are determined with reference to investment assets.

The main point is that there is still a possibility to defer but only until there is no substantial risk of forfeiture. All foreign entities are potentially implicated unless substantially all of their income is effectively connected income or they are in a jurisdiction where the profits are subject to a comprehensive foreign tax. This includes companies or partnerships where they qualify for the benefits of a comprehensive income tax treaty with the US. Therefore all Cayman Islands structures are caught by these new rules.

Substantial risk of forfeiture is defined in very similar terms to those in section 83 and the main grey area will be interpretation of the term "future performance of substantial services".

The carried interest provisions provide that the substantial risk of forfeiture provisions are not linked to services but rather dependent on the date of disposition of the investment asset by reference to which the compensation is determined.

An investment asset is any single asset (other than an investment fund) acquired directly by an investment fund and in which the fund does not participate in the active management and substantially all of the gain on sale of which is allocated to investors.

One of the real kickers in the rules is that if risk of forfeiture has lapsed but the amount cannot be determined, then there will be tax imposed when the amount is determinable. However, a penalty tax of 20% of the compensation plus interest applies on top of regular tax.

There are still a lot of outstanding questions which should be addressed in due course by the IRS, including rules on when does an amount become determinable for purposes of the 20% penalty tax and how this new section interacts with old section 409A.



Some Other Provisions of Interest in the Legislation

Tax policy writers believe that there is a substantial tax gap from under-reporting of capital gains by individuals. As a result, brokers are now required to track cost basis of all stocks in their client's portfolios to report correct gain or loss on Form 1099B. This provision is only required to be implemented as of 2011.

For anyone who is responsible for employer related payroll compliance, the additional FUTA surcharge of 0.2% is extended for another year.

AMT relief is extended by increasing the exemption amount for inflation and allowing certain credits to continue. Also, the long-term AMT credit is increased to 50% of the unused credit.

Other provisions that are extended for another year are the state and local sales tax deduction, the additional standard deduction for property taxes, the ability to transfer amounts from IRA's to charity without penalty and the ability to look through potential foreign personal holding company income of a Controlled Foreign Corporations (CFC) where it is from a related party.

Something which may have gone through unnoticed for those who are involved in the preparation of tax returns is that the paid preparer penalty standards relating to understatement of a taxpayer's liability have been relaxed back to reasonable basis rather than more likely than not.

IRS TO TIGHTEN UP PROCEDURES FOR LATE FILED FORMS 5471

Some of you may be aware that the IRS have had powers for a number of years to impose rather draconian penalties for the late filing of Form 5471 "Information Return of US persons with respect to Certain Foreign Corporations". The due date for filing this form is the same as the due date for filing your tax return (including extensions).

Historically, we have rarely seen these penalties, which amount to \$10,000 per late filed return, actually imposed. However, the IRS have recently issued a statement saying that, with effect from 1 January 2009, they will automatically impose the \$10,000 penalty for any late filed Form 5471. It will then be down to the taxpayer to demonstrate that there is 'reasonable cause' for the late filing in order to have the penalties removed.

Generally, Form 5471 is relevant to US individuals, corporations, partnerships, and trusts which own at least 10% of a controlled foreign corporation, or which acquire at least 10% of a foreign corporation in a particular tax year.

If you think that this may be relevant to you, and you have not filed this form, please contact your usual Frank Hirth representative as soon as possible.



COMPANIES ACT 2006 – KEY CHANGES FROM 1 OCTOBER 2008

Financial Assistance for Acquisition of Shares

The Companies Act 2006 will not prohibit a private company from giving financial assistance for the acquisition of its own shares. The prohibition on granting financial assistance will, however, remain in place for public companies.

Corporate Directors

A company will be required to have at least one director who is a natural person.

If a company had only corporate directors on 8 November 2006 (the date the Companies Act received Royal Assent), then there is a grace period for the company to appoint an individual until October 2010.

Annual Returns

Annual returns made up to a date on or after 1 October 2008 will contain reduced information relating to company shareholders.

The level of information disclosed will depend on whether the company is trading on a regulated market (traded company). Private and non-traded public companies are only required to disclose shareholders names not addresses. Traded companies need to disclose names and addresses for those shareholders holding at least 5% of shares issued.

Limited Liability Partnership

The accounts and audit provisions contained within the Companies Act 2006 came into effect for companies with financial years beginning on or after 6 April 2008. For Limited Liability Partnerships these provisions came into force for accounting periods starting on or after 1 October 2008.