



**We are currently in the midst of a multitude of new enactments by the US and UK governments as a direct consequence of the financial crisis we have experienced over the last two years. The requirements of compliance are ever increasing both for the taxpayer and financial institutions.**

New Acts are being imposed without fully formed guidance which lead to confusion and increased costs.

An example is the new information reporting and withholding tax obligations which accompany the US Hiring Incentive to Restore Employment (HIRE) Act. These provisions require Foreign Financial Institutions (FFIs) to undertake detailed exercises of identification of US persons, and the steps required to identify are challenging. We cover the foreign account tax provisions which as indicated in the February edition of Focus has been on the cards since May 2009. We have a lack of clarity on the future direction or plan for legislative change other than as a series of money raising initiatives.

Nevertheless, in this issue we look at the tax rate changes that have occurred in the UK and those planned in the US.

We also look at some actions to consider ahead of year-end, and discuss the Liechtenstein Disclosure Facility with the peculiarities of this specific arrangement. We have highlighted some of the pitfalls in the UK of taxation on the arising (worldwide) basis compared to the remittance basis.

And though we are fast approaching the end of 2010, there appears to be no further development on the reform of the US estate tax other than heading back to the 2001 exemption level of \$1 million and a tax rate of 55% from 1 January 2011 onwards. Please see our link back to the estate tax repeal article in [February](#) as a helpful reminder to the present rules.

## New Acts are being imposed without fully formed guidance which lead to confusion and increased costs

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# ROTH INDIVIDUAL RETIREMENT ACCOUNT (IRA) – CONVERSION AND FUTURE OUTLOOK

A lot has been written in the US financial press about the relaxation of the income limit for when individuals can convert a traditional IRA into a Roth IRA, as of 2010. A number of US citizens previously deemed ineligible to convert their traditional IRAs may have been contacted directly about this new opportunity.

For those US citizens living in the UK, before making the decision whether such a rollover is the best option for them, they need to carefully consider both the US and UK tax implications both in respect of the conversion itself and of the income on retirement. The answer may not be as straightforward as it first appears.

## The Transfer Itself

The traditional IRA in the US attracted relief at the point of contribution either from direct funding or historic accumulation that is then consolidated in the IRA. The Roth IRA by contrast is a tax exempt fund for retirement with no income tax being due on the pension when taken. Shifting funds to a Roth IRA from a traditional IRA is not a qualifying rollover for US purposes. US Federal income tax (and State tax where relevant) would be due on the value of the IRA though no penalty would be charged for any distribution occurring before the individual reaches 59.5 years of age. This possibility, from 2010 onward, can be an attractive proposition to consider where the fact pattern suits; take a tax hit now and a view on substantive growth going forward. A step up in basis of the fund is then achieved for US income tax purposes.

Since the changes to pension rules in the UK which took effect from 6 April 2006, transfers between different IRA types has been considered qualifying and therefore entirely exempt from UK income tax. As a result of no income tax being due there is no effective step up in basis of the fund for UK purposes.

As no UK income tax is due on the conversion, there are no foreign tax credits available to reduce the US income tax charge unless the individual already has an accumulation of excess foreign tax credits. This may then be a question of whether it is expected that US income tax rates will increase or decrease in the future, and how long the fund would have to grow tax free before needing to be drawn on to provide a retirement income.

The value of the fund being converted would also have to be checked to see if it breached the UK lifetime allowance available on a cumulative pension fund, currently at £1.8 million and set to decrease to £1.5 million from April 2011. This would only apply to the increase in value of the fund relating to contributions made while UK resident on the basis that income tax relief has been claimed for these.

## On Retirement

It is also necessary to consider the position on retirement to see if this would affect the decision.

Under the terms of the UK/US double taxation treaty, any pension income or annuity would be subject to UK income tax. Although the UK also makes available a 10% deduction in respect of foreign pensions and a 25% tax free lump sum allowance, if our income tax rates remain at the current level of up to 50%, this may have a significant impact on the tax efficiency of the rollover.



If the individual were to take a distribution of the full amount of the fund, the UK/US double taxation treaty would give exclusive taxing rights on a US plan to the US. This is irrespective of whether the relevant event would actually be subject to US tax. Given that Roth IRAs are outside the rules for required minimum distributions at age 70.5, there may therefore be an opportunity to take the fund tax free.

Again there would be a need to measure any lump sum being distributed, over the 25% provided for, against the lifetime pension allowance.

## Summary

No charge arises to UK income tax on the conversion from a traditional IRA to a Roth IRA as it is a qualifying transfer. There would, however, be a charge to US income tax on the rollover with no foreign tax credit. The likelihood of US income tax rates increasing in the future, the length of time to retirement and availability of excess foreign tax credits to reduce this initial cost will need to be taken into account in any decision process alongside the investment considerations that you would consider with your wealth advisor.

Even though it would be tax exempt in the US, under the UK/US double taxation treaty, there is a charge to UK income tax on retirement if the individual goes into drawdown or purchases an annuity (with 25% lump sum facility and 10% deduction for foreign pensions) at rates currently up to 50%. This may effectively negate over time any benefit achieved by the rollover as the whole fund would eventually be taxed at rates of potentially up to 50%.

If the full amount was taken out on retirement, the UK/US double taxation agreement would only subject the fund to tax in the US (even though it would be exempt) with no charge to tax in the UK.

From a tax perspective the opportunity to convert would work ideally for those planning to retire to the US by time of drawdown or who are happy to take a full distribution of the fund at retirement. It would also be more effective if there was a significant period for the fund to grow tax free before funds were required on retirement, and if US income tax rates increase.

## Update

The Roth rollover opportunity has been extended further by provisions in the Small Business Jobs Act signed by President Obama on 27 September 2010. This permits amounts in 401K plans to be rolled to a Roth account. For rollovers in 2010, the sum is subjected to tax in equal parts in 2011 and 2012.

# THE FOREIGN CURRENCY TRAP

If, since the April 2008 changes, you have started filing your tax returns in the UK on the arising basis, there is a requirement for you to report significant movements between foreign currencies. The resulting foreign exchange movements will be subject to Capital Gains Tax (CGT). Significant asset purchases, if bought using foreign currency, could also give rise to significant additional tax liabilities for the unwary.

HM Revenue & Customs (HMRC) have indicated that reasonable care should be taken in regard to tracking the foreign currency transactions which are reportable. For those with expenses in a number of countries, there may be numerous reportable transactions and it may be a difficult and onerous task to keep details of them all.

In an attempt to lower the administrative burden, HMRC have issued guidance which states that movements between accounts in the same currency overseas, and transfers between accounts in the same currency in the UK, can be disregarded. However, for non-UK domiciled individuals, even those on the arising basis, transfers between an account overseas and an account in the same currency in the UK cannot be disregarded.

Although the guidance sets out that the gain or loss on each currency movement should be calculated individually, it does provide that where this would prove difficult due to the frequency of the transactions, monthly calculations are acceptable. In addition, where a foreign currency balance has been developed over a number of years, an average exchange rate for up to six years can be used to calculate the cost basis in the currency disposed of.

The guidance also states that net foreign currency gains of less than £500 do not need to be reported on the return. This may not be of much benefit as it would be necessary to determine the relevant transactions and calculate the gain to check whether they are over the £500 limit.



As well as cash movements between currencies, another common transaction to consider is the redemption of a loan denominated in foreign currency. Unlike the US this would not be a relevant asset so no currency gain or loss would arise on redemption. The currency used to redeem the loan is, however, a relevant asset and is considered to be sold when the loan is redeemed.

Significant overseas asset purchases can also cause problems even for those on the remittance basis. This is because although any gain on the deemed sale of the cash used to buy the asset is not reportable at the time, it would effectively be 'rolled into' the new asset and may need to be reported at a later date when that asset is sold if the funds are subsequently remitted.

In summary, movements between foreign currencies and the purchase of foreign assets with foreign currency balances, can create administrative difficulties and result in an unexpected tax charge if not planned for carefully. If you regularly move money between currencies or are planning to pay down your overseas mortgage or acquire an overseas property, talk to your usual Frank Hirth contact about the best way to minimise the possibility of being faced with an unplanned foreign currency gain.

## STOP PRESS – EFFECT OF CHANGE IN CAPITAL GAINS TAX (CGT) RATE

When the detail of the law enacting the Chancellor's change in the CGT rate to 28%, from 23 June 2010 was published, it contained a couple of welcome exclusions from the general rule.

There is an exclusion where the individual is returning to the UK and falls under the temporary non-UK resident rules. Where this results in additional capital gains being subject to tax in the year of return, and the year of return is 2010/11, the rate of tax will remain 18% rather than 28%. This may present a short-term planning opportunity for those returning to the UK in the next few months who have not been outside the UK for five complete tax years and can resume residency by 5 April 2011.

A provision was also included which allows losses of the year to 5 April 2011 to be used in the most beneficial way so it may be worth reviewing your position before the year-end and crystallising further losses to reduce the amount which would otherwise be subject to tax at 28%. In undertaking any review it is worth bearing in mind that gains remitted after 23 June 2010, even if the transaction took place before that date, will be taxed at 28%.

For UK domiciled individuals who are settlors of an offshore trust arrangement, thought should be given to crystallising gains within the trust before 6 April 2011. Under transitional provisions, these gains would still be taxed on the settlor at 18%, rather than the 28% which will apply from 6 April 2011.

On a more general note, now that the rate of CGT is once again linked to taxable income levels, it would be worth seeing if there is the opportunity between married couples and civil partners for the gain to arise to a partner whose income is below the 40% threshold. This would allow the maximum benefit of the 18% rate.

If you would like more detail of any of these opportunities please contact your usual Frank Hirth advisor.

# FOREIGN ACCOUNT TAX COMPLIANCE – INITIAL GUIDANCE

We discussed the Hiring Incentives to Restore Employment (HIRE) Act legislation in a special Focus bulletin earlier this year.

One aspect of this, in relation to withholding tax obligations on any form of investments in the US, saw preliminary guidance being issued in September 2010.

The so called Foreign Account Tax Compliance Act (FATCA) comes into force at the end of 2012 and this seems some way off. However, the scale and quantum of the task and ramifications of fulfilling these new obligations are so far reaching that they are creating significant waves.

Institutions which are classified as Foreign Financial Institutions (FFIs) will need to agree to comply with some onerous obligations to identify all US persons, or entities/structures primarily owned by US persons, with a view to fulfilling information reporting to the Internal Revenue Service (IRS).

The alternative is an obligation to apply US withholding on all income generated, or sale proceeds on amounts invested into the US, irrespective of whether they represent benefit for a US person. The question is, what falls within the definition of an FFI? The drafting and guidance to date places obligations not only on foreign banks, brokers and investment houses, but also in prospect family offices and trusts. There are exceptions for Non Financial Foreign Entities (NFFEs) such as a foreign corporation engaged in a non financial industry business. FFIs will still be obligated to identify those with beneficial entitlement of the NFFE under the identification procedures.

This is the US imposing its desire to collect information on US persons and very much less about withholding taxes which are the stick necessary to bring about information disclosure.

## RIISING TAX RATES

National income tax rates have risen in the UK as we reported in our 2010 Budget edition. The top income tax rate is now charged at 50%, and 42.5% on dividends, where incomes are above £150,000 a year, since 5 April 2010. In the US, without action from Congress, the current marginal federal income tax rates, long-term capital gains rate and the favourable qualifying dividend rates expire. The top income tax rate is expected to revert to 39.6% and the long-term capital gains tax rate to 20% from 1 January 2011. Limits on the level of itemized deductions and exemptions available would come into play and qualified dividends would revert to be treated as ordinary income. If you are affected by either or both of these increases, is there anything you can do to reduce your tax bill?

For those paying tax on their worldwide income in both the UK and US, you should concentrate on reducing your income tax in the country in which you pay tax at the highest rate. With many income sources taxed differently between the two jurisdictions, there can be opportunities to make savings through the judicious choice of investment vehicle. Equally there are pitfalls for the unwary which can result in unrelieved double taxation. The interaction of the taxes charged in the two jurisdictions may not give you the result you expect, so talk to your usual Frank Hirth advisor before making a decision.

A bit of sensible planning can, for many families, have quite an impact on the total tax they pay. In the UK husbands and wives are taxed separately, each having their own personal allowances, basic and higher rate tax bands. If one spouse is a low or non-taxpayer, transferring income producing investments into their name can result in significant savings. For example, in 2010/11, income of £43,875 will use the whole of the individual personal allowance and basic rate band of the non-taxpaying spouse and will save income tax of between £14,457 and £15,392, depending on the type of income, if transferred from a spouse paying income tax at the top rates. In the US this is not an issue with married couples filing jointly.

Other strategies for investment income include investing in tax free investments such as Individual Saving Accounts (ISAs) in the UK. With an annual investment allowance of £10,200, a sizeable portfolio could be accumulated over the years. Just be aware if you are also a US taxpayer, ISAs are taxable in the US, so the choice of investments to be held in the account should be US friendly. In the US the interest on government and state bonds is tax exempt but is taxable in the UK.

Tax deferral could be an option if you do not need access to your investments for a number of years. However, this is something of a bet on where tax rates are likely to be in the future. Given the current state of the UK economy, we are unlikely to see a reduction in the top rates in the short-term. Nevertheless investing in pensions, insurance bonds and offshore funds can allow your savings to grow tax free until you draw on them. There is an additional advantage to pension contributions since they attract upfront tax relief of at least the basic rate of 20%, and on reaching age 55, 25% of the fund can be withdrawn tax free. If your investments are also taxed in the US, while you could benefit from the tax deferral within insurance bonds and offshore funds, there could also be a nasty surprise in a penal US tax charge when you cash in your investment.

You may find other tax efficient investments attractive, such as venture capital trusts, enterprise investment schemes and film partnerships, although these are often high risk and would require specialist investment advice.

If you are feeling philanthropic, donations under gift aid to UK, EU or EEA registered charities are relieved at your highest UK rate of tax. The charity is also able to claim an additional 28.2% of the gift as a tax repayment. This amount falls to 25% for donations made after 5 April 2011. If you are looking to make sizeable donations, why not set up your own personal charitable trust and donate your surplus income before 5 April 2011 to take advantage of the higher repayment rates for charities currently available. You can then take your time in distributing the trust funds, including the charity tax repayment, to your chosen causes.

Even with the recent increase in the UK capital gains tax rate to 28% for higher rate taxpayers, it is worth considering how income can be turned into capital. This could be as simple as avoiding certain types of investments where the whole return is treated as income, such as offshore funds and insurance bonds. You could also employ a strategy of investing for growth rather than income.

Where the majority of your income comes from employment, your employer may offer a salary sacrifice scheme for a range of benefits, some of which are tax free, such as extra holiday, a mobile phone or childcare vouchers. A tax favoured share scheme may also be available which could give you a capital gain if the company does well.

And finally for the self-employed, have you considered incorporating your business? This will give you the ability to accumulate profits within the company at corporate tax rates of 21% for small companies and 28% for larger companies, falling to 20% and 27% respectively from 1 April 2011. Taking funds out of the company in the form of dividends can also provide a saving.

## Advancing Income for US Purposes into 2010

If most of your tax is paid in the US, is there scope for advancing any of your income into 2010? Some employers may be amenable to paying bonuses early, particularly if the usual payment date is early in the New Year. It may also be worth advancing the payment of certain expenses such as mortgage interest, and state and local taxes, to benefit from a full itemized deduction for these amounts. Whether this would be of benefit is not straightforward as it will also depend on the expected level of your taxable income for 2010 and 2011 and whether you are subject to the Alternative Minimum Tax.

There are certainly strategies you could consider to reduce your tax rate, whether you pay tax only in the UK or in the US or in both. However, with the complexities of the tax systems in both countries, you should first speak to your usual Frank Hirth advisor before taking action.

## THE LIECHTENSTEIN DISCLOSURE FACILITY (LDF) – A ONCE IN A LIFETIME OPPORTUNITY

There have been a number of opportunities in the past few years for individuals to disclose undeclared UK tax liabilities to HMRC for a limited penalty. However, the LDF is the most generous and such a deal is unlikely to be repeated. Anyone with assets held outside the UK at 1 September 2009 may take advantage of the generous terms on offer, provided they are not already under investigation for serious tax fraud.

To participate in the LDF it is necessary to establish a "meaningful" relationship with Liechtenstein before the closure of the facility on 31 March 2015. This would entail transferring assets, opening a bank account or making an investment there. The funds transferred to Liechtenstein may come from another offshore location or the UK.

### What are the Benefits of the LDF?

- The years assessed are limited to those beginning from 6 April 1999. Under an HMRC investigation up to 20 years of unpaid tax could be assessed. This means all undisclosed liabilities prior to 5 April 1999 can effectively be wiped out.
- A fixed penalty of 10% of the unpaid tax declared under the LDF is charged for the years 1999/2000 to 2008/09.
- A single composite rate of tax of 40% up to 5 April 2009 may be chosen or the actual basis of tax can be used. This can be useful where income is subject to more than one tax, e.g. VAT and income tax, as the LDF applies to all taxes, direct and indirect.
- There is a guarantee of no criminal prosecution (providing the funds are not from criminal activity).
- There is no public identification by HMRC of participants in the LDF, whereas those caught evading tax outside the facility may be named and shamed.
- The appointment of an HMRC advisor to act as a single point of contact and the ability to open negotiations on a no-name basis.

These terms are applied to all UK liabilities, whether or not connected with offshore assets, so even those with substantial undeclared UK income and gains can participate, provided they have established a Liechtenstein connection. If a taxpayer has been investigated in the past, they may still participate on limited terms:

- Where HMRC has already made contact, under either of the two previous offshore disclosure opportunities in 2007 or 2009, the penalty under the LDF is increased to 20%.
- Those who have previously been the subject of a formal investigation into tax fraud, or arrested for a criminal tax offence and failed to disclose offshore assets to the investigation, will be subject to a penalty of 30% under the LDF.

Where an individual has an offshore bank account opened through a UK branch or agency of that bank, they will not be entitled to the benefits of the LDF for that account.

With the complexity of the UK tax system, particularly for anyone domiciled outside the UK, there may be many who fear they have undisclosed tax liabilities but don't know how to go about regularising the position. If that is the case, this could be the opportunity they are waiting for.

Given the government's pledge to crack down on tax evasion and the amount of information now flowing to HMRC from former secretive offshore jurisdictions, it is only a matter of time before many taxpayers find themselves under investigation. With that in mind, coming forward now would be the smart thing to do. Waiting to be found out could ultimately cost up to 200% of the undeclared tax in penalties alone, as well as risk prosecution and a prison term.

## STOP PRESS – BRINGING MONEY TO THE UK

### Q: Now that my foreign income and gains are taxed in the UK, can I bring in whatever money I want?

A: With the changes to the remittance basis from 6 April 2008, many individuals domiciled outside the UK will have decided to pay UK tax on their worldwide income and gains from 2008/09 onwards. However, this does not mean they can bring all their funds to the UK without increasing their tax liabilities.

All income and gains which arose prior to 5 April 2008, which escaped UK tax because they were kept offshore, could still be taxed in the UK if remitted. If you are in this situation, you should continue to hold such funds separately offshore and use them to pay non-UK expenses. If you need to bring any of these funds to the UK, take advice first to determine how any extra tax can be minimised or eliminated.

If you have any queries regarding any articles or points raised in this edition of Focus, or if you have any other tax related queries, please contact your usual Frank Hirth advisor for further advice and discussion.



This newsletter has been written for the general interest of our clients. It is therefore essential to take advice on specific issues. We believe that the facts are correct as at November 2010 but there may be certain errors and omissions for which we cannot be responsible.