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CANADIAN TAX *Highlights*

US Focus on Offshore Activity

Offshore voluntary disclosure. The IRS and Treasury continue to devote substantial attention to US persons' offshore activities, especially offshore financial accounts. Failure to file the recently revised form used by US persons (and others) to report a financial interest in or signature authority over one or more financial accounts in a foreign country (Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts") can trigger not only significant civil monetary penalties, but also criminal prosecution. (See "FBAR Uncertainties," *Canadian Tax Highlights*, March 2009.) Moreover, US persons must make various disclosures regarding interests in foreign entities; failure to do so attracts penalties. To encourage compliance with this offshore financial account and entity reporting, the IRS announced a voluntary disclosure offer: from March 23, 2009 to September 23, 2009, US persons have a six-month window to voluntarily and timely disclose unreported offshore accounts and assets. At the end of that period the IRS will re-evaluate its options.

A US person who meets the terms of the voluntary disclosure offer must pay applicable back taxes and interest on newly disclosed assets for six years, and must pay either a 20 percent accuracy or a 25 percent delinquency penalty on any unreported income for all six years. No reasonable-cause exception is available. A one-time 20 percent penalty also applies on the highest total annual value in the unreported account or entity in the six-year period. However, that penalty is reduced to 5 percent if (1) the taxpayer did not open the account or form the entity, (2) there has been no activity in the account or entity during the period that it was controlled by the taxpayer, and (3) all applicable US taxes have been paid on the principal in the account or entity and only the earnings therein have escaped US taxation.

Though the accuracy or delinquency penalty coupled with the 20 percent or 5 percent penalty may seem punitive, the IRS views this as a taxpayer-favourable outcome because it will forgo other potentially applicable penalties--for example, for fraud (75 percent of unpaid tax), for failure to file various information returns, and for willful failure to file the FBAR (the greater of $100,000 and 50 percent of the foreign account balance), all of which apply annually. Moreover, those who come forward during the six-month voluntary disclosure window mitigate their risk of criminal prosecution. Before the voluntary disclosure offer was in effect, an individual who wished to come forward and comply with his US tax obligations, including FBAR reporting, was often uncertain about, for example, what penalties the IRS would apply and to what extent; how many years of back returns might be required to be filed or amended; and whether criminal prosecution was possible. The voluntary disclosure offer provides some certainty on those issues. In announcing the initiative, IRS Commissioner Schulman warned that "the situation will only become more dire" for a US person who does not take advantage of this limited-time offer.

Although the voluntary disclosure initiative appears to be a response to the highly publicized problems with US persons and Swiss banks, its scope is broader and it may apply to US-citizen or resident non-filers who are resident in Canada and wish to come forward. In the past, the IRS provided additional guidance on the scope and application of its voluntary compliance initiatives, and one hopes that it will also do so in this context.

Congress addresses offshore evasion. While the IRS and Treasury focus on offshore financial account reporting, several Congressional legislative proposals also address perceived offshore tax evasion. One bill of particular interest to tax practitioners on both sides of the border is the Levin bill

(S 506; see also its companion House Bill HR 1265). The bill is at a preliminary stage, and if it is enacted its ultimate form may be significantly different; however, some parts of the proposal may be relevant to Canadian companies with activities in the United States.

For example, one provision treats a foreign corporation as a US corporation if the "management and control of the corporation occurs, directly or indirectly, primarily within the United States," but only if the foreign corporation is either publicly traded or has an aggregate asset value of $50 million during the current or any previous taxable year. An exception exists for certain CFCs, so long as the US parent conducts a substantial active US business. This management and control test completely overrides the general US tax rule that a corporation is resident in the jurisdiction where it is chartered. The proposal's relevant factors for residence depend on whether substantially all of the senior officers and executive management who exercise day-to-day responsibility for making decisions involving the strategic, financial, and operational policy of the corporation are located primarily within the United States. The Levin bill also addresses foreign-based investment structures that use US-based managers: the management and control of a corporation that primarily holds investment assets being managed on behalf of investors is deemed to occur where the investment decisions are made. The provision is currently proposed to be effective for taxable years beginning on or after the date that is two years from the date of enactment.

It is too soon to tell whether the Levin bill will ultimately become law and, if it does, whether it will include the provisions noted above. The Obama administration has indicated support for the Levin bill, and President Obama co-sponsored a predecessor version when he was a senator. On the other hand, days after the Levin bill was introduced, the Senate Finance Committee issued its own preliminary draft legislation addressing offshore tax havens, with the notable absence of a provision that treats as US corporations certain foreign corporations with US management and control. To some commentators, the absence of such a provision in the Senate draft indicates that, at the very least, this provision in the Levin bill will not survive the US legislative process. Nonetheless, Congress, the IRS, and Treasury are all focusing significant attention on offshore tax issues whose development is being monitored closely by tax practitioners on both sides of the border.

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