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US Tax Code Disproportionately Burdens Americans Abroad

Jonathan Lachowitz, CFP® | Financial Planner | Investment Advisor

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On March 25, Law360 published an opinion piece by Professor Edward Zelinsky in which he disagreed with US citizens living overseas about their criticisms of the way the US government taxes and treats overseas Americans. He noted a Wall Street Journal article from March 15, 2019, written by Laura Saunders highlighting Meghan Markle's potential US tax challenges and attempts to "defend current tax law." Zelinsky's article appears to be coming from high-level presumptions about how the US tax laws impact individual overseas American taxpayers rather than a practical understanding of the real-life double taxation costs of compliance and denial of access to financial services in their home countries. Additionally, in comparing the citizen-based income taxation of American citizens' worldwide income and the burdens it places on US taxpayers to the tax laws of other countries – especially the United Kingdom – the article shows a distinct lack of perspective on how these rules function.

American Citizens Abroad, of which I am a board member, has been advocating on behalf of American citizens living and working overseas for over 40 years and during that time, the burden of citizenship-based taxation, or CBT, a regime shared by the United States with the small African country of Eritrea (and soon South Africa) has increased in complexity and severity. ACA and many other organizations, professionals, and individual taxpayers applaud US Rep. George Holding's, R-NC, deep commitment to improving this situation which resulted in the introduction of the Tax Fairness for Americans Abroad Act of 2018, which if passed, would be a very big step in the right direction.

In Zelinsky's article he states that: "The US thus taxes the income of a citizen living abroad only when that citizen both has high income and pays little or no income taxes to the nation in which she resides." He appears to be referring to the Foreign Earned Income exclusion, or FEIE, that when applied, does exempt earned income, however, many taxpayers (including those in retirement, and with low or moderate incomes) have other income that is not excluded and ends up being taxed, often twice. Here are a few examples where the FEIE fails to mitigate double taxation:

- Employer contributions to foreign retirement plans are not exempt under the FEIE;
- Government pensions, such as social security, (US and foreign) are not exempt;
- Financial earnings: bank interest, dividends, capital gains;
- Foreign retirement savings is not "qualified" in the US and ends up being taxed at different times in the US and the foreign country;
- Investments in foreign mutual funds and other funds are subject to the passive foreign investment company rules;
- Foreign tax codes don't line up nicely with the IRS and a considerable amount of double taxation occurs, even for lower income taxpayers.

That average Americans living overseas are high-net worth individuals and therefore able to pay the increased tax burdens and the tax filings costs associated with hiring professional tax advisers is a common misconception of theoreticians with little on the ground experience of the issues. I would like to draw attention to a recent survey by Democrats Abroad. [1] The survey canvassed the tax filing issues and demographics for nonresident Americans. It is noted in the survey that overseas Americans are by and large not high-net worth individuals and the cost of compliance and the difficulty finding qualified professionals to do the job are considerably challenging.

The author and his colleagues have reviewed hundreds of US international tax returns prepared by US tax professionals including all the big four accounting firms and find them often full of errors, many of them significant. It was only just over a decade ago that many US-based tax preparers thought it was OK to advise their clients living outside the US to not file the FBAR (Foreign Bank Account Report FinCEN-114) forms. Most tax professionals in the US are not qualified to complete a tax return for overseas Americans without specializing in international tax policy; expecting ordinary citizens to master these additional complexities to complete an accurate tax return borders on the ludicrous.

The opinion piece completely sidesteps the considerable problems created by the Foreign Account Compliance Act, or FATCA, and the recent complications that the Tax Cuts and Jobs Act's international corporate transition tax is wreaking on small American business owners overseas.

The Foreign Account Tax Compliance Act was passed in 2010 as part of the HIRE Act. FATCA requires foreign financial institutions such as local banks, stock brokers, hedge funds, insurance companies, trusts, etc. to report the accounts of all US citizens (living in the US and abroad) holding certain US investments to the IRS or to the government of the bank's country for further transmission to the US through intergovernmental agreements or be subject to a 30% withholding on their US investments. The legislation was targeted as "bad actors" or American residents in the United States but holding undeclared offshore accounts for tax evasion purposes. For Americans living overseas, accounts held in the country of their residency for purposes of running a business or their everyday lives are not offshore accounts being used to evade US taxation.

The result of this legislation is that foreign banks and financial institutions, due to their increased compliance costs and fear of penalty application, are simply closing the accounts of Americans living overseas or limiting/refusing them services. This means that Americans overseas – who are working as missionaries, in nongovernmental organizations, for corporate America, for foreign and US multinationals, for the United Nations or who are simply trailing spouses – may not be able to procure a line of credit, a mortgage or an investment account for their employment or basic living needs. The Taxpayer Advocate has highlighted the serious ramifications of this legislation in several of their reports to Congress. [2]

The Tax Cuts and Jobs Act passed in December 2017 moved the US from a worldwide tax system to a participation exemption system by giving US (that is, domestic) corporations a 100% dividend received deduction for dividends distributed by a controlled foreign corporation, or CFC. To transition to that new system, the measure imposes a one-time deemed repatriation tax, payable over eight years, on unremitted earnings and profits at a rate of 8% for illiquid assets and 15.5% for cash and cash equivalents. The dividends received deduction is available only to US corporations that are shareholders in a CFC. The deduction is not available to individuals, nor to foreign corporations, which, for example, are owned by US individuals, including individuals living abroad. On the other hand, the repatriation tax applies to everyone, not merely US corporations. Accordingly, a US citizen residing abroad, who is a shareholder in a CFS, might be subject to the repatriation tax. These businesses may be a yoga studio in France, a restaurant in Norway or a consultancy in Thailand. They can be big or small and have probably not been incorporated taking US tax laws into consideration. Many of the individual small business owners who are subject to the repatriation tax might not have in hand the actual money needed to pay this tax. ACA testified to the IRS about this problem on Oct. 8, 2018. [3]

Additionally, the TCJA allows a deduction of up to 20% of pass-through income for specified service business owners with income under $157,500 (twice that for married filing jointly). The pass-through tax break, however, only applies with respect to domestic business income, that is,

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items of income, gain, etc. that are effectively connected with the conduct of the trade or business with the United States and therefore Americans overseas do not qualify.

Lastly, the state and local tax deduction of $10,000 cannot be offset by foreign tax credits. For many Americans overseas this means they cannot deduct their foreign property taxes.

Many of the misconceptions about Americans living overseas is due to the belief that these individuals are on equalization packages or being "taken care of" by an employer, meaning that their increased tax burden is equalized and that the hiring of a tax professional is paid for by the employer. Most Americans living overseas are not being equalized by employers for these costs. This misconception also leads to the belief that Americans overseas have no need to become "local" for their living and investments needs, a factor which complicates their US tax situation. For many Americans overseas there may be a reasonable need to invest locally either in retirements accounts (some of which are mandated by local laws), investment accounts or by purchasing their home or property. This is generally being done to manage their personal lives and not as a means to hide money from US taxation.

Consider for example the individual who for a variety of reasons may have made the decision to purchase their home overseas, using income and currency generated not in the United States but in the country of residency. Given the fluctuations in currency exchange rates and the requirement that individuals use the US dollar as their function currency, many Americans may have phantom gains on a sale of their property and no ability to pay these gains forcing them to either remain in a home they need to sell or rent their home only to have to pay to live elsewhere. Is it fair for a homeowner to take out a mortgage in another currency, pay back the exact amount, and then just because the exchange rate moves against them, have to pay taxes on this phantom gain?

The population of Americans overseas, as can be seen from recent surveys, is not that of the temporary "expat" that is still tethered to the United States, someone on short-term assignment and has no need to live like local. The post-World War II world of sending Americans overseas on temporary assignment has been replaced by an American work force that is mobile and moves overseas for a plethora of reasons. The advent of "working remotely" has also increased this mobility.

It is crucial to US business, economic and overall foreign policy to have Americans living and working overseas, in particular in critical new markets and where new technology and innovation is occurring. However, hiring an American to work overseas costs significantly more than hiring non-Americans due to the US tax code. Many multinationals will only hire American expats for key positions and on a short-term basis. Because of the way their expat benefits are taxed in the US, they are often at least 40% more expensive to hire than non-Americans under the same conditions (as has been analyzed by several of the multinational accounting firms). As a result, many international (including American) firms have policies in place that specifically exclude hiring US citizens for overseas/expat assignments.

Zelinsky notes that there are countries that "come close in practice to the US tax treatment of its citizens living abroad". This is not even close to how things work in practice as none of the other Organization for Economic Cooperation and Development countries have a tax system similar to the US citizenship-based taxation regime. UK citizens who are UK-domiciled but tax residents of another country have generally no ongoing income tax filing or payment requirements to Her Majesty's Revenue and Customs on their annual income. There are millions of overseas Americans who have US tax filing obligations and end up paying income tax to both the country where they reside and then to the US given that the US tax system does not align itself with many of the tax rules of other foreign jurisdictions. Many countries raise tax revenue through means other than income tax. In France there are a plethora of social taxes – many not recognized by the US tax system of foreign tax credits. Other countries use value-added taxes extensively – also not recognized by, or creditable in, the US tax system. Wealth taxes are imposed by some countries and these as well are not recognized by the US system. In most cases it is not an apples-to-apples situation and the result is double taxation in its purest form.

US income tax treaties, besides being incomplete, are extremely difficult to understand and treat overseas Americans differently in various countries as is evident by the savings clause in most treaties whereby the US retains the right to keep taxing its citizens regardless of where they reside and how they are taxed overseas. They often fail to accomplish one of their primary goals, which is to eliminate double taxation. This is especially the case with foreign retirement savings. One example of this is that US tax law does not treat most overseas retirement plans as "qualified" under the IRS regulations. While the current model treaty language recognizes previous flaws with respect to retirement income only a handful of treaties such as those with the UK and Canada come close to addressing the double taxation of retirement savings. The extra cost of compliance as well as double taxation that occurs makes retirement savings additionally costly and burdensome for overseas Americans.

Zelinsky's example of a UK citizen whose residency was unclear and was essentially trying to claim no country as their residency for taxation is not representative of what the millions of overseas American citizens who do have a foreign tax residence are faced with; it is not a fair example of the general situation and does a disservice to the community of Americans overseas. When individuals try to flout the law and their tax residency is questionable, this results in cases like the one he noted in his article, but again this is not the standard for the average American or other foreign nationals living and working overseas. The UK and all other OECD countries – other than the US – do not generally tax their overseas residents on income earned outside of their country of nationality. Currently there is no other country in the OECD whose tax code resembles the citizenship based taxation that the US imposes on its overseas citizens.

It is unsettling to hear that Zelinsky believes that "The tax burdens of US citizens living abroad are not as onerous as is often believed" as he makes casual reference to Turbo Tax. Turbo Tax is woefully inadequate for all but the most basic tax reporting for overseas Americans. Even the most professional software programs get many things wrong for overseas Americans. Most Americans

overseas, in order to correctly file their taxes, must hire a professional tax preparer and the cost of hiring a competent US tax preparer for international issues is multiples of the cost of a domestic preparer. Off-the-shelf software is not enough for most cases.

As far as being onerous, I suggest that anyone in doubt of the extra complexity Americans overseas face consult with the IRS website and review the number of hours it takes to fill out a few of the foreign forms:

- Form 5471 – Most certified public accountants and enrolled agents, or EAs – even those who specialize in international tax – are not qualified to complete this form. This is an information-only return that does not generate revenue, but generates real costs for overseas Americans. The IRS estimates it would take over 120 hours to learn about and prepare this form. A cost that is certainly not adding value for the US government for most overseas entities. Oh, and don't forget the $10,000 failure to file penalty that can be imposed.

- The 1040 – It is an enormous undertaking to try to interpret many foreign countries tax laws and income reporting any superimpose that into the 1040 requirements. Ordinary CPAs and EAs make a tremendous number of mistakes, even with the filing status, when preparing the 1040 for overseas Americans.

- The Foreign Earned Income Exclusion, Form 2555 – This is one of the easier forms to understand. The casual observer and tax professional alike can see how long it takes just to read and understand the instructions to see how this is correctly applied. The IRS estimates it takes about two and a half hours to complete this form.

- The Foreign Tax Credit, Form 1116 – Most US tax professionals who prepare this form realize that many taxes in different countries don't correspond nicely to the US tax code. Countries that have high VATs, wealth taxes and other taxes that don't line up nicely don't get counted. The IRS estimates it takes about four hours to complete this form.

- Tax Treaties – If you happen to live and work in a country with an up-to-date treaty that even takes into account how to properly deal with retirement savings (only the UK and Canada have accounts that comply). Many tax preparers get lost trying to interpret treaty provisions, not just the royals.

- The Foreign Bank Account Report, FINCEN 114 – Why should someone living in France have their French bank accounts treated as foreign just because they are a US Citizen and then have the threat of huge penalties. Did you happen to notice that the completion of their form is on the Financial Crimes Enforcement Network, or FINCEN, website and can only be filed electronically? In addition, much of the information required on the FBAR form is duplicated

on the FATCA Form 8938. IRS instructions on requirements for the different forms are confusing and unclear.

- Passive Foreign Income Company reporting, Form 8621 – As an overseas American trying to save for retirement or anything else, you may find yourself having to complete this beauty. Over seven hours to complete this form is needed, not including the time required to learn about the form. That is, of course, if you have not been locked out of the financial system of your country of residence because you happen to be a US citizen whose banks are somewhat scarred by the entire FATCA experience.

These are only a few of the more common international forms, there are dozens more that generally only tax professionals who are specialized in working with overseas Americans are familiar with.

Overseas Americans are not looking for any special treatment under the tax laws of the United States; they are only looking to be treated fairly by the United States government when it comes to the compliance with the law. Rep. Holding has provided for a commonsense solution to the tax problems of Americans overseas with his bill, Tax Fairness for Americans Abroad Act. [4]

We encourage constructive dialogue based on a deep understanding of the issues and the law and work within the system to foster positive change. Articles such as Zelinsky's opinion piece shows us that even in the professional community, there are still many people who have misconceptions on how the US tax law impacts overseas Americans.

Jonathan Lachowitz, CFP® is founder of White Lighthouse Investment Management.

Marylouise Serrato, executive director of American Citizens Abroad, and Mary Lundstedt, associate at Frost and Associates LLC, contributed to this article.

Disclosure: Lachowitz has been a volunteer and executive committee member at American Citizens Abroad for over a decade.

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[1] https://www.democratsabroad.org/carmelan/tax_filing_from_abroad_2019_research_on_non-resident_americans_and_u_s_taxation

[2] https://taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/REPORTING-REQUIREMENTS-The-Foreign-Account-Tax-Compliance-Act-Has-the-Potential-to-Be-Burdensome,-Overly-Broad,-and-Detrimental-to-Taxpayer-Rights.pdf

[3] https://www.americansabroad.org/media/files/files/c850be73/aca-comm-testimony-irs-965-regs-22-oct-2018.pdf

[4] https://www.americansabroad.org/media/files/files/b3989b0b/tax-fairness-for-americans-abroad-act-h-r-7358.pdf