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Concerns About the Taxation of Americans Resident Abroad

By Jacqueline Bugnion

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In this article, originally submitted as an open letter to the congressional taxwriting committees, Bugnion argues that citizenship-based taxation has a devastating effect on Americans residing abroad, and she urges lawmakers to introduce residence-based taxation. The comments are Bugnion's personal views and do not reflect those of any association with which she has been affiliated.

Two friends recently announced to me, separately but on the same day, that they were going to renounce their U.S. citizenships. They reside in Switzerland, as do I. I was shocked but not really surprised. That same day I read the July bipartisan report of the Senate Finance Committee's international taxation working group. That report is essentially devoted to international business tax issues, but it does mention in its final section that the submissions received from Americans resident abroad were by far the most numerous and recommended that the tax committees look seriously into the issues raised by those submissions.

These events are not mere coincidence: They should encourage the taxwriting committees to prioritize reforming the taxation of Americans resident abroad. The current tax laws are undermining the community of an estimated 7 million to 8 million Americans resident abroad. U.S. policy is unjust to Americans abroad and is detrimental to long-term U.S. prosperity.

I am an American citizen. I have resided in Switzerland for 50 years following my marriage to a Swiss citizen. For more than 10 years I was head of the tax team of American Citizens Abroad, an association speaking on behalf of overseas Americans, and I am fully aware of the issues facing Americans resident abroad as well as the pulse of Washington, having visited hundreds of congressional offices. I recently retired from American Citizens Abroad, but my concern about this issue has not abated.

My comments can be broadly divided into two parts: (1) an analysis of the current citizenship-based taxation (CBT) system and its devastating effect on Americans residing abroad; and (2) a recommendation to introduce residence-based taxation (RBT), with a probable break-even and a possible gain for the U.S. treasury.

CBT versus RBT has been the subject of intense debate within the academic community, with professor Michael S. Kirsch and others arguing for the status quo and professor Bernard Schneider and others arguing for change.[1]

A. CBT Restricts Human Rights

CBT, under which the United States taxes all U.S. citizens and green card holders on their worldwide income wherever they reside, is wrong, misguided, and highly discriminatory. It is unique in the world, and it breaks the fundamental tenet of taxation that a government's taxing authority rests on the services provided. A person residing in Ohio pays Ohio state taxes; he does not file or pay California or Texas taxes as well. An American residing in a foreign country pays taxes in the country of residence and receives in return government services from that country — roads, education, medical plans, social security programs, police forces, etc. Under CBT, the American abroad must also file U.S. taxes and pay the marginal income tax to the IRS if U.S. income taxes exceed those paid in the country of residence.

U.S. taxation based on CBT is not justified by the U.S. services rendered. All consular services are paid for through specific fees. The cost of repatriation from danger zones is invoiced to the citizen. U.S. expenditures for defense concern the interests and security of the country and the free world, not citizens residing abroad. Further, some U.S. governmental programs are designed to exclusively support the U.S. economy and U.S. residents; they specifically exclude benefits to Americans residing overseas.

[1]Video of a debate between Kirsch and Schneider can be found at http://acaglobalfoundation.org/.

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Defenders of CBT argue that all Americans should be taxed the same way and refer to "the citizen's membership in a national community" as justification. That highly theoretical view distorts reality.

First, because of their tax obligations to foreign governments, Americans abroad are not taxed the same way U.S. residents are taxed. In fact, many with incomes identical to U.S. residents pay higher foreign taxes than U.S. residents pay the IRS, but they can still owe U.S. tax.

Second, citizenship is a basic legal right not connected to taxation. It is a fundamental human right acquired by birth, through parents' nationality or naturalization, recognized by the United States and the United Nations' Universal Declaration of Human Rights. That right includes the freedom for an individual to leave one's country of origin, to live elsewhere, and to return to the country of origin. CBT restricts that freedom.

Defenders of CBT say that it is justified because citizenship provides the opportunity for Americans abroad to return to the United States at any time. But all other countries freely accept the return of their citizens from abroad — and many encourage it — yet they do not tax their citizens who reside abroad. The United States is the odd man out with this attitude.

For most of its history, the United States was almost exclusively an immigrant country. The origin of CBT was to penalize a few very wealthy individuals who left the country during the Civil War and were considered draft dodgers. The prejudice against Americans abroad has existed ever since. CBT was automatically included in the 1913 introduction of federal income taxes. Few Americans resided abroad then.

Today, with the globalization of the economy, low-cost transportation and communications, increasing mobility of individuals, the general acceptance in most countries of dual nationality, and the need for the United States to reinforce its international competitiveness, CBT has become even more of an anachronism. Immigration of highly qualified people into the United States is important to the United States for maintaining its technological edge, yet the severely critical press abroad regarding CBT and the related Foreign Account Tax Compliance Act legislation is such that academicians have highlighted the potential negative effect on future immigration into the United States.[2]

American politicians discount the recent escalation of U.S. citizenship renunciations as either quantitatively insignificant or morally misguided, a confirmation of their belief that Americans abroad lack patriotism. They are wrong on both counts. The statistics provided by the IRS, which showed renunciations exceeding 3,400 in 2014, are just the tip of the iceberg. They most likely understate the number of renunciations. An accurate image would come directly from the State Department, which executes and records citizenship renunciations with no time delay and no slippage through the cracks. But the State Department refuses to provide the data because Congress has not required it to do so. A couple years ago, when the official IRS number of renunciations was around 1,700 worldwide, the U.S. ambassador in Switzerland announced publicly that in Switzerland alone there were 900 renunciations that year. It is difficult to put much faith in the IRS listing, particularly when many names of individuals who have renounced do not appear. As for patriotism, it is not a lack of patriotism but rather self-preservation that is driving individuals to renounce their U.S. citizenship. Most do so with heavy hearts.

For every American who renounces U.S. citizenship, there are 1,000 Americans abroad who are highly upset by the current situation, which creates major difficulties for a normal life and severely restricts personal freedom and the ability to save for retirement. For many, the issue is no longer *if* they will renounce but *when* — particularly following the State Department's 422 percent hike in the fee for renunciation in September 2014, jumping from $450 to $2,350. Expensive for a 10-minute interview with a consular official! This high fee is designed to discourage renunciation. It is disproportionate to other consular services fees and the administration involved. It is literally a heavy tax on those with moderate incomes who need to renounce because they can neither afford the compliance costs nor live with the restrictions imposed by CBT and FATCA.

B. A Pattern of Legal Penalization

The hike in the renunciation fee followed a long series of legislative events that have led Americans abroad to feel increasingly discriminated against by congressional decisions. I mention here but a few of the recent changes, all working against the community of Americans abroad.

In 1994 Congress increased penalties for nonfiling of the foreign bank account report to levels that can be classified as extortion and that raise questions about their constitutionality under the Eighth Amendment, which prohibits excessive fines.[3]

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[2]Ruth Mason, "Citizenship Taxation," 89 *S. Cal. L. Rev.* ___ (coming 2015).

[3]*See* Robert W. Wood, "IRS Penalties Can Feel Cruel, But Are They Ever Unconstitutional?" *Forbes* (June 10, 2014).

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Then in 1996, the Reed Amendment authorized the U.S. attorney general to prohibit the entry into the United States of some former citizens.[4] That provision would be reinforced if future legislation includes the 2013 Reed-Schumer proposed amendment automatically disallowing some former Americans to return to the United States.[5]

With the Patriot Act of 2001, anything foreign became suspect.[6] "Know-your-client" requirements imposed on U.S. banks led them to close accounts of, or to refuse to open accounts for, Americans with a foreign address. It has proven impossible in recent years to reverse this blatant discrimination by U.S. financial institutions against U.S. citizens.

The Tax Increase Prevention and Reconciliation Act of 2005, enacted in May 2006, increased taxes on Americans abroad as a revenue-generating measure by weakening the foreign income exclusion under section 911 and effectively pushing Americans abroad into higher tax rate categories.

The IRS in 2009 initiated its highly contested and criticized overseas voluntary disclosure programs, which require costly, burdensome administration and lead to confiscatory, disproportionate penalties for benign cases of Americans residing overseas.[7]

For many overseas Americans, FATCA is the straw that broke the camel's back. Adopted by Congress in 2010, it has severely restricted overseas Americans' access to banking facilities where they reside, which is essential for daily life. Foreign financial institutions perceive American clients as toxic and regularly refuse to open accounts, grant mortgages, or provide other forms of credit or banking services. FATCA reporting procedures subject ordinary Americans to the same scrutiny as criminal tax evaders and money launderers. It requires Americans abroad to report all foreign financial assets on Form 8938, attached to Form 1040, even though they must also report financial assets on the FBAR (Financial Crimes Enforcement Network Form 114) to Treasury. FATCA penalties for nonfiling or erroneous filing are cumulative with FBAR penalties. FATCA reporting requirements expose Americans abroad to dangerous identity theft risks, since all personal information — including name, address, income, bank account numbers and balances, and bank names and addresses — are included in one set of computer files.

Provisions of the Affordable Care Act include the most obvious example of legislated double taxation discriminating against Americans residing abroad. The new net investment income tax of 3.8 percent became effective January 1, 2013, as a revenue raiser under the ACA. Foreign tax credits cannot be applied against it. Yet, the NII tax finances U.S. healthcare programs that are unavailable to Americans residing abroad.[8]

Americans abroad wondered what was coming next to punish them. Now they know. Embedded in the Senate version of the 2015 Highway Trust Fund extension bill was a revenue-raising provision to allow the government to revoke or withhold passports of filers with more than $50,000 of unpaid taxes (indexed to inflation) or to limit travel with a new or previously issued passport to return travel to the United States.[9] Imagine living overseas without your passport! Imagine domestic residents being deprived of their driving license for failure to timely pay taxes due!

Americans abroad have good reason to be upset with Congress and the IRS. Congress has labeled them as tax cheats, and U.S. legislation has turned them into second-class citizens. The IRS has been on a witch hunt using threatening communications to locate and penalize individuals abroad who may not be in full compliance, yet before this campaign many Americans abroad were not even aware of U.S. tax filing obligations because the IRS had no educational outreach to the community abroad. Even some return preparers were unaware of the

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[4]The Reed Amendment was part of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996. It states: "Any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States is inadmissible."

[5]*See* Sen. Jack Reed, D-R.I., release, "Reed Offers Amendment to Prevent Ex-Citizen Tax Dodgers From Reentering the U.S." (June 12, 2013).

[6]*See* Rosemary Jenks, "The USA PATRIOT Act of 2001: A Summary of the Anti-Terrorism Law's Immigration-Related Provisions," Center for Immigration Studies (Dec. 2001).

[7]The national taxpayer advocate initiated specific coverage of international tax filing issues in her report on 2010 activities. In subsequent annual reports, she was highly critical of the IRS administration of the overseas voluntary disclosure program, its "bait and switch" policies, and its excessive penalties and rigid one-solution approach, which severely penalized Americans abroad entering into compliance. *See* Office of the Taxpayer Advocate, "2011 Report to Congress," vol. 1, at 129 (Dec. 31, 2011); and Office of the Taxpayer Advocate, "2012 Report to Congress: Executive Summary," at 12 (Dec. 31, 2012).

[8]*See* IRS, "Questions and Answers on the Net Investment Income Tax" (Feb. 7, 2014).

[9]S. Amdt. No. 2266 to H.R. 22 (proposing to add new section 7345, "Revocation or Denial of Passport in Case of Certain Tax Delinquencies"). For an explanation of the proposal's serious impact on Americans overseas, see American Citizens Abroad, "Position Paper on Passport Revocation" (Nov. 13, 2014). The provision does not appear in the final version of the bill, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41); however, the same proposal has been part of earlier highway legislation and may well be introduced again. *See id.* at 3.

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FBAR reporting requirement, which was not enforced for more than 35 years. Today, despite press articles on the IRS campaign, some Americans abroad are still unaware of their tax filing obligations.

It is absurd that U.S. law is forcing U.S. citizens abroad to renounce their citizenships. Can you think of another member of the OECD with such a record?

C. Legal Discrimination Associated Under CBT

The Senate Finance Committee's subcommittee on international tax issues received multiple submissions from Americans abroad listing issues they face.[10] Below is a summary of the key issues, which highlight the systematic legislative discrimination against Americans abroad. It is the cumulus of these factors that lead to an unbearable situation. Americans abroad run into a concrete wall in five areas.

1. Tax compliance is excessively burdensome with the need to file and pay taxes in two countries. The high cost of compliance relates to the complexity of U.S. international forms and the consequent need to consult professional return preparers. The requirement for entrepreneurs to file all the documents for controlled foreign corporations (originally intended for large multinational corporations) forces them to maintain accounts in two currencies under different accounting standards, which is particularly onerous in time and cost. The excessive penalties linked to errors in specific forms required of Americans abroad — the FBAR, Form 8938, Form 5471, Form 3520, Form 8865, etc. — are much higher than penalties associated with the usual forms filed by U.S. residents.

2. CBT leads to double taxation. FTCs (section 901) and the foreign earned income exclusion (section 911) alleviate but do not eliminate double taxation. For example, the VAT and wealth taxes are not creditable against U.S. tax. Inevitable incompatibilities between U.S. and foreign tax programs lead to double taxation. The U.S. dollar is required as the functional currency for U.S. tax filing, which leads to taxation on phantom capital gains and obliges Americans abroad to assume foreign exchange risk — particularly dangerous for those who purchase a home abroad. The 3.8 percent NII tax specifically disallows the application of FTCs. Entrepreneurs living and working in countries that do not have totalization agreements with the United States are required to pay into both the U.S. and local country social security programs, which creates a significant competitive disadvantage. The U.S. taxes foreign invalidity payments received by a handicapped American citizen abroad from the government of the country of residence. While this may not technically be double taxation if the foreign government does not tax those support systems, it is morally unacceptable that the U.S. claim tax.

3. CBT restricts the ability of Americans abroad to save for retirement. The United States does not recognize foreign pension funds on the same terms as U.S. pension funds. Contributions to foreign pensions by employers and employees are subject to U.S taxation. Further, foreign pension funds are taxed and penalized as passive foreign investment companies. If an American has had a career split between the United States and overseas, U.S. Social Security payments are significantly reduced under the windfall elimination provision (WEP) because foreign social security is received even though the latter is proportional to contributions and in no way represents a full pension comparable to state employee pensions in the United States subject to WEP.

4. Americans abroad face enormous difficulty in accessing normal financial services either in the United States or abroad. U.S. banks refuse to accept Americans with foreign addresses as clients, particularly for investment accounts, because of the Patriot Act. U.S. mutual funds also refuse to accept Americans abroad as clients. Overseas, Americans face widespread difficulty to merely maintain current accounts with FFIs because of FATCA legislation. Americans are being pushed off joint bank accounts with foreign spouses. Mortgages are being canceled. As a result of the high compliance costs for banks under the FATCA rules, access to investment accounts with FFIs (local for Americans abroad) is limited to the few well-off individuals whose financial assets exceed $1 million. Those accounts carry high bank charges because of compliance costs and perceived legal risks for the foreign banks. Americans abroad cannot invest efficiently in foreign mutual funds or local exchange-traded funds because they are subject to PFIC reporting rules, which lead to a negative return. And Americans are legally prohibited from investing in many foreign-currency-denominated bonds.

5. Employment and professional activities are severely restricted by U.S. law. American entrepreneurs cannot enter into business arrangements with foreigners because of FATCA's 10 percent reporting rule. Foreign investors want no involvement with reporting to the IRS. The FBAR requirement that Americans must report on foreign financial accounts over which they have no financial interest but only signature authority shuts them out of

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[10] I particularly recommend American Citizens Abroad, "Residence-Based Taxation: A Necessary and Urgent Tax Reform" (Apr. 2015); and Schneider, "The End of Taxation Without End: A New Tax Regime for U.S. Expatriates," 32 *Va. Tax Rev.* 1 (2012).

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positions of financial responsibility with foreign corporations and charitable or voluntary associations that do not want their accounts reported to the United States. That reporting can even be illegal under the laws of the country of residence.

D. CBT Is an Inefficient Way to Tax

The total amount of tax collected under CBT is not divulged to the public. IRS statistics show that $5 billion in taxes were collected from Americans filing Form 2555, the foreign earned income exclusion form, in 2011. Those who file exclusively using FTCs (Form 1116) probably pay little in taxes, because the most Americans abroad reside in OECD countries with higher tax rates. The fact is that more than 80 percent of Americans abroad do not owe U.S. tax once they have applied Form 2555, Form 1116, or both; yet, the cost of filing for the individual can easily exceed $2,000 for a relatively uncomplicated return even when no U.S. taxes are due. It can be many times a multiple of that figure in more complicated cases. This high price of compliance is a real burden for many Americans abroad. Not only is it expensive, but it costs a great deal of time and worry concerning legal compliance risks and exposure to exaggerated penalties.

IRS costs linked to administering reports from abroad and the introduction of FATCA are no doubt substantial. The international tax forms, instructions, and regulations are among the most complex in the U.S. tax code. CBT is at best the equivalent of a minimal source of revenue for the U.S. government (less than 0.2 percent) and at worst a money loser. Only a study of all revenue and costs involved would reveal the answer.

In summary, the cumulative effect of all these burdens explains why long-term overseas residents, who represent more than two-thirds of Americans abroad, are increasingly asking themselves if it is worthwhile to maintain U.S. citizenship — particularly because they are also highly restricted in options for saving and investing, developing relationships with foreign partners, and maintaining bank accounts in the country where they reside.

E. RBT Is an Efficient and Fair Solution

Congress should introduce RBT in the upcoming comprehensive tax reform. Finance Committee Chair Orrin G. Hatch, R-Utah, in his December 2014 report, has already stated: "The United States needs to rethink its taxing rules for non-resident U.S. citizens."[11]

Under RBT, the United States would tax Americans residing abroad on the same basis it now taxes foreigners with U.S.-based assets or U.S.-connected incomes — that is, mostly by withholdings at the source. A detailed proposal for RBT has been sketched out by American Citizens Abroad.[12]

Having analyzed the statistics available to the public, I believe that the revenue generated through automatic withholding on U.S.-source income under RBT and other tax measures comparable to those applicable to nonresident aliens would be in the same ballpark as, and possibly higher than, the revenue collected today under CBT net of the IRS's costs. Tax revenue collection costs under RBT would be a fraction of those under CBT.

It has been stated by Senate Finance Committee members that the introduction of RBT would include a form of exit tax based on unrealized capital gains, modeled more or less on section 877A.[13] I urge you to *exclude* the concept of an exit tax, which could very well defeat the purpose of RBT, make it more restrictive for Americans to leave and reenter the country freely, and be of doubtful constitutionality because it would not be based on realized income. Further, the United States has already given up the right under CBT to tax most capital gains of Americans abroad because almost all countries have capital gains tax rates higher than those in the United States.

Congress fears that RBT would encourage wealthy Americans to move overseas. This fear is overblown because U.S. tax rates in general are lower than those in most other countries. The United States is competitive on the front of personal income taxes. This fear could be alleviated by simple corrective measures, such as a three-year delay in accessing RBT for individuals with assets exceeding a specified threshold. Even if some wealthy individuals do move abroad for personal reasons, it is likely that the bulks of their fortunes reside in the United States and that they would continue to pay U.S. taxes — either withholding taxes on passive U.S.-source income or income taxes for effectively connected U.S. income such as from partnerships. Any law designed to fiscally prevent a few wealthy individuals from moving abroad inevitably affects the free movement of all Americans and contravenes the fundamental right of individuals to live wherever they choose. It should not be

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[11]Senate Finance Committee Republican staff, "Comprehensive Tax Reform for 2015 and Beyond," at 283 (Dec. 2014).

[12]American Citizens Abroad, "Residence-Based Taxation," *supra* note 10.

[13]Section 877A, applicable since June 17, 2008, introduced an exit tax based on unrealized capital gains of covered individuals renouncing U.S. citizenship. The term "covered" is defined as individuals whose assets or income exceed defined thresholds. For details, see IRS, "Expatriation Tax," *available at* http://www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax.

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forgotten that when the Soviet Union imposed taxes on emigrants, supposedly to pay for the education received, the United States was up in arms and passed the Jackson-Vanik amendment to the Trade Act of 1974.

Switching to RBT would automatically and instantly eliminate several of the problems listed above. Under RBT, Americans, as bona fide overseas residents, would no longer qualify as U.S. persons under the U.S. tax code, would no longer file FBAR or forms 1040, 8938, 5471, 3520, etc., would be exempt from FATCA reporting by foreign banks, and would be free to select investments of their choosing without restrictions of U.S. law or SEC regulations.

Introducing RBT would have a major positive effect on the community of Americans overseas. It would restore the cohesiveness of Americans abroad with the United States. The current law is perceived as greedy, highly unfair, inefficient, overly complicated, and punitive. Americans abroad are sensitive to the fact that the American Revolution was initiated by the mother country on the other side of the ocean imposing taxes on the colonies for the benefit of the mother country. CBT is no different. It saddens me greatly to have observed firsthand over my 50 years abroad the significant change in attitudes of Americans abroad — from pride in representing their country to cynicism and a feeling of being victimized by misconceived laws that are increasingly restrictive and penalizing.[14]

RBT would immediately reverse that attitude. It would stop the rush to renounce U.S. citizenship. It would eliminate a barrier to Americans working abroad to gain international experience. It would allow U.S. companies to put Americans abroad on a competitive basis with foreign nationals. It would strengthen the competitiveness of the United States. It would improve the attractiveness of the United States for potential future immigrants. And it would demonstrate that the United States believes in personal freedom.

[14] *See* Amanda Klekowski von Koppenfels, ''Americans Abroad: A Disillusioned Diaspora?'' Migration Policy Institute (July 29, 2015).

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