A slam dunk

International Tax

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David Treitel discusses the current state of American tax reform

Key Points

What is the issue?

Trump’s team has outlined plans for significant tax cuts. The extent of timing of change is uncertain today.

What does it mean to me?

Any change could affect UK based American clients, so it is worth starting to educate any affected client about the possibility of US tax reform.

What can I take away?

Clients may already want to plan to accelerate or defer, including paying UK tax to HMRC earlier than usual.

Tweets and !!!???!!!

‘The consequences are obvious!’ This quote and exclamation mark is not taken from a recent Trump tweet; but instead was written longhand by economist Arthur Laffer way back in 1974, on a white cloth napkin (now displayed in The National Museum of American History). Laffer’s theory was in essence that sharp cuts in tax would of themselves spur enough economic growth to generate higher amounts of tax revenue.

This concept is based on the premise that at a zero per cent tax rate, the government would have no money. If tax rates were one hundred per cent, no-one would engage in economic activity. Since economists seem to like graphs and charts, Laffer argues that economists could theoretically plot a perfect tax rate that would generate the optimum amount of revenue for the government alongside the greatest amount of economic growth.

Economists have spent the past 40 years disagreeing as to the veracity of this theory; but whether or not one believes it will work this concept now sits at the heart of Trump policy. In the words of Steven Mnuchin, US Treasury Secretary, ‘The tax plan will pay for itself with economic growth’.

The ‘BIG’ plan

On 26 April, the Trump administration released (as predicted by a tweet from President Trump on 22 April) a one-page outline of plans for ‘BIG TAX REFORM AND TAX REDUCTION’. This list of proposals is, however, little more than a series of bullet points, although it strongly suggests (in line with Mnuchin’s promise) that a significant reduction in tax rates is planned. Details do not exist; including the dates from which any of these changes might become effective.

While lacking detail, the proposals that have been published include:

- Simplifying the current seven US tax brackets to just three rates set at 10%, 25% and 33%; the lowest of which is unchanged and the highest lower than the current highest of 39.6%.
- Eliminating the possibility of claiming any itemised deductions, other than mortgage interest; while increasing the standard deduction to $24,000 (for joint filers). Commentators have noted that because taxpayers can currently deduct state income tax paid, this proposal would largely benefit taxpayers in low tax states which are traditionally Republican, and negatively impact taxpayers in the largely Democratic states on the East and West coasts.
- A complete repeal of the Estate Tax (which Trump has enjoyed labelling as the ‘death tax’); but no suggestion as to what, if anything, might replace it (one existing proposal replaces Estate Tax with a Capital Gains Tax for estates over certain thresholds); or any comment as to whether the Gift Tax might also be repealed.
- Changing the rate of tax charged on ‘business’ income to 15%. It is not clear whether this rate will apply to ‘pass through’ business, such as partnerships and Limited Liability Companies. This proposal has led to speculation that millions of Americans might look to incorporate their self-employed business and partnerships, or even switch from being employed to creating service companies, simply to benefit from lower tax rates.

There was no mention in this 26 April announcement of the border adjustment tax, which would tax imports at a 20% rate but exempt exports from tax, previously proposed by some House Republicans. This proposal has been unpopular with many members of the House and Senate, on both sides, as well as with industries such as retail that rely on imports from outside the United States.

A funeral for Obamacare?

Trump has also spoken frequently of dismantling the Affordable Care Act (‘ACA’), generally referred to as ‘Obamacare’. To this end, he signed an Executive Order in January permitting the IRS to process individual tax returns even if the return does not indicate whether a taxpayer had health insurance. Most recently, a bill to repeal and replace major parts of ACA was narrowly approved by the House on 4 May. However, this bill is not expected to be approved by the Senate in its current form: a handful of Republican senators have already rejected it, signalling that they may start work on a completely new version before anything is sent to the Senate for approval.

It seems, nonetheless, a strong certainty that the 3.8% Net Investment Income Tax (NIIT) surcharge on wealthier taxpayers, designed in 2013 to pay for Obamacare, will be eliminated at some stage. The NIIT applies to investment income and capital gains of ‘high earners’, who report greater than $250,000 of income for a married couple; $200,000 for a single taxpayer; or $125,000 for a taxpayer who is married but filing a separate return.

The American abroad?

Americans living outside the United States frequently, however, have little interest in domestic US tax rates, because the rates of tax in much of the rest of the world are often higher than in the United States, resulting in very little US tax being payable. Americans in the UK, for example, frequently only end up owing US tax on source income and gains that the UK government has decided not to tax; such as from investments within ISAs and capital gains on the sale of a main residence. The extent of any such liability changed somewhat from the 2013 calendar year, because the IRS interpret the law to say that the NIIT cannot be reduced by foreign tax credits, leading to some Americans in the UK finding themselves paying NIIT when their income exceeds the threshold, even if they are already subject to UK tax on worldwide investment income and gains.

‘Nothing is certain but death and taxes’?

With perhaps significant tax cuts on the horizon, a few tax advisers in the United States are starting to question whether they will still have jobs, especially once the current complexity associated with itemised deductions disappears. It might be of some comfort for anyone concerned about jobs for tax advisers to learn that here in the UK we lost the ability some decades ago to deduct main residence mortgage interest, alimony and deeds of covenant. Nonetheless, government after government has not stopped legislating. Consequently, the ongoing requirement to keep up with constant change makes it seem inevitable that jobs in this profession should be safe on both sides of the Atlantic.

From a client's perspective, the ability to deduct US state tax, US real estate tax, US charitable contributions and other expenses has typically made little difference for most Americans overseas once the foreign tax credit has been calculated. (As mentioned above, abolition of the NIIT surcharge could still reduce tax overall for anyone affected.)

In the meantime, whilst Trump and Mnuchin appear committed to delivering significant tax cuts, we can expect both the House and the Senate to each produce competing tax plans. There seems likely be disagreement even within Republicans; so at this stage it is impossible to predict any precise outcomes or when any package might be finalised to which the House, Senate and President could ultimately agree. Indeed, many leading Republicans –along with some Wall Street analysts –have started suggesting that tax reform legislation may not be passed at all until 2018.

At a more fundamental level and perhaps of greater interest to many Americans in the UK, we are beginning to see genuine reaction within the United States to the reputational harm caused by the combination of citizen-based taxation and FATCA. It appears doubtful, however, in the current climate that there could be sufficient legislative time to significantly change either of these existing sets of rules.

Accelerate or defer?

While we are still at a moment where the entire policy remains light on detail, the best tax planning today relies on the traditional techniques of accelerate or defer.

A quick word of caution first. Although a reduction in the number of tax rates and an increase in the standard deduction might lower tax for many individuals, it seems inevitable with any major change that some groups of taxpayers may be worse off. While we could still have a long wait for any draft legislation confirming future tax rates or indicating when any tax reform might be implemented, clients will naturally still want to know soonest how they can best plan their finances for unknown and unpredictable tax changes.

Based on the decently strong premise that tax rates overall should reduce over the year or two ahead, especially at the higher levels, it could make sense for many clients to delay income or gains until rates are lower. Equally clients may want to arrange to pay and claim expenses currently while tax rates are higher.

While US tax rates are seemingly higher now than they are likely to be in the future, a US person might, as mentioned above, think of accelerating revenue and capital expenses to get tax relief at today's higher tax rates. Equally, it could be helpful to realise capital losses currently so that these can be offset against gains taxed at today's capital gains tax rates. Some clients may want to pay foreign (e.g. UK) tax earlier, in case foreign tax credits are of lower value or use in the future. Indeed, standard planning for the American in the UK has always been to pay UK tax by 31 December each year so that there are sufficient foreign tax credits to be claimed in the United States. Given a possible reduction in tax rates next year, pre-paying UK tax by 31 December 2017 may be prudent for a greater number of individuals this year than in the past. On a similar theme, individuals who have the cash available to pay real estate taxes, charitable contributions and other deductions that might disappear from the tax code may wish already to start paying (or pre-paying) these items.

American in the UK?

Beyond changes within the United States, some UK based Americans may have specific tax-saving opportunities today. For example, because of the sharp fall in the pound since the Brexit vote in June 2016, US individuals who have UK investment portfolios that show capital gains when expressed in Sterling might be prudent to review their investment portfolios to see if any of the same valuations might result in dollar losses that could be realised at today's US tax rates. The fall in the pound also presents an opportunity for many Americans in the UK to sell a broad range of investments that might not be considered 'US tax friendly'; such as most UK unit trusts, investment trusts and OEICs (these are generally unsuitable for US persons from a tax perspective, because of the anti-avoidance 'Passive Foreign Investment Company' rules enacted under President Reagan in 1986). While exploiting the fall in the Pound to save tax might appear unconventional tax advice, many Americans in the UK have historically held investments directly as well as within ISAs, Junior ISAs and Child Trust Funds without adequate consideration of US tax consequences.

For anyone in the UK who wants to avoid all US tax changes by renouncing US citizenship, the fall in the Pound over the past 12 months has reduced the Sterling equivalent of the expatriation tax threshold of $2 million, making it more straightforward for some individuals to expatriate free of a possible US tax charge.

Deferring income or gains may be something that many clients wish to do on the assumption that tax rates are likely to be lower in the future. For example, one might consider delaying anything that is likely to be subject to the NIIT; which could include delaying realising capital gains as rates might reduce in the future. For taxpayers with non-US dollar mortgages, delaying paying off capital could also save money, as the US tax rate on taxable foreign currency gains seems likely to be lower in future.

‘It’s a slam dunk’

The New York Times reported on 25 April that the 76 year-old Mr Laffer, at least, remains a strong advocate for tax cuts. He is quoted as believing about Trump’s tax policy that ‘it’s a slam dunk, it’s a no-brainer’. Whatever anyone else’s views; it seems likely that some significant tax cuts in the United States will be arriving over the year ahead and that Americans in the UK should start planning at this stage with this expectation firmly in mind.