AMERICAN CITIZENS ABROAD
EDUCATE, ADVOCATE AND INFORM

ACA GLOBAL FOUNDATION

Committee on Ways and Means
U.S. House of Representatives

Hearing on
How Tax Reform Will Simplify Our Broken Tax Code and Help Individuals and Families

Wednesday, July 19, 2017

Submission of
American Citizens Abroad, Inc. and
American Citizens Abroad Global Foundation

This Submission is made by American Citizens Abroad, Inc. and American Citizens Abroad Global Foundation. We appreciate the opportunity to contribute to the record of this Hearing.

American Citizens Abroad, Inc. and American Citizens Abroad Global Foundation represent the interests of Americans abroad. We are nonprofit, nonpartisan, volunteer, membership organizations. American Citizens Abroad, Inc. is qualified as a tax-exempt social welfare organization. Incorporated in 2012, it is the successor of American Citizens Abroad, which was organized as a voluntary association by American expatriates principally in and around Geneva in 1978. American Citizens Abroad Global Foundation (ACAGF) is a publicly-supported charity.

This Submission was prepared by Marylouise Serrato, Executive Director, Jonathan Lachowitz, Chairman, ACA, Charles M. Bruce, Legal Counsel of ACA and Chairman of American Citizens Abroad Global Foundation, and Glen Frost, Assistant Legal Counsel, ACA. Mr. Lachowitz is Founder, White Lighthouse Investment Management-Boston and Lausanne. Mr. Bruce is Of Counsel, Bonnard Lawson-Lausanne. Mr. Frost is Partner, Frost & Associates-Washington, DC. All members of ACA's Executive Committee and retired Director Jackie Bugnion contributed. For additional information, contact info@americansabroad.org. The views expressed herein represent those of ACA and not of any particular member of either organization.

Background

With respect to the enactment of residency-based tax rules, over the last three years, ACA and ACAGF (herein "ACA") have done first the spadework and then the detailed analysis necessary to foster this change. This started with a Forum on "Taxation of Americans Abroad in the 21st Century: Citizenship-Based Taxation vs. Residency-Based Taxation", held at the University of Toronto in May 2014. Beginning in early 2015 and steadily since then, ACA has dug into the details. It developed a so-called "middle-of-the-road" or "baseline" approach setting forth the issues in the form of a side-by-side comparison of current law with possible changes. This was not a legislative proposal, as such, but rather a listing of issues, which was intended to encourage

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careful consideration of all the points, large and small. It was also intended to be a basis for revenue estimates. ACA produced a detailed description of the approach. It developed and has revised several times Frequently Asked Questions on the subject. It has conducted several briefings for professionals. Also, it has liaised with other interested groups. Documents and descriptions relating to this activity appear on ACA's website at https://www.americansabroad.org. Starting several months ago, utilizing a novel crowd-funding approach, ACA began raising funds to support the scoring of residency-based taxation. http://www.acaglobalfoundation.org/donate.

ACA Urges Congress to Amend the Internal Revenue Code to Switch from Citizenship-Based Taxation to Residency-Based Taxation

ACA urges Congress to reform the Internal Revenue Code. It should do so as soon as possible. In the area of international tax provisions, at the same time it modernizes the rules applicable to U.S. corporations with foreign earnings and foreign subsidiaries and other operations, among other things adopting "territorial" tax principles, similarly it should apply "territorial" tax principles broadly to individuals.

Doing so will help the millions of Americans living outside the United States. It will help small businesses in the US who want to hire or contract with Americans abroad to help them promote and expand their businesses. Small businesses cannot afford to incur the costs associated with hiring and retaining Americans abroad.

"Territoriality" for corporations, as this Committee knows well, means that U.S. corporations, which are currently taxed, in general, on their worldwide income regardless where the income is earned, would be taxed only on income earned in the U.S. Under current rules, corporations benefit from partial territoriality in the sense that foreign subsidiaries organized and operated in highly circumscribed ways can defer U.S. tax. As for individuals, at present, they are taxed on their worldwide income regardless where they reside. Taxpayers meeting stringent residency-abroad tests, that is, they truly reside outside the U.S. and do so not just for short periods of time, are entitled to a form of partial territoriality in that they can exclude a portion of their foreign earned income, but not other types of income, and perhaps deduct some foreign housing costs.

Territorial tax treatment of individuals equates to taxation on a residency basis, according to where you reside, as opposed to taxation on a citizenship basis, that is, due solely to the fact that you are U.S. citizen.

Congress should amend the tax rules applicable to individuals residing abroad, making them taxable only on U.S. source income and income connected with the U.S. business or otherwise connected with the U.S. These rules would only apply to Americans truly residing abroad, not to Americans residing in the U.S.[1]

There are an estimated 9 million Americans living overseas. Many have lived there all their lives. They may have moved abroad after meeting their foreign spouse or partner or attending school or finding a job. They may have been born to non-U.S. citizens only temporarily in the U.S., for example, studying—well obviously not just studying—at a U.S. university. Based on 2014 census figures, if grouped like a state, Americans abroad would be the 11th largest state, just ahead of New Jersey and Virginia. Due to voting rules, however, they do not vote as a block. Rather their votes are mostly disbursed among the 50 states where they last lived or where their parents last lived.

American citizens, since the Civil War and without interruption since 1913, like corporations, have been taxed on their worldwide income, regardless where they reside or where the income arises. This rule was initially intended to catch individuals who dodged the draft or otherwise shirked their duties to the Union. Since 1926, however, a version of partial "territoriality" for individuals has permitted Americans residing abroad to not pay tax on limited amounts of foreign earned income and foreign housing costs. These rules are tortured and have been amended many times—17 times just since 1962.

As things stand, the U.S. is wildly out of sync with the rest of the world in the way it taxes individuals residing outside the country. It is the only country other than war-torn and impoverished Eritrea that taxes individuals based on their citizenship. An American citizen who, for example, has resided outside the U.S. all her life, who owns no property in the U.S. and who earns no U.S. source income, is required to file returns and pay U.S. taxes the same as someone living in St. Louis. The fact that she also pays tax to the country where she resides makes no difference. And because the U.S. does not have tax treaties with most countries, and many existing tax treaties are outdated, the goal of avoiding double taxation of income is often not completely achieved. A clear example is the 3.8% Net Investment Income Tax, enacted in combination with the Affordable Care Act 2010, which cannot be offset by foreign tax credits; thus, income can be taxed once by the foreign country where the individual resides in a second time by the U.S.

The tax rules and forms confronting the American citizen living overseas are mind-boggling, and the penalties for incorrect reporting or, more likely, simply not understanding the rules, can be financially ruinous. It's very difficult for taxpayers to prepare their own tax return. The forms for claiming exclusions and foreign tax credits and to report foreign financial assets are extremely challenging. A typical tax return for a relatively simple financial situation can easily run 75 to 100 pages and much more for self-employed individuals and small business owners.

[1] Americans residing in the U.S. who are shareholders in foreign corporations may benefit from changes in the rules for taxing these and similar foreign entities.

Only around 450,000 taxpayers, based on most recent figures, claimed the foreign earned income exclusion, which is the tax provision designed to help them. Many more, close to 4 million, claimed foreign tax credits. It is estimated, based on projections for 2018, that the exclusion, in saved taxes, was worth about $7 billion. Savings due to the foreign tax credit are generally not viewed as a tax expenditure because the credit is simply a way of avoiding patently unfair double taxation.

Now's the Time to Correct This Indefensible Incongruity

With the concept of "territoriality" on the table with respect to corporate tax law changes, the concept and its workings are on everyone's mind. A change for individuals can be made easily, without major surgery on the Internal Revenue Code. Simply put, Americans abroad would be treated essentially the same as foreign individuals. It follows, they would remain taxable on US-source income. This is the same approach used by all other developed countries. Moreover, it might be achieved without a loss of tax revenue. Loopholes can be guarded against with super strict drafting.

Problems associated with FATCA that today plague Americans abroad, such as the problem of "lockout" foreign financial institutions, would largely go away. An American citizen residing abroad would no longer be treated as a US account holder for FATCA purposes. Foreign banks would no longer need to be wary of providing services to this individual. Also, the problems of enforcing tax and foreign account reporting rules against Americans overseas could be reassessed. These individuals would be incentivized to bring themselves into compliance. There would no longer be the need to chase after them and employ complicated and sometimes unfair disclosure and other enforcement programs.

The amount of tax revenue involved, by any estimate, is minimal—less than the cost of running the Federal government for one day. With thoughtful choices about the design of the new rules and transition provisions, the cost might be reduced to nil. In fact, taking into consideration reasonable assumptions concerning improved compliance and without "cooking the books", the overall revenue effect might be slightly positive.

Residency-based taxation would encourage many taxpayers outside the US, who are currently not compliant for a myriad of reasons, to bring themselves back into the voluntary compliance system. This would lead to a pickup of revenues immediately following enactment and an ongoing stream of increased tax collections in the future.

Residency-based taxation would translate into more jobs for Americans and more exports of American goods and services around the world. As it stands, the tax code encourages U.S. businesses to expand and earn profits globally, but to do so without hiring U.S. citizens, who due to citizenship-based taxation can cost 2 to 3 times the amount of hiring a non-American. Congress should act strategically to encourage more Americans to live and work overseas. An enormous ambassadorial force would be created, which would encourage the purchase of American goods and services.

Small businesses would no longer face the problem of hiring Americans to work and market their products abroad. Larger exporters would save the costs of employing Americans abroad and having to incur the costs of equalizing their after-tax compensation and paying for the accounting and return preparation costs associated with this.

Where Does Enactment of Residency-Based Taxation Fit in The Landscape of Tax Reform?

There is a wide range of plans for reforming corporate taxes, but all of them include some form of "territoriality". House Republicans have developed a "blueprint" for tax reform that adopts a territorial approach for corporations and quite deliberately presents the possibility of changes for individuals. On the Senate side, Chairman Hatch's 2014 corporate integration proposal called for reconsideration of the taxation of nonresident citizens. Treasury Department and the White House, in the recently proposed 2018 budget, expressed interest in transitioning to a territorial system.

Individual members, such as Representative Holding up this Committee, have made a point of supporting elimination of citizenship-based taxation. Again, this is another way of stating "territoriality" for individuals.

Residency-based taxation for American citizens residing abroad fits comfortably alongside all the international tax reform proposals being developed, and importantly it can attract bipartisan support at a time when many would like to see more of this sort of thing. While differing on some details, Democrats Abroad, Republicans Overseas, Americans for Tax Reform, the Heritage Foundation, American Citizens Abroad, a number of American Chambers of Commerce overseas, and other business groups, all support changing from citizenship-based taxation to a residency-based taxation approach.

Well-crafted legislation will benefit individual Americans. It will benefit small business. It will result in increased employment of Americans, decreased costs to the government, simplification of the tax code, and a re-invigorated American diaspora to promote America's goods and services around the world.

ACA SUBMITS THE TIME IS NOW FOR THE CONGRESS TO ENACT RESIDENCY-BASED TAXATION FOR AMERICANS ABROAD. PROVISIONS TO THIS EFFECT, WE RESPECTFULLY REQUEST, SHOULD BE MADE A PART OF THE TAX REFORM PACKAGE BEING DEVELOPED.

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