



Welcome to the May edition of Focus which follows on from our recent 2009 Budget Report publication on forthcoming changes here in the United Kingdom. In this edition we will concentrate on the recent developments and proposed tax changes in the United States.

There has been mounting speculation since January 2009 regarding when, rather than if, President Obama will introduce federal tax increases and address perceived abuses. We outline his proposals from earlier this month that impact US businesses using offshore outsourcing arrangements, as well as the potential changes to how certain foreign affiliates and subsidiaries are treated; building on the Stop Tax Haven Abuse Act (STHAA) proposals.

There is a strong emphasis on increasing and shifting the burden of proof onto taxpayers and financial institutions which will substantially increase compliance burdens. We discuss the modifications to the Qualified Intermediary (QI) regime which will impose reporting obligations on financial institutions outside the US with American clients to the same degree as are required by US institutions. For individuals and other taxpayers, there are proposals to increase penalties for failure to disclose financial accounts held outside the United States. We place the spotlight also on recent Internal Revenue Service (IRS) guidance on voluntary disclosure by delinquent US taxpayers. The ground between those guilty of tax evasion and those paying taxes overseas, and inadvertently not in compliance, has been clouded by this programme.

Here in the UK we discussed the reality of dealing with the first UK tax year (ended 5 April 2009) following the changes to the rules on remittances and the diminishing availability of allowances and reliefs by claiming this status and, certainly for those here for seven years, the question of whether or not they should be taxed on a worldwide basis or pay the £30,000 levy. We understand that the IRS will be discussing this with HM Revenue & Customs (HMRC) as part of the planned tax treaty review this summer. We would hope that clear guidance will emerge from these talks but in many cases it will be necessary to take a position on this matter. With so many non-domiciled individuals likely to forego paying the £30,000 charge we expect to see more of our clients being subject to UK tax on their worldwide income. For US people switching to an arising basis of taxation in the UK, this is going to mean a re-orientation of their tax affairs with an increased burden in the UK and a need to claim relief or resource income on the US tax return.

On the other hand, projected increases in the top rate of UK tax and the significant curtailing of UK pension relief will make the arising basis of taxation more expensive and move many past the 'tipping point' when it becomes cost effective to pay the £30,000.

If you have not seen our recent 2009 Budget release, please contact your usual Frank Hirth representative for a copy, or follow this link: [Budget Report 2009](#).

Drawing a breath for a moment, we have some exciting news here at Frank Hirth. We are delighted to announce the addition of four newly promoted Associate Directors - Stephen Asher, Steve Butler, Annette Newell and Suzanne Willis. They will play an important role in the management of the tax groups within the firm over the coming years. In addition, from 1 April 2009 Jeffrey Gould has joined us as Associate Director and brings with him a wealth of technical expertise and experience to the firm. As many of you may know, Jeffrey has practiced in the US international tax world for over 30 years and he will add significantly to our capabilities in all areas of US and UK international corporate, income, estate and gift tax planning.

We also have had three promotions to senior manager; Kevin Brown, Graeme Privett and Iain Younger. Congratulations to all as we build our teams and expertise to deal with these UK and US legislative challenges.

Finally, we could not let this issue pass without drawing your attention to The Corporate Guide to Expatriate Employment which we have made a substantial contribution to, and which is available in all good book shops. Some of you may have seen Stephen Asher's article discussing this on our behalf on the CEO website - [www.the-chiefexecutive.com](http://www.the-chiefexecutive.com)

## Contents

Click on the links below to jump to the relevant feature:

**Recent IRS Voluntary Disclosure Guidance Complicates The Position For Delinquent US Taxpayers Overseas**

**President Obama Announces The Administration's International Tax Proposals**

- Getting Tough On Tax Havens
- Domestic Growth

## Stop Press

- IRS Announces Amnesty on Delinquent Foreign Bank Account Reporting (FBAR)

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# RECENT IRS VOLUNTARY DISCLOSURE GUIDANCE COMPLICATES THE POSITION FOR DELINQUENT US TAXPAYERS OVERSEAS

A recent announcement by the IRS regarding modifications to its voluntary disclosure programme may have significant fallout for any taxpayer who has failed to comply with his US tax filing obligations where there is an “international dimension”.

“Voluntary disclosure” is a term of art which applies to individuals who may have committed tax crimes by wilfully failing to report income and/or make required disclosures to the IRS. An individual who is in this position faces not only exposure to tax, interest and penalties in relation to any unreported income and civil penalties for any failure to disclose but also criminal sanctions including imprisonment and/or heightened fines. The IRS has always encouraged such individuals to make a voluntary disclosure of their position to the IRS criminal investigation division prior to the time that the IRS commences an investigation into the individual's tax affairs or otherwise receives information which could result in it independently discovering the individual's non-compliance. The disclosure is made in the first instance to the appropriate IRS criminal investigation unit, which then decides whether to prosecute, it being understood that the voluntary disclosure will be viewed as a favourable factor in that decision. If the decision not to prosecute is reached, the matter is referred to IRS tax investigators to agree liability and penalties.

Until now, the voluntary disclosure procedure has not been relevant to taxpayers who, although they have failed to fully comply with their tax filing obligations, have not done so with criminal intent but rather through inadvertence. Such individuals clearly are obliged to correct their non-compliance and in doing so to pay any liability and applicable penalties, with the possibility that penalties may be abated where a failure is due to reasonable cause. A subset of this group with which we have had considerable experience are those overseas Americans who have never complied with their US tax filing obligations, often without any tax avoidance because, as fully taxable residents of the UK or another country, their US liability will have been eliminated through credits. Over the years an informal practice has developed under which such individuals may effectively be considered to have brought themselves into compliance by filing back returns for a period of years (at most six). Any back liability for tax, interest and late payment/understatement penalties must be paid, but penalties for failure to report information may be

abated due to reasonable cause. Until recently it had been possible for penalties to be addressed directly with an IRS representative in an overseas embassy, but at least in relation to the US embassy in London this practice ended several months ago, making it necessary to deal with penalty issues as assessments which are issued by IRS offices processing the late information returns. Our experience in abating penalties in such cases has been almost uniformly positive.

The importance of being able to abate civil penalties for failure to meet international reporting obligations has grown exponentially in recent years as efforts have been made increasingly to impose “criminal size” penalties for mere civil failures owing to the IRS's inability to obtain this information any other way. These penalties, generally addressed at US residents, nonetheless apply alike to US citizens residing overseas. Among the most important of these are the penalties for failure to report Foreign Bank and Financial Accounts (the FBAR requirement on which we wrote to many of our clients recently [click here to download](#) – a hard copy of which can be provided by your usual Frank Hirth representative) which can run to \$10,000 per account per annum, failure to report the settlement of or receipt of distributions from a foreign trust, which is up to 35% of the amount transferred to or received from the trust and failure to report significant interests in foreign corporations, again up to \$10,000 per interest per annum. In all cases penalties can be abated for reasonable cause (with the addition, in the case of the FBAR requirement, that any income from the account has been fully reported). Penalties for the criminal violation of these provisions can in some cases be much worse and these, when coupled with underpayment penalties, can result in an individual owing more than 100% of the relevant income/assets.

## The IRS has announced it will be seeking to investigate other offshore financial institutions

The new changes in the voluntary disclosure procedure have been an indirect result of the IRS's recent widely reported success in prosecuting UBS for aiding and abetting US persons to evade tax by holding assets in undisclosed Swiss accounts. The case was settled with a substantial payment from UBS and UBS' agreement to release client information for certain US clients suspected of tax fraud. We understand some 200 criminal investigations of US taxpayers with undisclosed accounts at UBS have already been launched. The IRS has announced it will be seeking to investigate other offshore financial institutions suspected of similar practices.

This has led to a wave of frightened UBS customers and others similarly situated frantically seeking to regularise their position. The IRS is quite happy to welcome these individuals back into the system and to facilitate this announced on 23 March 2009 a penalty framework for individuals making voluntary disclosure involving overseas issues, provided any undisclosed income is not from illegal sources. Where the IRS decides not to prosecute such cases, the tax liability will be considered settled if the individual pays:

- all taxes and interest, and all underpayment penalties, going back six years (i.e. 2003 – 2008) or, if later, where the “account/entity” was acquired; and
- in lieu of all other penalties, including FBAR and information return penalties, a penalty equal to 20% of the maximum value of the account/entity during the six-year period. Except in extremely narrow circumstances, this penalty is not subject to abatement for reasonable cause.



Although the penalty framework is not stated in the notice, it seems clear that the "account/entity" referred to is one which has not been disclosed, or the income from which has not been reported.

In the past week there has been further information released about the new initiative, including clarification of the 20% penalty in relation to entities. Where the penalty is imposed on an undisclosed entity, e.g. an interest in a foreign corporation, the penalty is imposed on a pro-rata share of the entity's assets. The clarification states that "the twenty percent penalty applies to all assets ... held by foreign entities ... as well as all foreign assets (e.g. financial accounts, tangible assets such as real estate or art, and intangible assets such as patents or stock or other interests in a US business) held or controlled by the taxpayer."

The bold language if intended literally converts the 20% penalty from a charge on undisclosed accounts/entities into a charge on foreign assets generally, most of which are not subject to any disclosure requirement. Undoubtedly the clarification will itself require further clarification.

This framework is to be available initially for six months, i.e. until 23 September 2009. While not precluding the possibility it will be extended, the IRS has noted that this is not guaranteed and that if there is an extension it may not be on as favourable terms. In the words of IRS commissioner Shulman, "for taxpayers who continue to hide their head in the sand, the situation will only become more dire."

The penalty framework may be a welcome development for Americans who have been guilty of tax evasion involving undisclosed foreign accounts, etc., but may be less welcome for Americans, particularly those residing overseas, who while not in compliance with their tax obligations have not done so wilfully. While the voluntary disclosure procedure is clearly directed at the former group, the language of the recent IRS announcements suggests that the voluntary disclosure procedure is to be applicable to all cases in which an individual has understated his liability and there are "offshore issues", in other words the distinction between individuals who have engaged in tax fraud in relation to offshore interests and those who have not been eliminated. While it remains available for any individual to proceed outside the voluntary disclosure procedure by simply filing amended and late forms as necessary (referred to as a quiet disclosure), the IRS warns that its agents are instructed to fully develop cases involving undisclosed overseas income, "pursuing both civil and criminal avenues, and consider all penalties." Again, no distinction is made between cases involving wilful and non-wilful non-disclosure. We understand that all such cases will be funnelled to the same IRS units handling voluntary disclosures.

We nonetheless remain of the view that where no criminal behaviour is involved it should be possible to proceed outside the voluntary disclosure regime and making clear on submission that there is no attempt to avoid scrutiny, but rather that the voluntary disclosure process is not appropriate as there is no wilful or criminal behaviour involved. A careful analysis of defences to applicable penalties must be undertaken in each such case before deciding which route to take. Following discovery of any failure to fully comply with US tax and reporting rules in an international context, prompt action is even more important than ever.



# PRESIDENT OBAMA ANNOUNCES THE ADMINISTRATION'S INTERNATIONAL TAX PROPOSALS

Earlier this month, President Obama laid out his plans for international tax reform. Long perceived as the most abused section of the tax code, the proposals seek to raise \$210 billion over the next 10 years. The stated goals of the tax reforms are to reduce the amount of taxes lost to tax havens and to ensure that the tax code does not stack the deck against job creation in the US.

## Getting Tough on Tax Havens

In order to "get tough" on tax havens, the proposals include stricter reporting requirements for individuals and financial institutions. The aim is to crack down on perceived abuses of the system by Americans using tax havens to hide their wealth from US taxes. Offshore financial institutions with US clients will be coerced to join the Qualified Intermediary (QI) scheme. Under this programme, financial institutions enter into an agreement with the IRS to share information about their US clients and to produce 1099s as any US financial institution would have to do. In order to meet the QI requirements, all commonly-controlled financial institutions will also have to be QIs.

Any financial institution not choosing to join the QI scheme will be assumed to be facilitating tax evasion. US financial institutions will be required to withhold between 20% and 30% on any US payments to customers of non-QI institutions.

In addition, any US person holding an account with a foreign institution which is not a QI, will be assumed to have enough funds in their accounts to require foreign bank account reports be filed. It will then be up to the US person to prove otherwise. Further, if the account holds a balance over \$200,000 at any point in the year, the failure to file would be deemed "wilful" meaning greater penalties and perhaps criminal charges. These proposals represent a drastic change in the legal presumptions. The new legal presumptions would shift the burden of proof from the IRS to individuals and foreign financial institutions to prove they were not sheltering income or aiding in tax evasion.

Both US investors and non-QIs would also be required to disclose transfers of money or property between the US investor and non-QI account, with an emphasis on transfers made by foreign entities on behalf of the US person.

In order to aid the IRS, the administration proposes to hire 800 IRS agents devoted to international tax enforcement as well as to extend the statute of limitations for investigations and to increase the penalties on US taxpayers failing to adequately disclose their offshore accounts.

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## Domestic Growth

President Obama also announced reforms directed at US companies doing business abroad. The proposals seek to encourage domestic investment and jobs by removing tax benefits of operating abroad. Their implementation is much less clear however.

President Obama's proposals focus on unfair tax deferrals and tax loopholes which provide "significant tax advantage to companies who invest overseas". Currently US companies who invest abroad using foreign corporations are generally able to defer US taxation on profits until they are repatriated to the US. They can, however, take deductions on their US tax return for ongoing costs of the overseas investment, resulting in an effective deferral of US tax. Like previous measures proposed by the House Ways and Means Committee, this proposal would deny deductions (other than research and experimentation) until such foreign profits were repatriated.

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Other tax abuses this administration hopes to crack down on include foreign tax credit loopholes and loopholes created by the generous check-the-box regulations. Proposals will curb the foreign tax credit to actual taxes paid by a foreign corporation in a tax year and on income that is subject to US tax. In addition, check-the-box elections which effectively allow taxable income and tax rates across countries to be blended when included on the US tax return of a multinational would also be targeted. Unlike the denial of a tax deduction, the method for closing these loopholes is not yet clear. While directed at US corporations with overseas activity, implementation of any changes could have much more far reaching affects for small businesses and entrepreneurs by limiting the flexibility previously afforded.

Further details will be released when the Budget is announced, but these proposals are already facing strong opposition from the business community who say that further restrictions on US companies operating abroad will only hurt economic growth that legislators are so desperate to create. Instead of making it "more profitable for companies to create jobs here in the United States" as the President claims, business leaders say that these proposals would merely result in higher tax liabilities for those companies with foreign operations, further reducing the competitiveness of US corporations who already face one of the highest corporate tax rates in the world.

The ultimate reform of the tax code will likely change dramatically from this month's proposals, but the announcement is a strong indication of the new administration's state of mind. While targeting wealthy Americans and US multinationals "cheating" the tax system, the changes will inevitably increase the challenges and tax reporting burdens facing all Americans investing or operating abroad.



## STOP PRESS

### IRS Announces Amnesty on Delinquent Foreign Bank Account Reporting (FBAR)

We have written to many of our clients recently about this year's FBAR reports, due 30 June.

Failure to meet the obligation to report annually foreign accounts over which an American citizen or resident has ownership or signature authority normally carries heavy penalties, even if any income earned in the accounts has been properly reported on their US tax return. However, the IRS has just announced that individuals who are delinquent in their FBAR filings, but who have properly reported and paid tax on the income earned in the relevant accounts, will avoid penalties if the filings are made not later than 23 September 2009.

The delinquent reports, together with copies of tax returns for relevant years and an explanation for late filing, should be sent to:

*Philadelphia Offshore Identification Unit, 11501 Roosevelt Blvd. South Bldg., Room 2002, Philadelphia, PA 19154, USA.*