Residence-Based Taxation: The Other Territoriality

by Robert Goulder

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Missed opportunities. Life is full of them, and so are tax reform bills.

When Congress drafted the Tax Cuts and Jobs Act (P.L. 115-97) last year, it missed a chance to adopt reforms that would have benefitted the millions of Americans who live overseas. Under current law the United States taxes individuals on the basis of their citizenship, while every other country — with the exception of Eritrea — taxes individuals according to residence.[1] This would have been an easy fix, but it was not to be.

Citizenship-based taxation (CBT) is a crude instrument. It can result in double taxation and makes the United States an outlier with respect to international norms. Residence-based taxation (RBT) is the more refined approach, although it does provoke fear of possible base erosion. Those concerns, while legitimate, are certainly not insurmountable.

Today in Washington there's an emerging dialogue on the relative merits of CBT versus RBT. The debate is often framed in terms of territoriality, which parallels the familiar tension over how best to tax the foreign profits of multinational corporations. But the analogy only goes so far. Territoriality in the corporate setting has always been driven by a desire for economic growth and global competitiveness. In contrast, the momentum for territoriality in the individual context is fueled by our notions of fundamental fairness and neutrality.

Still, it's reasonable to offer the following query: If territoriality is the optimal paradigm for multinational corporations, why isn't it equally so for individual taxpayers?[2]

It's rare for tax scholars to express a spirited defense of CBT. (In the case of Eritrea, the ostensible justification is to force the diaspora to support the cost of military conflict with Ethiopia.) In the era of globalization, a nation's long-term interests are well served by having a robust expat community. Why, then, does U.S. tax law cling to CBT?

Perhaps the best answer is path dependency. We chose poorly many years ago and have resigned ourselves to enduring the consequences ever since, simply because change is difficult. This mentality is unfortunate. Converting from CBT to RBT need not be some arduous task; RBT does not require reinventing the wheel, nor does it rely on untested mechanisms. The approach basically tracks the treatment of nonresident aliens in sections 871 to 879 — there's nothing experimental about it. To the rest of the world, RBT is what a normal tax base looks like.

The U.S. tax code already has source rules, residence rules, and withholding rules in place. We also have information reporting programs up and running, like the Foreign Account Tax Compliance Act and foreign bank and financial

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[1] There are isolated pockets of CBT that exist elsewhere, for example, as between France and its tiny neighbor Monaco. French citizens who reside in Monaco are fully taxable for purposes of France's personal income tax. Monégasque residents who are citizens of countries other than France are taxable only on their French-source income. Monaco itself abolished individual income taxation long ago. France applies RBT everywhere else. This allocation of taxing rights reflects the countries' unique diplomatic relationship; France is responsible for Monaco's national defense.

[2] It should be noted that despite outward appearances, the TCJA failed to deliver a true territorial regime for corporate taxpayers. This is evidenced in multiple ways, including the treatment of foreign branch profits and gains on the sale or disposition of foreign assets, like shares in a controlled foreign corporation. None of that income would be subject to U.S. taxation in a pure territorial system. Likewise, the new anti-base-erosion measures have the overall effect of confining the participation exemption to a relatively modest slice of a corporation's foreign earnings, approximating a deemed return on foreign depreciable assets. For some U.S. multinationals, that's not much of a benefit. For related coverage, see Daniel N. Shaviro, "The New Non-Territorial U.S. International Tax System," *Tax Notes Int'l*, July 2, 2018, p. 27. *See also* Shaviro, "The New Non-Territorial U.S. International Tax System, Part II," *Tax Notes Int'l*, July 9, 2018, p. 125.

accounts reports regimes. Our congressional taxwriting committees are well equipped to draft antiabuse rules, which would be necessary under RBT.

Frankly, the TCJA was more than just a missed opportunity from the standpoint of U.S. expats. If anything, the statute operates against their interests. As others have noted, the new participation exemption (section 245A) allows a 100 percent dividends received deduction for corporate taxpayers that hold shares in CFCs while denying the same treatment to individual U.S. taxpayers who own shares in CFCs — a common scenario for Americans living overseas. The TCJA also saddles individuals with tax liability under the mandatory repatriation provision (section 965), causing an imbalance that clashes with the matching principle. Individual taxpayers get stuck with the pain but miss out on the sweetener.

The effect is accentuated by the TCJA's repeal of the downward attribution rule (section 958(b)), which causes individuals who were not previously shareholders in CFCs to attain that status. Finally, the special treatment afforded to passthrough entities (section 199A) fails to benefit U.S. taxpayers living overseas who earn foreign income through such business structures.[3] These are bizarre outcomes for a tax reform package that outwardly professed adherence to territorial principles.

Will tax reform 2.0 be any different? Probably not.

That legislative package comprises three separate bills that have already passed the House of Representatives and are awaiting a response from the Senate. The package lacks bipartisan support and will presumably be enacted sometime in 2019 — under reconciliation — if the GOP retains control of Congress following the midterm elections.[4] Should the Democrats take either the House or the Senate, tax reform 2.0 will never happen, period. Meanwhile, there's no obvious plan for how Congress would pay for another round of generous tax cuts, and recent news about the post-TCJA growth of the deficit is discomforting.[5]

At times like this it's useful to reflect on the true purpose of tax reform, which is not to dispense tax cuts per se, but to replace suboptimal policies with better and fairer ones — and to do so in a fiscally responsible manner. This article attempts to advance the public debate by examining the pros and cons of replacing CBT with RBT.[6]

How It Works

There have been several plans for RBT in the United States over the years. The best place to start is the plain-vanilla approach circulated last year by the advocacy group American Citizens Abroad (ACA).[7] One of the architects of the ACA outline is Charles M. Bruce, of counsel with Bonnard Lawson in Lausanne, Switzerland, and legal counsel to ACA. The outline envisions the transition to RBT being revenue neutral. One recent analysis — not by ACA — puts the cost at $400 million, or roughly 0.01 percent of the federal government's annual revenue.[8] A stated purpose of the outline is to establish a suitable baseline that facilitates revenue estimation. Bruce adds that the objectives for the plain-vanilla approach were to "make sure that it is revenue neutral, which it can be; make sure it is tight against abuse, which it can be; and in the process make no one worse off than they are now."

The most salient feature of the outline is that U.S. citizens and resident aliens (including green card holders) would have the opportunity to be

[3]For further coverage, see the congressional testimony of American Citizens Abroad to the Senate Finance Committee hearing on early impressions of the TCJA, Apr. 24, 2018.

[4]The package we refer to as "tax reform 2.0" consists of three distinct bills: The Family Savings Act of 2018 (H.R. 6757), the Protecting Family and Small Business Tax Cuts Act of 2018 (H.R. 6760), and the American Innovation Act of 2018 (H.R. 6756). The House of Representatives approved the three bills on September 28, 2018. For prior analysis, see Marie Sapirie, "A Guide to Round 2 of the TCJA," *Tax Notes*, Oct. 1, 2018, p. 13.

[5]*See* Jim Tankersley, "Budget Deficit Jumps Nearly 17% in 2018," *The New York Times*, Oct. 15, 2018.

[6]For prior coverage, see Jacqueline Bugnion, "Residence-Based Taxation: Is Revenue Neutrality Possible?" *Tax Notes*, Aug. 28, 2017, p. 1131. *See also* Bugnion, "The Implications of an Exit Tax in the RBT Framework," *Tax Notes*, July 30, 2018, p. 659.

[7]*See* "Residency-Based Taxation: A 'Baseline' Approach to Replacing Citizenship-Based Taxation," American Citizens Abroad (Sept. 27, 2017). ACA explains that its outline is "not intended as a legislative proposal, but rather as a means of promoting careful consideration" of the subject matter.

[8]*See* "Residence-Based Taxation," *supra* note 6, at 1132. The table in that article is based on pre-TCJA revenue figures.

taxed only on their U.S.-source income. This would create a new class of individual known as a qualified nonresident taxpayer (QNRT). Obtaining this status would be elective on the part of each taxpayer and hinge on the issuance of a departure certificate by the IRS.

The certificate requirement would play a vital regulatory role. Nobody could avoid tax on their foreign-source income simply by moving overseas. Self-help is not what proponents of RBT have in mind. Applicants for departure certificates would, among other things, need to establish that they are compliant with all federal income tax obligations. Noncompliant taxpayers would be ineligible for QNRT status until they settle up.

For taxpayers who live in the United States there would be no change from current law. State and local tax laws would not be directly affected, although they could be indirectly affected to the extent state and local rules piggyback on the federal tax base and related calculations on federal returns. Payroll tax rules would not change, and RBT would not affect U.S. immigration policy or naturalization policies.

Under the outline, QNRTs would be able to enjoy RBT treatment regardless of where they reside. There would be no government-approved white list of eligible host countries, nor any blacklist of prohibited jurisdictions. There would be no requirement, for instance, that a QNRT must reside in a country that has a tax treaty with the United States.

Significantly, there would be no requirement that the individual's foreign-source income be subject to full tax somewhere in the world. This design element is noteworthy because it would permit people to reside in a tax havens if they so choose. That means double nontaxation in the individual context (as distinct from the corporate variety) could occur, but only where U.S.-source income is not involved. The justification for this rule is not that we want people absconding to tax havens, but a matter of jurisdictional restraint that's consistent with territorial principles.

Consider a hypothetical scenario in which a U.S. citizen earns foreign-source income from investments in Germany and then decides to resettle in Bermuda, a zero-tax jurisdiction. Under the outline, it would be the exclusive responsibility of the source country (Germany) and the host country (Bermuda) to worry about whether her foreign-source income is adequately taxed. True, double nontaxation could result from that interplay, but the critical point is that U.S.-source income is not involved. As viewed through that lens, the U.S. public fisc would no longer have a horse in that race, despite the involvement of a U.S. citizen. This is the most obvious point of differential between CBT and RBT.

Naturally, the above example assumes that the U.S. residency rules are not being gamed. The person must be a bona fide resident of Bermuda. It also assumes that our source rules are not being gamed. The income must not be effectively connected to a U.S. trade or business. If it were, the income would be subject to U.S. tax just as if the person were a nonresident alien. There should be no need for Congress or Treasury to develop a new batch of effectively connected income rules; the current ECI doctrine is well established and would do just fine. That said, prudence suggests that a detailed review of our source and residence rules should be undertaken as part of any transition to RBT.

Although not specifically addressed in the outline, it's easy to imagine an alternate approach that might restrict the locations where RBT treatment is permitted. Tax havens (however defined) could be deemed off-limits, as could any jurisdictions considered hostile or subject to international sanctions. Again, the outline is intended to provide a preliminary baseline for an RBT regime; future modifications are an expected part of the deliberative process.

Other Details

The rules for determining QNRT status would lean on familiar definitions that already exist in tax code. Principal among these is the "qualified individual" test for purposes of section 911. That code section is very familiar to expats as it provides both the foreign earned income exclusion (FEIE) and the housing cost allowance.

This test covers individuals whose tax home is a foreign country and who (in the case of U.S. citizens) can establish they were a bona fide resident of a foreign country, or countries, for an uninterrupted period that includes an entire tax year. It also covers citizens or residents of the United States who, during any period of 12 consecutive months, are present in a foreign country or countries for at least 330 full days.

Under the outline, taxpayers who hope to become QNRTs must satisfy the qualified individual standard for five consecutive tax years. This is the so-called aging rule. A grandfather rule would apply to expats who have already resided overseas for an extended duration. The aging rule might seem harsh, but it discourages people from cashing out on a tax-free basis. Otherwise, taxpayers would be tempted to relocate to a tax haven just as they are on the verge of selling highly appreciated assets or otherwise realizing a substantial gain.

Another key feature of the outline is that section 911 would be repealed. FEIE and the foreign housing cost allowance would be ended on the grounds they would no longer be needed once RBT was in place. A limited exception would allow taxpayers to claim the benefits of section 911 during their 5-year aging period. The decision to apply section 911 in that manner would be a one-time opportunity and could not be revoked without consent of the Treasury Secretary.

Eligibility for RBT would not depend on whether the individual was working, either as an employee or in any other capacity. Retired expats would be at no disadvantage relative to those with jobs. Nor would eligibility depend on whether the taxpayer was lawfully present in the country where they reside. Violating the host country's immigration laws, for example, would have no bearing on U.S. tax outcomes. RBT would not be available to members of the U.S. diplomatic corps or members of the military.

All current rules for determining the geographic source of income would still apply, whether based in statutory law or in tax treaties. Statutory withholding would not change, nor would the ability to obtain reduced withholding rates through tax treaties. However, the savings clauses in U.S. tax treaties would need to be overridden by statute.[9] The rules pertaining to the Foreign Investment in Real Property Tax Act (section 897) would continue to apply.

RBT would involve a one-time transition tax modeled after section 877. The measure would subject QNRTs to tax as if their property were sold on the day before the departure certificate was issued. Taxpayers who, prior to the enactment of RBT, already satisfied the section 911 test for qualified individuals for at least three years would not be subject to the transition tax, as they wouldn't pose an avoidance risk. Domestic real estate holdings would be excluded from the transition tax as they'd be covered separately by FIRPTA.

QNRTs would need to keep the IRS informed of any change of address or relocation from one foreign country to another. Those changes would be reflected in an annual certification made under oath and filed with the IRS. Failure to timely file the annual certificate would cause the taxpayer to lose RBT treatment, resulting in a reversion to CBT without the benefits once afforded by section 911. Affected individuals who eventually move back to the United States, or who otherwise wish to voluntarily terminate their QNRT status , could do so by requesting a termination of election from the IRS.

The outline would not change FBAR reporting requirements. The FATCA regime would survive unscathed, apart from the introduction of a same-country exception (SCE). SCE would eliminate the "lockout" effect, whereby U.S. expats are unable to obtain local bank accounts because foreign banks don't want to accept U.S. clients and subject themselves to burdensome compliance obligations.[10] ACA also advocates for the SCE as a standalone FATCA reform, apart from its stance on RBT.

Help by Other Means

Not everyone is convinced that RBT complies with the benefits principle. It's often mentioned that expats benefit in various ways from retaining their U.S. citizenship, and therefore ought to bear the associated costs. In particular, some would find a justification for CBT in the continued ability of QNRTs to:

- vote in U.S. elections;

[9] Savings clauses generally allow a contracting state to tax its own residents as if no tax treaty was in place. The statute enacting a RBT system (and the supporting legislative history) should clearly specify that it operates as a treaty override in this respect.

[10] For related coverage, see Allison Christians, "Could a Same-Country Exception Help Focus FATCA and FBAR?" *Tax Notes Int'l*, July 9, 2012, p. 157.

- avail themselves of consular services provided by U.S. embassies;
- travel internationally under a U.S. passport;
- take advantage of U.S. courts; and
- return to U.S. territory at any time.

These are valid concerns. The reasonable costs of citizenship should not be disregarded. That's not an issue for RBT, however. QNRTs would continue to pay U.S. tax on their U.S.-source dividends, interest, rents, and royalties — plus any income that's effectively connected to a U.S. trade or business. As Bruce puts it, "They don't stop being U.S. taxpayers because of RBT."

Another argument against RBT is that it may not be necessary, given the benefits permitted under section 911 and the foreign tax credit rules. As mentioned, the FEIE rules allow U.S. taxpayers, under some circumstances, to exclude a portion of their foreign-source wage income and self-employment income from their U.S. income taxes. The exclusionary amount for 2018 is $103,900. One problem with FEIE is that it can be stingy. Recent litigation, like the *Sidney O'Kagu v. Commissioner* (No. 3835-18; 151 T.C. No. 6) case, illustrates how the rule fails to assist some taxpayers.[11]

Preventing double taxation requires something more, according to Bruce. "Some would say, let's just ride with section 911 and the foreign tax credits, and leave it at that. The problem with that argument is that section 911 doesn't cover everything it needs to. It doesn't help people who don't have earned income; it doesn't help people receiving pensions; it doesn't help people receiving social security. And foreign tax credits don't cover all the people whom, for one reason or another, are capped out — either because they live in a low-tax country, somewhere in the Middle East, for example, or they have technical problems with creditability. It helps to think of these provisions as a tablecloth that doesn't come close to covering the entire table," he told *Tax Notes*.

Congress sometimes tinkers with section 911 in unhelpful ways. For instance, the Bipartisan Budget Act of 2018 (P.L. 115-123) modified the tax home requirement to extend benefits to taxpayers who maintain an abode in the United States while residing overseas ("abode" is not a defined term for purposes of the IRC).

Previously, maintaining a home or other dwelling in the United States would have spelled serious trouble for FEIE eligibility. It could disqualify the person from being a bona fide resident of the foreign host country. The new law changes that outcome, but only for taxpayers supporting U.S. armed forces and working in designated combat zones. This change recognizes that it's not always feasible for Americans working abroad to bring their families with them as they relocate. But it's not clear why that policy shouldn't extend to all nonresident Americans.

For better or worse, the benefits allowed under section 911 will always be regarded as a tax expenditure. They stand out as a deviation from the normative tax base, meaning they are perpetually vulnerable. Congress could scale them back, or eliminate them altogether, any time it needs a revenue raiser. That instability is not helpful.

Like so many other tax policy issues, the fate of RBT will eventually come down to political will. Are the interests of several million Americans living abroad a loud enough constituency for Congress to take up their cause? Only time will tell, but the issue certainly isn't going away. ■

[11] For prior coverage, see Eric Yauch, "Tax Court Says Government Employee Can't Exclude Foreign Income," *Tax Notes Int'l*, Sept. 24, 2018, p. 1376.