How Donald Trump's proposed tax reforms could affect US expats

By: David McKeegan, Co-founder, Greenback Expat Tax Services | 17 Oct 2017

Plans to reform the US tax system have been making the rounds of Washington in recent weeks. Among those lobbying on behalf of the expatriate community, the focus has been on campaigning in favour of changing the current system of taxation based on citizenship to a system based on the individual's country of residence – which is what almost every other country in the world does.

As this publication and others have frequently reported, the US system has been causing major problems in recent years for many expatriates, as the American tax authorities have sought to collect more tax from non-resident Americans, some of whom have responded in growing numbers by renouncing their citizenships.

Here, David McKeegan, co-founder of the Hong Kong-incorporated Greenback Expat Tax Services accounting firm, considers what the current version of US president Donald Trump's tax reform bill is likely to mean for US expatriates around the world, assuming that the campaign to get the US to adopt a residence-based system doesn't succeed.

The first thing to say is that there are still a lot of questions about how, exactly, the US tax code will look once the tax reform law is proposed, even if it were to be approved in its current form.

The nine-page framework that represents the current proposal doesn't, for example, address such key issues for American expats as the citizenship-based versus residence-based taxation system or the Foreign Account Tax Compliance Act (FATCA). It's important to note that the plan is still in its infancy, and more details are to come as the US Congress details out specific legislation.

Also not mentioned in the current draft are either the Foreign Earned Income Exclusion or the Foreign Tax Credit – the two tax provisions that are critical for reducing the tax burden on US expats. These deductions allow expats to decrease their US taxable income, based on their residence status abroad and taxes paid to other countries.These provisions are unlikely to change in my opinion, but I do want to mention upfront that these are not explicitly addressed in the current plan.

Simplification of the Tax Filing Process

As for whether the proposed changes will have any effect on the currently burdensome, document-heavy reporting requirements now expected of American expatriates, given the Republican Party's avowed determination to simplify tax reporting for Americans generally, it's difficult to say yet. The current draft of the tax reform doesn't mention the information reporting elements specific to US expats.

At present, your average American expatriate has to file many, if not all, of the following documents in addition to their Federal Tax Return every year:

• Report of Foreign Bank and Financial Accounts (FBAR)

• Statement of Foreign Financial Assets (Form 8938)

• Information Return of U.S. Persons with Respect to Certain Foreign Corporations (Form 5471)

• Return of U.S. Persons with Respect to Certain Foreign Partnerships (Form 8865)

It is also still unclear in the current document how Passive Foreign Investment Companies (PFICs) or Foreign Trusts will be treated, if differently from the way they are at present.

Nevertheless, the Republican plan does emphasise simplification, reduction, and territorialisation of the US tax system throughout the document. So, I would think that if addressed at all, these expat reporting elements would be simplified, too.

Obviously, if the final version of the bill introduced a shift to a territorial-based tax system, this would represent a major development for American expats, assuming it affected individuals as well as corporations.

Tax Reform Plan's Definite Maybes

For now, at least on the surface, there are a few elements of the tax reform package that seem likely to affect expats. These include the proposed lowering of the highest marginal tax rate to 35% from 39.6%, which would clearly be a gain for higher-income Americans living outside of the US. These individuals by definition are earning above the Foreign Earned Income Exclusion amount.

In other words, in 2016 a US expat taxpayer can reduce their US taxable income by up to US$101,300, so any amount above that threshold is subject to taxation.

Additionally, the elimination of the Alternative Minimum Tax (AMT), as is currently proposed, would be beneficial for most expats, whether they are high-earning or not, due to the reporting burden for those that are claiming Foreign Tax Credits.

Most times, if you are claiming this credit you are required to calculate the AMT, even if it comes out to zero.

The Alternative Minimum Tax is a second, 'alternative' tax calculation required for high-earners in the US, which ensures that a 'minimum' amount of tax is paid on their income despite deductions and exemptions they may qualify for using the standard tax rules. Elimination of the AMT would remove this requirement for high-earners. And for expats, even those who do not normally pay the AMT would still benefit from having less paperwork associated with their Foreign Tax Credit.

The Net Investment Income Tax Question

The Net Investment Income Tax (NIIT) is another tax on high earners, and for expats it is truly an instance of double taxation.

The NIIT is a 3.8% tax assessment on investment income for citizens above a certain annual income. This tax applies to US expats even in countries where tax burden is normally reduced through tax treaties.

The current draft of the Trump tax reform plan currently doesn't explicitly mention the NIIT, but it has been targeted in the past for repeal by the president, and my expectation is that they would want to eliminate this.

My thinking was that they might have just regarded it as a bit too specific for this first proposal. I'd like to see if this gets repealed, given that it is a double tax, and if it were, it would be good news for expats as well as overdue.

Biggest Wildcard

As mentioned above, the biggest question concerning the Trump tax reform package – and the element with the potentially largest impact on US expats — would be, if it ends up being included, a move to a territorial taxation model.

In the framework we have seen thus far, this is only mentioned with regards to multinational corporations, but it does make me wonder whether they will propose applying this to individuals as well. (Expat groups are lobbying hard to ensure that it will, including the overseas operations of both the Republican and Democratic parties.)

Alternatively, if the government grants territorial taxation to corporations but not individuals, it might then be possible for individuals to set themselves up as a corporation, in order to benefit from this new regime. In other words, people who moved abroad and wanted to work as independent professionals might be able to set themselves up as a business, and have the 100% dividend exemption apply to them.

For now, this is all sheer speculation, but it is definitely something to watch, as it could have major impact.

That said, another element of the framework as it is currently written appears to partially contradict such possibilities, by stating that the US would tax "on a global basis the foreign profits of US multinational corporations."

What this is, of course, is an effort to stop the increasingly popular practice of "offshoring" by US companies. And there is not nearly enough detail given in this initial draft to say what this would actually do, or how it might affect individual US expatriates.

(Assuming it were to be signed into law and had the desired effect of ending some corporate offshoring, meanwhile, that might be bad news for some expats, as far as their continued employment overseas were concerned, if they happened to be employed by one of these US companies' offshore businesses!)

For the moment, though, there simply isn't enough detail here to do more than speculate as to what might happen.

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Greenback Expat Tax Services is incorporated in Hong Kong, with a multi-jurisdictional staff of around 34 American tax specialists looking after American expatriate clients – as well as assisting advisers who need expert help with their American expat clients' tax needs – around the globe.