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Investment Management

Jonathan Lachowitz – Input to Senate Finance Committee

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To: Senate Finance Committee

From: Jonathan Lachowitz CFP® Lexington, Massachusetts

Re: Overseas Americans & Input, data, and information for the Committee's bipartisan tax working groups

Chairman Hatch, Ranking Member Wyden, and distinguished members of the Committee,

I am responding to your March 11 Press release seeking input from the public on Bipartisan Tax Reform. Your recent hearing on March 17, 2015 "On Building a Competitive US International Tax System" while laudable in its efforts to better understand the perspective of US Corporations doing business overseas, largely missed the underrepresented constituency of Overseas American individuals. Specifically, I am writing on behalf of the estimated 5-8 million Overseas Americans ad how improvements to our nations Federal Tax System can support economic growth and job creation while simultaneously easing the tremendous fear and burdens unduly placed on many of our compatriots who choose to live overseas for personal and professional reasons.

First, as an introduction, I believe my professional and personal experience gives me some unique insights from which to inform the committee on tax issues affecting overseas Americans. I am a small business owner and Certified Financial Planner™ professional who is a specialist in cross-border financial planning and I have served hundreds of overseas American individuals and families over the last decade. I was born and raised in New England, I have lived overseas for close to two decades, and currently reside in Lexington, Massachusetts just a mile from the famous Lexington Battle Green with my wife and four young children. I have been a Board Member of American Citizens Abroad for almost a decade and have worked on several of our position papers, including the Residency Based Taxation proposal, which your Republican members referenced on page 282 of their December 11th, 2014 release on a framework for reform to federal taxation. While I am neither a tax attorney nor a CPA, I have read thousands of pages of tax laws, guidance, tax treaties, opinions and proposals all in an effort to be super educated on issues that affect my clients and more broadly overseas Americans. Recently, I was asked to start writing for the Wall Street Journal as an expert on International Personal Financial Issues.

I will start with one simple premise: Some of the best people to import America's exported goods and services are Americans who are living overseas. With a little imagination, someone who has never lived overseas may realize that by encouraging more Americans to live and work overseas, set-up companies overseas, and pull American products and services to all corners of the world, we can be much more effective in stabilizing our country's future and world standing without shipping jobs outside the country. Today the US has one of the lowest percentage of its citizens living overseas; this is in no small part due to our tax code.

If you remember only three things from what I am submitting, I would ask you to remember the following:

1. A country's tax code can be used strategically to enhance the ability of both its corporations and **Citizens** to compete in the global economy.

2. The most qualified people to import American products and services into other countries are American Citizens.

3. The current American tax code, as it is written, puts American citizens, American businesses (big and small) and the country as a whole, at extreme disadvantages in our ability to export our products, services and values around the world.

About 10 years ago I decided to start my own small company overseas with the goal of helping people with what I am good at, which is working with numbers and solving problems. I specifically chose to become a Certified Financial Planner ™ professional mainly because of the deeply engrained code of ethics which requires CFP professionals to put our clients' interests first when giving financial advice.

I specialize in working with Americans overseas and have witnessed hundreds of situations where hard working US citizens and small business owners are needlessly suffering due to the overly complex financial and tax rules. The implementation of FATCA along with several IRS voluntary disclosure programs, while understandably an attempt to increase American tax compliance and cooperation from foreign financial institutions and governments, has had some perverse effects: Tens if not hundreds of thousands of overseas Americans who were mostly compliant with tax laws in their home country and often ignorant and misinformed about the complex US tax code as it applies to their foreign status, have been made to feel like criminals by both the American government (especially the IRS and Treasury Department) and foreign financial institutions. While this has somewhat improved with the introduction of the Streamlined OVDP process, it has also left deep emotional and financial scars with the most appalling aspect being the number of citizens who have chosen to give up their American citizenship; often times feeling that had no choice as they were being compelled by foreign spouses, foreign employers and/or intense pressure on just trying to live a "normal" life overseas without being persecuted by some countries financial systems due to their American citizenship.

I am sure most of you have opinions about the US Federal tax code and its need for reform. All I can say is that it is much worse in all aspects for most Americans living overseas. Based on my experience in working with dozens of CPAs, tax attorneys and IRS employees I would say that most American CPAs and most employees of the IRS are unqualified to file or review a tax return on behalf of Americans living overseas.

I believe many of you have seen the recent news stories around large companies, like GE, Apple, and Starbucks, that are encouraged by the US tax code to earn profits overseas (normally in low tax jurisdictions) and retain those profits overseas, so they avoid being taxed in the US until those profits are repatriated. You have also heard much testimony about how companies look into various merger and acquisition options, corporate structuring and profit shifting strategies. These are all important to address. However, the two back stories that are overlooked here are:

1. That many of those same large companies have specific policies (mostly unwritten) in place to limit the number of Americans they hire into overseas positions; and in several cases I have heard of, US based companies aim to eliminate all of their overseas American expatriates, for one reason…They cost a lot more to hire than non-Americans because of the unique aspects of the American tax code.

2. That small American owned overseas businesses are largely excluded from these same tax advantages available to large companies and, in fact, they or their owners are also punished just like American individuals overseas.

While I could share dozens of personal stories and would be willing to do so in person or writing, the remainder of my writing will focus on more concrete suggestions for improvement of the tax code. I have purposefully kept this submission non-technical (not referring to specific code sections) to make it understandable to a broader audience.

So now, how is it specifically that the American tax code today leads to greater unemployment and decreases exports? I'll give you some of the more common examples:

Depending on the country or the position, it can cost anywhere from 30% to 300% more to employ an American in an overseas position rather than a non-American. Why?

1. The United States if the only OECD country in the world to tax its citizens based on their citizenship. All other OECD countries tax based on residency.

    a. A typical senior level American expatriate on assignment from a US employer will receive benefits [thought most overseas Americans do not have such benefits] such as: A housing allowance, English language schooling for their children, home leave for the family to go back to the US, tax preparation services and often tax equalization so they don't end up paying higher personal income taxes than they would if they stay employed in the United States. On a US tax return this makes the employee look

very highly compensated because of the cost of these benefits and especially the tax equalization effects. In most European countries and many other high tax (because of high social benefits) countries, this leads to an American employee costing 2 to 3 times as much to employ as a non-American. So what do Employers do, they find plenty of bright Europeans, Chinese, Indians and other non-Americans [who are not subject to tax reporting and income tax in both their country of residence and citizenship], many of whom have studied and worked in the US and they hire them for senior roles because they cost a lot less. This happens with great regularity though you will find few corporate executives who will admit this to you in testimony.

Adopting a Residency based taxation system would help to level the playing field for Americans overseas. The ACA Residency Based Taxation (RBT) proposal has many sound suggestions and would likely be close to revenue neutral. Scoring this proposal to see the projected cost would be a great next step; adopting RBT would help to level the playing field for overseas Americans and if well designed should be close to revenue neutral and reduce significantly the administrative costs of the IRS.

2. The Tax Treaties the United States has with many countries are largely outdated and where most of them fall short (exceptions being Canada and the UK) are on the taxation and reporting of foreign pension contributions by employees and their employers. The IRS does not consider the vast majority of foreign pensions to be "qualified plans" and so overseas Americans often get double taxed on this income by the United States at the time of contribution and then often decades later by the foreign country at the time of payout. Many foreign retirement plans are considered foreign trust for US tax purposes, which result in onerous and complex reporting requirements for which there is no direct IRS guidance, leaving most foreign resident Americans and their tax preparers at a loss.

Foreign pensions should be treated like qualified plans in the US in most circumstances. If that is not possible, you could consider raising the foreign earned income exclusion to ~$1,000,000 or higher to allow more retirement contributions by the employer and employee in the foreign country to be excluded from current US taxation.

3. Every small business owner with an overseas company may have to file a form 5471, 8865, 8858 or 8621, which are returns that by the IRS's own instructions can take up to 3 weeks per year to fill out. More than 300,000 of these forms are filed per year. If we assume only 2 weeks per form on average, our small businesses are paying for the equivalent of 12,500 people's full time salaries for an INFORMATION RETURN FOR the IRS. This adds tremendous costs to small businesses not to mention the IRS. There are too many forms to fill out, many with the threat of onerous penalties and which in many cases, particularly for the smaller size business, no one even looks at.

Implement annual income and asset value limits to the forms 5471, 8621, 8858 and 8865 to reduce the paperwork for small business owners to a level that is sensible in relation to the benefit to the US Treasury brought about by this reporting and that lowers the costs of running the IRS.

4. Next is the FBAR, Foreign Bank Account Report – Fincen114: As part of these regulations we require American citizens who have signatory power over their employer's foreign bank accounts to fill out FBARs even when the taxpayer has no beneficial interest in the accounts. What does this mean? Any American working in the finance, treasury or senior role requires them to disclose private information about their employer to the IRS. And "breaking a foreign law" is not a reasonable defense in the eyes of the IRS for not completing this form. So the IRS encourages Americans to break foreign privacy laws to comply with the FBAR rules which are "information only". What's happening is US citizens are having to choose between their career and their citizenship. Overseas employers don't want to hire Americans in most financial or senior roles when they understand this requirement. The FBAR itself is really a mess, but this one small part, which again leads to no increase in tax revenue, is leading to American unemployment overseas and a decrease in exports. Why? Companies are finding that doing business with America and Americans has too many financial risks. The US has become a scary place to do business.

Consider a same country exemption for FBAR reporting where "foreign" is in relation to where an individual resides as a taxpayer and not just "foreign" to the US. Exempt [or significantly increase] FBAR requirements for employer accounts, client accounts and other accounts where the US taxpayer or a close relative does not have a beneficial interest. Also, for the online filing (which is mandatory) change the website http://bsaefiling.fincen.treas.gov/NoRegFBARFiler.html . Why do we make law abiding Americans file an information only return on the Financial Crimes Enforcement Network website?

Examples like this unnecessarily make Americans overseas feel mistreated by their government. While this is not explicitly a tax law change, it is highly related since the IRS has gotten very involved in FBAR issues over the last few year.

5. The FBAR penalty structure was put in place to give the Federal government another weapon to fight international drug cartels, terrorists and money laundering. No one I know in the overseas American community supports tax evasion (or any other crime) and when used properly this is an effective weapon against financial criminal activity, but before 2008 there were generally fewer than 10 FBAR penalties assessed per year. Since about 2008, the FBAR regime combined with the Voluntary Disclosure programs is causing great damage to people whose worst crime in most cases was not being well informed about the American tax and US Treasury information reporting. This is an important factor in many Americans overseas being (1) Denied business opportunities, (2) Denied employment

opportunities, (3) Getting pressure from non-American spouses and/or employers to consider renouncing their citizenship. Complying with the FBAR rules requires many Americans to break secrecy laws of the countries they live in or break the terms of their employment contracts. This is unjust.

The Penalty Structure for FBARs needs to be revisited. A Same Country Exemption for the FBAR and FATCA would also be useful whereby financial accounts in a country where an American has residence should not be considered "foreign". Further simplifications could be found by consolidating the 8938 and Fincen114 filing requirements for Americans living abroad since they largely report the same assets. The Streamlined Filing Procedures and the Delinquent FBAR filing procedures have gone some way to rectifying some of these past issues where taxpayers were inadvertently making mistakes but improvements are still needed.

6. Americans overseas pay US taxes but have limited or no access to certain benefits such as Medicare, Medicaid and unemployment insurance. If we are going to continue to tax overseas Americans on their income they should at least get equal access to benefits.

If we continue to tax overseas Americans on their income, they should be afforded the same government benefits as a US based taxpayer; the US tax code should not on the one hand tax Americans living overseas and then deny them access to the benefits of being an American taxpayer.

7. Americans often pay US Payroll taxes and foreign payroll taxes on the same income, but have no ability to use Medicare outside the US. This is especially the case for self-employed people who work in countries with no totalization agreement on social security on other federal benefits. Additionally the recently enacted Net Investment Income Tax (NIIT) has overseas Americans helping to finance Medicare when they have no claims to benefits.

Self-employed Americans overseas should not be required to pay payroll taxes in both the US and a foreign country. However, it may be beneficial for Americans overseas to voluntarily pay US FICA taxes especially if they plan to retire in the US. Taxing overseas Americans for Net Investment Income Taxes should be strongly questioned. Allowing overseas Americans to voluntarily contribute to US Social Security and Medicare should be considered.

8. Americans overseas have to keep all of their records in their local currency for local taxation and for US dollars for US taxation; companies are allowed to have a functional currency, why not American individuals? Without a function currency many Americans pay real US income taxes on phantom gains. For example, if an American bought a primary residence for 200,000 euros when the exchange rate was 1 euro = $1.50 and they sell the same home for 200,000 euros when 1 euro = $1.00, the would have a US taxable gain of $100,000 in phantom profit. This same example applies to mortgages and a variety of other investments.

In many cases, Americans have to pay taxes on these exchange rate gains but cannot use the losses if they occur.

If we are going to continue to tax Americans overseas, allow them to use a functional currency (like company's already can), this would remove a lot of complexity and unfairness in the tax code.

9. Our tax treaties have too many inconsistencies which often result in double taxation. For example: More retirement accounts should be afforded treaty protection, similar to that afforded by the US-UK and US-Canada treaties. As more countries continue to privatize their social security and expand retirement savings programs, this double taxation of foreign retirement accounts hurts the ability of Americans working overseas to save effectively for retirement and is another area that makes Americans overseas more expensive for employers.

A replacement should be sought for the current system of tax treaties that allows for much more efficient updating on a regular basis with our most important trading partners. Tax treaties are often decades old, terribly complex and have failed to serve their purposes.

10. We are even seeing the IRS trying to assess FBAR penalties on overseas pension plans. How is it right to try and take about 25% or more of someone's retirement savings when the individual followed all of the rules of their country of residency and when most IRS employees and tax preparation professionals much less ordinary tax payers, understand the nuances of offshore account reporting requirements?

FBAR penalties should not be allowable on retirement plans.

11. US citizens have a $5.43 million estate tax exemption (2015), non US domiciled non-Americans have a $60,000 estate tax exemption on US property (including stocks in US companies). So overseas investors are advised not to use US brokerages and to avoid buying US shares because a 40% or more estate tax is too big a risk, there are better opportunities elsewhere.

    Raise the estate tax exemption to $1,000,000 (and index it to inflation) for US situs assets owned by non US citizens domiciled outside of the US. This will encourage broader ownership of US real estate and shares in US corporations. This will increase US tax withholding revenues on dividend income paid by US corporations and rental income earned by non US persons and will also make US financial investments more attractive to the overseas middle class.

12. One of the newest threats to America's place in the financial world, again, comes from within, FATCA. Many countries are threatening to pull investments out of the US, to retaliate against US banks with the same reporting requirement or just plain deciding not to do business with

US citizens or in the US markets. Americans are finding their access to banking and financial services overseas limited more and more on both a personal and professional level. Less access to banking means less business overseas and less exports.

While many overseas Americans, foreign financial firms and some members of Congress are calling for a repeal of FATCA, the author admits that while this may be desirable, it is unlikely. FATCAs weaknesses must be addressed namely: the data security of ordinary citizen's financial information, keeping access to financial services to Americans wherever they reside (banning account holders due to American citizenship should be forbidden), make same country exception where an account in an account holders country of residence is not reportable, easing of massive costs of reporting to FFIs…There are many other improvements but they are beyond the scope of this letter.

13. Americans who are married to non-Americans and who choose to live outside of the US are also punished. They are often forced into choosing a filing status of married filing separately which has punitive tax rates and prevents them from other benefits such as making Roth IRA contributions.

If RBT is not adopted, allow an American who is married to a nonresident alien to file as single or head of household without having to include their non-American spouse's income and assets.

14. PFIC, another 4-letter word. It stands for passive foreign investment company. Virtually every non US mutual fund, hedge fund, exchange traded fund, money market fund and retirement fund overseas are PFICs. Some active business can be PFICs under the asset test, including many professional service businesses and actively managed rental property businesses. US individuals who want to save and invest [especially for retirement] are penalized by the US tax code for owning PFICs which hinders their ability to save and invest and restricts their access to global financial markets. Additionally the IRS form 8621, which can take over 17 hours each year for each fund, has to be filed…making reporting terribly burdensome and unaffordable.

The entire tax rules for PFICs should be revisited and greatly simplified for overseas Americans: Specifically you should consider no PFIC reporting should be required for any overseas retirement accounts and if overall PFIC holdings are less than perhaps $1 million, no 8621 should be required. Treating PFICs like US investment funds for taxation should also be considered; leave anti-abuse rules for the wealthy targets but don't retain the burdens for ordinary Americans.

This letter is by no means complete; it is only a highlight of ways to rectify some of the more common issues that Americans overseas are facing. The author is willing to volunteer his time to give further input to any of the working groups of the Senate Finance Committee who are working to improve our tax code.

In summary, I would like to encourage the US Congress, as they embark on historic deliberations that will influence the financial health and stability of our country for several decades, to look at the American overseas community as a strategic asset, not a liability whenever changes to the tax code are considered.

Please remember:

1. A country's tax code can be used strategically to enhance the ability of its corporations and citizens to compete in the global economy.

2. The most qualified people to import American products and services into other countries are American Citizens.

3. The Internal Revenue Code, as it is written, puts American citizens and especially American small businesses, at extreme disadvantages leading to increased unemployment and decreased exports.

Thank you for your consideration,

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