AMERICAN CITIZENS ABROAD
THE VOICE OF AMERICANS OVERSEAS

Adapting Citizenship-based taxation (CBT) to the 21st Century

LOCAL CURRENCY AS FUNCTIONAL CURRENCY

ACA recommends that, for Americans resident abroad, the currency of the country of residence, not the U.S. dollar, should be recognized as the functional currency for computing capital gains or losses for U.S. tax filing.

Problems with the current system

When Americans reside overseas, it is only normal that they save, own property and/or invest in financial assets in the country where they reside.

Under CBT, applying the dollar as the functional currency penalizes Americans abroad with unavoidable foreign exchange risks. It leads to taxation on phantom capital gains, i.e. gains which derive solely from the rise of the local currency against the dollar over time. Phantom capital gains cannot be offset by local capital gains taxes, since there is no such gain in the local currency. Worse yet, if the purchase of a property is financed by a local currency mortgage, foreign currency losses in U.S. dollars cannot be applied against phantom gains, but if a forex gain is associated with the mortgage repayment, the phantom gain is taxed as income..

Using the U.S. dollar as the functional currency for U.S. citizens residing abroad is inconsistent with the tax principles that apply to U.S.-owned companies abroad, defined as QBU (Qualified Business Units). As the Financial Accounting Standards Board states, "An entity's functional currency is the currency of the primary economic environment in which that entity operates."[1] For individuals, it should be no different.

The requirement for American citizens residing abroad to use the dollar as the functional currency is set forth in *Chapter 26 CFR 1.985-1 – Functional currency*, *paragraph (b)(1)(i)*, which states: "The dollar shall be the functional currency of a taxpayer that is not a QBU (e.g., an individual)." [2]

Recommended change in the law

Replace the above reference with: "The dollar shall be the functional currency of a taxpayer resident overseas that is not a QBU (e.g., an individual) except for the purpose of computing capital gains and losses for which the currency of country of residence shall be the functional currency."

The rule defined above would be applied as follows:

- Capital gains on worldwide investments in financial assets, e.g. stocks, bonds, pension funds, mutual funds, ETFs, etc., would be calculated first in the currency of the country of residence of the taxpayer, and then translated into U.S. dollars at the exchange rate on the date of sale.
- Capital gains on real estate would be calculated and taxed in the currency of the country where the real estate is located, in accordance with general international practice, and then translated into U.S. dollars at the exchange rate applicable on the sale date.
- Exchange differences on the reimbursement of mortgages would not be subject to U.S. taxation.
- Income earned during the year would be translated into dollars at the average exchange rate for the year, as it is today. No change.

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[1] http://www.fasb.org/summary/stsum52.shtml
[2] http://www.law.cornell.edu/cfr/text/26/1.985-1

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