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Tax Reform Has Officially Arrived – What Does It Mean For US Expats? (Part I – Personal Taxation)

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Introduction

In December 2017, President Donald Trump officially signed into law the Tax Cuts and Jobs Act ("TCJA"),[1] the much-anticipated Republican tax reform legislation that was the subject of intense political wrangling throughout the first year of Trump's presidency.

By all accounts, this new legislation represents the largest overhaul of the US federal tax system in several decades. The impact will be felt by Americans almost immediately as the legislation takes effect starting with the 2018 tax year.

In this week's and next week's articles, we carefully review the provisions of the legislation that we believe will most significantly impact US citizens living abroad in terms of personal taxation (Part I) and business taxation (Part II).

What Didn't Change Under The TCJA?

Before we get to the legislative changes in the TCJA, it's important to first acknowledge that the major features of US taxation affecting expat individuals generally did not change under the new law.

1. No change to the basics of individual expat taxation

Perhaps most fundamentally, US expats continue to be subject to citizenship-based taxation on their worldwide income. While the TCJA does change the scope of taxation in this regard for US corporations (which we discuss next week), it does not affect the overall tax and reporting obligations of US individuals living abroad. So yes – FBAR [2] and FATCA [3] and the other foreign information reporting rules and concepts we've become accustomed to will continue to apply.

The TCJA also does not change the major provisions benefiting US expats, such as the foreign earned income exclusion [4] and foreign tax credit [5] for individuals, so US expats can continue to utilize these and other methods to reduce or eliminate their tax obligations (although, as we often point out, these methods do not exempt expats from filing tax returns and FBARs with the IRS on an annual basis).

Notable changes that were proposed in previous versions of the bill, but did not make it into the final version, include:

2. No change to the Net Investment Income (Obamacare) Tax

One of the bigger surprises in the final bill is the retention of the Net Investment Income Tax (NIIT),[6] sometimes called the Obamacare Tax, which Trump had pledged a number of times to repeal.

To briefly explain how the tax works: if an individual has income from investments, the individual may be subject to the 3.8 percent NIIT on the lesser of their net investment income (such as interest, dividends, capital gains, rental and royalty income, among others), or the amount by which their modified adjusted gross income exceeds the statutory threshold amount based on their filing status.

Why is no change to the NIIT significant for expats?

The basic answer is that the foreign tax credit [7] cannot be used to reduce the tax. Consequently, a US expat who otherwise has 100 percent foreign source income and sufficient foreign tax or other credits to credit against such income, can still end up paying US federal income taxes by virtue of the NIIT. Depending on the amount of investment income, the 3.8 percent tax can end up being significant for expat investors. Unfortunately for expats, the exclusion was not repealed by the TCJA.

3. No change to the exclusion from gain on sale of principle residence

A previous version of the tax reform bill would have modified the current "primary residence exclusion" rule,[8] which allows an individual to exclude gain of up to USD250,000 realized from the sale of his or her home (USD500,000 if married and filing jointly), provided they meet the "ownership" and "use" tests for two out of the five years leading up to the sale.

The previous version would have increased the required period of ownership from two of the previous five years to five of the previous eight years, including phase-outs of the exclusion for wealthier individuals. In the end, however, the beneficial exclusion was not changed.

Why is no change to the exclusion from gain on the sale of a principal residence significant for expats?

The principal residence exclusion is often an important tax-saving method for expats because it is not limited to homes in the United States. Since many foreign jurisdictions offer an exemption on the sale of a personal residence (thereby creating no foreign tax credits to utilize), a sale of a personal residence triggers taxable gain only for US tax purposes. However, due to the exclusion, expat sellers only have to pay tax to the extent the gain exceeds the USD250,000 or USD500,000 amount. Fortunately for expats, the exclusion remains untouched by the TCJA.

What Did Change Under The TCJA?

The following are the provisions of the TCJA that we believe will most significantly impact US citizens living abroad in terms of personal (non-business) taxation. The changes generally apply through to year 2026, but many expect that they will be renewed at that time.

Some of the changes that we list are only relevant if the expat taxpayer has at least some US tax due (*i.e.*, taxable income is not completely eliminated by the foreign earned income exclusion or foreign tax credit).

1. Change to personal income tax rates

The TCJA keeps the seven ordinary income tax brackets but with generally reduced rates: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent. Capital gains rates remain the same (0/15/20 percent), but the brackets are adjusted to correspond with the new ordinary income tax brackets.

2. Standard deduction increased but personal exemption eliminated

The TCJA nearly doubles the standard deduction amounts to USD12,000 for individuals, USD18,000 for heads of household, and USD24,000 for married couples filing jointly.

To offset this increase, the personal exemption is eliminated. Interestingly, for the 2018 tax year only, employers can withhold as if the personal exemption is still allowed, allowing taxpayers to delay their tax payment, if due, to the time of filing.

3. Many itemized deductions eliminated or limited

For those taxpayers who think their itemized deductions may exceed the new standard deduction, it should be noted that a number of itemized deductions are eliminated or limited, including, among others:

- Miscellaneous itemized deductions which exceed 2 percent of adjusted gross income (AGI) (an example includes the deduction for tax preparation services) are eliminated;
- The deduction for mortgage interest is limited to an underlying indebtedness of up to USD750,000 (USD350,000 for married taxpayers filing separately); and
- State and local income and property tax deductions are collectively limited to USD10,000 per year (foreign real property taxes may not be deducted).

4. Child tax credit increased

The TCJA doubles the child tax credit to USD2,000 per child, which is refundable up to USD1,400, subject to higher phase-out thresholds (USD400,000 for married taxpayers filing jointly and USD200,000 for all other taxpayers). It also includes a temporary USD500 nonrefundable credit for other qualifying dependents (for instance, older adults).

This increased credit can be significant for expat parents as it can be used to offset the NIIT, whereas the foreign tax credit cannot be so utilized (as discussed above).

5. Estate and gift tax exemption amount increased

Following previous iterations of the tax reform that included a repeal of the estate tax and then a phase-out of the estate tax, the final bill keeps the estate tax for US individuals intact but increases the lifetime estate and gift tax exemption from the USD5m base amount, set in 2011, to a new USD10m base amount.

The exemption is adjusted for inflation each year, so in 2018, an individual would be able shelter approximately USD11.2m in assets from the estate and gift tax. Couples who do proper planning can double the estate tax exemption to approximately USD22.4m. (Non-US individuals remain subject to the US estate tax and gift tax with respect to "US-situs property" in excess of USD60,000.)

The increase in the gift tax exemption could prove very beneficial for wealthier individuals who want to renounce [9] their US citizenship but avoid the dreaded "exit tax." The exit tax applies to renouncers who, among other things, have a net worth of USD2m or more. The utilization of gift planning in order to fall under the USD2m threshold is made significantly easier with the increase to the lifetime estate and gift tax exemption.

Other Changes For Individuals

For the sake of completeness, the following are some of the other changes for individuals under the TCJA that are perhaps less relevant for most expats, but are still noteworthy:

- New measure of inflation provided;
- Alternative minimum tax (AMT) retained with higher exemption amounts;
- The moving expenses deduction and exclusion for moving expense reimbursement are eliminated;
- Deduction for interest on home equity eliminated;
- Charitable contribution deduction limitation increased to 60 percent;
- Kiddie tax modified;
- Alimony deduction eliminated; and
- New deferral election for qualified equity grants.

Summary Chart Of Tax Reforms In TCJA (Personal Taxation)

As a quick reference guide, here is a summary of the tax reforms in the TCJA that are of particular significance for US citizens living abroad:

Tax Issue	Previous Law	New Law Under TCJA
Basics of US Expat Taxation	Citizenship-based taxation of individual's worldwide income; Beneficial provisions such as the Foreign Earned Income Exclusion and Foreign Tax Credit; FATCA, FBAR and other foreign reporting rules and requirements.	No change
Net Investment Income (Obamacare) Tax	3.8 percent on Net Investment Income; Foreign tax credit cannot be credited against the tax.	No change
Exclusion of Gain on Sale of Personal Residence	Exclusion of gain of up to USD250,000 from sale of home (USD500,000 if married filing jointly); Requires meeting "ownership" and "use" tests for two out of the five years leading up to the sale.	No change

Tax Issue	Previous Law	New Law Under TCJA
Personal Income Tax Rates	Ordinary income rates have seven brackets with top rate of 39.6 percent; Capital gains rates have three brackets with top rate of 20 percent.	Ordinary income rates have seven brackets with top rate of 37 percent; Same capital gains rates with adjusted brackets.
Standard Deduction and Personal Exemption	Standard deduction for 2018 would be USD6,500 for individuals, USD9,550 for heads of household (HOH), and USD13,000 for married couples; Personal exemptions of USD4,510 each allowed.	Standard deduction increased to USD12k for individuals, USD18k for heads of household (HOH), and USD24k for married couples; Personal exemptions eliminated.
Itemized Deductions	Many itemized deductions allowed.	Miscellaneous itemized deductions eliminated and other deductions eliminated or limited.
Child Tax Credit	Credit of USD1,000, which is refundable.	Credit of USD2,000, a USD1,400 portion of which is refundable (with higher phase-out thresholds).
Estate and Gift Tax	Lifetime estate and gift tax exemption base of USD5m (adjusted for inflation).	Lifetime estate and gift tax exemption base of USD10m (adjusted for inflation).

In next week's article, we'll continue our analysis of the TCJA by covering the provisions of the legislation that we believe will most significantly impact US citizens living abroad in terms of business taxation issues.

Endnotes

1 https://www.congress.gov/bill/115th-congress/house-bill/1.

2 https://www.expattaxprofessionals.com/expat-tax-information-fbar/.

3 https://www.expattaxprofessionals.com/expat-tax-information-fatca/.

4 https://www.expattaxprofessionals.com/Form-2555-Foreign-Earned-Income-Exclusion.

5 https://www.expattaxprofessionals.com/Form-1116-Foreign-Tax-Credit.

6 https://www.irs.gov/newsroom/net-investment-income-tax-faqs.

7 *Supra*, note 5.

8 https://www.expattaxprofessionals.com/expat-tax-information-other-information-foreign-real-estate/.

9 https://www.expattaxprofessionals.com/expat-tax-information-other-information-renouncing-us-citizenship/.