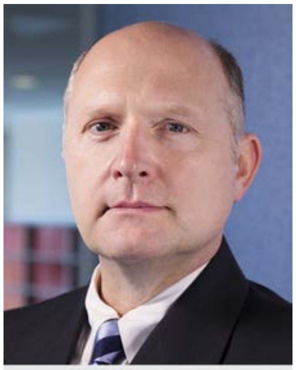
Would Residence-Based Taxation Break the Bank?

by Robert Goulder



Robert Goulder

Let's talk about U.S. exceptionalism. Regular readers know the United States is the only country that taxes individuals based on citizenship.[1] This policy is difficult to reconcile with the benefit principle of taxation. That's the idea that primary taxing rights over a person's income should lie with the jurisdiction in which the taxpayer consumes public services.

Call me old fashioned, but I favor the notion that paying tax can be conceptualized as the purchasing of a bundle of public services. There's no harm in acknowledging the flaw in this transactional metaphor. An actual economic exchange is a voluntary act. Individuals can choose which goods and services they purchase in a marketplace, but they possess no similar discretion on the matter of paying tax. Taxes are compulsory payments.

So our little metaphor ain't perfect. There's still virtue in the benefit principle. Most people have some freedom to choose where they live. Selecting one's place of residence should — ideally — function as a fair proxy for determining where one pays income tax. That would be true if we occupied a world where all governments adhered to residence-based taxation (RBT). We're not quite there yet. RBT is the global standard, but there's a stubborn holdout. Uncle Sam clings to citizenship-based taxation (CBT). Hence the exceptionalism.

A predictable thing occurs when I suggest Congress replace CBT with RBT: Some well-intended person warns that the change represents a forfeiture of tax base and that it would deprive the public fisc of needed revenue. The purpose of this week's column is to respond to these arguments and invite responses from readers.

RBT represents no meaningful forfeiture of tax base when other nations apply the same doctrine. That is, if those countries' citizens can migrate to the United States and settle into long-term residence, while being subject to RBT by their countries of origin. Other countries already do that. Reciprocity isn't forfeiture.

For every sliver of tax base theoretically relinquished under an RBT regime (as an expat departs), a matching slice of tax base is gained elsewhere (as a foreign national arrives). From a consistency standpoint, whether the volume of outbound traffic exceeds the inbound flow is beside the point. These migratory subtotals need not produce a numerical wash for there to be parity of design parameters.[2] RBT creates no structural imbalance as to how nation-states divvy up the tax base. Quite the opposite.

Then there's the money question — which is why you're reading about RBT this week.

Would RBT cost a boatload of revenue and blow a hole in the federal budget deficit? I have long assumed the answer depends on how lawmakers choose to draft the implementing legislation. Depending on the particulars, RBT could be constructed as a revenue loser, as a revenue raiser, or as revenue neutral. Take your pick.

I'm banging the drum for revenue neutrality. RBT need not break the bank. As of last month, we have analytical confirmation. It arrived courtesy of a study performed by the District Economics Group LLC (DEG), a nonpartisan economic consulting firm. The DEG study goes deep into the money question, examining whether it's possible

[1] Apart from Eritrea. For the sake of simplicity, the remainder of this article refers to the United States as the only country applying CBT.

[2] The intellectual case for RBT should not hinge solely on whether tax base is gained or lost, though the inquiry is clearly relevant to forming revenue projections. Losing any segment of the tax base requires pay-fors elsewhere if revenue neutrality is to be preserved.

for RBT to be revenue neutral. Spoiler alert: Of course it's possible.[3]

The revenue effects of RBT over a 10-year budget period, running from 2022 to 2031, are estimated at $0.67 billion on the plus side. As someone who has lived inside the Capital Beltway for too long, I reserve the right to declare that anything that raises (or costs) less than $1 billion over 10 years can be safely rounded down (or up) to zero.

Bingo. There's your revenue neutrality — or the nearest thing to it.

Proof of Concept

DEG's computational model was applied to a so-called vanilla approach to achieving RBT, developed by American Citizens Abroad (ACA), a nonprofit membership organization that represents the interests of U.S. citizens living overseas. The primary architect of the approach is tax attorney Charles M. Bruce, a former practitioner with substantial experience in navigating the U.S. international regime. Bruce previously worked in government, academia, and law firms. These days he serves as ACA's legal counsel, splitting his time between Washington and London.

DEG's analysis was prepared for ACA's sister organization, the American Citizens Abroad Global Foundation, a tax-exempt charitable organization.[4] The study is a timely update on an earlier report the group prepared for ACA in 2017, which predated enactment of the Tax Cuts and Jobs Act. Over the last five years, ACA has modified details of its approach to stay current with the post-TCJA environment. DEG's new study reflects these changes. It also reflects the realities of the COVID-19 pandemic, which has had a chilling effect on the movement of people.

The term "vanilla" implies plainness, as if to temper expectations. In fact, ACA's approach is clever and soundly constructed. It's basic in that its purpose is to provide a reference point, on which the drafters of future RBT proposals can build. It's not a legislative proposal. ACA hesitates to even label it as a "plan."

Similarly, the DEG study isn't meant as a substitute for an official revenue estimate. It relies entirely on publicly available information, including data from the IRS Statistics of Income, the Federal Reserve Board, the Social Security Administration, and the United Nations.[5]

DEG estimates there are 3.9 million U.S. citizens residing overseas. The group anticipates that half of them, about 2 million, will opt for RBT if it were available. What explains the likelihood that only half of these folks would jump at the opportunity? Some expats might not go for RBT because their U.S. tax bill is already netted out by operation of section 911 or foreign tax credits. Others might decline because they're highly mobile workers who bounce among multiple countries, not staying in one spot long enough to establish bona fide residence.

As it turns out, many of the U.S. citizens living abroad do not file a U.S. return, and they too might have little use for RBT. DEG estimates there are 1.6 million nonfiling U.S. citizens residing abroad. That's a larger number and a cause for concern about an overseas tax gap, distinct from the domestic one, but it's not necessarily an indicator of tax evasion. The number can be partly explained by individuals who don't earn enough income to trigger a U.S. filing obligation. These might be retirees who live off their Social Security benefits or a modest pension.

The occurrence of U.S. individuals not appearing on tax returns is nothing new, and it certainly isn't unique to the expatriate community. Domestically, nonfilers are roughly 13 percent of the U.S. population. Their presence is a fact of life, not a reason to quit on RBT.

Another of the study's findings relates to the income profile of U.S. citizens residing overseas.

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[3] For prior coverage, see Andrew Velarde, "Group Insists Residency-Based Taxation Can Be Revenue Neutral," *Tax Notes Int'l*, May 2, 2022, p. 705.

[4] The DEG study was financed by tax-deductible contributions to the ACA Global Foundation from private contributors, many of whom are ACA members.

[5] DEG did not have access to confidential tax return information and did not purchase data from commercial data vendors.

Based on adjusted gross income figures, the sources of their reported income were 74 percent foreign and 26 percent domestic. This shows that Americans living abroad receive a significant share of their income from U.S. sources.[6]

ACA's approach is inspired by three objectives:

- RBT should make nobody worse off;
- RBT should be tight against abuse; and
- RBT should be revenue neutral.

Checking those three boxes may alter how people think about RBT. The concept begins to look less like fiscal largesse and more like an appropriate course correction.

Plain Vanilla

U.S. tax law lumps citizens together with resident aliens and taxes the lot of them on their worldwide income. That's irrespective of where they reside.

The blanket treatment stands in contrast to that of nonresident aliens, who are generally subject to U.S. tax on two pools of income: U.S.-source income and income effectively connected to a U.S. trade or business.

The vanilla approach differs from current law, most fundamentally, in that it removes U.S. citizens who reside overseas from the category of persons subject to U.S. income tax on their worldwide income. Instead, it treats them on the same terms as NRAs. Accordingly, a U.S. citizen residing abroad would remain subject to U.S. tax on every penny of their U.S.-source income and effectively connected income, but not the remaining foreign-source income. Note that RBT treatment would not extend to resident aliens. As a result, a green card holder who expatriated would not be eligible.

That outcome strikes me as reasonable, given that there's no natural linkage between the relevant income and U.S.-based economic activity.

Under the vanilla approach, the taxpayer in question must qualify for RBT treatment, which involves several restrictions. The taxpayer must also voluntarily opt into the regime. This approach to RBT is elective. A feature of this electivity is that the rules under section 911 (pertaining to the earned income exclusion and housing cost amount) are left alone. U.S. expats who believe they're better off outside of RBT can retain treatment by not making the election.

Parallel Lines

Some basic parallels to the treatment of NRAs should be called out.

U.S. citizens living abroad may be required to file a bevy of IRS tax forms. These include the Form 1040 (the annual return for individuals), Form 2555 (statement of foreign earned income), Form 1116 (FTCs), Form 8938 (statement of foreign financial assets), and Form 8621 (information return by a shareholder of a passive foreign investment company or qualified electing fund).

NRAs don't file those IRS forms. Instead, they file a Form 1040-NR to pick up any U.S.-source income, ECI, or fixed or determinable annual or periodic income that wasn't subject to regular withholding.

Under the vanilla approach, U.S. citizens residing abroad would be relieved of the annual obligation to file a basic Form 1040. They'd be pushed over to Form 1040-NR, the same as NRAs. There's no need to invent a new tax form for these purposes. Form 1040-NR is fit for purpose.

What about withholding? Under section 871(a)(1), an NRA is subject to a 30 percent withholding tax on some U.S.-source income. That category of income includes interest income (other than original issue discount), dividends, rents, salaries and wages, premiums, annuities, compensations, remunerations, emoluments, and other FDAP gains. It excludes capital gains, which are separately addressed under section 871(a)(2). The 30 percent statutory withholding can be reduced by applicable treaty provisions.

Under the vanilla approach, all these withholding rules would extend to U.S. citizens living abroad. Likewise, the treatment of capital gains would mirror the rules for NRAs. As a result, the 30 percent withholding would not apply to capital gains, unless section 871(a)(2) was implicated by the taxpayer being present in the

[6]The breakdown of foreign and domestic income did not change much as incomes increased.

United States for 183 days or more during the taxable year.[7]

Social Security benefits paid to U.S. citizens living abroad would be taxed as U.S.-source income and subject to withholding, as is done for NRAs under section 871(a)(3). Another parallel concerns taxpayer withdrawals from individual retirement accounts, which would similarly be taxed as U.S.-source income and subject to withholding — as well as applicable penalties in the case of early withdrawals. Ditto for required minimum distributions from retirement plans. Pension distributions for services performed in the United States would be treated as U.S.-source income.

The application of tax treaties would not change, apart from a modification concerning savings clauses. These clauses normally preserve a contracting state's right to tax its own citizens and residents as if no treaty were in place. Under the vanilla approach, U.S. citizens living abroad would not be subject to the savings clause of any U.S. tax treaty. In this sense RBT would operate as a partial treaty override. Form W-8BEN might need to be revised to reflect the enactment of RBT.

TCJA Stuff

A few pieces of the TCJA international framework would be modified. Although the changes relate to individual taxpayers, they dovetail with the familiar corporate provisions.

The participation exemption under section 245A is restrictive in that the 100-percent dividends received deduction does not apply to U.S. taxpayers who reside outside the United States. Under the vanilla approach, the participation exemption would be available to U.S. citizens residing overseas.

Although section 245A does not benefit U.S. taxpayers living abroad, the one-time transition tax under section 965 applies to them. This was always an odd juxtaposition of benefits and burdens stemming from the design of the TCJA. It's a purposeful mismatch between who gets relief through the participation exemption and who suffers the transition tax. That mismatch would be flipped under the vanilla approach, because the section 965 transition tax would no longer apply to U.S. citizens living abroad.[8]

Another twist related to the TCJA involves the scope of section 199A, which allows qualifying business owners to deduct 20 percent of some income derived from passthrough entities. The deduction is not available for foreign-source income. The vanilla approach would alter section 199A so that the disallowance would not apply to U.S. citizens living abroad. Section 199A is scheduled to sunset after 2025, so realistically this feature would be relevant only if section 199A were extended. It's factored in to conform to the 2022-2031 budget window.

FBARs and FATCA

The rules controlling foreign bank account reports would not change. FBAR filings are mandated by the Bank Secrecy Act, not the IRC. The reports are sent to the Treasury's Financial Crimes Enforcement Network unit, not to the IRS. U.S. citizens who opt into the RBT regime would continue to be subject to all FBAR requirements, including the related penalties — which have become a contested litigation issue regarding whether the statutory penalties are incurred per-year or per-account.[9]

You didn't think we were going to gloss over the Foreign Account Tax Compliance Act, did you?

FATCA would not be repealed. However, the vanilla approach would add a same-country exemption. That's something critics have requested for years. The national taxpayer advocate included a same-country exemption for FATCA in the annual purple book.[10]

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[7] Realistically, I don't think we'd encounter capital gain withholding per section 871(a)(2) in this context. That's because we shouldn't see any expats who are present in the United States for 183 days. If they were here for that long a stay, they shouldn't be able to qualify as a bona fide foreign resident.

[8] The modification to section 965 might not pack much punch, given that most of the relevant income (previously tax-deferred earnings and profits) would have already been sucked up by the transition tax long before any version of RBT comes to fruition. The modifications to the section 245A participation exemption seem more important, because they would have an enduring effect.

[9] The litigation involving FBAR penalties invokes the Eighth Amendment's prohibition against excessive fines. For prior analysis, see Velarde, "Circuit Says Excessive Fines Clause Doesn't Apply to FBAR Regime," *Tax Notes Int'l*, May 9, 2022, p. 826.

[10] For prior coverage, see Robert Goulder, "A Random Walk Through the Purple Book: 2022 Edition," *Tax Notes Int'l*, Feb. 21, 2022, p. 967.

This would effectively turn off FATCA obligations when a foreign financial institution is located in the same country in which the U.S. taxpayer resides. Strictly speaking, this change has nothing to do with RBT. The same-country exemption would apply across the board, including situations in which a U.S. citizen resides overseas but does not opt in to RBT.

Eligibility and Elections

Not every U.S. citizen residing abroad would be eligible for RBT. Perhaps the most important condition is that the individual be current as to all U.S. taxes. This precludes the possibility that RBT would extend to persons who incur a massive tax deficiency and then flee the country.

Members of the U.S. armed forces and diplomatic corps would not be eligible. Nor would other U.S. citizens living abroad and receiving employment compensation from the U.S. government or any federal agency.

RBT would not extend to U.S. citizens who reside abroad based on a tourist or visitation visa. Those visas envision a relatively brief stay. That short-term orientation is incompatible with the concept of establishing long-term residence overseas. Similarly, those who reside abroad under a so-called golden visa would be ineligible for RBT.

An eligible taxpayer would opt in by submitting a departure certificate to the IRS. This would be an annual election. It's through the departure certificate that individuals demonstrate to the IRS that they're bona fide residents of some foreign country. The requirement for maintaining a foreign tax home precludes anyone who claims to be stateless.

To obtain RBT treatment, the individual would certify bona fide foreign residency for the past five years. That's a substantial waiting period, intended to filter out those who aren't legitimate expats. The approach is silent as to whether an individual must reside in the same country for the entire five-year waiting period. That would have implications for individuals who work overseas for a single multinational corporation but are seconded to different locations for extended periods.

An exception would be made for individuals who have held bona fide foreign resident status for at least three years before the enactment date of RBT legislation. These individuals would be immediately eligible for RBT. That's a way to grandfather in long-term expats. The approach is also silent as to whether an individual must reside in the same country for the three-year requirement.

Those grandfathered in would not be charged a user fee. Everyone else submitting the departure certificate would be charged a one-time user fee, which the vanilla approach sets at $2,350. The amount was borrowed from the State Department fee charged when a person renounces U.S. citizenship.

There's pending litigation regarding the legality of the renunciation fee. Federal courts will have to decide if there's a fundamental right to renounce citizenship without incurring a financial charge.[11] Renunciation is how so-called accidental Americans, and others, get out from under FATCA. We've observed that in the matter of Jenny Webster, who was not an accidental American but nevertheless hard done by FATCA.[12]

For some taxpayers, the availability of RBT could be an alternative to renunciation. Retaining your U.S. citizenship could come in handy — for example, if an individual requires the consular services of a U.S. embassy.

Sanctioned Countries

U.S. citizens who reside in sanctioned countries for FTC purposes would be ineligible for RBT. The list of sanctioned countries changes from time to time and includes jurisdictions like Iran, North Korea, and Syria.

As recently discussed, I wholeheartedly approve of adding Russia and Belarus to the U.S. sanctions list.[13] Do we really want Steven Seagal, or other Putin cronies, to benefit from RBT? Ditto for NSA whistleblower Edward Snowden, who now lives in Russia.

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[11] For prior analysis, see Laura Snyder, Karen Alpert, and John Richardson, "Should Overseas Americans Be Required to Buy Their Freedom?" *Tax Notes Int'l*, July 12, 2021, p. 161.

[12] *See* Goulder, "The FATCA Wars: Jenny Goes to Court," *Tax Notes Int'l*, Nov. 22, 2021, p. 959.

[13] *See* Goulder, "The Russia-U.S. Treaty: Who Wants to Weaponize Double Taxation?" *Tax Notes Int'l*, Apr. 25, 2022, p. 589.

For these purposes, the effect of the sanctions listing goes beyond a territorial disqualifier. It extends to income sourced from sanctioned countries, effectively creating a category of sanctioned income. In other words, RBT would provide no benefit to a U.S. citizen who receives income from a source within a sanctioned country (say, an employer based in Iran) although the individual might live in a non-sanctioned country (say, France).

Tax Havens

Opponents of RBT will always point to the possibility of some high-net-worth individual ditching life in the United States for a low-tax jurisdiction, placing themself beyond the reach of the IRS. The natural instinct is to look skeptically at RBT, and to ask why the tax code should encourage that behavior or in any way accommodate those people. That's a fair question. A well-constructed approach to RBT must provide an answer. Remember our proviso: RBT must be tight against abuse.

The vanilla approach contains two features that address this. First, U.S. citizens residing in jurisdictions that lack an income tax (or apply a zero rate) would not be eligible for RBT. This has implications for anyone thinking of moving to Bermuda, the Bahamas, the Cayman Islands, or Monaco.

Another group that could be affected by this condition are Americans who live in the Middle East or Persian Gulf states. Several of those nations (such as Bahrain, Kuwait, Qatar, and the United Arab Emirates) don't rely on income taxes because they're able to finance themselves using revenues from the petro-economy.

Second, the vanilla approach authorizes Treasury to establish a list of prohibited low-tax jurisdictions for RBT purposes. Yep, we'd be getting into the blacklisting business, with all the baggage that entails.

Even if you're sold on the virtues of RBT, we should acknowledge that the history of tax haven blacklists is not stellar. The exercise tends to be intellectually impure for various reasons. The composition of these lists gets lobbied behind the scenes.

You might recall that no less an enterprise than the OECD dabbled with a tax haven blacklist about 20 years ago, with mixed results. Tax havens are not a homogeneous bunch. Some of them held enough clout to finesse their way off the OECD blacklist, while those less well-connected faced the prospect of defensive countermeasures. There were even racial overtones. Some commentators note that privileged European havens had a way of sliding off the blacklist, while jurisdictions from more "ethnic" regions encountered more resistance.[14]

How you feel about the viability of the ACA's approach could turn on how you feel about the Treasury department's ability to properly assemble this sort of tax haven list. Would the department get it right? Would the listing be underinclusive or overinclusive?

Some tax haven blacklists have failed to achieve the desired effect, and ultimately reflected poorly on the entity propagating the list. The project carries a risk of hypocrisy.[15]

A few international bodies have done better with their tax haven lists. Since 2017 the European Union has maintained a tax haven listing that grew out of the OECD's base erosion and profit-shifting initiative (BEPS action 5 on harmful tax practices). The EU effort is split between a blacklist and a grey list.[16] It hasn't proved too controversial, apart from some members of the European Parliament requesting that the U.S. state of Delaware be added. Some nongovernmental organizations, such as Oxfam America Inc., argue that the EU tax haven list should be significantly longer and include such places as Cyprus, Malta, and Switzerland.

In theory, a tax haven list prepared by Treasury could end up looking a lot like the EU list. That's especially so if Treasury were to invoke BEPS action 5 as a foundational basis for delineating what constitutes tax haven status. Relying on an external reference point has the advantage of not requiring you to start from

[14] For prior analysis, see Steven A. Dean, "FATCA, the Congressional Black Caucus, and the OECD Blacklist," *Tax Notes Int'l*, July 6, 2020, p. 83.

[15] Would the Treasury Department label another country as a tax haven due to the lack of adequate beneficial ownership practices? It's been pointed out that some U.S. states aren't particularly strong in that area.

[16] The EU tax haven blacklist includes 13 jurisdictions: American Samoa, Anguilla, Dominica, Barbados, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, U.S. Virgin Islands, and Vanuatu.

scratch. In a sense, piggybacking on BEPS action 5 means somebody else (the OECD) would have already done the heavy lifting for you.

A Treasury-prepared blacklist might differ from the EU version regarding low-tax jurisdictions with U.S. ties. American Samoa, Guam, and the U.S. Virgin Islands appear on the EU blacklist and are U.S. territories. How they're treated for RBT purposes remains to be seen.

Regardless of whether Treasury decides to mimic the EU approach to calling out tax havens, we know that blacklists work best when the formative selection process is as transparent as possible, and when the criteria by which nations are judged can be expressed in objective terms. We don't want tax haven status — and the consequences it carries — to boil down to a subjective eyeball test.

The Treasury officials responsible for compiling such a blacklist would need to be vigilant against bias and favoritism. A tax haven is still a tax haven, though it might do the occasional favor for other branches of the U.S. government. Would tax haven status be influenced by a country's criminal extradition agreement with Washington? Or whether the country is willing to host a U.S. military facility? Or whether it purchases large quantities of U.S. agricultural output?

Would there be interference in the form of political horse-trading that has nothing do with tax policy? Would Treasury be tempted to go easy on the Isle of Man or the Channel Islands if the U.K. government were to cooperate on the extradition of WikiLeaks founder Julian Assange? The possibilities are endless, and it's probably naïve to assume that such interference won't occur.

You get the point. There's a non-trivial chance that any attempt at preparing and maintaining a tax haven blacklist would be unduly swayed by nontax considerations. The possibility is a good argument for tying the exercise to BEPS action 5 compliance.

The purpose of a tax haven blacklist is not to offend foreign governments and provoke diplomatic spats. The objectives are to narrow the scope of an RBT regime so that it is tight against abuse, as promised. If we have confidence that the blacklist won't be botched, then critics of RBT should be able to stop worrying about abuse.

Once the money question has been asked and answered, we should get serious about the other details of RBT. The DEG study is noteworthy in that it shows proof of concept. RBT can be revenue neutral. ■