FATCA, TAX AND THE NON-RESIDENT AMERICAN

Briefing Note: House Oversight and Government Reform Committee Hearing on FATCA

Democrats Abroad supports a return to residency-based taxation, which would bring the taxation of non-resident U.S. citizens into alignment with the tax policy of all other developed nations. If residency-based taxation is not possible, we believe it is critical that FATCA regulations be reformed to include a Same Country Safe Harbor Exception exempting the financial accounts of Americans abroad from FATCA disclosure.

The Foreign Account Tax Compliance Act ("FATCA") requires US Persons and the foreign financial institutions (FFIs) they bank with to report information annually to the IRS on financial accounts. The costs to FFIs of complying with the law's reporting obligations has had grave consequences for Americans living abroad – ordinary, middle class Americans who use their accounts to pay bills and save for the future, and not to hide assessable income. (See Appendix I – FATCA and How to Fix It)

One in six Americans abroad surveyed report having had a financial account in a foreign financial institution closed due to FATCA. Nearly one quarter of them report being refused new savings or retirement accounts upon application. Arranging everyday banking services such as mortgages has become problematic. The survey respondents were overwhelmingly middle class Americans; not high-income individuals. (See Appendix II – FATCA: Affecting Everyday Americans Every Day)

The Same Country Safe Harbor Exemption from FATCA reporting for Americans abroad is the regulatory remedy for these problems endorsed by the National Taxpayer Advocate as well as these non-partisan organisations representing Americans abroad: American Citizens Abroad, Association of Americans Resident Overseas and Federation of American Women's Clubs Overseas. (See Appendix III – Reforming FATCA: The Same Country Safe Harbor Exemption for Americans Abroad)

The primary objective of FATCA is to stop tax evasion by U.S. residents who use foreign bank accounts to hide money. An important secondary effect of FATCA, however, (even though there is no evidence to suggest this was part of the FATCA policy rationale) is that the U.S. capacity to enforce citizenship-based taxation is greatly enhanced.

Citizenship Based Taxation

The US is the only country, aside from Eritrea, that taxes its citizens on their world-wide income. All others tax citizens on income generated domestically but not abroad.

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 US tax with no exemptions or offsets. They are 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 with the IRS itself imposes a substantial cost on even ordinary, middle class Americans abroad because reporting foreign income is so complex, confusing and stressful. Although a range of expat tax return preparer services are available to meet demand, the cost of preparing a return that includes both earned and investment income is over $US2,000.

Citizenship based taxation discriminates against Americans abroad. Their tax burden is higher; their investment options are narrower; their compliance costs are greater; and, to the extent that these factors increase the cost of hiring US citizens, their employment options are fewer.

Compounding these injustices is a fact acknowledged by the IRS itself that the U.S. has utterly failed to properly inform 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 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.

Residency-Based Taxation

Democrats Abroad is a long-time advocate of residency-based taxation (taxes are levied based on residence, source or location/position). It is the basis upon which most nations tax their citizens. Congress is currently debating comprehensive tax reform, including a discussion of a territorial corporate tax system which would exempt from U.S. tax the overseas earnings of U.S. corporations. Now is the time to re-consider citizenship-based taxation.

If residency-based taxation is not possible then Americans abroad need Treasury to amend the FATCA implementation rules to include the Same Country Safe Harbor Exception, exempting from FATCA disclosure the financial accounts of Americans living abroad.

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APPENDIX I - FATCA AND HOW TO FIX IT

What is FATCA?

The Foreign Accounts Tax Compliance Act (FATCA) was passed in 2010 in response to a growing concern that Americans, mostly living in the US, were using offshore accounts for tax dodging and money laundering. The legislation mandates two things:

- Every American with signatory power over accounts in Foreign Financial Institutions (banks, brokerage houses, etc) that, in aggregate, exceeded certain thresholds ($50,000 in the US and $200,000 abroad) report all such accounts on Form 8938 with their federal tax return. Note that this applies not only to personal accounts but accounts over which the individual controls - but may not own - the funds. (A corporate treasurer or CFO, for example).

- Every Foreign Financial Institution (FFI) must report to the IRS the details of every account held by a US Person. Any FFI that fails to do so faces a withholding of 30% of all funds coming into that bank from US sources.

The Unintended Consequences of FATCA

FATCA imposes crippling fines on FFIs who do not demonstrate compliance. This places both a burden and a risk on the bank and the result is inevitable. Banks all over the world are electing to deny financial services to Americans. It is increasingly difficult for an American to open or maintain a bank or brokerage account abroad solely because of their citizenship. More and more banks are asking all customers to certify whether or not they are a US citizen. If the answer is yes, service is often denied and accounts closed.

Ordinary, middle class, law-abiding Americans are suffering solely because they happen to live outside the US. An American living in Toulouse, France, for example, has the same need for financial services as an American living in Pittsburgh. But the denial of basic financial services to Americans living abroad is a serious unintended consequence of FATCA.

Democrats Abroad conducted a survey in June/July 2014 which garnered about 6,500 responses in a matter of weeks. About 16% of respondents reported having an account closed and that percentage is certainly higher now. A one-page summary of the horrifying results of the survey can be found in the appendix.

A Same Country Safe Harbor for Americans Abroad from FATCA Reporting

Democrats Abroad, American Citizens Abroad, Association of Americans Residing Abroad and Federation of American Women's Clubs Overseas propose the establishment of **a Same Country Safe Harbor for Americans Abroad from FATCA Reporting.** The Same Country Safe Harbor would require the Treasury to treat the financial accounts in the country in which an American is legally resident the same as an account in the US held by an American resident in the US. For example,

- An American living in, for example, Toulouse, France would not have to file a FATCA report with the details of any accounts he had in France; and
- Any FFI in France that held the account of an American legally resident in France would not be required to report on that account to the IRS (and would not face any penalties for failing to do so).

The US National Taxpayer Advocate has also endorsed the FATCA Same Country Safe Harbor for Americans abroad, as have both Democratic Party candidates for president of the United States.

The FATCA Safe Harbor is a Win-Win for Americans living abroad, the IRS and Treasury

The unintended consequences of FATCA on banking abroad would be eliminated for all overseas resident Americans with financial accounts in the country where they legally reside. Our 2014 survey data suggests this might include 85-90% of such Americans abroad.

Congress has made serious cuts to the budget of the IRS over the past few years. IRS Commissioner John Koskinen has publicly expressed his concern that about whether IRS has adequate enforcement resources. Implementation of the Same Country Safe Harbor would cut FATCA data inputs by 85% or more, and leave behind the FATCA filings of those of true interest to the IRS and Treasury.

If the Same Country Safe Harbor were implemented, it would be far easier to find the real targets of FATCA - the tax dodgers, money launderers and other financial crimes perpetrators – who, it stands to reason, do not use financial accounts in their countries of residence to carry out their criminal acts.

Urgency is key

There has rarely been an issue that so unites the community of Americans who live and/or work overseas. Everyone would benefit from the adoption of the Same Country Safe Harbor except those for whom the original legislation was intended.

Ideally, like the other organisations representing Americans abroad, Democrats Abroad favors a switch from Citizenship Based Taxation to Residency Based Taxation, which would largely eliminate the problems that FATCA causes overseas Americans. With Congressional and White House attention now focussed on comprehensive tax reform there may be a real opportunity to see this important policy shift enacted. We support our colleague organisations who are working steadily towards the preparation of a Residency Based Taxation model that would make the policy revenue neutral to the federal budget. We expect revenue neutrality would make it possible to insert the legislation into any personal tax reform package that makes its way to a vote in Congress.

Circumstances being what they are, Congress may not succeed in progressing comprehensive tax reform. In the interim, therefore, we will continue to encourage the IRS and Treasury to *urgently* adopt the Same Country Safe Harbor for Americans abroad.

APPENDIX II - 2014 FATCA RESEARCH PROJECT
"FATCA: Affecting Everyday Americans Every Day" - Executive Summary

INTRODUCTION

Between June 18 and July 15, 2014 Democrats Abroad carried out a survey of overseas Americans[1] to examine their experiences related to the Foreign Accounts Tax Compliance Act ("FATCA"). FATCA was passed into law in 2011 and requires US Persons and foreign financial institutions to report annually on financial accounts to the US Internal Revenue Service.

There were 6,552 responses from Americans from all 50 states and the District of Columbia and living in locations across six continents. The data and the comments presented in this paper were collected on an anonymous basis.

These survey results show the intense impact FATCA is having on overseas Americans. Their financial accounts are being closed, their relationships with their non-American spouses are under strain, some Americans are being denied promotion or partnership in business because of FATCA reporting requirements and some are planning or contemplating renouncing their US citizenship.

This paper summarizes the findings detailed in "FATCA: Affecting Everyday Americans Every Day", which publishes the 2014 FATCA Survey data as well as powerful comments selected from amongst the thousands of comments submitted anonymously by survey participants. Comments were selected for their clarity in illustrating the data and bringing the unintended consequences of FATCA to life.

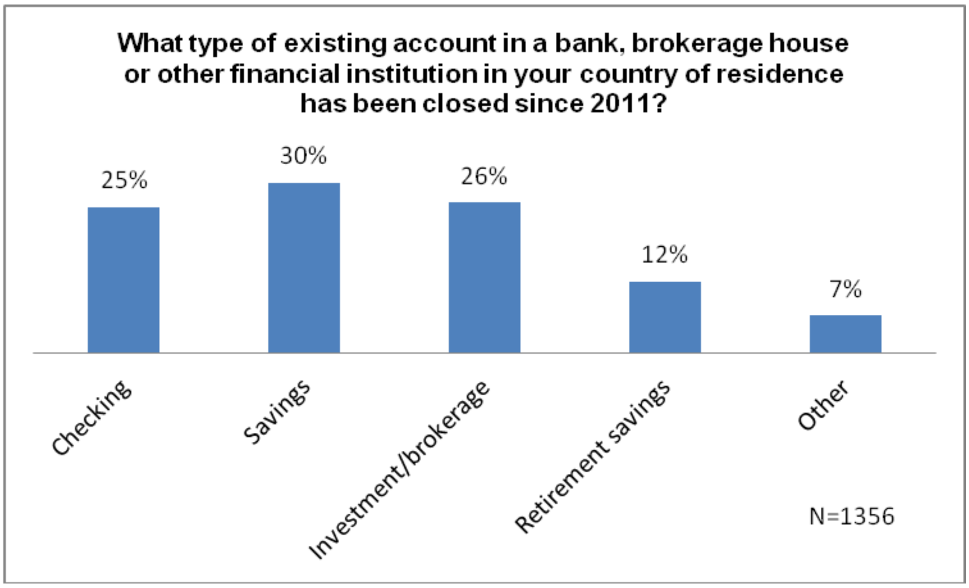
It bears noting that many remarks from survey participants include genuine support for policy designed to fight tax evasion.

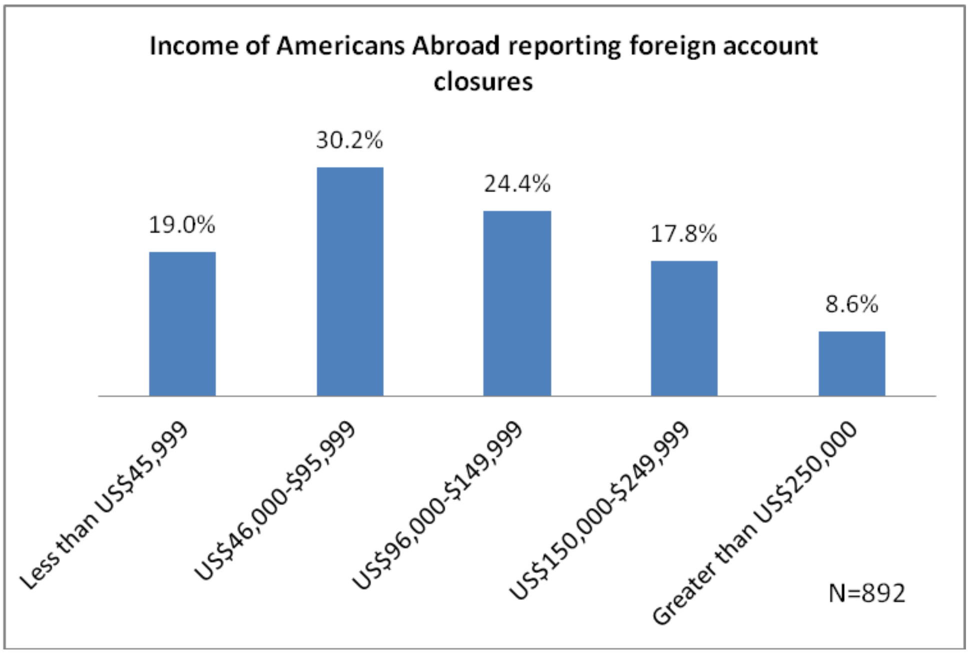
ACCOUNT CLOSURES

The 2014 FATCA survey shows that **one in six Americans has been affected by FATCA with the closure of an account in a foreign bank or brokerage house**.

The Americans affected are largely middle-class, married and have moved overseas to be with a partner, for a job or to retire. The following graphs demonstrate that they are ordinary people having accounts closed that are essential for everyday personal and household needs.

[1] The survey was distributed to the Democrats Abroad global membership and promoted on the Democrats Abroad website, Facebook pages, DA and other Twitter handles and the websites of organizations of Americans abroad such as the Association of Americans Resident Overseas (AARO) and the Federation of American Women's Clubs Overseas (FAWCO).

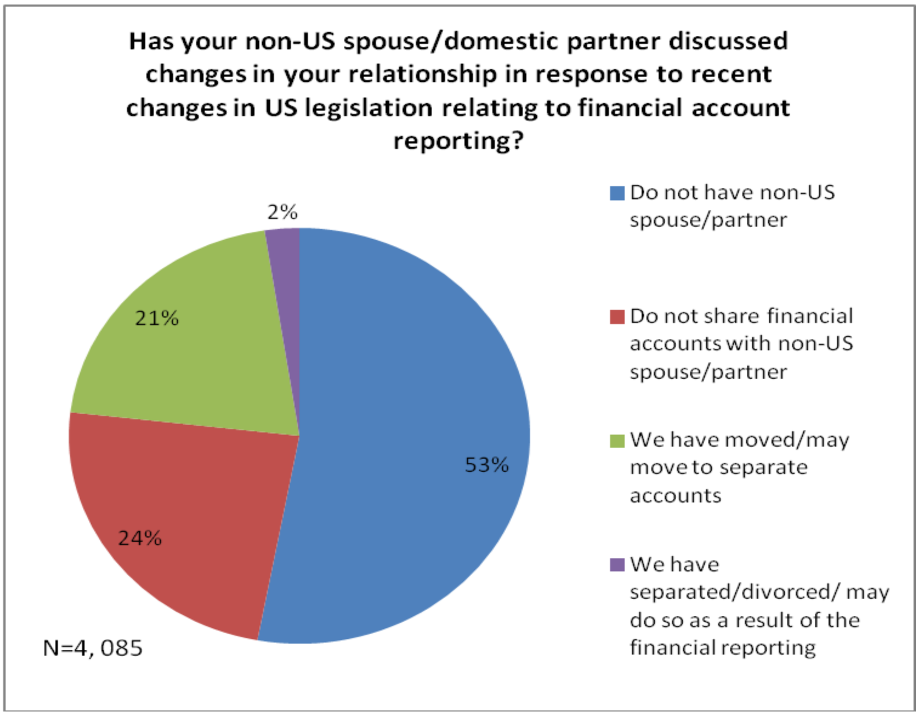




STRAINED RELATIONSHIPS

Some 2.4% of respondents with a partner reported changes in their relationship with a partner (divorce or separation), while 21% reported that they either no longer have joint accounts or are thinking of moving to separate accounts.

Many more noted that the reporting requirements caused stress and conflict between them and a non-American spouse. FATCA can place individuals in an insecure position: **"My husband refuses to share a main savings account with me now, which puts me at a disadvantage in the event that something should happen to me, as I would have no legal access to that account. It has put great stress on my marriage."**



These decisions are also made on the basis of professional advice: **“Some years ago, our British financial advisor recommended transferring my UK investments to my non-US wife because of IRS complications foreseen by UK financial institutions.”**

DENIED EMPLOYMENT, PROMOTION AND BUSINESS OPPORTUNITIES

The survey data suggests that about one-fifth (19.6%) of overseas Americans are self-employed. Others work in business. The reporting requirements on accounts on which Americans hold signatory authority has negatively and profoundly affected their ability to own their own businesses and to advance in their profession.

5.6% state that they were denied a position because of FATCA. Their comments make the connection between the two clear: **“[I was] told they did not want an "American person" and refused to recognize my EU citizenship. Too costly, complicated and dangerous, they said.”**

For the self-employed, who often are direct links between the United States and their countries of residence, the situation is also difficult, as this person said: **“Cannot open a business. Period. Cannot sell US products.”**

One comment was made numerous times – the general perception of businesses and employers in Americans’ countries of residence: **“Distrust of the entire US extraterritorial reach.”**

QUESTIONING US CITIZENSHIP

A considerable and highly troubling number of responses indicate FATCA is causing some Americans abroad to question their US citizenship.

"I really hope that FATCA will be reformed so that those of us who choose to live in another country are not faced with this burden. I find it ridiculous that we should have to pay the price for US residents hiding their money overseas. It is seriously making me rethink my US citizenship. I feel woefully uninformed about FATCA, and the idea that the IRS might now come after me because I was previously ignorant about the guidelines (and because I am not even certain that I properly filled things out) is terrifying. It is only the last few years that I have even had enough money in the bank for this to be a concern. All the money in my bank accounts is money that I declared on my income tax forms; it is savings. As a result, I truly feel like I am being punished."

In some cases, it was a financial advisor who recommended renunciation: **"Although I have not had any accounts closed, I have been warned by my banker that it would be in my and my family's best interest to renounce my U.S. nationality as quickly as possible, as things may get to the point where the bank will stop providing services to any person with U.S. connections!"**

STRESS AND COST OF MAINTAINING COMPLIANCE

FATCA is having a grave impact on retirement planning and causing confusion, frustration and fear of making errors. The financial and emotional costs of complying, now and into the future, are deemed excessive.

"Because of FACTA (sic) I have had to consult a CPA in order to sort out all of these issues, which will cost me between $3,000 - $5,000 to ensure compliance. This is an incredible amount of money and is causing quite a bit of consternation in my life -- will I have to pay this every year to ensure compliance?!"

"For me, the key issues are significant compliance costs for decades to come, fear of serious noncompliance consequences, unfair enforcement and the general feeling that FACTA (sic) is not aiming at the right people, we just happen to be Americans who have settled abroad and dutifully file our returns every year, we are not here for tax reasons in fact our taxes here are higher than at home; this extra burden is unfair and overly broad, surely they can create reasonable exemptions for people like us."

FATCA Awareness

Income plays a key role in awareness of FATCA, understanding of FATCA and the amount of professional advice one receives on understanding and complying with FATCA. Those with higher income have higher awareness, more understanding and more professional advice. Those with lower incomes have less awareness, less understanding and less professional advice – they have fewer options and will be more adversely affected by FATCA.

Please contact Carmelan Polce at carmelanpolce@gmail.com for a copy of the whole 2014 report, the datapack of survey responses or the storypack of comments provided by survey respondents.

APPENDIX III - REFORMING FATCA

A SAME COUNTRY SAFE HARBOR FROM FATCA REPORTING FOR AMERICANS LIVING ABROAD

Democrats Abroad has been working for more than five years to demonstrate to Congress, the IRS and the US Treasury that the financial accounts of law-abiding, tax compliant overseas resident Americans in their countries of bona fide legal residence should be exempted from FATCA reporting because they present none of the dangers the legislation was intended to proscribe. Despite the grave injuries and inconvenience they've suffered[i], Americans living abroad were never the target of the law.

As it happens, Congress is accustomed to rectifying the unintended and unanticipated adverse consequences of legislation they have enacted. To fix errant aspects of ratified legislation Congress subsequently enacts further provisions to protect the law's innocent victims, often termed "safe harbor" provisions. That is what we are seeking for Americans abroad in relation to FATCA: a safe harbor exemption from FATCA reporting.

When a safe harbor exemption is applied to FATCA, the law would treat the financial accounts of Americans abroad in their country of residence the same way as it treats the US accounts of Americans residing in the US. In brief, foreign financial institutions would be exempt from filing FATCA reports on the accounts of US-tax compliant Americans residing legally in the same country. A FATCA safe harbor exemption would only exempt accounts held in the country in which the account holder is *legally* resident[2].

It will preserve the original intent of FATCA to fight illegal tax avoidance by Americans using overseas accounts to hide assessable earnings from the IRS, but alleviate the useless reporting, by Americans *and by their banks*, of ordinary accounts used by law abiding citizens living abroad to pay their bills and save for the future.

- No American would have to file a FATCA report on accounts held in his or her country of residence; and
- No foreign financial institution would be required to file reports on exempt accounts to the IRS.

This FATCA reform resolves the key concerns of Americans living overseas, especially the concern that they will lose access to a diversified supply of banking and brokerage products when financial institutions elect not to do business with American customers because of the FATCA compliance requirements.

Democrats Abroad supports the establishment of a Same Country Safe Harbor Exemption from FATCA reporting for law-abiding Americans living legally abroad and is working to generate support from Congress, the IRS and the US Treasury for making this change to the FATCA implementation rules.

<u>Making the case</u>

A FATCA Same Country Safe Harbor exemption for Americans living legally abroad will not affect the battle against tax evasion and money laundering.

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[2] A mechanism to determine 'legal residency' is already provided for in the US tax code (Section 911) and is used routinely by Americans abroad when claiming the Foreign Earned Income Exclusion.

- Firstly, the IRS is highly unlikely to miss out on the capture of lost tax revenue by putting a same country exception into the FATCA implementation rules. Tax evaders, after all, do not hide assessable earnings in accounts in the countries where they are resident taxpayers. The same is true of terrorism financiers, money-launderers, gun-runners or drug lords. They funnel their illicit funds into accounts in other jurisdictions. The FATCA Same Country Safe Harbor Exemption is, therefore, of no use to them as a loophole to avoid detection.
- Secondly, the cost to the financial sector of complying with FATCA, put in the range of $US7-10b, will be materially mitigated by the Same Country Safe Harbor Exemption, depending upon what mechanism is established for claiming the exemption. Because of 1) the cost of implementing reporting regimes and 2) the penalties for compliance failures, the compliance frameworks being created by some foreign financial institutions includes the exclusion of some American customers for certain products. The FATCA Same Country Safe Harbor Exemption will simplify the compliance exercise, lowering costs and lowering risks. Banks and brokerage houses currently refusing service to Americans will be very pleased to stop turning these customers away and Americans seeking financial products in their country of residency will be very pleased to see the supply of financial products and service providers restored.
- Lastly, honest, law-abiding Americans holding normal savings and investment accounts in countries where they pay local taxes are not FATCA's target. The data collected through FATCA reporting will be far more useful to Treasury's efforts to identify and apprehend tax cheats when it is scrubbed of data that is useless and distracting to their efforts. The FATCA Same Country Safe Harbor Exemption will do that by eliminating reporting on everyday financial accounts that are highly likely to be of no use to tax and law enforcement efforts.

The FATCA Same Country Safe Harbor Exemption, also known as the FATCA "Same Country Exception", has the support of American Citizens Abroad, the Association of Americans Resident Overseas and the Federation of American Women's Clubs Overseas. It is endorsed by the IRS National Taxpayer Advocate and has the support of the House Americans Abroad Caucus.

For more information please contact the Democrats Abroad FBAR/FATCA Task Force on fatca@democratsabroad.org.

April, 2017

[i] See Democrats Abroad published research on the unintended adverse consequences of FATCA, "FATCA: Affecting Everyday Americans Every Day."