AMERICAN CITIZENS ABROAD
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American Citizens Abroad (ACA) Update: Torturous Road Leading to TCJA and Its Progeny, the Transition Tax and GILTI.

Changes in the Internal Revenue Code and Treasury Department tax regulations elaborating on these changes go from bad to worse. All this is so miserable for American small business owners abroad that a little "crimp" looks like something major which should be celebrated. We should be thankful for anything, but we need to keep our eyes on the ball. We need a big change in the way Americans abroad are taxed.

Transition Tax and GILTI. Both these maddeningly complicated provisions are the product of the massive Tax Cuts and Jobs Act enacted immediately after the 2016 election, as a majority of the House and the Senate were in a near panic to deliver tax cuts to their supporters. The structure of the legislation jumped around radically from one approach to another in the last couple of months. The final version was a mash up. Transition Tax and GILTI materialized when it was seen that the new Participation Exemption System for taxing corporations' foreign income (a form of territorial taxation for corporations – but not individuals, including Americans abroad) would lose several hundred billion dollars in tax revenue over the relevant 10-year period. The Transition Tax, which hits not only corporations, the ones benefited by the new Participation Exemption System, but also individuals, more than plug the hole. GILTI, which was directed principally at US corporations with profitable intellectual property and operations in low-tax foreign countries, was estimated to pick up about one-third of what Transition Tax picks up, but this number is halved after deductions for foreign-derived intangible income and global intangible low-taxed income.[1]

GILTI/Section 250 Regulations. In regulations on section 250, published on July 15, 2020, several rules were clarified in favor of taxpayers. Section 250 is applicable to GILTI and foreign-derived intangible income (FDII).[2] Thankfully, it confirmed what was originally provided in proposed regulations in March that individuals, not just corporations, can take advantage of this deduction by making a special section 962 election to be treated like a corporation. On its face, section 250 provides the deduction "[i]n the case of a domestic [that is, US] corporation for any taxable year …." (Emphasis added.) In the case of American individuals owning and operating corporations overseas, the taxpayer is an individual, not a corporation, and if there is a corporation involved, the corporation almost always is not "domestic". To maneuver around the problem, taxpayers, including individuals residing abroad, who are shareholders in a foreign corporation (more specifically, a so-called "controlled foreign corporation" (CFC)), wondered if they could make the special election under section 962 – one of the dozens of Internal Revenue Code sections sitting within horribly complicated Subpart F, to be taxed like a corporation and,

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[1] The reality shown by the revenue effects tell you why the Treasury Department GILTI regulations, especially the provisions providing deductions against GILTI, are a critical subject for corporations. Maximizing these deductions is the best way to reduce the impact of GILTI.

[2] Because aimed at US corporations structuring themselves and their operations to offshore profits on intangibles, FDII has less of an impact on Americans abroad than GILTI and certainly less than Transition Tax.

as a result, access the section 250 deduction. Many large corporate groups that contain non-corporate entities very much wanted to be able to make the section 962 election. This benefit is not given only to Americans abroad, it has general application. Nor is it tailored to small taxpayers. Two other benefits in the recent section 250 regulations likewise were of great benefit to taxpayers, large and small, regular corporations and taxpayers that elect to be taxed as corporations: The section 962 election can go back to 2018, the first year of GILTI's applicability, and the election generally can be made on an amended return.

As one might expect, almost all the 46 parties pressing for changes in the GILTI Regulations, including the section 250 regulations, were large corporations and trade groups.[3] An exceptional submission, dated May 6, 2019, was made by Libin Zhang, wherein, for the most part, he repeats comments made in an article appearing in Tax Notes.[4] This submission and accompanying article provide a detailed explanation of the workings of GILTI and the section 250 rules for individuals, and the complications attendant to a section 962 election.

For Americans abroad with businesses subject to the Subpart F rules[5] and the GILTI provisions – recall GILTI came into the law as part of the Tax Cuts And Jobs Act of 2017 and the income is taxed alongside other Subpart F income, this can be a big help. Also, as mentioned, the regulations permit taxpayers to make the section 962 election with limited retroactive effect (back to 2018), and the election can be made on an amended return. This helps many taxpayers and many of these happen to be Americans abroad.

American Citizens Abroad, Inc. (ACA) did not submit comments on the section 250 regulations as it was apparent from the regulations proposed in March that a section 962 election would be allowed. It had been pointed out by commentators that this would significantly mitigate the impact of GILTI. Large corporations and trade associations were hammering all the right points.

GILTI/High-Tax Kick Out Regulations. As if the other batches of GILTI Regulations were not enough, Treasury, on July 23, 2020, published more regulations under the GILTI and subpart F provisions of the Code regarding the treatment of income that is subject to a high rate of foreign tax. These regulations affect the many Americans abroad that are treated as owning controlled foreign corporations. As noted in a footnote below, there are many more of these than immediately meets the eye.

The GILTI high-tax exclusion can be a significant benefit especially for Americans abroad in high-tax jurisdictions, such as, many countries in Europe. One has to make an election, however, to take advantage of this set of rules. In an odd way, the regulation writers seem to

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[3] https://www.regulations.gov/docket?D=IRS-2019-0012.
[4] Zhang, Simultaneous Equations for Simpler Tax Analysis, Tax Notes October 29, 2018.
[5] What has gone largely unnoticed is the fact that many more expats are being treated as involved with a controlled foreign corporation because the recent massive tax bill (TCJA, enacted in 2017) changed constructive ownership rules so as to cause US shareholders in a foreign corporation, for example, an expat individual, to be treated as owning shares in a corporation that on its face are owned by a foreign related individual (spouse?) or related entity (family partnership or trusts?). Congress was in such a rush that it never paused to consider the harmful effects of repeal of the pre-TCJA favorable rule, which said that constructive attribution rules could not be applied so as to consider a US person as owning stock which was owned by a foreign person (again, spouse, other related person?). Ownership of foreign businesses by members of the family or other related parties is extremely common. See IRC 958(b), as amended by 2017 TCJA §1421(a).

"get it" when it comes to small taxpayers: "Finally, because the guilty high-tax exclusion applies on an elective basis, taxpayers may choose not to make the election if the compliance burdens of the computation outweigh the benefits." (Of course, the taxpayer would have to "run the numbers" to figure out what the benefits are and then shop around to determine the cost of claiming the benefit on a return.) In these regulations, like another GILTI and Transition Tax regulations, *de minimis* rules for small taxpayers and safe harbors are eschewed.

As with all regulations like these, the Treasury Department is required, under the Regulatory Flexibility Act (RFA), to consider whether regulations will have a significant economic impact on a substantial number of small entities, is defined by the Act. The regulations tread carefully on this subject probably in part because the applicability of the RFA was brought into question by, among others, ACA in its testimony on the Transition Tax regulations and the taxpayer in SILVER, ET AL. v. IRS. (See below.)

In order to give the full flavor of the regulations, we quote the regulations at length below.[6]

We read the regulations to say that the Treasury Department does not have the data to say how many small businesses, and certainly not how many expat-owned small businesses, might be affected. Nonetheless, US shareholders of CFCs, it is asserted, are generally not small businesses: CFCs are something for large businesses, not small businesses. And in any event,

[6] The regulations read:

> The data to assess the number of small entities potentially affected by § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C) are not readily available. However, businesses that are U.S. shareholders of CFCs are generally not small businesses because the ownership of sufficient stock in a CFC in order to be a U.S. shareholder generally entails significant resources and investment. The Treasury Department and the IRS welcome comments on whether the proposed regulations would affect a substantial number of small entities in any particular industry.
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> Regardless of the number of small entities potentially affected by § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C), the Treasury Department and the IRS have concluded that there is no significant economic impact on such entities as a result of § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C). Furthermore, the requirements in § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C) apply only if a taxpayer chooses to make an election to apply a favorable rule. Consequently, the Treasury Department and the IRS have determined that § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C) will not have a significant economic impact on a substantial number of small entities. Accordingly, it is hereby certified that the collection of information requirements of § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C) would not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public on the impact of § 1.951A-2(c)(7)(viii)(A)(1)(i) and (ii) and § 1.951A-2(c)(7)(viii)(C) on small entities.

TD 9902 (7/23/2020), Part III, Regulatory Flexibility Act, Fed Reg. Vol 85, No. 142 (July 23, 2020), pp 44638.

small businesses need not be adversely affected; they can simply not seek to avail themselves, like their large business cousins, of the benefit of the high-tax kick out.

This approach is the sort of thing that drives Americans abroad crazy. Treasury Department should do its homework. It should dig into the data. It has access to every snippet of data that could possibly exist. It should figure out how many small businesses are affected and, of these, how many, in fact, are expat small businesses. Then, with the facts in hand, it should insert a *de minimis* rule in the regulations. This situation screams for a *de minimis* rule.

Stepping back and looking at Transition Tax and GILTI. In the massive Tax Cuts and Jobs Act passed in 2017, the move to territorial taxation for corporations (or participation exemption system; which was a major goal, if not the number one goal, of Congress), the transition tax, which was necessary to offset some of the income lost due to the move to territorial taxation, and GILTI, which similarly was necessary to avoid losing large amounts of revenue once territorial taxation was in place, are all intertwined. And transition tax and GILTI sit within the Subpart F/controlled foreign corporation rules which, in the view of some of the smartest international tax attorneys, are the most difficult and complex provisions in the Internal Revenue Code.

Subpart F of the Code was enacted in the early 1960s, during the administration of President Kennedy. The original effort was to tax US corporations on their worldwide income, full stop. There would be no beneficial treatment of foreign source income. Proponents did not have the votes necessary to accomplish this fully, so the compromise was to put Subpart F in place and to make it as much like a Rube Goldberg machine as possible.[7] Other countries were expected to follow suit. Then everyone, pretty soon, would become sick and tired of it, and the US could go back and enact worldwide taxation for corporations, as originally hoped for. Things did not work out that way. Over 50 years later, following the 2016 election, it was hoped by the new Administration and new leaders in Congress that the exact opposite could be achieved, that is, corporations could be taxed on a strictly territorial basis and foreign income would not be subject to US tax, full stop. Again, but this time in reverse fashion, there were not enough votes, and, therefore, Congress had to come up with a modified territorial taxation regime for corporations. Immediately, problems and unexpected outcomes sprung out of the woodwork, especially for subsets of taxpayers like Americans abroad. There was no time to address these problems.[8] Transition tax and GILTI are just two of the many quirky provisions that resulted.

Transition Tax Regulations. ACA submitted lengthy and detailed comments on the Transition Tax regulations and followed up with in-person testimony at the IRS hearings on the regulations.[9] ACA was the only group representing Americans abroad that did this. This action provided ACA with a great deal of visibility at Treasury Department and the IRS and put us in close and regular contact with other taxpayer groups. This has proved very valuable in our work on other matters, such as residency-based taxation.

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[7] A Rube Goldberg machine, named after American cartoonist Rube Goldberg, is a machine intentionally designed to perform a simple task in an indirect and overly complicated way.

[8] Congressman Holding (R-NC) and one or two others flagged the problem, and it was said that they would get back to it at a later time.

[9] In these comments, ACA raised the problems of the Treasury Department not following relevant procedurals. To the best of our knowledge, this issue had not been raised before by any commentator.

Apart from communications on regulations, ACA wrote to Treasury Department and the IRS on Transition Tax and GILTI. Our number one point was that Americans abroad should be taken out from under these convoluted rules, aimed at very large US multinational corporations. This can be done with a simple, sensible *de minimis* rule. ACA also criticized the failure of the regulations to follow the required procedural rules. (i.e. Paperwork Reduction Act, Regulatory Flexibility Act addressed below)

The problem with fighting the war with skirmishes inside tax regulations. Provisions such as GILTI are overwhelmingly a large corporation's battlefield. By twisting into a pretzel, Americans abroad can dodge this or that bullet and can mitigate some of the bad results. However, they remain US taxpayers. They must still keep US-style tax records. They must place themselves and any entities that they are involved with, in the proper Internal Revenue Code-defined categories: corporations, disregarded entities, partnerships, etc. If there is a benefit buried in a tax provision or Treasury Department regulation or instructions to a form, they have to dig it out and claim it. Almost without exception, they must hire not just a run-of-the-mill tax advisor but a super tax advisor. This is expensive.

The problem is while they live and work outside the United States and everything governing their life and business there is different from that of an American living State-side, they are subject to the same substantive tax and filing rules as their cousins living in New York, California, Florida, Taxes, Virginia, or anywhere else in the States. This is completely different from the approach of every other country apart from hard-put-upon Eritrea. The problem, as American Citizens Abroad, Inc. and other groups and many individuals have said again and again, for years, is citizenship-based taxation (CBT). The ONLY solution is residency-based taxation (RBT).

There is no reason why the US should not make this change. RBT can be made revenue neutral, tight – really tight – against abuse, surprisingly simple, and such that no one is worse off than they would be under existing rules.

RBT must be "put on the table" for Congress to turn it inside out and ensure itself that it is "as advertised". There must be no surprises. First, there should be Congressional hearings where everything is laid out. ACA, with other groups, is pushing hard for hearings.

The dozens of groups, companies and others that work with Americans abroad should cooperate in the effort to enact RBT. This need not be an elaborate arrangement. They simply need to demonstrate that RBT has broad support.

It will be necessary for there to be a big piece of tax legislation to which RBT can be attached. And here's the good news; everyone can be absolutely assured that there will be big tax bills coming through Congress in the near term. The Federal government cannot live with a multi-trillion dollar deficit for long without making historic tax law changes. Americans abroad need to be "at the table" when the tax laws in general are restructured.

Little steps. In the meantime, little steps are absolutely possible. Treasury Department, whether it is in a Republican Administration or a Democratic Administration, can insert a same country exemption (SCE) in the FATCA regulations. This will greatly alleviate the problem of Americans abroad being locked out from foreign financial services. It is well-known that this action does not require legislation. It only requires a Secretary of Treasury and Deputy Assistant

Secretary for International Tax Affairs, with apologies to NIKE, to "Just Do It". ACA has drafted and presented to the Treasury and the IRS a proposal for SCE.

A second "little step", which is easy as easy can be, is to stick in the Transition Tax and GILTI regulations a *de minimis* rule. Treasury Department was wrong not to have done this in the first place. Now they should do it. This will sidestep, or go a long ways towards sidestepping, among other things, questions as to why they "blew past" the niceties of the Paperwork Reduction Act and the Regulatory Flexibility Act, as pointed out in ACA's submission dated October 8, 2018, on the section 965 regulations. This issue was raised prominently in ACA's written comments and then oral testimony on the section 965 transition tax regulations. Smartly, it is the subject of litigation which is not going well for the Treasury Department. SILVER, ET AL. v. IRS, ET AL., 124 AFTR 2d 2019-7128, Code Sec(s) 951; 962; 965; 7421; 7805, (DC Dist Col), 12/24/2019 (IRS's motion to dismiss denied. Plaintiff's subsequent motion for summary judgment filed May 15, 2020.)

ACA has sought to bolster the plaintiff's case by publicly stating that in its promulgation of the Transition Tax regulations, the official estimated average annual burden per taxpayer, which is said to be 5 hours, in our view, is simply incorrect. ACA believes it grossly underestimates the burden.[10] How the Treasury Department arrived at this figure is unclear. ACA operates an online Expat Tax Services Directory, which is very popular with persons looking for return preparers and similar service providers. An informal search for information from return preparers listed in the Directory tells us that the time required to comply with the new rules is much higher than that suggested in the Regulations.

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US citizens living and working abroad experience an increasingly long list of problems resulting from the imposition of citizenship-based taxation. Problems from the Transition Tax and GILTI provisions are one more example of why RBT is ultimately the right corrective measure. Communications to ACA with regard to overseas small businesses indicate that some individuals pay upward from $5,000 to $10,000 simply to comply with requirements – even when they don't owe any additional US taxes. Regrettably, some small businesses call it quits given the onerous filing requirements.

It's time for Congress to hold hearings on taxation of Americans abroad and the problems of citizenship-based taxation. Everything relating to residency-based taxation should be put on the table. Then everyone can move to drafting an RBT bill. To learn more about RBT please visit the ACA website at: https://www.americansabroad.org. This update can also be found online here: https://www.americansabroad.org/news/aca-update-the-torturous-road-leading-to-tcja-and-its-progeny-the-transition-tax-and-gilti/

[10] Letter from American Citizens Abroad to Sec. of the Treasury Mnuchin, Assistant Sec. for Tax Policy Kautter, Commissioner, Large Business & International, IRS O'Donnell, IRS Commissioner Rettig, and Deputy Assistant Secretary (International Tax Affairs) Harter, dated July 10, 2020 (reprinted by Tax Notes at https://www.taxnotes.com/tax-notes-today-international/controlled-foreign-corporations-cfcs/american-citizens-abroad-calls-de-minimis-rule-gilti-regs/2020/07/14/2cq7w?highlight=American%20Citizens%20Abroad).

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