Old Habits Die Hard: Should the United States Abolish Citizenship-Based Taxation?

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Abstract

The dramatic rise in citizenship renunciations by US nationals living overseas is likely pegged to increasingly stringent reporting requirements in particular and to the regime of citizenship-based taxation (CBT) in general. In this paper, the author maintains that the United States should consider scrapping CBT in favour of residence-based taxation (RBT), which is employed by every other OECD member country.

1. Introduction

With so many people applying for US citizenship,¹ it may be surprising to learn that US citizens living abroad are renouncing their citizenship in record numbers (see Diagram 1). More than 3,400 US citizens relinquished their citizenship in 2014, an almost 15-fold increase from six years prior.² The third quarter of 2015 reported the highest number of renunciations in US history, with 1,426 Americans relinquishing their citizenship, and the total for 2015 reached a new record of 4,279 renunciations, a 25% increase from 2014. Of the estimated seven million US citizens living abroad,³ more than 10,000 have relinquished their citizenship over the past five years.⁴,⁵

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¹ According to US Citizenship and Immigration Services (USCIS), approximately six million petitions and applications are received and adjudicated annually from individuals and employers. These petitions and applications typically allow foreign nationals to stay in the United States as lawful permanent residents or immigrants, to stay temporarily to work as non-immigrants for some other purpose or to obtain US citizenship. As reported by USCIS in its Naturalization Fact Sheet, 729,995 people were naturalized in fiscal year 2015.

² A. Velarde, Theories for Expatriation Numbers Abound, but Answers Elusive, Tax Notes Today (9 Sept. 2015).

³ The exact number of US citizens living abroad is unknown. Estimates range from three to seven million. Note: Based on the percentage of foreign returns, it is obvious that many, if not most, overseas taxpayers do not file.


⁵ The actual number of renunciations is thought to be significantly higher. Both the Internal Revenue Service (IRS) and the Federal Bureau of Investigation (FBI) track Americans who renounce their citizenship, but there is a marked discrepancy in the totals (the numbers reported by the FBI surpass those of the IRS). The Department of the Treasury publishes a quarterly “name and shame” list based on IRS information; however, the list is incomplete, as it does not include, for example, consular expatriations. The Isaac Brock Society, which is comprised of individuals concerned about the treatment of US citizens living in Canada and abroad, began tracking FBI data in 2013.
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Diagram 1

Number of Official US Expatriates

Source: US Department of the Treasury

For those US citizens who renounce their citizenship, the costs can be high. The US Department of State’s fee for renunciation increased by 422% in September 2014, rising from USD 450 to USD 2,350.⁶ In some cases, an exit tax based on unrealized gains is imposed. Expatriating US citizens who own illiquid assets (e.g. private companies or real estate) need to obtain a fair market valuation to determine what gains would be realized if they were sold, although the first USD 680,000 (2014) in gains are excluded.

US citizens who renounce their citizenship may have difficulty travelling into or through the United States. Those with communicable diseases or who have committed crimes of moral turpitude⁷ (i.e. conduct that is inherently base, vile or depraved) may be denied entry if they have not obtained prior permission. Such persons may be detained and even arrested if they attempt to cross a US border. US citizens who renounce their citizenship and do not possess a

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⁶ J. Bugnion, Concerns About the Taxation of Americans Residing Abroad, 148 Tax Notes (24 Aug. 2015).

⁷ A definition of moral turpitude can be found on the US Department of State website.
foreign nationality may be rendered stateless, which would create significant issues with regard to travel, legal employment and legal housing. 8

In 1996, the Reed Amendment 9 was added to the US Immigration and Nationality Act in order to deny re-entry to the United States of former citizens who have officially renounced their citizenship and who are determined by the Attorney General to have renounced their citizenship for the purpose of avoiding taxation. Significantly, the burden of proving tax avoidance as the purpose of renunciation lies with the US government.

Renouncing US citizenship provides no relief from military duty or outstanding tax obligations in the United States, and renunciants will not avoid prosecution for crimes committed in the United States. In most cases, the only way to regain US citizenship is through the lengthy process of naturalization under current US immigration law.

2. CBT v. RBT

In a citizenship-based tax regime, tax liability is based on citizenship rather than residence. With regard to the United States, this means that foreign income earned by a US citizen living abroad is subject to tax in the United States, even though such income is also assessed by the foreign jurisdiction. In a residence-based system, residents of a country are subject to tax on their worldwide income (domestic and foreign), while non-residents are only subject to tax on their domestic-source income.

Only two nations in the world tax the worldwide income of their citizens living abroad: Eritrea and the United States. 10, 11 The majority of nations employ RBT, imposing worldwide taxation only on their residents.

Non-resident US citizens were first subject to taxation during the Civil War. According to Jacqueline Bugnion, a former director of American Citizens Abroad (ACA), an advocacy agency for US expatriates, the intention of CBT was to “penalize a few very wealthy individuals who left the country during the Civil War and were considered draft dodgers”. She adds that the prejudice against Americans living abroad has existed ever since.

Michael S. Kirsch, a staunch supporter of CBT, argues that the United States should retain its current regime, albeit with some modifications to mitigate the burdens faced by overseas citizens. Among other reasons, Kirsch defends CBT on the basis that “those who enjoy the benefits of citizenship should share in its burdens”. He cites “the ability to enter the United States at any time” as one of the more significant benefits of citizenship. 12 On the other hand, Reuven Avi-Yonah, a proponent of RBT, contends that a citizen’s right to enter the United States “seems a weak

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10 A few other countries (i.e. Finland, France, Hungary, Italy, Spain and Turkey) tax based on citizenship, but only for a limited duration or in special cases.
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basis for such a heavy price as worldwide taxation”. Moreover, as Bernard Schneider notes, "[t]he right to return is no greater than the parallel right held by expatriates of other countries, who are not subject to worldwide taxation by their country of citizenship while non-resident".

Another commonly cited benefit of citizenship and, therefore, a justification for CBT is protection. However, such a benefit does not carry much weight for the majority of expatriate US citizens who live in stable states. Schneider notes that, in more volatile regions, it is sometimes citizenship that endangers US citizens in the first place.

The fact that CBT is largely unenforceable remains the strongest argument against it. Also, CBT is ineffective in raising tax revenue (it raises as little as 0.2% of federal tax revenue), while it is costly to administer for both taxpayers and the Internal Revenue Service (IRS).

In its proposal presented to the International Tax Reform Working Group of the US House Committee on Ways and Means in March 2013 (and again in April 2015), ACA asserts:

CBT is grossly unfair as Americans abroad can pay taxes twice, while the U.S. provides them little or no services (education, infrastructure, healthcare, etc.). Furthermore, due to the Foreign Account Tax Compliance Act (FATCA) and the Foreign Bank Account Report (FBAR) combined with CBT, overseas residents are being denied access to banking and other financial services as well as employment and investment opportunities, to the point that increasing numbers are compelled to renounce their U.S. nationality to be able to lead a normal life.

In a December 2014 report, the US Senate Committee on Finance references the 2013 ACA proposal and concedes that "the United States needs to rethink its taxing rules for nonresident U.S. citizens".

Schneider, who concludes that the worldwide taxation of non-residents is no longer warranted, writes:

In an era of economic globalization and increased personal mobility, worldwide taxation of nonresidents is increasingly dysfunctional. It is challenging to justify on economic or moral grounds; it is difficult, if not impossible, to enforce against many expatriates; and it sends the wrong message regarding the value of citizenship.

3. Problems Faced by US Citizens Abroad

Although most expatriate Americans end up with no US taxes to pay on their worldwide income as a result of a foreign tax credit and a foreign earned income exclusion (USD 100,800 for 2015), all Americans must file and some

15 Id., at p. 48.
16 End the American Expat Tax, Bloomberg View (24 Apr. 2015).
17 American Citizens Abroad, Residence-based Taxation: A Necessary and Urgent Tax Reform, Working Paper (2013). In April 2015, an updated proposal, complementing the 2013 version, was submitted to the US Senate Committee on Finance.
18 US Senate Committee on Finance (Republican Staff), Comprehensive Tax Reform for 2015 and Beyond, p. 283 (Dec. 2014).
19 Schneider, supra n. 14, at p. 1.
must pay. Even when no tax is due, the cost of filing for an individual can be high, especially in more complex cases that require myriad forms and professional advice.

CBT systematically discriminates against US citizens residing abroad, for whom the primary problems, as summarized by Jacqueline Bugnion, include:

- the high cost of compliance;
- double taxation;
- restricted retirement savings; and
- refusal of US banks to accept US citizens with foreign addresses.

**The High Cost of Compliance**

Due to the complexity of US tax forms and the need to consult tax professionals and preparers, the burden on US citizens living abroad is disproportionate. The penalties associated with errors on the forms required by US citizens living abroad are significantly higher than the fines associated with the standard forms filed by resident US citizens. The National Taxpayer Advocate, which represents the interests of taxpayers to Congress, described the penalties for non-resident US citizens who fail to file properly as “excessive to the point of possibly violating the U.S. Constitution”.

**Double Taxation**

Double taxation is not entirely eliminated by foreign tax credits and the foreign earned income exclusion. For example, wealth taxes cannot be credited against US tax. Also, as the US dollar is the default currency for US tax filing, phantom capital gains often result.

**Restricted Retirement Savings**

Foreign pension funds are often not recognized as “qualified” by the United States, which leads to immediate taxation of contributions. If a US citizen has divided his working years between the United States and another country, US Social Security payments are significantly reduced under the windfall elimination provision (WEP). WEP is a provision of US law that affects benefits paid under Title II of the Social Security Act. It reduces the amount of an individual’s retirement benefits when such a person is entitled to a pension from a job that is not covered by Social Security, i.e. an overseas occupation.

**Refusal of US Banks to Accept US Citizens with Foreign Addresses**

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20 Bugnion, supra n. 6.
21 National Taxpayer Advocate, Annual Report to Congress 147 (2012).
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The recent spike in US citizenship renunciations is most likely linked to the enactment in 2010 of the Foreign Account Tax Compliance Act (FATCA) (see Diagram 2), which requires US citizens (including those residing outside of the United States) to report their non-US financial accounts to the Financial Crimes Enforcement Network and requires all foreign financial institutions to report the assets and identities of US citizens to the US Department of the Treasury. FATCA allows the United States to gather data from more than 77,000 institutions and 80 governments regarding the financial activities of US citizens. Although FATCA is targeted at citizens residing in the United States who are hiding income overseas, it has had significant impact on citizens living overseas.

Foreign banks sometimes decline US citizens as clients because of stringent FATCA legislation. According to ACA, “bank accounts of Americans abroad are being forcibly closed, mortgages are being denied … and Americans are excluded from joint bank accounts with foreign spouses”.

Diagram 2

4. The Way Forward

In its Working Paper, ACA outlines in detail a viable plan for adopting RBT in the United States. ACA asserts that the adoption of RBT in the United States would ensure that “Americans abroad would be taxed on the same basis as

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22 C. Bosley & R. Rubin, A Record Number of Americans are Renouncing Their Citizenship, Bloomberg Business (10 Feb. 2015).
23 American Citizens Abroad, supra n. 17.
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non-resident aliens, primarily through a system of withholding taxes on passive U.S. source income … and capital gains taxes on U.S. real estate”. According to ACA, RBT promises, inter alia, to:

- increase tax revenue by about USD 30 billion over ten years;
- provide for fair, equitable and efficient taxation of US citizens living overseas;
- align US law with that of nearly all other nations; and
- emancipate US citizens living abroad from the complexity and costs associated with CBT, FATCA and FBAR reporting requirements.

5. Conclusion
Given that the taxation of non-resident US citizens raises such meagre revenue at such a significant cost to both taxpayers and the IRS, perhaps the United States should consider scrapping its existing regime of CBT in favour of RBT. In 2014, the Republican National Committee (RNC), which is responsible for developing and promoting the political platform of the Republican Party, voted unanimously in support of ending CBT, emphasizing that “history reveals that replacing [CBT] with [RBT] will raise net Federal tax revenue because of increased economic growth”.24 Moreover, the RNC urged Congress “to permit restoration of citizenship for those who were compelled to renounce their citizenship because of the crushing burdens of FATCA and FBAR”.25 It seems the desperate pleas of US expatriates are finally being heard. Perhaps the time is right for the United States to let old habits die and abolish its outmoded CBT regime.

The IBFD welcomes your feedback. Please forward your feedback as follows: Mike Hammer at M.Hammer@ibfd.org. Mr Hammer is a Tax Writer/Editor at IBFD.

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25 Id.