



DEMOCRATS ABROAD

July 17, 2017

U.S. Senator Orrin Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Hatch,

Re: Submission for providing tax relief to overburdened middle-class individuals and families living abroad through reforms to the individual income tax system.

Thank you for inviting comment from tax stakeholders with ideas, proposals and feedback on how to improve the American tax system. Our submission relates primarily to the first of the four key issue areas outlined in your June 16, 2017 letter, as our recommendations would provide relief to ordinary, U.S. citizens living outside the U.S. However, it bears noting that the reform recommendations contained herein would also strengthen the businesses owned and operated by Americans living abroad (key issue area 2), remove current tax system impediments to savings and investment by Americans living abroad (key issue area 3), and make urgently-needed updates to U.S. international tax policy that improve our competitiveness in the global economy and preserve our tax base (key issue area 4).

Democrats Abroad joins the rest of the Americans abroad community in our strong support for:

- reforms to the tax system that help reduce inequality, boost opportunity and raise revenue to meet public demands primarily from those with the greatest ability to pay;
- Residency Based Taxation, as a replacement for the current U.S. system of Citizenship Based Taxation;
- safeguards in the Residency Based Taxation system to ensure that off-shore residency is not abused by those seeking primarily to protect their earnings from U.S. taxation, therefore causing an unfair and odious erosion of the U.S. tax base;
- relief from foreign financial account reporting for the ordinary accounts of Americans abroad in our countries of residence that we use to pay our bills and save for the future;
- reforms to a litany of tax code provisions that inadvertently discriminate against Americans living abroad that, even under a system of Residency Based Taxation, will continue to burden those who choose to carry on reporting their offshore income from abroad; and
- simplified and improved tax filing for Americans abroad, which would address the hardship of Americans abroad filing even following the implementation of Residency Based Taxation for those who elect to continue to file.

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SIMPLIFY THE TAX SYSTEM BUT PROTECT THE VULNERABLE

We believe the 115th Congress has an opportunity to enact common sense reforms that clarify and simplify filing, make the tax code fairer for all Americans and protect programs that benefit indigent, elderly or otherwise vulnerable Americans. We support reforms that help reduce inequality, boost opportunity and raise revenue, predominantly from those with the greatest ability to pay.

REPLACE CITIZENSHIP BASED TAXATION WITH RESIDENCY BASED TAXATION

Americans resident abroad pay taxes to their local tax authorities on the income earned in their country of residence and then report their income again to the IRS. The Foreign Earned Income Exclusion and the Foreign Tax Credit ensure that most Americans abroad are not double taxed on their ordinary earnings. However all other types of income – such as investment earnings, retirement savings and even social welfare payments – are subject to U.S. tax with no exemptions or offsets. These items are, in fact, double taxed.

State-sponsored retirement savings programs trigger highly-punitive passive foreign investment company (PFIC) rules under the U.S. tax code. So do non-U.S. mutual funds held by U.S. citizens living abroad, even if the mutual fund is located in the jurisdiction where the citizen is living. Aside from the punitive tax treatment, by the IRS's own estimate, PFIC filings take over 40 hours to complete.

Filing itself imposes a substantial cost on even ordinary, middle class Americans living abroad because reporting foreign income on specially designed forms is so complex and often stressful. Although a range of expat tax return preparer services are available, the cost of preparing a return that includes earned income and retirement savings runs to hundreds if not thousands of U.S. dollars, even when no tax is owed.

Citizenship Based Taxation discriminates against Americans abroad. Their tax burden is higher; their investment and retirement savings options are narrower (see Appendix I); their compliance costs are greater; and, to the extent that these factors increase the cost of hiring U.S. citizens, their employment options are fewer.

Compounding these injustices is the fact, acknowledged by the IRS itself, that the U.S. has utterly failed to properly advise citizens abroad of their tax filing and reporting obligations. Due to a combination of ignorance, misinformation, cost and confusion, tax compliance amongst Americans abroad is low. Serious penalties for non-compliance, combined with the ability of Foreign Account Tax Compliance Act (FATCA) disclosures to bring non-compliant taxpayers abroad to the IRS's attention, are creating enormous anxiety and anger at the innate unfairness of Citizenship Based Taxation.

As Congress considers a territorial system of corporate taxation, which would exempt from U.S. tax the foreign earnings of U.S. corporations, it is appropriate for

Congress to consider replacing Citizenship Based Taxation with Residency Based Taxation for individuals.

ENACT SAFEGUARDS TO PREVENT THE ABUSE OF OFFSHORE RESIDENCY

Of enormous concern is the risk, under a Residency Based Taxation system, that financial planners and tax advisors will establish ways for High Net Worth Americans to use offshore residency as a tax planning tool; i.e. rendering certain income exempt from U.S. tax reporting during a scheduled period of offshore residency (in a low- or no-tax jurisdiction) by the taxpayer. Research suggests there are policy mechanisms that both obstruct tax avoidance schemes of this nature and protect the freedom of movement of non-resident Americans who elect to stop filing under Residency Based Taxation. Democrats Abroad is open to a broad range of solutions for structuring and implementing Residency Based Taxation, but certain key criteria should be taken into consideration:

- It must not open loopholes or otherwise facilitate avenues for abuse by U.S. taxpayers using offshore residency for tax avoidance purposes.
- It should not impose punitive costs on or impact the freedom of movement of non-resident Americans who elect to stop filing.
- It must include straightforward criteria for Americans abroad to use in establishing their eligibility to stop reporting their offshore income.
- It would ideally be revenue-neutral to the federal government.

ELIMINATE THE DISCLOSURE OF FOREIGN FINANCIAL ACCOUNTS USED BY AMERICANS ABROAD FOR PAYING BILLS AND SAVING FOR THE FUTURE

Americans with more than \$10,000 in aggregate in accounts in non-U.S. financial institutions are required to report these assets to the IRS on the Report of Foreign Bank and Financial Assets (FBAR). Americans living abroad with more than \$200,000 in aggregate in foreign financial institutions are also required, under FATCA, to report the same financial account information on IRS Form 8938. FATCA is a law designed to catch citizens using foreign accounts for money laundering and tax evasion; it was not designed to collect information about U.S. citizens who use the accounts in their foreign country of residence to pay bills and save for the future.

Because of the difficulty and cost to foreign financial institutions of FATCA compliance - and the enormous penalties for FATCA compliance failures – banks outside the U.S. are refusing service to Americans. In addition to the loss of access to a diversified supply of banking and investment products, FATCA reporting, in its current form, is making it harder for Americans to find jobs, start business partnerships and maintain stress-free domestic relationships with non-Americans who object to their joint accounts being shared with the IRS.

Democrats Abroad supports an exemption from FATCA reporting for the foreign financial accounts of tax-compliant Americans who reside legally outside the U.S. This reform is the substance of the Overseas Americans Financial Access Act introduced this year in the House; we are working to see a parallel bill introduced in the Senate. Further, we recommend reforming the FBAR provisions in the Bank Secrecy Act to update the reporting thresholds and eliminate FATCA reporting duplication.

ELIMINATE DISCRIMINATION IN TAXATION SUFFERED BY AMERICANS LIVING ABROAD

Many areas of the Internal Revenue Code were developed without due consideration for the impact they would have on Americans abroad tax filers and therefore, they inadvertently discriminate against Americans abroad. Even if Residency Based Taxation were to be implemented for qualifying U.S. non-resident taxpayers, those who elect to continue to file (perhaps because they intend only a limited period of residency outside the U.S.) will continue to suffer. **In Appendix II we have prepared a summary of the reforms needed to cure the inequitable tax treatment of U.S. citizens living outside the U.S.**

IMPROVE TAX FILING FROM ABROAD

In Appendix III we have prepared a summary of recommendations for improving and simplifying tax filing from abroad. As noted in the previous section, even if Residency Based Taxation were to be implemented, those who continue to file will benefit from changes to IRS resources and procedures for those filing from abroad.

Thank you for your consideration of this submission. Please contact me or Carmelan Polce, Chair of the Democrats Abroad Taxation Task Force (cpolce@tpg.com.au) at any time with questions or for further information.

Respectfully submitted,

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APPENDIX I
CONSTRAINED INVESTMENT AND RETIREMENT SAVINGS FOR AMERICANS
ABROAD

Investment options for Americans abroad are increasingly limited and fraught.

For example, due to Depression-era legislation and regulations designed to protect consumers in the market for financial products, a provider of mutual fund products must be registered to sell and market their products in a foreign jurisdiction. Although U.S. brokerage firms have over time turned a blind eye to this requirement, more recently, in an atmosphere of increased disclosure and oversight, and in order to avoid foreign registration requirements, **many U.S. mutual funds have elected to prohibit U.S. clients residing abroad from investing.** Exchange-Traded Funds are a legal work-around for Americans abroad interested in a mutual fund-type investment exposure, however even Exchange-Traded Funds may not be an option for U.S. citizens whose foreign and/or U.S. bank and brokerage accounts have been closed.

These are features of the U.S. tax code or other federal regulations impacting investments, savings plans and retirement savings that *uniquely* penalize Americans residing abroad:

- Punitive taxation of retirement savings plans which qualify and are taxed under local laws but are not qualified plans for U.S. tax purposes;
- Punitive taxation of foreign government sponsored retirement savings plans that are not qualified plans for U.S. tax purposes;
- Capital gains tax laws that do not take into account currency fluctuations and so create assessable capital gains upon conversion of funds from the sale of assets where otherwise there are none;
- The inability to claim the foreign tax credit against taxes owing under the Affordable Care Act, the 3.8% Net Investment Income Tax;
- Inflexible regulations involving Social Security and Medicare contributions particularly disadvantage self-employed Americans abroad.
- the Windfall Elimination Provision which drastically reduces the Social Security payments owed to Americans also receiving foreign pension payments;
- The Social Security benefit taxation regime for taxpayers who are Married Filing Separately provides no exclusion for spouses. Americans married to foreign nationals normally file as Married Filing Separately and so do not get the exclusion afforded Americans married to Americans who file jointly;
- Welfare payments made by foreign governments to Americans who are handicapped, unemployed or disadvantaged are subject to tax though they are normally not taxed abroad.

APPENDIX II ELIMINATING TAX CODE DISCRIMINATION AGAINST AMERICANS ABROAD

In our examination of the provisions in the Internal Revenue Code that govern tax filing and reporting of non-resident Americans we have identified these areas that require remedies in order to address the unintended adverse consequences that arose for Americans abroad when the code was written.

It is fair to say that these problems would be resolved for most Americans abroad if the U.S. tax policy were to shift from Citizenship based taxation to Residency based taxation, depending upon how Residency based taxation was implemented.

If the implementation model contains provisions that make it difficult or disadvantageous for Americans abroad to achieve eligibility these matters would continue to afflict those who, for whatever reason, elect not to become non-resident citizens for tax purposes.

- U.S. Capital Gains Tax Exclusion – harmonisation of capital gains treatment for properties owned by citizens living abroad with treatment of properties owned by citizens living in the U.S.
- Artificial Capital Gains/Losses due to Currency Fluctuations – elimination of artificial capital gains and losses when no currency has been exchanged, by allowing the currency of the country of residence to be the functional currency for tax reporting purposes.
- Applying foreign credits to NIIT – allow Americans abroad to apply foreign income tax credits in calculating Net Investment Income Tax
- Marital deduction for bequests to foreign surviving spouses – reinstate the marital deduction for bequests to surviving foreign spouses in the calculation of estate tax.
- Declaration of foreign long term savings plan income – tax the income from foreign long-term savings plans at the time the money is withdrawn from the plan.
- Taxation of welfare payments – tax foreign government invalidity, unemployment and social welfare payments to disabled and disadvantaged Americans abroad only by the country making the payments, i.e. the country of residence.
- Tax-free transfer of foreign retirement plan assets – render tax-free the transfer of assets from foreign retirement plans deemed qualified plans under international tax treaties to retirement plans in the taxpayer's new country of residence, be it the U.S. or another foreign country.
- Revise punitive PFIC rules – For citizens residing abroad revise the punitive Passive Foreign Investment Company rules and reporting requirements that apply to non-U.S. pension plans, foreign mutual funds and other investment savings vehicles that prohibit Americans abroad from saving effectively for retirement.
- Taxation of non-U.S. non-qualified pension plans – simplify the reporting structure for non-U.S., non-qualified pension plans that would alleviate the onerous need for Form 3520 filings for non-employer funded pension schemes.
- Reforms to the FEIE and FHE – maintain the Foreign Earned Income Exclusion, merge it with the Foreign Housing Exclusion and eliminate the ceiling. This would completely eliminate double taxation of earnings of non-resident taxpayers.

APPENDIX III
IMPROVING TAX FILING AND REPORTING FOR AMERICANS ABROAD

Although these reforms would have far less importance for most Americans abroad under Residency Based Taxation, they would be enormously helpful for those who elect not to stop filing.

- Optional simplified earnings declaration – provide non-resident taxpayers who owe no U.S. federal income tax with the option of a one-sentence, handwritten or printed declaration of earnings, accompanied by a tax return or assessment from the taxpayer’s country of residence.
- Translated IRS publications and forms – provide translated versions of IRS publications and tax forms commonly used by non-resident, non-English speaking U.S. citizens.
- Remove FBAR filing requirement for FATCA filers – the disclosures made on the FBAR foreign financial account report established under the Bank Secrecy Act are duplicated on the FATCA Report. Not all foreign financial account holders have balances that exceed the FATCA reporting threshold, but there should be no FBAR filing requirement for those who do.
- Harmonize International Tax Treaties – align all international tax treaties with the U.S. Model Income Tax Convention of November 15, 2006 as they apply to private pensions, social security benefits, annuities, alimony, child support and pension plans.
- Promote the Streamline Filing Compliance (Offshore) Procedures – expand awareness of the SFCP, a tax amnesty program introduced in 2014 for Americans who non-wilfully are not compliant with their tax filing and reporting obligations.
- Improved communication – encourage the IRS to do even more to expand communication with Americans living abroad, starting with the reopening of its offices outside the U.S. and the restoration of offshore services lost due to cuts in IRS funding.
- Protect American Citizens Services – ensure that the Trump Administration’s proposed cuts to State Department funding do not result in further reductions to critical American Citizen Services provided out of U.S. embassies and consulates.