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Worldwide Taxation of U. S. Citizens Living Abroad
Impact of FATCA and Two Proposals

By

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By J. Richard (Dick) Harvey, Jr.[1]

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[1] The date of this article is March 1, 2013. Since August 2010 the author has been the Distinguished Professor of Practice, Villanova University School of Law and Graduate Tax Program. Immediately prior to joining the Villanova faculty he was the Senior Advisor to IRS Commissioner Doug Shulman and worked significantly on the development of FATCA, other international issues, and Schedule UTP. Professor Harvey joined the IRS upon retiring from a Big 4 accounting firm as a Tax Partner and Leader of the U.S. Banking and Capital Markets Tax Practice. Professor Harvey also served in the United States Treasury Department's Office of Tax Policy during the drafting and implementation of the 1986 Tax Reform Act.

1 Introduction, Purpose of Article, and Intended Audience

The United States currently taxes its citizens on their worldwide income.[2] For United States citizens resident in the United States, this is usually not a big deal; their income is earned in the United States and not taxed by other countries. The same cannot be said for U.S. citizens living abroad. The worldwide taxation of their income has historically created compliance burdens and the potential for double taxation.

Because of these concerns, coupled with the fact that the United States is the only developed country with a worldwide system of taxation for individuals, some commentators have suggested the United States should adopt residence-based taxation.[3] The common theme of these proposals is that citizens resident in the United States would continue to be taxed on their worldwide income while citizens living abroad would be treated as nonresident aliens. Nonresident aliens are only subject to U.S. tax on income or assets with a clear U.S. connection.[4]

These proposals historically have been unsuccessful for a number of reasons, including: (i) U.S. citizens living abroad have little political clout, (ii) the worldwide tax system has been a fixture of U.S. tax law for over 100 years,[5] and (iii) the U.S. government could collect less tax revenue. Has anything changed that could result in a different result? The short answer is *possibly*.

First, the Foreign Account Taxpayer Compliance Act's ("FATCA") March 2010 enactment further complicated the tax burdens of American citizens living abroad.[6] For example, many foreign financial institutions are blaming FATCA's reporting obligations for their refusal to provide necessary financial services to U.S. citizens.[7] In addition, FATCA requires all U.S. citizens, including those living abroad, to report more information on their non-U.S. financial assets.[8] As would be expected, U.S. citizens living abroad can have a substantial number of non-U.S. financial assets.

Second, there is significant discussion in Washington, D.C. about changing the worldwide tax system for corporations to a territorial system.[9] It is not beyond the realm of possibility that Congress could consider totally abandoning the worldwide tax system for both corporations and individuals.[10]

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[2] I.R.C § 61(a) (West 2013). In addition, the United States also taxes the worldwide income of resident aliens defined as (i) lawfully admitted permanent residents (i.e., so-called Green Card holders), and (ii) aliens who meet a substantial presence test. Since the issues they face are similar, this article will generally use the term "U.S. citizens" to refer to both United States citizens and lawfully admitted permanent residents.

[3] *See, e.g.*, Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 VA. TAX REV. 1, 1 (2012); Cynthia Blum & Paula N. Singer, *A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals*, 41 VAND. J. TRANSNAT'L L. 705, 705 (2008); Reuven S. Avi-Yonah, *The Case Against Taxing Citizens*, (Univ. of Mich. Pub. Law, Working Paper No. 190, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1578272.

[4] I.R.C. §§ 871, 2103 (West 2013).

[5] Citizenship based taxation dates back to the civil war. *See* Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 449 n.17 (2007).

[6] Foreign Account Taxpayer Compliance Act ("FATCA"), Pub. L. 111-147, § 501(a) (2010). For background that led to FATCA, see J. Richard. Harvey, Jr., *Offshore Accounts: An Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. 471 (2012), *available at* http://ssrn.com/abstract=1969123.

[7] *See* J. Richard Harvey, Jr., *FATCA – A Report From the Front Lines*, 136 TAX NOTES 713 (2012), *available at* http://ssrn.com/abstract=2122491.

[8] *See, e.g.*, I.R.S. Form 8938 (Nov. 2012).

[9] *See* Press Release, H. Comm. on Ways & Means, Camp Releases International Tax Reform Discussion Draft (Oct. 26, 2011),

Finally, three groups representing U.S. citizens abroad, collectively known as Citizens Abroad ("CA"), have jointly made a relatively comprehensive legislative proposal to adopt a residence-based tax system for individuals ("CA Proposal"). [11]

Given this brief introduction, there are several purposes for writing this article, including

- Provide background on the taxation of U.S. citizens living abroad and the issues they face, including the recent enactment of FATCA;
- Explore whether certain U.S. citizens still have a motivation under current law to surrender their citizenship (i.e., expatriate);
- Discuss whether FATCA should result in the United States adopting a residence-based tax system;
- Make two recommendations to address the issues faced by U.S. citizens living abroad – one proposal applies if the United States retains a worldwide tax system, while the other applies if a residence-based system is considered; and
- Briefly describe the CA Proposal and provide observations.

The article is intended for various audiences, including: government policy makers, U.S. citizens abroad and others advocating change, and interested students and academics. The article is divided into several sections: Section 2, Background; Section 3, Analysis and Discussion; Section 4, Two Proposals; Section 5, Proposal by CA; and Section 6, Summary and Conclusions.

The Background section is intended for those with little or no knowledge of the subject matter. More knowledgeable readers should focus on the rest of the article, especially the proposals in Sections 4 and 5.

2 Background

This section discusses several background issues that may be important for readers to understand, including the taxation of U.S. citizens compared to the taxation of nonresident aliens (Section 2.1), and the taxation of U.S. citizens that expatriate (Section 2.2). In addition, Section 2.3 summarizes categories of U.S. citizens living abroad.

2.1 Taxation of U.S. Citizens Compared to the Taxation of Nonresident Aliens

2.1.1 General

For income tax purposes, U.S. citizens are taxed on their worldwide income with a foreign tax credit to minimize or eliminate the impact of double taxation.[12] Nonresident aliens generally do not incur U.S. tax unless they have (i) U.S. source income or (ii) income in connection with a U.S. trade or business.[13] The

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available at http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=266168 (last visited Mar. 1, 2013). Currently U.S. corporations are taxed on their worldwide income. A territorial system would only tax U.S. corporations on income earned from activity in the United States.

[10] However, a change for corporations would seem substantially more likely than a change for individuals.

[11] The three groups are American Citizens Abroad, Association of Americans Resident Overseas, and Federation of American Woman's Clubs Overseas, Inc. These three groups will collectively be referred to in this article as CA. *See also* CA Proposal, *infra* note 127; see *infra* Section 5 for a detailed discussion of the CA Proposal.

[12] *See, e.g.*, I.R.C. § 61(a), 901 (West 2013).

[13] I.R.C. § 871 (West 2013).

former can be subject to a 30% withholding tax,[14] while the latter is subject to normal graduated tax rates. For estate and gift tax purposes, U.S. citizens are subject to tax on their net worth, wherever located.[15] Nonresident aliens are only taxed on assets situated in the United States.[16]

Given these significant differences in taxation, it can be very important for a nonresident alien to avoid becoming a resident alien for U.S. tax purposes. Similarly, a U.S. citizen living abroad may surrender their citizenship to reduce or eliminate any future U.S. tax.

2.1.2 Definition of Resident vs. Nonresident Aliens

The discussion below is important to understand when evaluating the CA Proposal in Section 5 (i.e., the proposal uses the substantial presence test in I.R.C. § 7701(b)(3) for determining whether a U.S. citizen living abroad should be entitled to nonresident taxation).

The United States currently taxes both citizens and resident aliens on their worldwide income. Resident aliens are defined in I.R.C. § 7701(b) to include (i) lawfully admitted permanent residents (i.e., so-called green-card holders) and (ii) aliens who meet the substantial presence test in I.R.C. § 7701(b)(3).[17] Substantial presence is generally defined as (i) being present in the United States for at least 31 days during the current calendar year and (ii) that the weighted average number of days present in the United States during the current and the prior two calendar years exceeds 183 days.[18]

The practical effect of the weighting factor is that an alien can be present in the United States for 121 days on average, each calendar year, and avoid being classified as a resident alien subject to U.S. tax on their worldwide income.

There are several exceptions to this general rule, but the most significant is that an alien can be present in the United States for up to 182 days during a calendar year if the alien can establish (i) they have a tax home in a foreign country, and (ii) they have a closer connection to that foreign country than the United States.[19]

2.1.3 Income Tax Exemptions (I.R.C. § 911)

A qualified individual may elect to exclude earned income and excess housing costs from gross income. Since the housing cost exclusion is complicated, it will not be discussed.[20] For 2013, the earned income

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[14] The 30% rate can be reduced or eliminated by a tax treaty between the United States and a foreign country. However, there are many exclusions whereby no tax is imposed on U.S. source income (e.g., portfolio interest exemption in I.R.C. § 871(h)(1) (West 2013)).

[15] I.R.C. §§ 2001(a), 2031(a) (West 2013). Thus, assets located outside the United States are subject to estate tax.

[16] I.R.C. § 2103 (West 2013).

[17] I.R.C. § 7701(b)(1)(A)(iii) also allows a "first year election" for an alien who technically does not meet other qualification requirements. (West 2013).

[18] Weighting is based on a multiplier of 100% for the current year, 33.33% for the first preceding year, and 16.67% for the second preceding year.

[19] I.R.C. § 7701(b)(3)(B) (West 2013).

[20] *See* I.R.C. § 911(c) (West 2013).

exemption amount is $97,600.[21] However, this exclusion only applies for income tax purposes; it does not apply to employment taxes.[22]

A qualified individual is generally defined as (i) a citizen of the United States who has been a bona fide resident of a foreign country or countries for an uninterrupted period, which includes an entire taxable year, or (ii) a citizen or resident of the United States present in a foreign country or countries during at least 330 full days during a 12-consecutive-month period.[23]

It should be noted there was no cap (i.e., there was an unlimited exclusion) on the earned income exemption from 1926 to 1962. After 1962, there generally has been a cap of varying amounts.[24]

2.1.4 Estate and Gift Tax

U.S. citizens are subject to estate tax on a worldwide basis (i.e., the net value of their estate is taxed regardless of where the property is located).[25] Gifts are also subject to a gift tax on a worldwide basis (i.e., no matter where the assets or recipients are located).[26] A foreign tax credit is allowed for foreign estate, inheritance, legacy, or succession taxes paid to a foreign country for property situated in that foreign country.[27] A foreign tax credit is generally not allowed for gift taxes.[28]

Nonresident aliens are only subject to the estate tax with respect to property within the United States.[29] The definition of property within the United States, however, is relatively narrow. For example, it does not include bank deposits and certain other obligations.[30] For gift tax purposes, nonresident aliens are only taxed on the transfer of tangible property. Intangible property is generally not taxed.[31]

In summary, like the income tax, there is a clear incentive, with the estate and gift tax, to avoid being taxed as a U.S. citizen or resident alien.

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[21] Per I.R.C. § 911(b)(2)(D)(ii), the amount is indexed for inflation. (1986). The 2013 amount per Rev. Proc. 2012-41. I.R.B. 435 § 3.17.

[22] I.R.C. § 911(a) (1986). However, international social security agreements (i.e., Totalization Agreements) may prevent double taxation. *See U.S. International Social Security Agreements*, SSA, http://www.ssa.gov/international/agreements_overview.html#a0=11 (last visited May 30, 2013).

[23] I.R.C. § 911(d)(1) (West 2013).

[24] Kirsch, *supra* note 5, at note 72.

[25] I.R.C. § 2103 (West 2013).

[26] I.R.C. § 2501(a) (1986).

[27] I.R.C. § 2014(a) (1986).

[28] *But see* I.R.C. § 2501(a)(3)(B) (1986).

[29] I.R.C. § 2103 (1986).

[30] I.R.C. § 2105(b) (2010).

[31] I.R.C. § 2501(a)(2) (1986).

2.1.5 Compliance Burdens on U.S. Citizens Living Abroad

U.S. citizens living abroad face a number of tax compliance burdens not faced by their fellow citizens resident in the Unites States. The following are among the additional burdens:[32]

- Requirement to file a U.S. income tax return with very complex calculations, including: foreign currency translation,[33] the foreign tax credit,[34] and the excess housing cost exclusion.[35]
- High probability of filing at least one foreign income tax return, and possibly more.
- Very high probability of reporting foreign assets on both (i) the FBAR form,[36] and (ii) IRS Form 8938,[37] the latter of which is required by FATCA.[38]
- Reporting on miscellaneous other forms[39] that have a higher probability of applying to taxpayers located outside the United States.

In addition to the tax filing burdens listed above, the implementation of FATCA has created some very practical financial issues. Specifically, many foreign financial institutions are blaming FATCA for their refusal to provide necessary financial services to U.S. citizens. [40] For example, some foreign financial institutions are closing the bank and custody accounts of U.S. citizens and permanent residents because the foreign financial institutions hope to avoid the FATCA reporting obligations.

FATCA also requires all U.S. citizens, including those living abroad, to report more information on their non-U.S. financial assets.[41] As would be expected, United States citizens living abroad can have a substantial number of non-United States financial assets. Failure to carefully follow these reporting obligations can result in significant penalties and an indefinite extension of the statute of limitations. See Section 3.5 for a discussion of whether FATCA justifies a change by the United States from a worldwide to a residence-based tax system.

2.2 Taxes on U.S. Citizens that Expatriate

Since the United States has a worldwide income and estate/gift tax system for U.S. citizens, Congress has historically been concerned U.S. citizens would expatriate[42] primarily for tax reasons. As a result, many

[32] Schneider, *supra* note 3, at 1–2; NAT'L TAXPAYER ADVOCATE, *infra* note 95.

[33] *See, e.g.*, I.R.C. § 985 (West 2013).

[34] *See generally* I.R.C. §§ 901-09 (West 2013).

[35] I.R.C. § 911(c) (West 2013).

[36] I.R.S. Form TD F 90-22.1 (Jan. 2012). This form is entitled Report of Foreign Bank and Financial Accounts ("FBAR").

[37] I.R.S. Form 8938 (Nov. 2012).

[38] FATCA, Pub. L. 111-147, § 501(a) (2010). For a comparison of the two forms, see *Comparison of Form 8938 and FBAR Requirements*, IRS, *available at* http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements (last visited May 29, 2013); *Reporting Foreign Accounts to IRS*, GAO, *available at* http://www.gao.gov/assets/590/588921.pdf (last visited May 29, 2013).

[39] *See, e.g.*, I.R.S. Form 5471 (Dec. 2012); I.R.S. Form 8865 (2012).

[40] *See* Harvey, *supra* note 7, at 715.

[41] *See, e.g.*, I.R.S. Form 8938 (Nov. 2012).

[42] Expatriation would entail a U.S. citizen giving up his U.S. citizenship or Green Card.

tax law provisions have been enacted over the years to deter tax-motivated expatriation.[43] The latest revision was in 2008,[44] when two new internal revenue code sections were added: I.R.C. § 877A and I.R.C. § 2801. Both are described below.

2.2.1 Deemed Mark-to-Market Exit Tax (I.R.C. § 877A)

Prior to the enactment of I.R.C. § 877A, it was relatively easy for U.S. citizens to expatriate and avoid taxation of income and gains accrued during their period of U.S. citizenship. I.R.C. § 877A attempts to address this concern by requiring "covered expatriates" to treat all property[45] as sold for its fair market value on the day before their expatriation.[46] Thus, unrealized gain is deemed realized subject to a *de minimis* exemption (e.g., $668,000[47] in 2013).

In 2013, a covered expatriate is generally defined as an individual that meets *any* of the following three criteria:[48]

- More than $155,000 of average annual net income tax for the 5 taxable years preceding the date of expatriation.[49]
- $2 million of net worth at the date of expatriation.
- Failure to certify compliance with the U.S. tax laws for the 5 taxable years preceding the date of expatriation.

There are two very limited exceptions to the definition of a covered expatriate.[50] The first is for certain dual citizens, defined as:[51]

- An individual who, at birth, became a citizen of both the United States and another country,
- On the date of expatriation, the individual is a citizen of, and is taxed as a resident of, the same other country, <u>and</u>
- The individual has been a resident of the United States for no more than 10 taxable years during the 15 taxable years prior to the date of expatriation.

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[43] For more information, see Bradford Craig, Note, *Congress, Have a Heart: Practical Solutions to Punitive Measures Plaguing the Heart Act's Expatriate Inheritance Tax*, 26 TEMP. INT'L & COMP. L.J. 69 (2012).

[44] Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624.

[45] I.R.C. § 877A(c) (2008) excludes certain property (i.e., deferred compensation, tax deferred account, and interests in a nongrantor trust) that special rules are provided for in I.R.C. §§ 877A(d)–(f) (2008).

[46] I.R.C. § 877A(a)(1) (2008).

[47] I.R.C. § 877A(a)(3)(A) (2008) requires annual adjustment for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435 § 3.16.

[48] I.R.C. § 877A(g)(1)(A) (2008), *referring to* I.R.C. § 877(a)(2) (1986).

[49] Per I.R.C. § 877(a)(2) (1986), the amount is indexed for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435 § 3.15.

[50] See *infra* Section 4.3 for suggestions on how these two exceptions could be expanded to include other sympathetic cases.

[51] I.R.C. § 877A(g)(1)(B)(i) (2008).

Note that if a U.S. citizen obtained citizenship in foreign country A at birth, has never set foot in the United States, but now lives in foreign country B, they will not qualify under this very limited dual citizen exception.[52]

The second exception is for children becoming adults. In order to qualify for this exception, a U.S. citizen must:[53]

- Relinquish their citizenship before attaining the age of 18½, and
- Have been a resident of the United States for no more than 10 taxable years before they surrender their citizenship.

The practical issue with this exception is that very few 18-year-olds are cognizant of tax and immigration issues in general, let alone the potential need to relinquish U.S. citizenship by the time they are 18½.

Although there are many other technicalities to this expatriation, or exit, tax, one worth noting is that individuals can make an election to defer the tax on a property-by-property basis until the property is sold.[54] If the election is made, the individual will be charged interest and must provide adequate security that the tax will be paid (e.g., a security bond).[55]

See Section 3.2 for a discussion of whether I.R.C. § 877A meets its objectives (i.e., taxing unrealized gains earned while a U.S. citizen). (2008). In summary, it does, subject to valuation and enforcement issues.

2.2.2 Inheritance Tax (I.R.C. § 2801)

Prior to the enactment of I.R.C. § 2801 in 2008, it was also relatively easy to avoid the U.S. estate and gift tax by expatriating. I.R.C. § 2801 partially addressed this concern by adopting an inheritance tax that is applicable to the same covered expatriates defined for purposes of the exit tax in I.R.C. § 877A.[56] Specifically, if a U.S. citizen or resident receives a gift or bequest from a covered expatriate, a tax at the highest rate under the estate tax is imposed on the fair market value.[57] The recipient pays the tax; thus, it is an inheritance tax, not an estate tax.

Other noteworthy provisions within I.R.C. § 2801 include:

- The provision is applied to both direct and indirect gifts and bequests, including those through domestic and foreign trusts.[58]

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[52] *See id*.

[53] I.R.C. § 877A(g)(1)(B)(ii) (2008).

[54] I.R.C. § 877A(b) (2008).

[55] I.R.C. § 877A(b)(4) (2008). Security can be in the form of a bond, or other form of security meeting United States Treasury requirements.

[56] I.R.C. § 2801(f) (2008).

[57] I.R.C. §§ 2801(a)–(e) (2008).

[58] I.R.C. § 2801(e) (2008).

- Tax is reduced by any gift or estate tax paid to a foreign country with respect to the covered gift or bequest.[59] Based upon the statutory language, however, it would appear that other inheritance taxes would not be creditable.[60]

See Section 3.2 for a discussion of whether I.R.C. § 2801 eliminates the estate and gift tax incentive to expatriate. In short, there can still be an incentive to expatriate if the anticipated recipients of the bequests or gifts are neither U.S. citizens nor U.S. residents.

2.3 Categories of U.S. Citizens Abroad

Like any group of individuals, from a tax policy perspective there are various subgroups of U.S. citizens living abroad[61] that one might conceivably treat differently. The first subgroup would be those citizens abroad on a short-term basis (i.e., intending to return to the United States within the foreseeable future). This subgroup includes those who are overseas for education, travel, and/or temporary work assignments.

The second group would be citizens who are overseas on a long-term basis (i.e., not intending to be resident in the United States for the foreseeable future). There are potentially several ways to characterize individuals within this subgroup. For example, they could be characterized as including individuals who

- **Have a U.S. passport** (individuals who almost certainly know they are U.S. citizens),[62] or

- **Never had a U.S. passport** (individuals who may reasonably not know they are U.S. citizens).

Individuals could also be characterized by the degree of contact they have had with the United States. For example,

- **Significant contact** refers to individuals who were born in the United States to U.S. parents and have spent a substantial amount of their life in the United States, and

- **Insignificant contact** refers to individuals who have spent little or no time in the United States, but were either (i) born in the United States to foreign parents or (ii) born outside the United States to U.S. parents.

As discussed in Section 2.2.1, Congress has provided two very narrow exceptions to the Section 877A exit tax for certain dual citizens and young adults who have spent most of their lives outside the United States. See Section 4.3 for a discussion of why these exceptions should be expanded.

Finally, since the United States is the only major country taxing its citizens on a worldwide basis,[63] it should be noted that many U.S. citizens living abroad do not understand they have a U.S. tax filing obligation. These citizens may have inadvertently subjected themselves to significant penalties.

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[59] I.R.C. § 2801(e)(4)(B)(ii) (2008).

[60] Inheritance taxes are more common than the estate tax imposed by the United States. *See* JOINT COMM. ON TAXATION, 108TH CONG., REVIEW OF THE PRESENT-LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP & TERMINATION OF LONG-TERM RESIDENCY 153 (Comm. Print 2003).

[61] For a more comprehensive discussion, see Schneider, *supra* note 3, at § II.

[62] However, it is possible that a parent could obtain a passport for a child without a child's knowledge.

[63] *See, e.g.*, Schneider, *supra* note 3, at 1.

3 Analysis and Discussion

This section discusses several topics, including: tax issues facing U.S. citizens abroad (Section 3.1); whether U.S. citizens still have a motivation to expatriate (Section 3.2); arguments for and against worldwide taxation (Section 3.3); the political landscape (Section 3.4); and whether FATCA justifies a change to residence-based taxation (Section 3.5).

Proposals to specifically address the issues facing U.S. citizens living abroad are not discussed in this section, but rather in Sections 4 and 5. However, Section 3.2 does discuss a proposal to further discourage ultra-wealthy (over $25 to $50 million of net worth) US citizens from surrendering their citizenship to minimize their future estate tax liability. This proposal could also be used to generate tax revenue to provide relief to US citizens abroad who are not ultra-wealthy.

3.1 Selected Tax Issues Facing U.S. Citizens Abroad

A U.S. citizen living abroad faces many potential issues not faced by a fellow citizen resident in the United States. The major potential issues include:[64]

- **Higher overall tax burden** – Income can be taxed two or more times (e.g., first by the country where the income is earned, second by the foreign country of residence, and third by the United States).[65] In order to minimize double taxation the United States allows a foreign tax credit ("FTC"), but the FTC is generally not allowed for certain major foreign taxes (e.g., value added tax and social security/payroll taxes).[66]

- **Insufficient income exclusion** – Earned income can be excluded from the U.S. return, but the exclusion is relatively low (e.g., $97,600 in 2013).[67] In addition, there is no specific exclusion for passive income, even a *de minimis* amount.

- **Substantial annual tax compliance responsibilities** – These include (i) the requirement to file a U.S. income tax return with complex calculations (e.g., foreign exchange, FTC, and the excess housing cost exemption); (ii) the likelihood that at least one foreign income tax return will also need to be filed; and (iii) annual U.S. reporting obligations for foreign assets (i.e., FBAR form and I.R.S. Form 8938).[68]

- **Difficulty obtaining routine financial services** – The introduction of FATCA has resulted in many foreign financial institutions closing the deposit and investment accounts of U.S. citizens living abroad or, alternatively, offering sub-optimal financial products.[69]

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[64] For a more comprehensive discussion, see Schneider, *supra* note 3, and NAT'L TAXPAYER ADVOCATE, *infra* note 95.

[65] In most cases, one would expect the source country and the foreign country of residence to be the same. However, that is not always the case.

[66] *See, e.g.*, I.R.C. §§ 61(a), 901-02 (West 2013).

[67] I.R.C. § 911(b)(2)(D) (1986); I.R.S. Notice 2013-31, § 2.

[68] *See, e.g.*, I.R.S. Form 8938 (Nov. 2012); I.R.S. Form TD F 90-22.1 (Jan. 2012).

[69] I.R.C. § 63(a) (West 2013); *see generally* Harvey, *supra* note 7.

In addition, some U.S. citizens may not know they are U.S. citizens.[70] Other U.S. citizens may not understand they have a U.S. filing obligation since worldwide taxation is not the norm overseas. Both may have unknowingly subjected themselves to significant penalties for failure to file an income tax return and an FBAR form.

3.2 U.S. Citizens Still Have a Motivation to Expatriate

Given the issues discussed in Section 3.1 above, there clearly is a motivation for U.S. citizens to consider expatriation. However, there are two code sections potentially standing in their way to this "Promised Land". As summarized in Section 2.2, I.R.C. § 877A and I.R.C. § 2801 were enacted in 2008 to make it more costly for U.S. citizens to surrender their citizenship, assuming they had the wherewithal and inclination to do so. I.R.C. § 877A and I.R.C. § 2801 are only applicable to covered expatriates,[71] and provide the following:

- **I.R.C. § 877A** – Imposes a mark-to-market regime on the day before expatriation with the result that all unrealized income above $668,000[72] is realized.

- **I.R.C. § 2801** – Imposes an inheritance tax on U.S. citizens and U.S. residents who inherit or are gifted money by a covered expatriate.[73]

Despite potential administrative and enforcement issues, these two code sections should substantially reduce the incentive for U.S. citizens to expatriate for tax reasons. However, as described below, the incentive is not completely eliminated, especially for those individuals attempting to minimize or avoid the U.S. estate and gift tax.

- **Income tax** – I.R.C. § 877A ensures that all income earned while an individual is a U.S. citizen is subject to tax in the United States.[74] Since income earned after expatriation will escape U.S. taxation, there still is a motivation to expatriate for individuals expecting substantial future income. Nevertheless, from a tax policy perspective, the United States should not be entitled to tax income truly earned when an individual is no longer a U.S. citizen.

- **Estate and gift tax** – I.R.C. § 2801 substantially eliminates the incentive to expatriate for those individuals planning to ultimately bequeath or gift their assets to U.S. citizens or U.S. residents. If, however, a covered expatriate's recipients are neither U.S. citizens nor U.S. residents at the time of the bequest or gift, the I.R.C. § 2801 inheritance tax is avoided.[75] Thus, an expected future recipient can surrender their U.S. citizenship prior to receipt and avoid the inheritance tax. For a covered expatriate who is merely wealthy, as opposed to ultra-wealthy, this strategy may be

[70] For further discussion, see *supra* Section 2.3.

[71] See *supra* Section 2.2.1, but it is generally defined as an individual with at least (i) $2 million of net worth or (ii) $155,000 of average annual income tax in the past 5 years. I.R.C. § 877(a)(2) (1986); Rev. Proc. 2012-41, I.R.B. 435, § 3.15.

[72] See I.R.C. § 877A(a)(3)(A) (2008), where the amount is annually indexed for inflation.

[73] I.R.C. § 2801(a) (2008).

[74] As a practical matter, there may be valuation issues and it is not crystal clear whether the IRS will be informed of all individuals giving up their citizenship. Nevertheless, U.S. citizens expatriating and following the law should not escape taxation on income earned while in the United States.

[75] I.R.C. § 2801(a) (2008) (naming a U.S. resident or citizen as a recipient).

difficult to execute because of a recipient's need to retain a substantial presence in the United States (e.g., to work).[76] For the ultra-wealthy, this may be less of an obstacle.

In summary, there still is a motivation for wealthy U.S. citizens, especially the ultra-wealthy, to surrender their citizenship to avoid the U.S. estate and gift tax. From a tax policy perspective, this suggests Congress may want to consider various proposals, including:

- **Deemed mark-to-market for estate tax purposes** – Given I.R.C. § 877A already requires a mark-to-market calculation, such a calculation could be used to determine the hypothetical estate tax due if the covered expatriate died on the day immediately prior to expatriation.[77] Similar to I.R.C. § 877A, this deemed estate tax could be deferred, with interest and subject to security,[78] until the underlying property is ultimately sold. In addition, Congress could decide to only apply this deemed estate tax to very large estates (e.g., over $25 to $50 million).

  This proposal raises at least two potential tax policy issues. The first is similar to the discussion above surrounding the income tax. Specifically, there still would be an incentive for a U.S. citizen to expatriate if they anticipated a material increase in their net worth before death.[79] In these cases, expatriation would remove the future increase in net worth from U.S. taxes. But again, similar to the income tax analysis above, from a tax policy perspective one would be hard pressed to argue the United States is entitled to tax the future accretion of net wealth for an individual who is no longer a citizen.

  The second policy issue could be more troubling to some. Specifically, when combined with IRC § 877A, this deemed estate tax proposal could result in more tax for a United U.S. citizen who expatriates versus a citizen who does not expatriate. For example, a U.S. citizen who does not expatriate will be subject to estate tax but can escape taxation on any unrealized gains at the time of death.[80] In contrast, under this proposal, an expatriate is effectively taxed on both his unrealized income (per IRC § 877A) and net worth at the time of expatriation, per the deemed estate tax.

  One counter-argument could be that Congress has already crossed this bridge by enacting I.R.C. § 877A. Another counter-argument is, if an ultra-wealthy individual wants to expatriate, he surrenders the right to take advantage of the step-up in basis upon death.[81] Personally, I believe Congress should consider a deemed estate tax for those ultra-wealthy citizens that expatriate.

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[76] *See* I.R.C. § 7701(b) (2006) (for substantial presence).

[77] The tax calculated in I.R.C. § 877A would be subtracted from the deemed value of the covered expatriate's estate.

[78] Requiring security could make enforcement of a deemed estate tax more certain than the current inheritance tax that is effectively on the honor system.

[79] In order to provide an economic benefit, the future appreciation of net worth would need to be in excess of the interest rate charged to defer the deemed estate tax.

[80] The exclusion of unrealized gain at death is a major loophole in the current U.S. income tax that could be the subject of a completely separate paper. Suffice it to say that ultra-wealthy U.S. taxpayers (e.g., Steve Jobs) have avoided income tax on a very high percentage of the wealth they created during their lifetime. Reasonable policy makers can disagree on whether an estate and gift tax is appropriate, but this author sees no reason to allow unrealized gains to escape income taxation at the time of death.

[81] Said differently, they did not meet the necessary criteria (i.e., death as a U.S. citizen) to obtain a stepped-up basis upon death (i.e., tax basis to heir is increased to the fair market value of the asset at the date of death).

Nevertheless, if Congress is persuaded that a deemed estate tax upon expatriation is not appropriate, then another option is discussed immediately below.

- **Higher of I.R.C. § 877A tax or the deemed estate tax** – Another option would be to require the higher of the two taxes, but not both. Thus, to the extent an expatriate would have a greater tax due under the deemed estate tax than he would under current law I.R.C. § 877A, the expatriate would pay the higher tax. This could be a significant deterrent for those U.S. citizens considering expatriation that have relatively modest amounts of unrealized gain and would therefore escape relatively unscathed by I.R.C. § 877A.

- **Expand existing I.R.C. § 2801** – The definition of recipients subject to inheritance tax could be expanded to include a former U.S. citizen or resident (e.g., a U.S. citizen at the time of expatriation, or some suitable period prior to expatriation, by the covered expatriate). Such a proposal would make it more difficult for a wealthy U.S. citizen to expatriate and avoid the inheritance tax in I.R.C. § 2801, but it would not be impossible. For example, the obvious way to plan around such a rule would be to have the expected recipients surrender citizenship prior to the wealthy donor's expatriation. In addition, such a proposal would add to the significant enforcement issues already surrounding I.R.C. § 2801. Because of these issues, either of the two deemed estate tax proposals discussed above would be preferable.

In summary, after the effective date of I.R.C. § 877A and I.R.C. § 2801, there still can be substantial estate and gift tax benefits for U.S. citizens surrendering their citizenship.[82] Although the absolute number of U.S. citizens that could practically benefit may be low, the tax dollars at stake could be high (i.e., billions of dollars). Thus, if Congress wants to further discourage expatriation by U.S. citizens, it should consider the above proposals.

3.3 Major Arguments For and Against Worldwide Taxation

There already exists a great deal of scholarship on this subject.[83] The arguments for a worldwide system basically boil down to:

- U.S. citizens living abroad receive benefits from being a citizen.
- If a residence-based system is adopted, it could allow wealthy U.S. citizens to shift their residence overseas to avoid U.S. tax but still retain U.S. citizenship.

The arguments against a worldwide system include:

- The United States is the only developed country that taxes its citizens on a worldwide basis.
- The tax compliance burdens on U.S. citizens abroad are excessive.
- The FTC may not fully compensate for the tax burden imposed by other countries.
- U.S. citizens are encouraged to surrender their citizenship to avoid worldwide taxation.
- U.S. citizens may be at a competitive disadvantage when pursuing jobs overseas.[84]

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[82] There also can be income tax benefits to the extent the individual expects substantial income after expatriation. However, in theory, the mark-to-market regime of I.R.C. § 877A should capture all unrealized gain at the date of expatriation, subject to valuation issues.

[83] *See generally* Schnedier, Blum & Singer, Avi-Yonah, *supra* note 3; Kirsch, *supra* note 5.

[84] In a world where jobs are important, the hiring of a U.S. citizen abroad could potentially result in one less U.S. citizen being unemployed in the United States.

All of these arguments have some merit and, therefore, reasonable policy makers may have different views as to the correct policy. Personally, it is troubling to see previously proud U.S. citizens surrendering their citizenship to avoid the administrative and financial burdens of being a U.S. citizen.

From a tax policy perspective, I am most concerned about two issues. First, I am very sympathetic to the annual tax compliance burdens currently faced by U.S. citizens living abroad, especially those

- Without substantial economic resources to pay for the needed tax preparation assistance, or
- Who have relatively minor amounts of passive income (i.e., substantially all of their income is earned and presumably taxed in their country of residence).

Second, the adoption of a residence-based tax system could encourage wealthy U.S. citizens to shift their permanent residence overseas in an effort to avoid U.S. tax. For example, if an ultra-wealthy U.S. citizen moves their residence to a low-tax or no tax jurisdiction (i.e., a tax haven) jurisdiction, they could completely eliminate any future U.S. tax obligation. To the extent this occurred, it would reduce tax revenue and create a fairness issue (i.e., further solidify the perception held by many that the wealthy may not be paying their fair share).

Given these two concerns, the real-world question becomes: Is there a legislative proposal that addresses both concerns and has a realistic chance of being enacted, given the current political landscape?

3.4 Political Landscape

One could describe today's political landscape by various adjectives, including dysfunctional, polarized, selfish, infantile, and others not suitable for a legal publication. Nevertheless, most would agree the following two tax policy issues are consuming a lot of oxygen in Washington, D.C.:

- **Trillion dollar annual budget deficits** – If a proposal to change the existing worldwide tax system loses substantial revenue, the probability of passage is very low.

- **The wealthy should pay their fair share of taxes** – Fairness has been a constant theme of many in Washington, D.C. The practical consequence being that any proposal will need safeguards aimed at making sure the wealthy do not avoid paying their fair share – whatever this term means.

Any legislative proposal aimed at U.S. citizens living abroad will clearly need to address these two inter-related concerns. Is it possible? Yes, but it will not be easy.

Before discussing potential proposals in Sections 4 and 5, a quick discussion surrounding FATCA is needed.

3.5 Does FATCA[85] Justify Changing to Residence-Based Taxation?

Prior to FATCA's enactment, U.S. citizens abroad faced a myriad of issues briefly summarized in Section 3.1. The practical impact of FATCA has been to create additional problems for U.S. citizens living abroad, including

- Difficulty obtaining basic financial services,[86] and

[85] See *supra* Section 3.5 for background on FATCA.

[86] *See, e.g.*, § 1471(b)(3) (2010).

- The need to complete two forms for foreign financial assets (i.e., FBAR form and IRS Form 8938).[87]

Thus, a legitimate question is whether FATCA is the straw that should break the proverbial camel's back and result in the United States abandoning its system of worldwide taxation for individuals.

In short, my response is "no". The major practical problems of FATCA can be adequately addressed through more targeted changes. For example, the difficulty obtaining basic financial services should, over time, be substantially reduced through the following measures:

- **Intergovernmental agreements and regulations surrounding FATCA's implementation** – Because of concerns expressed by U.S. citizens abroad, the United States Treasury has inserted a provision in the model intergovernmental agreements conditioning certain benefits on foreign financial institutions not discriminating against U.S. citizens.[88]

- **Movement towards a multilateral FATCA system –** Currently some foreign financial institutions ("FFIs") are attempting to address their own FATCA problems by excluding U.S. citizens from their customer base.[89] This may be a rational response when the United States is the only country with a FATCA regime and U.S. customers comprise a small percentage of the FFIs' customer base. However, as FATCA ultimately spreads around the world, FFIs will need to bite the proverbial bullet by adopting adequate customer due diligence procedures and FATCA reporting systems. When this occurs this should eliminate any incentive to discriminate against U.S. citizens living abroad.

The administrative complexity associated with filing both the FBAR form and IRS Form 8938 should be addressed by either combining or otherwise coordinating the forms. If legislative or regulatory changes are needed to make this a reality, such changes should be pursued.[90]

In summary, although FATCA is not a justification for adopting residence-based taxation, it can be a catalyst for encouraging discussion of how U.S. citizens abroad should be taxed. Section 4 outlines two proposals for addressing the issues facing U.S. citizens abroad. One proposal assumes the existing worldwide tax system is retained, while the second assumes a residence-based system.

4 Two Proposals

As stated in Section 3.3, I have significant sympathy for the annual tax compliance burden of U.S. citizens living abroad. However, I am also very concerned about wealthy U.S. citizens, especially those

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[87] For a comparison of the two forms, see *Comparison of Form 8938 and FBAR Requirements*, IRS, *available at* http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements (last visited on Mar. 1, 2013).

[88] For a brief description, see Mark J. Mazur, *Treasury Responds to Congressman's FATCA Concerns*, 2012 TAX NOTES TODAY 248-23 (Dec. 21, 2012).

[89] *See* Harvey, *supra* note 7, at 715.

[90] For example, changes may be needed to conform the due dates of each form. In addition, although IRS processes both forms, the FBAR form is technically under Title 31 (related to anti-money laundering/terrorist financing), while IRS Form 8938 is under Title 26 (related to taxes). Thus, there may need to be changes to allow the sharing of information if the forms are combined or coordinated.

with material passive income, moving abroad under a residence-based tax system to avoid U.S. tax. This latter concern is based upon both fairness and tax revenue concerns.

First, it is not fair for wealthy U.S. citizens to make their fortune in the United States and then move abroad to avoid substantial U.S. taxes. However, as discussed in Section 4.3, I am less concerned about U.S. citizens that have (i) already moved abroad while the United States has a worldwide tax system, and have (ii) continued to meet their U.S. filing obligations. Any fully-informed, law-abiding[91] U.S. citizen would clearly not have moved abroad to avoid U.S. taxes.

Second, a proposal could lose substantial tax revenue if it allows wealthy U.S. citizens to accomplish two previously unattainable goals simultaneously: maintaining their U.S. citizenship, while eliminating or significantly reducing their future U.S. tax liability.

If tax policy makers have similar concerns, it would appear there are two basic alternatives for attempting to address many of the issues facing U.S. citizens abroad:

- Keep the current worldwide system, but (i) increase income exemptions, (ii) greatly simplify the current annual tax filing obligations, and (iii) continue efforts to make sure routine financial services are available to U.S. citizens living abroad.

- Adopt a residence-based system, but one with very tough rules designed to prevent tax avoidance. Variations could include (i) stringent rules on U.S. citizens visiting the United States coupled with an *ironclad* departure tax, and/or (ii) an exception for U.S. citizens resident in a tax haven.[92]

Both of these two general alternatives will be discussed in more detail in Section 4.1 and Section 4.2 below.

4.1 Keep Worldwide System but with Changes

U.S. citizens abroad may prefer a residence-based system, but obtaining a change will be difficult given the potential fairness and tax revenue concerns coupled with the existence of a worldwide tax system in the United States for over one hundred years. As an alternative, Congress could provide substantial relief to U.S. citizens within the existing worldwide tax system by enacting some or all of the following:

- **Increase the $97,600 earned income exemption**[93] – In today's world, $97,600 is not a lot of earned income. One would hope many U.S. citizens living abroad with earned income are earning substantially more. Thus, it may be reasonable to substantially increase this exemption. An exemption of $300,000 to $400,000 should ensure that substantially all earned income of U.S. citizens abroad would be exempt from U.S. tax. Plus, to the extent the vast majority of U.S. citizens abroad with significant earned income likely live in relatively high tax jurisdictions, the revenue cost of this proposal may be manageable,[94] but see Section 4.4 for further discussion.

[91] There may be some U.S. citizens that moved abroad hoping to evade U.S. tax because of the practical difficulties the IRS has identifying such taxpayers. I have no sympathy for these U.S. citizens.

[92] Individuals resident in a tax haven could still be subject to U.S. tax on a worldwide basis.

[93] Per I.R.C. § 911(b)(2)(D)(ii) (1986), the amount is indexed for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435, § 3.17.

[94] Said differently, under current law the FTC should eliminate the U.S. income tax.

- **Provide a *de minimis* passive income exemption** – One of the goals of this overall proposal is to eliminate or greatly simplify the annual tax filing requirements for the vast majority of U.S. citizens living abroad. In order to accomplish this objective, it would be reasonable to annually exempt from U.S. taxation a *de minimis* amount of passive income (e.g., $50,000 to $100,000). This exemption could be limited to only foreign-source passive income, or it could be applied to both U.S.- and non- U.S.-source passive income. If limited to just foreign-source income, it may have the undesirable effect of effectively encouraging U.S. citizens abroad to avoid investing in U.S.-source income.

- **Eliminate or greatly simplify the U.S. income tax return filing requirements** – Given the complexity and cost of preparing an annual income tax return for a U.S. citizen living abroad, one has to question whether a tax return is necessary when clearly there is no U.S. income tax liability. For the 2009 tax year, only 9% of taxpayers living abroad had a tax liability after application of (i) the FTC and (ii) the I.R.C. § 911 earned income exemption.[95]

  The above proposals to increase the income exemption were partially designed to allow for either the elimination of the income tax filing obligation or a significant simplification. Significant simplification could include:

  - **Simple certification that all income is below the exemption level** – If income levels are below the exemption levels, U.S. citizens living abroad should only need to file a one-page statement signed under penalties of perjury that their income is below the exemption amounts and they qualify for the exemption.[96] A complete U.S. income tax filing would still be required for U.S. citizens living abroad with income above the exemption levels. Since the income for individuals over the exemption levels would be relatively high, finding and affording the necessary tax advice should be less of an issue.

  - **Simple certification that all income is taxed in a designated high-tax country** – A U.S. citizen could certify under penalties of perjury they paid tax on all of their income to a designated high-tax country.[97] They would also be required to disclose their foreign tax identification number. One issue with this proposal is that it would require the IRS to maintain a list of countries qualifying for high tax status. Hopefully this would not be too burdensome, but it would be necessary.

  If Congress does seriously consider any of the above simplifications, it should condition the simplification on a U.S. citizen meeting his U.S. income tax filing and reporting obligations for some specified prior period (e.g., 3 to 6 years). If a U.S. citizen had not previously met these obligations, but owes little or no tax, a simplified certification may also be useful.

- **Combine or coordinate the FBAR[98] and IRS Form 8938[99] filing obligations[100]** – Given there is significant overlap of the information requested on these two forms, they should be combined.

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95 NAT'L TAXPAYER ADVOCATE, 1 *2011 Annual Report to Congress* 156 fig.1.8.2, *available at* http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_1.pdf.

96 A variation might be to file a one page statement, but require that gross income be disclosed.

97 A variation would be to also require disclosure of gross income and possibly the amount of income tax paid to the foreign country. If the IRS wanted to selectively audit taxpayers, they could request information from the foreign tax administrator.

98 I.R.S. Form TD F 90-22.1 (Jan. 2012).

99 I.R.S. Form 8938 (Nov. 2012).

One possibility would be to have Part 1 of a combined form disclose foreign assets that are common to both filing requirements. Part 2 could then address those disclosures required under the current FBAR form, but not required in Form 8938. Part 3 could then address those disclosures required under the current Form 8938, but not required under the FBAR form. If one form is not possible, at a minimum the forms could be coordinated (i.e., information shown on one form need not be shown on the other because of incorporation by reference) and have the same due date.

- **Continue efforts to ensure routine financial services are available** – Given FATCA has created some practical problems,[101] the United States Treasury should continue pressuring foreign countries and foreign financial institutions to ensure U.S. citizens living abroad have suitable access to routine financial services. In the long-run, this problem should decrease as the world hopefully moves toward a multilateral FATCA regime. In the short-run, however, it could be a problem in selected markets.

- **Provide an exemption from employment taxes –** Currently the earned income of U.S. citizens abroad can be subject to U.S. employment taxes, even though it is exempt from U.S. income tax.[102] Given many countries impose their own employment taxes on earned income, one has to question whether it makes sense for the United States to also impose employment taxes. Options for Congress could include: (i) exempting earned income from employment taxes to the extent of the earned income exemption; (ii) giving U.S. citizens abroad a choice of whether to participate in the social security/Medicaid system; or (iii) expanding the list of countries with international social security agreements (i.e., Totalization Agreements).

Adoption of all the above proposals would allow U.S. citizens to (i) maintain their citizenship, (ii) substantially reduce their U.S. tax compliance burdens, and (iii) reduce the possibility of double taxation. If Congress does not want to adopt all of the proposals (e.g., those that could lose tax revenue), it could nevertheless greatly simplify income tax filings through a simple certification process as outlined above. As summarized in the National Taxpayer Advocate's 2011 Annual Report to Congress, 91% of U.S. taxpayers abroad in 2009 did not have tax liabilities after application of the FTC and earned income exclusion.[103]

Finally, the above proposals would not address complexities resulting from the U.S. estate and gift tax. Such complexities are not the primary purpose of this article, but with an estate tax exemption over $5 million ($10 million for couples) adjusted for inflation, the U.S. estate tax should only be applicable to the relatively wealthy.

Although this article is not intended to discuss the complexities of the estate and gift tax, §3.2 discussed the potential estate and gift tax benefits that still exist for U.S. citizens who surrender their U.S. citizenship. Congress may want to further reduce the benefits by enacting a deemed estate tax as

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[100] *See, e.g.*, I.R.S. Form 8938 (Nov. 2012); I.R.S. Form TD F 90-22.1 (Jan. 2012). Although the IRS processes both forms, the FBAR form is technically under the Title 31 (anti-money laundering/terrorist financing) while IRS Form 8938 is under Title 26 (tax). Thus, there may need to be legislative or regulatory changes to allow the sharing of information if the forms are combined or coordinated.

[101] *See generally* Harvey, *supra* note 7.

[102] However, international social security agreements (i.e., Totalization Agreements) may prevent double taxation. *See* I.R.C. §911(a) (1986); *see also U.S. International Social Security Agreements*, *supra* note 22.

[103] NAT'L TAXPAYER ADVOCATE, *supra* note 95, at 156 fig.1.8.2.

proposed in §3.2. Such a change could be a stand-alone change to address fairness, or it could be used to raise revenue to pay for increased exemptions for U.S. citizens living abroad (see §4.4 for more discussion).

The next section of this article discusses the other major alternative for addressing issues faced by U.S. citizens living abroad (i.e., the adoption of a residence-based tax system).

4.2 Adopt Residence-Based System with Safeguards

Given there is significant discussion about abandoning the worldwide tax system for U.S. corporations, it is possible Congress may consider something similar for individuals (i.e., changing to a residence-based tax system consistent with the rest of the world). Although such action is very unlikely, stranger things have happened in Washington, D.C.

In my view, the main advantage and disadvantage of the United States changing to a residence-based tax system are as follows:[104]

- **Advantage** – allows U.S. citizens to eliminate their annual U.S. income tax filing obligation while maintaining U.S. citizenship.

- **Disadvantage** – could result in fairness and tax revenue issues to the extent U.S. citizens are allowed to move their residence out of the United States in order to avoid U.S. taxes.

If Congress does seriously consider changing to a residence-based tax system, most members of Congress will need to be satisfied that there are safeguards in place to ensure the disadvantage does not outweigh the advantage.

As a practical matter, it is only the wealthy that likely have the resources to move their residence out of the United States for tax purposes. This could be wealthy U.S. citizens living on investment or retirement income, or possibly wealthy entrepreneurs or executives that have the freedom to select where they reside. Although this may be a relatively small group of U.S. citizens, they can have very high profiles and could potentially avoid substantial U.S. taxes.

In order to substantially minimize the chances of this occurring, Congress may want to consider the following:

- **Impose significant restrictions on visiting the United States** – If U.S. citizens can avoid U.S. tax by being a nonresident, but still retain substantial contact with the United States, there could be a public uproar. There is room for reasonable debate as to what "substantial contact" might be, but retaining a residence in the United States or visiting the United States for a significant number of days during a calendar year would cause concern for most. For example, if Congress were to adopt the definition of nonresident in I.R.C. § 7701(b)(3),[105] a U.S. citizen could visit the United States for as many as 182 days a year. A substantially lower number of days visited would be more appropriate (e.g., 45–60 days).[106]

[104] See *supra* Section 3.3 for a more complete list of advantages.

[105] For additional discussion, see *supra* Section 2.1.2.

[106] However, exceptions could be made for family emergencies and health related issues.

- **Adopt an ironclad departure tax regime** – I.R.C. § 877A and I.R.C. § 2801 were adopted to discourage U.S. citizens from giving up their citizenship.[107] Because the United States currently has a worldwide tax system, it is not necessary to apply these two code sections to U.S. citizens who have moved or are in the process of moving their permanent residence abroad. In addition, as discussed in Section 3.2, I.R.C. § 2801 may not completely compensate for the estate and gift tax applicable to U.S. citizens taxed on a worldwide basis. As a result, if Congress decides to adopt a residence-based tax system,[108] it should:

    - **For income tax purposes** – I.R.C. § 877A should be generally applied to U.S. citizens who will, in the future, be taxed on a resident basis.[109] Application of I.R.C. § 877A will be necessary to make sure U.S. citizens do not avoid U.S. income tax on unrealized income earned while the United States had a worldwide system of taxation.

    - **For estate/gift tax purposes** – I.R.C. § 2801 should be applied to minimize the possibility that U.S. citizens avoid U.S. estate and gift tax on their net worth accumulated while the United States had a worldwide tax system.[110] In addition, strong consideration should be given to a deemed estate tax as described in Section 3.2, especially for those U.S. citizens currently resident in the United States.

- **Minimum time period living abroad to qualify** – Adoption of a residence-based system would necessitate determining who should qualify for nonresident treatment. In addition to imposing significant restrictions on visiting the United States, it would also be appropriate for U.S. citizens to have lived overseas for a specified period of time before they qualified (e.g., 2 or 3 years). For example, a U.S. citizen living abroad should only qualify for nonresident treatment if (i) he has lived overseas for at least 2 to 3 years and (ii) his intent is to live outside the United States permanently.

In addition to the above proposals, a special tax haven rule could be considered in either of two following circumstances.

- **General tax haven exception –** Congress may want to exclude U.S. citizens resident in a designated tax haven from residence-based taxation. Rather, those citizens would continue to be taxed on a worldwide basis. A tax haven should be defined broadly to include special tax regimes designed to attract wealthy retirees.

- **Departure tax regime not expanded –** If a departure tax regime is not extended to cover U.S. citizens leaving the United States worldwide tax system, a special tax haven rule will be essential. Said differently, failure to include a special tax haven rule, coupled with the lack of a departure tax, would create a significant incentive for wealthy U.S. citizens to live outside the United States.

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[107] For additional discussion, see *supra* Section 2.2.

[108] It is possible that a residence-based tax system could be applied for the income tax, but not the estate and gift tax.

[109] However, for a discussion of existing U.S. citizens living abroad, see *infra* Section 4.3.

[110] For additional discussion, see *infra* Section 4.3.

The definition of a tax haven would be subject to debate, but any country that imposes little or no income tax on U.S. citizens should qualify.

In summary, if Congress decides to adopt a residence-based system for individuals there should be very tough rules designed to prevent tax avoidance, including stringent rules on U.S. citizens visiting the United States coupled with (i) an *ironclad* departure tax, or (ii) an exception for U.S. citizens resident in a tax haven.

4.3 Should U.S. Citizens Already Living Abroad Get Special Treatment?

U.S. citizens living abroad that have met their prior U.S. tax obligations are very unlikely to have moved overseas for tax reasons.[111] Thus, it may be appropriate for Congress to (i) consider some form of relief to either the current law exit tax in I.R.C. § 877A and I.R.C. § 2801 (i.e., assuming a worldwide tax system is retained), or (ii) a modified exit/departure tax (assuming a residence-based system is adopted).

Since the fact patterns are different depending upon whether the United States retains a worldwide tax system or adopts a residence-based system, the two will be discussed separately below.

4.3.1 Worldwide System Retained

If Congress retains the worldwide tax system, but provides income tax relief as proposed in Section 4.1, many U.S. citizens with substantial income or net worth may still feel the need to surrender their citizenship to avoid future U.S. taxes.[112] Thus, one question is whether there are any additional categories of U.S. citizens who should qualify for relief from I.R.C. § 877A or I.R.C. § 2801.[113]

The short answer is "yes" for those U.S. citizens living abroad who have had very little contact with the United States. Specifically, it would be reasonable to expand the I.R.C. § 877(g)(1)(b) exceptions to the definition of "covered expatriate" for U.S. citizens who

- Never had a U.S. passport and have lived outside the United States for some period of time (or significant percentage of their life), or
- Spent very little or no time during their life in the United States and were either
    - (i) born in the United States to foreign parents, or
    - (ii) born abroad to U.S. parents.

If Congress is inclined to provide relief to some or all of the above more sympathetic cases, the next question is whether to also provide relief to other U.S. citizens currently living abroad who have spent a substantial percentage of their life living abroad. Reasonable people could disagree on the answer.

Assuming Congress expands the income exemptions available to U.S. citizens living abroad and simplifies their annual U.S. filing and reporting obligations, I personally would not provide additional exceptions to the definition of covered expatriate beyond the more sympathetic cases discussed above. Reasons include:

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[111] Given the United States currently has a worldwide tax system, U.S. citizens currently living abroad have likely increased their tax burden by living overseas.

[112] Their income still exceeds the proposed I.R.C. § 911 exemptions and/or their net worth could trigger a future I.R.C. § 2801 tax (or a deemed estate tax).

[113] This includes the proposed tightening of the inheritance tax in I.R.C. § 2801 to better mimic the estate tax.

- These individuals currently living abroad who have spent a substantial percentage of their life living abroad are highly likely to have known they were U.S. citizens.
- These individuals will have already received substantial annual income tax relief will have already been provided.
- The estate tax includes relatively generous exclusions (e.g., $5 million plus per individual and $10 million for a couple).
- If relief is provided, one would expect many wealthy U.S. citizens living abroad to take advantage of that relief, thus creating a potential loss in tax revenue (i.e., both income and estate/gift tax).

In summary, some sympathetic cases exist that are not already exempted from the definition of covered expatriate under current law. For U.S. citizens that have had a significant connection with the United States during their lifetime, an exemption does not seem warranted. However, if Congress wants to compromise, they could agree to one of the following:

- Exempt a certain percentage (e.g., 50%) of unrealized gain under I.R.C. § 877A for those U.S. citizens that have been living abroad for some specified period of time.
- If Congress accepts the proposal to tighten the inheritance tax in I.R.C. § 2801 to better mimic the estate tax, it could exempt U.S. citizens who have been living abroad for some specified period of time at the date of enactment.
- Some combination of the above two measures.

4.3.2 Residence-Based System Adopted

If Congress adopts a residence-based tax system and adopts a departure tax of some type,[114] Congress will face a similar issue to the one discussed in Section 4.3.1. Specifically, should there be relief from the departure tax for certain U.S. citizens that have been living abroad for a period of time?

My suggestion on how Congress should analyze the need for exceptions to any future departure tax is similar to that in Section 4.3.1. Thus, at a minimum, relief would be appropriate for U.S.citizens who

- Never had a U.S. passport and have lived outside the United States for some period of time (or significant percentage of their life), or
- Spent very little or no time during their life in the United States and were either
  - (i) born in the United States to foreign parents, or
  - (ii) born abroad to U.S. parents.

As discussed in Section 4.3.1, I personally would not provide relief for other U.S. citizens even though they have spent substantial time living overseas. However, reasonable people could disagree on this conclusion. A possible compromise could be similar to that discussed at the end of Section 4.3.1 (e.g., exempt a certain amount of unrealized gain determined under I.R.C. § 877A, or exempt the application of a deemed estate tax).

4.4 Budget Impact

As discussed in Section 3.4, the impact of any legislative proposal on the United States' budget deficit will be crucial. Legislative change will therefore need to be approximately revenue-neutral or will need

[114] *See supra* Section 4.2.

to raise tax revenue. Given this concern, a brief analysis of the proposals in Section 4.1 and Section 4.2 on the United States' tax revenue is warranted.

4.4.1 Worldwide System Retained[115]

The Joint Committee of Taxation ("JCT")[116] will clearly estimate a revenue loss from increasing the earned income exemption and providing a *de minimis* exemption for passive income. However, the revenue loss may not be that material. Under current law, 91% of U.S. citizens living abroad are reportedly not paying *any* U.S. tax because of the current earned income exemption.[117] An additional 3% are not paying tax because of the FTC.[118]

If the income exemptions for U.S. citizens living abroad were substantially increased, presumably (i) the 3% not paying tax because of the FTC would be unaffected by the proposal and, (ii) at most, an additional 6% of U.S. citizens living abroad would no longer pay U.S. income tax. However, without knowing the current composition of this 6% (i.e., what percentage of individuals and dollars of tax are attributable to those with income above and below the proposed exemption levels), it is difficult to estimate the revenue impact.

The proposal also suggests eliminating payroll taxes on earned income up to the earned-income-exemption amount. Current law subjects U.S. citizens living abroad to U.S. employment taxes on earned income qualifying for the I.R.C. § 911 exemption.[119] Thus, this proposal will also result in some lost tax revenue.

Given these potential revenue losses, the obvious question is what can be done to get the proposal closer to revenue neutrality. Options for raising revenue (or reducing revenue loss) could include:

- **Implementing a tax haven exception** – Do not allow the enhanced income exemptions for U.S. citizens resident in a tax haven or income from tax haven jurisdictions.

- **Imposing a cliff on the enhanced income exemptions (i.e., once a taxpayer goes over the exemption amount, they lose the exemption)** – Alternatively, the earned and passive income exemptions could be phased down to zero as income increases over the exemption amount.

- **Eliminating the housing exemption in I.R.C. § 911(c)** – This could also be justified on simplification grounds if the earned income exemption is materially increased.

- **Enacting a congressionally-sanctioned voluntary disclosure initiative** – Allow certain sympathetic U.S. citizens living abroad to voluntarily disclose tax liabilities with minimal penalties. The IRS currently has a voluntary disclosure program that has been very successful,[120]

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[115] See *supra* Section 4.1 for a description of the proposal.

[116] The Joint Committee on Taxation ("JCT") is the official revenue estimator for tax legislation.

[117] NAT'L TAXPAYER ADVOCATE, *supra* note 95, at 156 fig.1.8.2.

[118] *Id.*

[119] U.S. citizens resident in certain countries can avoid double tax through an international social security agreement (i.e., Totalization Agreement). *See U.S. International Social Security Agreements*, *supra* note 22.

[120] *See* I.R.S. News Release IR-2012-64 (June 26, 2012).

but one suspects many U.S. citizens abroad have not participated in the IRS program for various reasons.[121]

- **Not exempting any earned income from the payroll tax** – Retaining current law should not result in reduced payroll tax collections. Alternatively, U.S. citizens could be provided a choice; for example, some might opt to pay payroll tax so as to minimize the loss of revenue.

- **Expanding I.R.C. § 2801 to mimic the estate tax[122]** – Congress may want to adopt this proposal anyway to address the expatriation by high profile citizens who want to avoid the estate and gift tax.

Although JCT's revenue estimators would need to evaluate the above alternatives, one hopes the list provides enough ammunition to provide revenue-neutral relief to U.S. citizens living abroad.

4.4.2 Residence-Based System Adopted[123]

If Congress were to adopt a residence-based system with no departure tax, the lost tax revenue should be greater than the revenue lost from retaining a worldwide system with increased exemptions, a payroll tax exemption, and simplified filing obligations. Reasons include:

- **Income tax** – In a residence-based system the foreign income of nonresident U.S. citizens would totally escape U.S. income taxation. In a worldwide system, some foreign income would still be taxed (e.g., those U.S. citizens living in a lower-taxed country with foreign income above the substantially increased exemption thresholds).[124] In addition, in a residence-based system, U.S. source- passive income will generally escape U.S. In a worldwide system, U.S. source income would be taxed.

- **Estate/Gift tax** – In a worldwide tax system, the net worth of all U.S. citizens living abroad would be subject to estate and gift tax.[125] In a residence-based system, only certain assets located in the United States would be subject to estate and gift tax.

The above two revenue losses may be somewhat reduced by an increase in the United States' withholding taxes on U.S. citizens living abroad. For example, if a U.S. citizen currently has earned income from U.S. sources that is also taxed in his country of residence, he may not pay any U.S. tax after taking the FTC into consideration. Under a resident-based system, such income would be subject to U.S. tax. One doubts, however, that many citizens living abroad would have substantial earned income from the United States that would be subject to withholding tax.

In addition, if behavioral considerations are taken into account, it would be reasonable to further assume

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[121] CA estimates there are at least three million U.S. citizens abroad who are currently not compliant with U.S. tax laws. *See* CA Proposal, *infra* note 127, at 18, ex. I.

[122] *See supra* Section 3.2.

[123] *See supra* Section 4.2.

[124] Admittedly, it is not clear how much of this tax the IRS actually collects, but it collects some.

[125] I.R.C. §§ 2001(a), 2031(a) (West 2013).

- Nonresident U.S. citizens would likely divest themselves of any assets that could result in either U.S. income or estate/gift tax, and

- Many wealthy U.S. citizens currently resident in the United States would attempt to obtain a permanent residence abroad to reduce their U.S. tax burden. This would be especially attractive as they would not need to surrender their citizenship.

In summary, after considering behavioral considerations, adoption of a residence-based tax system without a departure tax could be a major tax revenue loser. Thus, if Congress adopts a residence-based tax system, it seems clear that Congress must seriously consider some or all of the safeguards discussed in Section 4.2:

- An ironclad departure tax regime.
- Significant restrictions on visiting the United States.
- A tax haven exception.
- A minimum time period living abroad to qualify.

Additional tax revenue could be generated through a congressionally-mandated voluntary disclosure initiative similar to that described in Section 4.4.1 above.

I will defer to JCT as to whether a revenue-neutral proposal could be crafted over the typical ten-year budget period, but my suspicion is it could be. The reason is that such a proposal would likely include large one-time transition revenue sources (e.g., voluntary disclosure initiative and Departure Tax). However, over the long-term, tax revenue is likely to decrease from the adoption of a residence-based tax system.

5 <u>Proposal by Citizens Abroad</u>

As briefly discussed in Section 1, various organizations representing U.S. citizens living abroad[126] have recently made a legislative proposal advocating the adoption of a residence-based tax system, referred to as the CA Proposal.[127] Section 5.1 briefly describes the major provisions of this proposal while Section 5.2 provides some observations.

5.1 Description

The CA Proposal includes several of the concepts discussed in Section 4.2.[128] The centerpiece is a change to a residence-based tax system for both income and estate tax purposes.[129] Nonresident taxation would be applicable to U.S. citizens and Green Card holders who are *qualifying nonresidents* of the United

[126] For further discussion of CA, see *supra* note 11

[127] For the complete CA Proposal, see Am. Citizens Abroad ("CA") et al., *Residence-Based Taxation: A Necessary and Urgent Tax Reform* (Overseas Am. Week, Working Paper Jan. 2013), *available at* http://www.overseasamericansweek.com/documents/2013/oaw2013rbttaxpositionfinal.pdf.

[128] This author had absolutely no involvement in developing the CA Proposal.

[129] *See* CA Proposal, *supra* note 127, at 3.

States and obtain a *Departure Certificate*.[130] If a U.S. citizen living abroad wanted to continue being taxed on a worldwide basis, he could fail to obtain a Departure Certificate.[131]

The definition of a qualifying nonresident has several key components. Specifically, the individual:

- Has been resident overseas for at least 2 years.[132]
- Has met the I.R.C. § 7701(b)(3) substantial presence test[133] (i.e., allowing a nonresident U.S. citizen to visit the United States for up to 182 days in some cases, 121 days in others).[134]
- Is not resident in a tax haven (the CA Proposal does state however that "[c]lassification of countries as tax havens should be the rare exception" and should apply to "only countries where the tax laws have been designed to attract rich foreigners with fiscal privileges."(emphasis omitted)).[135]
- Is not a U.S. military member or a member of the U.S. diplomatic service.[136]

In order to obtain a Departure Certificate, an individual must do the following:

- **Become current on IRS filings for the past 3 years** – This requires payment of taxes, interest, and underpayment penalties, but there is no criminal prosecution or penalty for failure to file the FBAR form and IRS Form 8938 (i.e., effectively a congressionally-mandated voluntary disclosure initiative).

- **Pay a departure tax on U.S. residents moving overseas** – This tax is patterned after I.R.C. § 877A and, therefore, imposes a deemed sale at fair market value for most capital assets at the date of departure. The *de minimis* exceptions are similar to I.R.C. § 877A, but for purposes of determining a covered expatriate the net worth threshold is increased from $2 million to $5 million. Most importantly, the Departure Tax is *not* applicable to individuals who have resided overseas for over 2 years and are compliant with their U.S. filing obligations for the past 3 years.

After paying any back taxes and a departure tax (if applicable), the major practical effects of the CA Proposal on U.S. citizens permanently living abroad would include:

- Income would be taxed as if they were nonresident aliens (i.e., only U.S. source income would be taxed, but even then certain exclusions like the portfolio interest exemption would apply[137]).
- FBAR and FATCA reporting obligations could be avoided.
- There would be no U.S. employment taxes.

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[130] *See id.*

[131] The ability to effectively make an election has tax revenue consequences since one would expect taxpayers to choose the option that is most beneficial to them and therefore should lose tax revenue.

[132] The proposal technically states that Congress "may determine" a two year rule is necessary for "certain types of temporary overseas mandates." CA Proposal, *supra* note 127, at 3.

[133] For details of the substantial presence test, see *supra* Section 2.1.2.

[134] CA Proposal, *supra* note 127, at 7.

[135] CA Proposal, *supra* note 127, at 8.

[136] CA Proposal, *supra* note 127, at 3.

[137] *See supra* note 14.

- Estate and gift taxation as if they were nonresident aliens (i.e., only applying to assets with situs in the United States, but even then certain exclusions would apply[138]).

Finally, the CA Proposal estimates its proposal would decrease the United States' budget deficit by $33 billion over 10 years – composed of the following:

- **$23 billion** – Excess of annual taxes collected under the nonresident system versus the residence-based system.[139]
- **$3 billion** – Payment of back taxes, interest, and underpayment penalties to allow participation in the nonresident tax system (i.e., congressionally-mandated voluntary disclosure initiative).
- **$4 billion** – Departure tax.
- **$3 billion** – Reduction in IRS administrative and enforcement costs.

Observations on the CA Proposal are in Section 5.2, immediately below.

5.2 Observations

The CA Proposal is relatively comprehensive and, if accepted by Congress, would represent a *grand slam home run* for U.S. citizens living abroad. In effect, U.S. citizens that have been living abroad for at least 2 years would

- No longer be subject to U.S. income tax on worldwide income;
- Avoid U.S. estate and gift tax, except for certain U.S. situs assets;
- Retain their U.S. citizenship and the right to visit the United States in some cases for up to 182 days a year, and in others for 121 days; and
- Avoid the payment of any departure tax.

Given the ability of U.S. citizens to transform their investment portfolios by converting U.S. source assets to foreign source assets, it is safe to say that many would never pay another dime of U.S. tax. It will be interesting to see how this proposal is greeted by lawmakers in Washington. Like any proposal, some lawmakers will be supportive, and others could be totally outraged.

Section 4.2 discussed key issues for Congress to consider if it seriously plans to adopt a residence-based tax system. The following is a list of those key issues and how the CA Proposal compares.

- **Imposing significant restrictions on visiting the United States** – Since the CA Proposal adopts the substantial presence test in I.R.C. § 7701(b)(3), it effectively allows U.S. citizens abroad to visit the United States for up to 182 days in some cases, and on average 121 days a year in other cases.[140] Personally, I believe this is too generous and would suggest a maximum of 45–60 days.[141] Congress will need to form its own opinion.

- **Adopting an ironclad departure tax** – Conceptually, the CA Proposal moves in this direction by extending the I.R.C. § 877A departure tax to cover U.S. citizens wanting to be taxed on a non-

[138] *See supra* note 30.

[139] This result is not very intuitive and the author is not sure he agrees. For more discussion, see *infra* Section 5.2.

[140] For discussion of the substantial presence rule of § 7701(b)(3), see *supra* Section 2.1.2.

[141] There is a limited exception for certain family emergencies.

residence basis. However, the CA Proposal provides a very generous exception for *all* U.S. citizens that have been living abroad for at least two years. In addition, the CA Proposal does not propose to tighten the I.R.C. § 2801 inheritance tax by imposing a deemed estate tax. Thus, there will be a major incentive for ultra-wealthy U.S. citizens to move their residence out of the United States in order to avoid U.S. estate and gift tax.

I would not be so generous.[142] One option would be to prospectively tighten IRC § 2801 by including a deemed estate tax applicable to the ultra-wealthy (e.g., net worth in excess of $25 to $50 million). This provision could be applied to all U.S. citizens seeking to be taxed on a non-residence basis, or just to U.S. citizens currently resident in the United States who desire to be taxed on a non-resident basis.

An alternative option would be to only apply residence-based taxation for income tax purposes, and not estate tax purposes. Said differently, U.S. citizens living abroad would still be subject to U.S. estate and gift tax on a worldwide basis. However, this option could be difficult for the IRS to practically enforce and, thus, the deemed estate tax would seem the better option.

Finally, I agree the exceptions to the I.R.C. § 877A exit tax need to be broadened for certain U.S. citizens, but completely exempting U.S. citizens that have been living abroad for an extended period of time may not be appropriate.[143] A compromise might be to only tax some percentage of the I.R.C. § 877A deemed mark-to-market gain. Again, Congress will need to reach its own conclusion.

- **Having a tax haven rule** – Again, CA embraces this concept in its proposal, but states that it wants the rule to apply "rarely."[144] Given the lack of an ironclad departure tax in the , the tax haven rule should apply more broadly (e.g., to any country that taxes U.S. citizens at less than some specified income tax rate).

- **Having a maximum time period for living abroad to qualify** – The CA Proposal seems to understand this general concept, but leaves it to Congress to determine whether it is appropriate. In addition, the CA Proposal seems to allow U.S. citizens to immediately qualify for nonresident treatment if they have no intention of returning to the United States. A bright line rule, as opposed to an intent rule, may be better for both the IRS and U.S. citizens. For example, it may be more appropriate to require at least two or three years of permanent residence overseas before a U.S. citizen living abroad could qualify for nonresident treatment.

Finally, given the CA Proposal boldly projects $33 billion of additional tax revenue over 10 years, the following very brief comments may be of interest:[145]

- **Generally** – Despite an exhibit providing more detail on the estimate, it appears to be very much a back-of-the-envelope calculation. Given CA's resources this is not a surprise, but one would expect JCT to do a substantially more thorough estimate.

[142] *See supra* Section 4.2.

[143] For my reasoning, see *supra* Section 4.3.

[144] CA Proposal, *supra* note 127, at 8.

[145] CA Proposal, *supra* note 127, at 15.

- **$7 billion of transition revenue (i.e., Departure Tax and back taxes, interest, and penalties)** – Clearly some transition revenue would be raised. I will defer to JCT as to whether the CA estimate of $7 billion is reasonable (it could be).

- **$23 billion increase in annual tax revenue** – In short, this was a surprising estimate. Most would expect an annual revenue loss, not a revenue gain. This would especially be the case if behavioral reactions, like shifting an investment portfolio from U.S. source to foreign source, are taken into account. In addition, the CA Proposal is effectively elective. Presumably those that would be negatively impacted by a residence-based system would elect to continue in the worldwide tax system.

  Although not crystal clear to this observer, it seemed the key assumptions behind the large revenue estimate are that there would be little or no behavioral response and that, under existing law, many U.S. citizens living abroad have not been paying U.S. tax on U.S. source income. In effect, this latter assumption seems to imply many U.S. citizens abroad may be either committing tax evasion[146] or are currently eliminating U.S. tax with a FTC that will not be available if they are taxed as a nonresident. No doubt some of this could exist, but the CA Proposal suggests there could be a very material amount.

- **Reduced Estate Tax Collections** – There was no indication the estimate considered the impact of a residence-based tax system on estate and gift tax revenue. Given there are millions of U.S. citizens living abroad that are currently subject to U.S. estate and gift tax, and given the proposal basically allows these U.S. citizens to avoid future estate and gift tax, one would expect some estate and gift tax revenue to be lost.

In summary, if Congress considers adopting a residence-based system for U.S. citizens living abroad, the CA Proposal could be part of the discussion. In concept it includes many, but not all, of the design features that would need to be considered. However, one suspects many members of Congress will not support the CA Proposal once they better understand its details. Specifically, the proposal could lose revenue and allow wealthy U.S. citizens to avoid substantial future U.S. taxes by virtue of either moving their permanent residence overseas, or by already residing overseas.

6 Summary and Conclusions

Since the United States taxes its citizens on a worldwide basis, U.S. citizens living abroad face significant compliance burdens and the possibility for double taxation. These burdens have been further complicated by the enactment of FATCA in March 2010. For example, many foreign financial institutions are blaming FATCA's reporting obligations for their refusal to provide necessary financial services to U.S. citizens living abroad. In addition, FATCA requires all U.S. citizens, including those living abroad, to report more information on their non- U.S. financial assets than what they are currently required to report.

Because of these burdens, CA have made a legislative proposal to adopt a residence-based tax system for individuals.[147] They claim their proposal will decrease the budget deficit by $33 billion over 10 years. In addition, other commentators have suggested that the United States should adopt a residence-based tax system.

[146] Or at the very least they are totally ignorant of their obligation to pay U.S. tax on U.S. source income.

[147] See *supra* Section 5.1 for a description of the CA Proposal.

Given there are various legislative proposals to change the worldwide tax system for corporations to a territorial system, it is not beyond the realm of possibility Congress could consider totally abandoning the worldwide tax system for both corporations and individuals.[148] Thus, this article has attempted to provide background and analysis on a number of topics relating to U.S. citizens living abroad. The main conclusions are as follows:

- **The issues faced by U.S. citizens living abroad are significant**[149] – Issues include substantial tax compliance responsibilities, potential for higher overall tax burden, and difficulty obtaining routine financial services.

- **Certain U.S. citizens still have an incentive under current law to expatriate**[150] – As demonstrated by the high profile expatriation of Eduardo Saverin, co-founder of Facebook, Inc.,[151] current tax law still potentially allows wealthy U.S. citizens to minimize their estate and gift tax by expatriating. The 2008 enactment of an inheritance tax in I.R.C. § 2801 was a step in the right direction, but Congress should consider a deemed estate tax for ultra-wealthy U.S. citizens that expatriate (e.g., net worth over $25 to $50 million).

- **FATCA does not justify changing to a residence-based tax system**[152] – There are more targeted ways of addressing the FATCA-related problems (e.g., through intergovernmental agreements and combining or coordinating the FBAR form and IRS Form 8938).

- **Legislative action is appropriate to address issues faced by U.S. citizens living abroad** – If possible, Congress should consider legislative action. Relief can be provided by either modifying the existing worldwide tax system, or adopting a residence-based system.

    - **If the worldwide tax system is retained**,[153] Congress could provide significant relief by (i) substantially increasing the IRC § 911 earned income exemption (e.g., $300,000 to $400,000); (ii) providing a *de minimis* exemption for passive income (e.g., $50,000 to $100,000); and (iii) greatly simplifying or eliminating the U.S. tax filing requirement for citizens living abroad with no tax liability. Additional relief could be provided by eliminating U.S. payroll taxes on earned income below the IRC § 911 exemption. Various revenue offsets are suggested to minimize or eliminate a material loss in tax revenue.[154]

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[148] However, a change to a territorial system for corporations would seem much more likely than a change to a residence-based system for individuals.

[149] See *supra* Section 3.1 for more discussion.

[150] See *supra* Section 3.2 for more discussion.

[151] *See* Danielle Kucera et al., *Facebook Co-Founder May Gain Choosing Singapore over U.S.*, BLOOMBERG, May 11, 2012, *available at* http://www.bloomberg.com/news/2012-05-12/facebook-co-founder-may-gain-choosing-singapore-over-u-s-.html (last visited Mar. 1, 2013).

[152] See *supra* Section 3.5 for more discussion.

[153] See *supra* Section 4.1 for more discussion.

[154] See *supra* Section 4.4.1 for more discussion.

- If a residence-based tax system is adopted,[155] the major concern will be wealthy U.S. citizens resident in the United States shifting their permanent residences overseas to minimize U.S. taxes. Thus, appropriate safeguards are needed to minimize fairness issues and a loss of tax revenue. Appropriate safeguards include: (i) an ironclad departure tax; (ii) significant restrictions on visiting the United States; (iii) adoption of a tax haven rule, especially if the departure tax is not ironclad; and (iv) a two- to three-year minimum time period living abroad before a U.S. citizen can qualify for nonresident treatment. In addition, a congressionally-authorized voluntary disclosure initiative may be needed to bring certain taxpayers into compliance and to raise tax revenue.

- **Although relatively comprehensive, the CA Proposal has deficiencies**[156] – If enacted, this proposal would represent a *grand slam home run* for U.S. citizens currently living abroad. In effect, they could retain their U.S. citizenship and visit the United States for 121 to 182 days, but effectively avoid ever paying another dime of U.S. tax. In addition, wealthy U.S. citizens currently living in the United States could have a significant incentive to adopt a permanent residence overseas. Finally, it is questionable how the CA Proposal would decrease the deficit by $33 billion.

Overall, I am very sympathetic to the issues facing U.S. citizens abroad and believe Congress should take action. Action could be taken to modify the existing worldwide tax system, or to adopt a residence-based system.

Although this article addresses both possibilities, my strong suspicion is that Congress will not adopt a residence-based tax system for individuals because of fairness and tax revenue concerns. The more likely course of action may be to pursue changes within the existing worldwide tax regime, including an increased I.R.C. § 911 earned income exemption, a *de minimis* exemption for passive income, and a significant simplification in income tax filing obligations. Even if the income exemptions are not increased, a significant simplification in filing obligations would be a major step in the right direction.

[155] See *supra* Section 4.2 for more discussion.

[156] See *supra* Section 5.2 for more discussion.