Transition Tax Relief May Buy Time for Residency-Based Tax Bill

by Andrew Velarde

American Citizens Abroad may have scored an incremental victory with delayed enforcement of transition tax payments as it continues its push for residency-based taxation for individuals, but the details of any potential legislation remain elusive.

In a June update to its frequently asked questions concerning the section 965 transition tax, the IRS announced that it would be waiving some late payment penalties and providing relief for individual taxpayers.

"There is going to be an effort to change the rules from citizenship-based to residency-based [taxation]," said Charles Bruce, legal counsel for American Citizens Abroad. "[The relief] buys some time to let Congress catch up. Only big changes are going to solve the problem, because it's not just repatriation tax — it's also [global intangible low-taxed income]; it's the passthrough rules that don't work for Americans overseas. . . . By accident, they really clobbered Americans overseas with these provisions," Bruce said.

Generally, an individual with a section 965 liability is required to report it on a tax return and pay the full amount of the liability. Taxpayers may elect to pay that tax on accumulated offshore earnings (15.5 percent on cash, 8 percent otherwise) over eight annual installments. Installments will be accelerated, however, by events like missing a payment.

FAQ 16 provides that if an individual with a section 965 liability of less than $1 million makes an installment election in 2018 and fails to pay the first installment, that failure will not result in an acceleration event if he pays the amount by the 2018 tax return due date (along with the second installment amount). For U.S. citizens and residents abroad, that due date is June 17, 2019. No penalty will be assessed for failure to pay the first installment, though taxpayers are still liable for interest. FAQ 17 provides that if an individual has filed his 2017 return but has not made the installment election, he may still file another return making the election, and be treated as if an extension request had been made.

While Bruce said the $1 million cutoff is unusual, calling it an example of "rough justice," he praised the relief in general.

In a March 22 letter, American Citizens Abroad asked Treasury to delay the imposition of section 965 for taxpayers residing abroad until final regs on the transition tax are published. It also asked for a de minimis rule to exempt small taxpayers residing outside the United States when reporting would otherwise be required, calling it a common-sense approach. The letter estimated that Americans overseas can easily have interests in more than 10,000 controlled foreign corporations that may be subject to the transition tax.

"For thousands of Americans abroad, these new provisions create a compliance nightmare. We submit that as to an overwhelming majority of them, they will not be able to comply within the time deadlines," the letter stated, noting that a calculation to conform with very detailed rules on overseas earnings would be necessary for reporting by April 15, 2018. "The new rules call for reporting, which, frankly, for many American individuals living abroad, is nigh-on impossible," it added.

Revenue Neutrality

American Citizens Abroad's ultimate goal for legislation on residency-based taxation may obviate the need for Americans abroad to make calculations and filings based on the transition tax, with the newly announced section 965 relief filling in as a stop-gap measure. The group has spent several years lobbying for residency-based taxation, which can be understood as territorial taxation for individuals that would generally exclude Americans residing overseas from U.S. income tax liability. It has continually tweaked and polished a proposal that would encapsulate the finer points of this move and had hinged its inclusion in the Tax Cuts and Jobs Act (P.L. 115-97) based on its revenue neutrality. Unfortunately for American Citizens Abroad, however, the proposal was left out of that legislation.

The group has not abandoned hope, though, and is still looking for legislation on the matter, possibly later this summer, if it can be packaged with another legislative vehicle like phase 2 of tax reform, according to Bruce. He echoed previous sentiments that revenue neutrality would make it easier to earn congressional support — a goal that could be achieved "with careful choices" like elimination of favorable withholding rates for non-grandfathered citizens on U.S.-source income and income from real estate investment trusts. This would be in addition to a separate departure tax for a move to residency-based taxation that would treat property as sold on the day before departure and an aging test to prove bona fide residency, both subject to thresholds that could be adjusted for purposes of revenue neutrality and avoiding abuse, he said.

In January the group's baseline score, completed by District Economics Group, was passed along to the Joint Committee on Taxation, Bruce said.

The most recent version of its side-by-side comparison of citizenship-based taxation rules and residency-based taxation from May includes provisions that would seek to exclude nonresident Americans from the TCJA's transition tax. It also would apply the dividends received deduction under the TCJA's participation exemption system to nonresident Americans and exclude nonresident Americans from the exception to the 20 percent passthrough deduction for foreign-source income.

Bruce has previously pointed to the bipartisan Americans Abroad Caucus — whose members include Rep. Carolyn B. Maloney, D-N.Y., co-chair and co-founder of the group — as the group's target for congressional support for residency-based taxation. Support for residency-based taxation also extends across the political spectrum to an endorsement from both Grover Norquist's Americans for Tax Reform and Democrats Abroad.

Bruce told Tax Analysts that based on lawmakers' behavior near the end of work on the TCJA last year, including a floor colloquy between House Ways and Means Committee Chair Kevin Brady, R-Texas, and Ways and Means member George Holding, R-N.C., American Citizens Abroad believes Republican leadership genuinely favors a change. Holding championed the measure during the November 2017 House session, arguing that citizenship-based taxation made it 40 percent more expensive to employ Americans overseas than their foreign counterparts.

Brady told Tax Analysts that while no decision on residency-based taxation has been made yet, he is still working with Holding and Americans for Tax Reform on the matter. He added that discussions are continuing, specifically related to individual income but not for individuals that own foreign subsidiaries. ■

Dylan Moroses contributed to this story.