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TAX REFORM BILL AND AMERICANS ABROAD: WHAT HAPPENED? WHAT'S NEXT?

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At around noon today, President Trump signed into law H.R. 1, the Republicans' tax reform plan. The President announced his intention to do so in a message posted on his Twitter account shortly after 10 a.m. EST this morning. There has been great deal of speculation as to when, exactly, the President would sign the legislation.

Because the Continuing Resolution, which the President also signed this morning, includes a waiver of the statutory PAYGO requirement that the tax reform bill's deficit effects be added to the Office of Management and Budget's PAYGO scorecard for 2017, the sequester (*i.e.*, automatic spending cuts) that would have otherwise resulted from the enactment of H.R. 1 will not kick in.

The Tax Cuts and Jobs Act (TCJA) itself runs a little more than 500 pages. The Conference Committee explanation adds another approximately 500 pages. An enrolled/final version of the legislation is available on the Government Printing Office website.

THIS WRITING IS NOT INTENDED AS A COMPREHENSIVE EXPLANATION OF TCJA, NOR, IN ANY WAY, SHOULD IT BE VIEWED AS TAX ADVICE. THE READER IS URGED TO CONSULT WITH HIS OR HER INDEPENDENT ADVISORS.

What happened?

Changes in the basic rules for Americans abroad were not made.

Since Americans abroad will continue to be taxed on a citizenship basis the same as taxpayers residing in one of the States or the District of Columbia, just about everything in the legislation is relevant, including changes in individuals' tax rates, deductions, credits, estate, gift and generation-skipping transfers taxes, changes in corporations' tax rates, small business rules, and literally hundred other provisions. Changes in the tax treatment of Alaska native corporations and settlement trusts may not be a hot item, but many other provisions, depending upon an individual's specific circumstances, could have an impact.

There are strong indications that Congress will soon return to the subject of tax law changes to make corrections in what was done and to address issues that were postponed. A couple of days ago Chairman Brady said, "I'm going to recommend that we do have some form of tax reconciliation in future budgets because there are still areas of the tax code I think . . . can be improved, including retirement savings, education, and streamlining," Brady said. "And we had a number of good ideas from our members we weren't able to accommodate. Plus, I think we'll have to continue to modify the international code over time."

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What has not changed?

The basic foreign earned income and housing cost amount exclusion (FEIE) has not changed. There was no serious treatment of the subject one way or the other. Some thought that raising the subject of taxation of Americans abroad might "boomerang" and cause FEIE to be changed or repealed. This did not materialize.

As to residency-based taxation (RBT) for Americans residing outside the US and its "cousin", some form of territorial approach affecting Americans residing either inside or outside the US, no bill or legislative provision was introduced by any Member. (Recall, ACA's approach to residency-based taxation for Americans abroad simply treats them, in general, like non-resident individuals and thus does not tax their foreign income. It is the simplest form of territoriality for these individuals.)

Moreover, it appears that the treatment of Americans abroad may not have been entirely "thought through" in the context of other changes that were made. See below.

While thought was given to repealing FATCA and at one point it was believed that Sen. Paul (Republican-Kentucky) would offer his and others' proposal to repeal FATCA as an amendment to the tax reform bill, this not happen.

A couple of additional points: (a) The 3.8% net investment income tax to fund Medicare and The Affordable Care Act, remains in place and continues to apply in a way that, for Americans abroad, exposes them to double taxation because they are not allowed to credit foreign taxes against it. (b) A same country exemption from the FATCA rules was <u>not</u> added to the statute. It should be noted that this relief can easily be provided by the Treasury Department dropping it into the FATCA tax regulations. This would not require congressional action. (ACA has written Treasury Department asking that it do this.)

There are some serious problems.

There are some serious problems with the Tax Cut and Jobs Act. These will need to be carefully analyzed and steps taken to correct them.

(a) <u>The new participation exemption system adversely affects Americans abroad by not providing the dividends received deduction and yet taxing an individual on the deemed distribution</u>.

The Act moves the US from a worldwide tax system to a participation exemption system by giving US (that is, domestic) corporations a 100% dividends received deduction for dividends distributed by a controlled foreign corporation (CFC). To transition to that new system, the measure imposes a one-time deemed repatriation tax, payable over 8 years, on unremitted earnings and profits at a rate of 8 percent for illiquid assets and 15.5 percent for cash and cash equivalents. The dividends received deduction, which obviously is a major benefit, is available only to US corporations that are shareholders in the CFC. The deduction is not available to individuals, nor is it available to foreign corporations, which, for example, are owned by US individuals, including individuals living abroad. On the other hand, the repatriation tax would apply to everyone, not merely US corporations. Accordingly, an individual, for example, a US citizen residing abroad, who is a shareholder in a CFC, might be subject to the repatriation tax. Note that this individual might not have in hand the actual monies needed to pay this tax.

This change is likely to come as a surprise to many Americans abroad who own foreign companies with accumulated earnings and profits. A special anti-abuse rule is intended to prevent people cleaning out the accumulated E&P account on or before December 31 of this year; it catches E&P determined as of November 2, 2017, the date of introduction of the bill.

(b) Special reduced rates for so-called "passthroughs" do not benefit Americans abroad that earn from a passthrough foreign income.

The Act allows a deduction of up to 20% of passthrough income for specified service business owners with income under $157,500 (twice that for married filing jointly). The rationale is because corporate rates were dropped from a graduated rate structure with the top rate of 35% to a flat 21% rate, unless something was done for unincorporated, so-called passthrough arrangements, such as partnerships and limited liability companies, and the owners of these are taxed at individual rates which rapidly proceed well above 21% to as high as 37%, these businesses would bear a significantly higher burden, influencing many of them to incorporate. The passthrough tax break generally will not be useful for Americans abroad because it only applies with respect to domestic business income, that is, items of income, gain, etc. that are effectively connected with the conduct of the trade or business within the US.

Ironically, this is a prime example of "upside down" territoriality. Under a territorial approach, such as, residency-based taxation, the taxpayer is expressly *not* taxed on foreign income. Here, the taxpayer – say, an American abroad – for sure will be fully taxed on foreign income, whereas his or her cousin in the States who earns domestic business income will enjoy the 20% deduction.

(c) Foreign real property taxes can no longer be deducted under the Act. This change came up in the context of proposals to eliminate all State, local, and foreign property taxes and State and local sales taxes, except when paid or accrued in carrying on a trade or business or an activity relating to the production of income. An exception allows a taxpayer to claim an itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of State and local property taxes not paid or accrued in carrying on a trade or business or an activity relating to the production of income and State and local income, war profits, and excess profits taxes. However, expressly cut out from this exception are foreign real property taxes. Political considerations attaching to individuals' real property taxes in high-tax States, such as, California and New York obviously did not come into play with individuals' foreign taxes. These rules apply to taxable years beginning with 2018 and ending with 2026.

These new rules generally are effective in 2018 – so in about a week's time. There can be many variations on this point.

What are the good points?

There are a few good points to be noted.

Overall, the visibility of the subject of taxation of Americans abroad has greatly increased. The House Republican Blueprint for tax changes, developed early on, said that legislators would consider "appropriate treatment of individuals living and working abroad in today's globally integrated economy." Ways and Means Chairman Brady said that Congress is thinking about changes in the way American individuals abroad are taxed. Lawmakers, he added, take seriously the call for a shift from a citizen-based income tax system to a residence-based

system that would only tax people on the income they earn in the U.S. Finance Committee Chairman Hatch's corporate integration proposal called for reconsideration of the taxation of nonresident citizens. Individual Members, such as, Representative Holding (Republican-North Carolina), have said that changing the way Americans overseas are taxed is high on their list of priorities. Late in the process, there was a very good floor colloquy between Representative Holding and Chairman Brady on the need to take up this subject afresh in the near future.

The fact that obvious problems exist with the Act, including those flagged above, may lead to an early consideration of changes, including adoption of RBT. Americans abroad can be expected to react strongly and, one hopes, "get engaged".

In the tax reform process, it became clear that reliable data on the tax implications for Americans abroad, especially revenue estimates, were not previously available.

One of the most positive things that happened was that ACA successfully developed the best, most comprehensive baseline set of data for detailing the taxation of Americans abroad. This baseline information did not previously exist. It required five months of work by ACA and its independent revenue estimator, District Economics Group (DEG). Utilizing this information, ACA has been able to greatly refine its description of a possible approach to changes in the law and to run revenue estimates. All of this shows that enactment of RBT can be made revenue neutral. This is an extremely important outcome. ACA has always said that for RBT to be adopted, it must be revenue neutral, tough against abuse, and fair for everyone, meaning among other things that no one would be worse off. ACA's numbers-crunching shows that RBT can be adopted and the, at the same time, section 911 can be left in place. This goes a long way to solving the problem of "short-termers", that is, people who move abroad, move back to the US, maybe move abroad again. They could not satisfy an aging rule requiring them to stand in place outside the US for, say, 5 years. This way, if they wish, they can simply stay the course with section 911.

Another positive thing is that the course of its detailed work, ACA has solicited and received a large number of comments from a broad range of people that would be affected. In the process, it has learned about dozens of detailed and often complicated subjects; and it has gotten good advice from many directions. Based on all of this, it has continuously amended and improved its so-called "vanilla" approach. For example, while not directly on the point of RBT but rather having to do with the application of FEIE (section 911), it is addressing the problem of Americans abroad being denied FEIC benefits on the ground that the taxpayer does not have a "tax home" in a foreign country. ACA believes that the section 911 regulations in the way they treat the concepts of "tax home" and "abode" are either incorrect or are being misapplied. ACA strongly supports fixing this problem; and the revenue cost, based on baseline figures, should be *de minimis* or nil.

Groups representing Americans overseas, individually, have become better organized and more focused. The fact that they need to pull together appears to be more widely recognized.

What's next?

Americans abroad need to keep pushing. They cannot break stride or turn away from the task of getting RBT enacted into law. RBT is a major change in the law. It's not surprising that it will take a major effort to get the law changed.

Congress did not consider RBT and reject it. It's noteworthy that no Member or committee arrived at the point where an RBT/territoriality-for-individuals proposal was put by a Member on the table, drafted in legislative language and "scored" for its revenue effects.

Republican interest groups, as well as other groups such as Democrats Abroad, AARO, and FAWCO, all talked with many Members and "knocked on many doors". They deserve great credit for their efforts. ACA, making good use of its Washington-base, with Executive Director and others there, over the last year, had numerous meetings with Members, Members' staffs, the staff of the Joint Committee on Taxation, Senate Finance Committee and House Committee on Ways and Means, and the top officials at Treasury Department. Some Members and staffs it met with multiple times. However, the big, high-visibility subjects, including changes in the international tax rules for corporations, commanded most of the attention of decision-makers. Also, the approaches to these subjects, including the various versions of proposed changes in the corporate tax rules, resulted in a constantly changing landscape and made it difficult to insert residency-based taxation alongside them.

The effect of work on the other subjects can be seen from the fact that many effects on Americans abroad were simply overlooked or not fully appreciated until very late in the game, if it all.

ACA believes that Members, including Chairman Brady, Chairman Hatch, Representative Holding, and others, are sincere in saying that they want to change the tax rules for Americans abroad. We don't think they would've made the statements they did if this was not the case.

With so many things going on at the same time, there was a lack of clarity, for some concerned, about "territoriality" for corporations and essentially the same thing, in the form of residency-based taxation, for individuals. Also, some wanted to stretch the subject to cover foreign income of individuals resident in the US, not just individuals truly resident abroad. The details of the workings of RBT, especially the anti-abuse rules, probably were not well understood by everyone. And the need for the new rules to be revenue neutral may not have been fully appreciated.

Americans abroad and their supporters are just now absorbing the fact that the territoriality rules in TCJA provide no benefit for Americans abroad because benefits only run to US corporations. Also, the benefits of lower rates for passthrough businesses also bypass many if not most Americans abroad because their partnerships, LLCs and similar entities are earning foreign source income, to which the benefit does not attach.

The work done on RBT and especially the work done on the revenue estimates –the baseline depicting in great detail the situation of Americans abroad – is the biggest "plus" of what has taken place. The baseline information developed by ACA/DEG is unique: It simply did not exist prior to this exercise. It was 5-months in the making. (ACA is also very proud of the fact that it successfully raised the funds for the DEG project on a crowd-funding basis.)

In light of what was not addressed in TCJA and some of the overlooked outcomes, ACA strongly believes NOW IS THE TIME FOR CONGRESS TO HOLD HEARINGS ON THE TAX TREATMENT OF AMERICANS ABROAD. These can lay out the existing rules, including the rules added by TCJA. The Joint Committee on Taxation, the lead committee on matters having to do with tax, can construct its own baseline for dealing with the subject. ACA is making the results of the ACA/DEG study available. Hearings can also identify the key topics, including, for example, treatment of tax havens, various anti-abuse topics, etc. All the interested parties can

present their views. It's an opportunity for everyone generally to "get on the same page" or say why they choose not to be on that page. Of course, there will be differences in opinion as to what changes should be made. ACA suggests that the hearings be held by the Ways and Means Subcommittee on Tax Policy. It looks to Members, both Republicans and Democrats, who have historically taken an interest in the subject to support hearings.