

## AMERICAN CITIZENS ABROAD

### RESIDENCY-BASED TAXATION: A “VANILLA” APPROACH TO REPLACING CITIZENSHIP-BASED TAXATION

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Congress and the Administration are expected to consider changes in US tax rules affecting the taxation of Americans abroad. This document, prepared by American Citizens Abroad, Inc. (ACA), provides a description of a “middle-of-the road” or “vanilla” approach to replacing citizenship-based taxation with residency-based taxation.<sup>1</sup> It is not intended as a legislative proposal but rather as a listing of the various issues, which can serve as a way of promoting careful consideration of this important subject.

#### TRANSITION FROM CITIZENSHIP-BASED TAXATION TO RESIDENCY-BASED TAXATION

##### Present Law

##### In general

Americans are taxed on the basis of their citizenship, not residency. A US citizen, no matter where he or she resides, is subject to US income tax, if certain income thresholds are met, and that individual must file a tax return with all the associated forms and schedules and pay tax. One of the associated forms requires reporting of information about Specified Foreign Financial Assets, including foreign deposit and custodial accounts and certain other foreign assets.<sup>2</sup> Special rules provide, as part of the regular income tax return, a foreign earned income exclusion, which can include a housing expense.<sup>3</sup> This benefit, in effect, is a type of partial territorial tax treatment for some individuals. Upon an individual’s death, if the individual was a US citizen, his or her estate, if it is of a certain size, must file an estate tax return and pay estate tax with respect to its worldwide assets. Similarly, a US citizen is generally subject to gift taxation regardless where the individual resides and where the assets are situated. Other special rules deal with the tax treatment of expatriation.<sup>4</sup> In addition, if certain thresholds are met, a US citizen must report foreign bank accounts.<sup>5</sup> All other countries, with almost no exceptions, only tax residents of that country, that is, an individual is not subject to tax rules if he resides outside the country.<sup>6</sup> There are many details affecting this subject, but this is the general “lay of the land”.

##### “Middle-of-the-Road” or “Vanilla” Approach to Residency-Based Taxation

The following describes a so-called “Vanilla” Approach to taxing US citizens and resident aliens on a residency basis as opposed to a citizenship basis. It provides information about what legislation to effect a change from citizenship-based taxation (“CBT”) to residency-based taxation (“RBT”) might look like. Based on this, decision-makers and interested parties can make or propose modifications. Importantly, it provides a starting point for preparing revenue estimates.

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<sup>1</sup> This document, which revises a version dated February 7, 2017, is posted on the website of American citizens Abroad, Inc., <https://www.americansabroad.org/>. It was prepared by Charles M. Bruce, Legal Counsel, American Citizens Abroad, Inc. and Counsel, Bonnard Lawson-Lausanne. He is solely responsible for any errors. Glen E. Frost, Assistant Legal Counsel, and Partner, Frost & Associates, LLC-Maryland, contributed to this draft. Thanks go to all members of ACA Executive Committee and retired Director Jackie Bugnion. Comments, questions and corrections, all of which will be appreciated, should be directed to [cmb@ifl.ch](mailto:cmb@ifl.ch).

<sup>2</sup> Form 8938 (Statement of Specified Foreign Financial Assets).

<sup>3</sup> The exclusion is claimed on Form 2555 (Foreign Earned Income).

<sup>4</sup> See section 87 and 877A, dealing with expatriation to avoid tax and tax responsibilities of expatriation.

<sup>5</sup> The filing of a Foreign Bank Account Report is a Bank Secrecy Act requirement, not an Internal Revenue Code requirement.

<sup>6</sup> Exceptions are Eritrea, perhaps North Korea, and perhaps South Africa, all to various degrees.

First published on December 5, 2016 in the form of a side-by-side comparison with current law<sup>7</sup>, it has been modified based upon comments received from ACA members and supporters, the public at large, and Congressional Members' and committee staffs. Comments by all concerned are greatly appreciated.

New RBT rules, it should be noted, would operate only at the federal level. They might not influence state income, gift or inheritance rules. Also, these tax rules would not affect US immigration and nationality rules. The rules governing the issuance and renewal of a US passport would not change.

### Taxpayers/Affected Individuals

For federal income tax purposes, US citizens and resident aliens, including "green card" holders, would be taxed on a residency basis, i.e., generally tax only on US source income. Nonresident alien individuals would not be affected. Generally speaking, US citizens and resident aliens ("green card" holders and others) qualifying under the new provisions – herein called "non-resident Americans" – would be treated the same as nonresident alien individuals not living in the US. The definitions of US citizen and resident alien would be the same as those that exist under current law.

Normal sourcing rules in the Internal Revenue Code and bilateral income tax treaties, including provisions for reduced withholding tax rates, generally would apply. US source income would be taxed under the rules currently applicable to non-resident aliens. Likewise, existing effectively connected income (ECI) and Foreign Investment in Real Property Tax (FIRPTA) rules would be applicable. Thus, a US citizen residing outside the US and qualifying for the new rules would be taxed on business income, if he conducted a business in the US, and on gain from the sale of US real property.

As with nonresident alien individuals, Social Security benefits would be taxed as US source income. As is the case with US taxpayers residing in the US, benefits would be reported on Form SSA-1099 issued by the Social Security Administration. Taxes would be withheld if requested by the recipient. [Comments on this subject would be appreciated.]

Early withdrawals and required minimum distributions from an IRA or retirement plan would be taxed as US source income and subject to withholding. Treaty provisions to the contrary would be overwritten. Thus, these withdrawals would be taxed the same as they are if received by US taxpayers residing in the US. [Comments on this subject would be appreciated.]

Individuals could "opt out" of the new residency-based taxation rules simply by not applying for a Departure Certificate (discussed below). An individual might do this if, for example, he anticipated spending a good deal of time in the US and, therefore, in some years might become again taxable. He might not want to be bothered with "day-counting". He might be a so-called "short-termer" who, for example, has been assigned overseas by his employer for only a couple of years. He might foresee running afoul of one of the anti-abuse rules, below. Also, he might not want his estate to be subject to what possibly might be a lower estate tax exemption.

Residency-based taxation would not be available to members of the armed services and diplomatic corps.

Special definitions and other rules in bilateral income tax treaties would apply to non-resident Americans that otherwise qualify under the treaty's provisions. "Savings clauses" in tax treaties, which preserve the US's ability to tax its citizens, would be overridden in the statute.

The RBT rules would apply regardless of the fact that the US citizen or other individual in question was residing in a so-called "tax haven" and, therefore, was not subject to tax anywhere. As with the existing foreign earned income exclusion, there would be no requirement that to qualify the individual must be subject to income tax in another country. For example, an American living in Bermuda, which is a zero-

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<sup>7</sup> [https://www.americansabroad.org/media/files/files/ad2154e6/Residency-Based\\_Taxation\\_ACA\\_Proposal\\_Side-By-Side\\_Comparison\\_161201\\_Final.pdf](https://www.americansabroad.org/media/files/files/ad2154e6/Residency-Based_Taxation_ACA_Proposal_Side-By-Side_Comparison_161201_Final.pdf).

tax country, and qualifying under US RBT rules would pay no tax in the US or Bermuda. Similarly, there would be no exception from the RBT rules for income from a so-called “sanctioned country”, such as, Iran. Of course, other US laws might apply to make certain conduct illegal. [An alternative approach might be that individuals resident in a “tax haven” country would not qualify for RBT. “Tax haven” country might be defined as a country that does not impose an income tax. Treasury would be authorized to designate “tax haven” countries and to exclude from this category countries where the presence of US citizens is determined to be of strategic importance. Comments on this subject would be appreciated.]

### Qualification

In order to qualify for residency-based taxation, an individual would have to satisfy the test for “qualified individual” under existing section 911 (Citizens or Residents of The US Living Abroad). In general, a “qualified individual” is an individual whose tax home is in a foreign country and who is (a) a US citizen and establishes that he has been a *bona fide* resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year or (b) a citizen or resident of the US and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period. An individual can qualify even though he or she is retired, is not “working”, and receives no “earned income” but only earns, for example, interest, dividends and gains from a securities portfolio. He or she might be present in the foreign country but not comply with local rules, including immigration and employment rules.

Additionally, the residency test in current section 911, above, would have to be met for the most recent 5 taxable years prior to the year of claiming non-resident American status. The concern is that a US citizen or resident alien individual should not be able to “cash out” free of tax on holdings or businesses built up while he was fully taxable by simply moving abroad. He should be required to move abroad and remain there for a minimum of 5 years before becoming entitled to the benefits of RBT.

### Special Rules for Citizens or Residents Abroad

#### Section 911

Section 911 (including both the foreign earned income exclusion and the housing cost amount) would not be repealed.

#### Special Rules for Specified Short-Turn Overseas Employment

There would be no special rules for individuals who do not satisfied the rules for a “qualified individual” because, for example, they reside overseas for relatively short periods of time. An individual might be on “temporary assignment” for, say, 3 years and come and go from the US on a regular basis. [Comments on this subject would be appreciated.]

“Short-termers”, it is anticipated, will simply not place themselves within the RBT regime but will continue to claim the section 911 exclusion for foreign earned income and certain housing costs.

### Estate and Gift Taxation

The estate of a non-resident American would be taxed the same as an estate of a non-resident alien individual which is not subject to US estate tax; in other words, in general, there would be no exposure to US estate tax. The estate, however, would be taxed on US property, including US real property and the shares of US companies, as this is the case with a non-resident alien’s estate. It would be required to file an estate tax return if the fair market value at death of the decedent’s US-situated assets exceeded \$60,000. Substantial lifetime gifts of US property by the decedent could reduce this figure. The “exemption” for estates with combined gross assets and prior taxable gifts of \$5,490,000 or less (2017 figure) would not apply. Thus, for the estate of an American residing outside the US and qualifying for the RBT rules, but subject to tax on a second home in the US, an estate tax might apply because the value

exceeded the relatively low \$60,000 threshold, whereas an estate tax would not apply in the absence of the RBT rules. [Comments on this subject would be appreciated.]

In order to qualify for the unlimited exemption from estate taxation, the decedent must have qualified as a non-resident American for 3 full calendar years prior to date of death. For example, if date of death was July 1, 2021, the individual must have qualified under these rules for 2018, 2019 and 2020. The concern is that without this restriction, an individual – the individual’s estate – could avoid US estate tax simply by beginning to reside abroad. Similarly, a non-resident American would be taxed the same as non-resident alien individual under current gift tax rules. Also, the donor would have to qualify as a non-resident American for 3 years prior to date of gift.

#### Grandfather Rule for Americans Abroad

Americans resident outside the US for a period including the most recent 3 calendar years prior to year of enactment would be treated as “non-resident” for purposes of these estate and gift tax rules. In other words, if date of enactment was December 22, 2017 and an individual was a “qualified individual” in 2014, 2015 and 2016 and the first 355 days of 2017, his or her estate would not be subject to US estate taxation. An individual could “elect out” of the grandfather rule by filing with the IRS by the due date of his return for the year of enactment.

#### Filing Requirement

Individuals who qualify and who wish to be taxed on a residency-basis would be required to apply to the IRS for a Departure Certificate. Non-resident American status would commence with the date of issuance of the Departure Certificate. An individual could not cease to file tax returns and pay US tax simply because he moved abroad and did nothing else. He would have to take actions to place himself in the category of a non-resident American.

The year of issuance of a Departure Certificate would be a split year. For the year of issuance, a qualified individual would file a dual return (Form 1040NR and Form 1040). For example, for an American residing abroad who came within the “Grandfather Rule”, above, if the year of issuance of a Departure Certificate was 2018 and date of issuance was July 1, 2018, for taxable year 2018, she would file a dual return Form 1040NR with Form 1040 attached, reporting income for January 1-June 30, 2018 on the Form 1040 and any income for July 1-December 31, 2018, which might be, for example, income from the sale of US real property, on Form 1040NR. This approach is similar to the approach applicable to an individual who renounces US citizenship.

Non-resident Americans with effectively connected income would file a Form 1040NR.

There would be no requirement that a non-resident American report a change of residence from one foreign country to another.

Any individual claiming RBT would be required to file an annual certification stating under oath that he/she is a US citizen or resident alien and fulfils the residency requirements for the taxable year (including the 5-year rule, above), and does not have income related to a “restricted country”. Failure to file an annual certification would terminate the individual’s status as a non-resident American. The concern is that without some on-going responsibility to maintain the status, individuals might return to the US, live in the US and improperly avoid paying US tax.

#### Departure Tax Provision

General Rule. Individuals who obtain a Departure Certificate and meet the threshold test of current section 877 (Expatriation to Avoid Tax), would be subject to tax on income as if property was sold on the day before the date of the Departure Certificate. The concern is that if there is not some form of Departure Tax, individuals could accumulate wealth while being a US citizen living in the US, and then avoid any US tax by simply moving abroad. Not only might this be the wrong result from a tax policy

standpoint, it would greatly increase the revenue costs of instituting RBT. [Comments on this subject would be appreciated.]

Threshold tests for application of the Departure Tax would be the same as those in section 877, except the \$2 million or more figure in section 877(a)(2)(B) would be increased to \$5 million and US real estate subject to FIRPTA rules would be excluded. Rules similar to those in sections 877 and 877A would apply to pensions and other forms of deferred compensation and interests in trusts. [Comments on this subject would be appreciated.]

Special Rule for Americans Abroad. Individuals meeting the residency test for RBT for at least 3 years prior to date of enactment of these rules and who certify under penalty of perjury that they have been tax compliant, would not be subject to the Departure Tax. [Comments on this subject would be appreciated.]

IRS User Fee. Under current law, there is a State Department fee of \$2,350 charged for renunciation of US citizenship. Under the RBT approach, there would be a one-time IRS User Fee for issuance of a Departure Certificate equal to the State Department's then applicable renunciation fee. Americans abroad qualifying for the special 3-year rule, above, would not be subject to this User Fee. [Comments on this subject would be appreciated.]

Special Rule-“Covered Expatriates”. Under current law, there are special rules taxing bequests and gifts to US persons from a so-called “covered expatriate” (in general, certain US citizens who relinquish citizenship and certain long-term US residents who cease to be a lawful permanent resident). These are taxed to the recipient at the highest estate tax or gift tax rate then applicable. The RBT approach contains no comparable provision. Non-resident Americans are not treated as a “US person” for purposes of these rules.

#### Effective Date; Transition Rules

In the first year that an individual holds a Departure Certificate, days spent in the US would not apply for a Departure Certificate. Section 911 benefits would continue to be available.

The beginning date for residency-based tax status for an individual applying for a Departure Certificate would be the date of issuance of the Certificate. It would not be retroactive to an earlier date.

Residency-based taxation, in effect, could be elected for a taxable year by an eligible individual by obtaining a Departure Certificate. Status as a non-resident American would remain in effect so long as the individual qualifies and files an annual certification that he/she qualifies or until the individual files with the IRS a request for termination of election and such request is approved.

The RBT provisions would be effective for taxable years beginning after the date of enactment. For example, if the provisions were enacted on December 22, 2017, they would be effective for calendar years 2018 and thereafter. An individual who has received a Departure Certificate would be treated as having commenced a new taxable year as of the date of issuance of the Departure Certificate. [Comments on this subject would be appreciated.]

Special Elections. Individuals not wishing, in effect, to elect RBT treatment could simply not apply for a Departure Certificate. Individuals falling within the Grandfather Rule could elect out of its coverage (see above).

#### Anti-Abuse Rules

Gain from sale or disposition of securities for a 2-year period following issuance of a Departure Certificate would remain taxable as under current law, regardless whether linked to prior employment in the US. Thus, if an individual residing in the US changes were to move abroad (change residence to a foreign

residence) and sell or dispose of securities within 2 years of obtaining a Departure Certificate, gain would remain subject to US tax. [Comments on this subject would be appreciated.]

Issuance of a Departure Certificate would require proof that individual is a resident of a foreign country and is subject to taxation in that country on the same basis as others who are residents there. [Comments on this subject would be appreciated.]

Issuance of a Departure Certificate would require proof that the individual in question has met all federal tax requirements. This is similar to the requirement for US resident aliens and nonresident aliens (with certain exceptions) to obtain an IRS tax clearance document, commonly referred to as a "sailing permit".

Individuals eligible for the special rule for individuals residing abroad (RBT rules, above) would be subject to the Departure Tax, whether or not they are tax-compliant. The date of departure for such individuals would be the subsequent date of issuance of a valid Certificate.

If an individual who was a non-resident American for any of the prior 5 years and was a resident American for any year prior to that period, and again becomes a resident American, then he or she shall be treated as a resident American for each of the prior five years. Otherwise, a returning non-resident American will be treated the same as a non-resident alien who becomes a resident alien for US tax purposes. The concern is that an individual not be able to remove himself from US tax status, then realize income which is not subject to US tax, and subsequently again become subject to US tax rules. This rule mirrors the 10-year rule for expatriates authorized by section 877(e)(5).

#### FATCA; FBAR Filing Requirement

The "Hiring Incentives to Restore Employment Act" ("HIRE Act"), enacted in March 2010, included the "Foreign Account Tax Compliance Act" or "FATCA". These provisions, among other things, created voluminous new Chapter 4 withholding tax rules. They also created the requirement for taxpayers to file a Statement of Foreign Financial Assets (Form 8938), overlapping, to a significant degree, the Foreign Bank Account Reporting requirements.

FATCA. FATCA would not be repealed. [Comments on this subject would be appreciated.]

"Same Country" Exemption. FATCA contributes to the "lockout" of Americans abroad from foreign banking services. This is one of the principal reasons supporting a repeal of FATCA. FATCA would be amended to add a "same country" exemption for certain accounts of individuals residing in a foreign jurisdiction, where the account is with a foreign financial institution in the same country where the individual resides.

Form 8938. FATCA adds to the paperwork burden on persons, including Americans abroad, who have foreign bank accounts, which they use in the normal course. FATCA would be further amended with respect to the requirement to file Form 8938 as an attachment to a Form 1040. This requirement would be changed so as to allow any US taxpayer, not simply individuals qualifying for the RBT, to not file a Form 8938 if the only foreign financial assets that would have been reported on such form had been properly reported on a Foreign Bank Account Report. The filer would certify to this effect. [Comments on this subject would be appreciated.]

FBAR Reporting. Existing rules requiring the filing of Foreign Bank Account Reports (FBARs) would not be changed. These rules were first enacted in 1970 as part of the Bank Secrecy Act and are ordinarily treated as separate from the tax rules in the Internal Revenue Code. FBAR reporting is defended as a means of combating terrorism, illegal drug trafficking and other money-laundering schemes, as well as the use of foreign financial accounts to evade taxation. [Comments on this subject would be appreciated.]

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