Bernard Schneider

April 15, 2015

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Tax Reform—Individuals Income Tax and International Tax

Dear Sirs,

In response to the request for comments on the U.S. tax reform, I am writing on the subject of citizenship based taxation and the tax treatment of U.S. expatriates.

Personal Background and Basis for Contribution

I am a tax lawyer with a J.D., an LL.M. in Taxation and a Ph.D. in Law. I practiced for more than 10 years in the areas of U.S. and international taxation, initially in New York and most recently in the United Kingdom. I am now Lecturer in International Tax Law at the Queen Mary University of London School of Law. I have researched, written and lectured extensively on the taxation of U.S. expatriates, and an article of mine on the subject, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 Virginia Tax Review 1 (2012), was cited by the Committee on Finance in its International Competitiveness Option Paper of May 9, 2013. For your convenience, I have included a copy of the article with this submission; it is also available for download at http://ssrn.com/abstract=2186076.

The Current Situation

The United States is the only major country to tax its citizens and foreigners admitted as permanent residents (lawful permanent residents or "LPRs") (collectively, "U.S. persons") on their worldwide income, regardless of their residence.

Current Tax Treatment

Generally speaking, U.S. persons abroad (or "U.S. expatriates") are treated like U.S. residents and taxed on their worldwide income. There are various ramifications of this largely "residence blind" approach, some of which operate to the benefit of the taxpayer. For example, the mortgage interest deduction is available to U.S. expatriates on the same basis as it is to resident taxpayers. There are some exceptions however; for example, foreign property is not treated as "like property" of U.S. property for the purposes of the like kind exchange rules.

In many cases a general provision has particular consequences for U.S. persons abroad. For example, the charitable deduction is generally only available for contributions to U.S. charities.

Similarly, a U.S. person married to a noncitizen, nonresident spouse normally files as "married filing separately," which generally subjects him or her to greater tax liability than would be the case if he or she were able to file as a single taxpayer.

Indeed, many of the tax problems U.S. expatriates face are caused by general provisions that are aggravated by foreign residence. The most important of these are the following:

1) U.S. persons are required to calculate all items of income, gain and loss in U.S. dollars, regardless of the currency in which the income, gain or loss was actually realized. This is not problematic where foreign currency transactions are only occasional, but it is onerous when the foreign currency in question is in fact the individual's functional currency. U.S. persons abroad are also subject to phantom gains because fluctuations in the value of the U.S. dollar relative to their functional currency can give rise to income or gain or a decrease in loss that does not reflect a real change in economic circumstances. A decline in the value of the U.S. dollar also affects the value in real terms of tax credit and exclusion amounts.

2) Generally speaking, in the absence of a tax treaty, foreign retirement plans are not recognized by the United States as tax exempt retirement vehicles, with the result that local tax favored retirement plans, including employer plans, are not beneficial to U.S. persons abroad because any local tax benefit is offset by the tax cost in the United States.

3) The Passive Foreign Investment Company ("PFIC") rules impose a harsh default tax regime on foreign corporations used as investment vehicles, in order to prevent their use to defer U.S. taxes. Unfortunately for U.S. expatriates, most foreign mutual funds and other investment vehicles are PFICs. Because such funds generally do not provide individual investors with the information required to treat the fund as a qualified electing fund, if the fund is not traded on a qualified exchange, the operation of the PFIC rules means that the fund will not be a viable investment option for U.S. persons. U.S. expatriates are thus effectively excluded from using many local investment vehicles by the operation of the PFIC regime.

Two regimes are designed to ameliorate the double taxation of U.S. expatriates. The first is the foreign tax credit ("FTC") regime that applies to all U.S. taxpayers. Complicated sourcing, timing, and limitation rules apply in calculating the credit available. From the point of view of the U.S. expatriate, the FTC has two major limitations. First, the FTC is limited to foreign income taxes; it does not apply to wealth taxes and consumption taxes such as the value added tax that constitute a major portion of some U.S. expatriates' tax burden. Second, the FTC provides no credit for foreign taxes that exceed the U.S. level of taxation on that income.

The second regime that is designed to ameliorate double taxation is the joint operation of the foreign earned income exclusion or deduction and the foreign housing exclusion or deduction (collectively, the "FEIE"). If a U.S. expatriate satisfies the bona fide residence or the physical presence test, he or she can exclude, or in some cases may choose to deduct, certain amounts of foreign earned income and housing costs. The amounts are limited, and the FEIE regime operates as exemptions with progression.

The net effect of the joint operation of the FTC and the FEIE is the effective total exemption of foreign earned income, except for U.S. taxpayers in low tax jurisdictions whose earned income exceeds the FEIE maximum. Because the FEIE only applies to earned income, the United States taxes the difference between the foreign tax paid and the U.S. tax liability on any foreign investment income. In addition, the application of the FTC and FEIE adds considerable complexity to the return.

The FTC and FEIE are cited for the notion that U.S. persons abroad are taxed no worse, and perhaps even more favorably, than U.S. residents. But the argument is backwards. It is the imposition of worldwide taxation on U.S. expatriates that requires the FTC regime, at least with respect to expatriates; the FTC cannot and does not justify worldwide taxation. Similarly, it is worldwide taxation that necessitates the FEIE. Furthermore, if the worldwide taxation of U.S. expatriates is justified, it is hard to justify the FEIE. The FTC would not be required for U.S. expatriates and the FEIE could be completely eliminated if worldwide taxation was not imposed on U.S. expatriates. If worldwide taxation does not stand up to scrutiny, it should be eliminated, not ameliorated by the FTC and FEIE.

The complexity of U.S. taxation of expatriates and the interaction between U.S. and local tax regime means that tax filing for U.S. persons abroad is generally more complicated and expensive than it is for resident taxpayers. This is true even if, as is often the case, there is no U.S. tax liability due to the operation of the FTC and FEIE. In fact, in many cases the cost of preparing the U.S. tax returns far exceeds any actual U.S. tax liability. Furthermore, relatively few tax professionals are able to deal with the U.S. international tax regime and its interaction with local tax law, with the result than taxpayers often receive poor or incorrect advice.

Reporting Requirements

Two additional reporting regimes deserve special mention. The Foreign Bank and Financial Account reporting regime (the "FBAR" regime) requires annual reporting of financial interests in and signatory authority over foreign financial accounts that exceed $10,000 in the aggregate. This threshold is very low and has not been adjusted since the FBAR regime was put in place by the Bank Secrecy Act of 1970. The numbers reported are not economically meaningful because the FBAR regime requires reporting highest account values, not averages, such that the temporary presence of funds in an account are disproportionately valued, and transfers between accounts of the same person are double counted. In addition, the applicable exchange rate is the U.S. Treasury rate at the end of the year, not an average of exchange rates over the year. Because the FBAR regime requires the reporting of financial account information if a U.S. person has signatory authority over the account, many foreign entities are unwilling to put U.S. persons in positions that involve signature authority over entity accounts. Finally, the FBAR regime imposes potentially draconian penalties even for non-willful violations, penalties that are calculated in terms of highest account value, not unpaid taxes, if any.

The Foreign Account Tax Compliance Act ("FATCA") regime is an unprecedented use of withholding to force disclosure of information. It is highly problematic due to its complexity, heavy-handedness, extraterritoriality and externalizing of the cost of and responsibility for enforcing U.S. tax law to foreign financial institutions and governments. It has particularly serious consequences for U.S. expatriates. Many non-U.S. financial institutions have decided not to deal with U.S. persons, including those living in the same jurisdiction.

Both the FBAR and FATCA regimes were designed to cover U.S. domestic taxpayers and have been applied unthinkingly to U.S. expatriates. They treat foreign bank and investment accounts as inherently suspect, even though they are absolutely necessary for U.S. persons abroad. Furthermore, they do not distinguish between foreign jurisdictions, even though from the point of view of the U.S. person abroad, the country in which he or she lives is not "foreign."

U.S. expatriates live abroad for a variety of perfectly legitimate personal and professional reasons and should not be presumed to be tax evaders. The rhetoric surrounding FATCA has been particularly unfortunate. Although there is indeed a problem of tax evasion by U.S. persons, it is almost exclusively committed by U.S. residents—the overwhelming majority of U.S. persons abroad are not trying to evade taxes and in fact live, and pay taxes, in jurisdictions with tax rates as high as or higher than those of the United States.

Numbers and Types of U.S. Persons Abroad Affected by U.S. Worldwide Taxation

There are no definitive statistics on the number of U.S. persons abroad who are subject to U.S. taxation on their worldwide income. A series of reports have estimated that there are six to seven million U.S. citizens living outside the United States. It is important to note that several distinct groups are lumped together under the category of U.S. expatriate. This general category includes short-term and long-term expatriates; it also includes U.S. government employees and military personnel and private persons, some of whom are affiliated with or employed by U.S. organizations. These different types of individuals typically have very different relationships to the United States. It is not known for certain how many U.S. expatriates fall into each of these subcategories, but probably more than half of all U.S. expatriates do not have a U.S. government or corporate connection, and such individuals are more likely to be longer-term expatriates. It is reasonable to expect that this type of U.S. expatriates will increase as a proportion of the total U.S. expatriate population, as the total number of U.S. expatriates increases while the number of U.S. government affiliated expatriates remains relatively static.

The other important issue is where U.S. expatriates are located. Again, there are no definitive numbers, but the majority of U.S. persons abroad live in Canada, Mexico, Western European countries and other jurisdictions with tax rates and overall tax burdens that are as high as or higher than those of the United States. Thus, whatever their motivations may be for living abroad, in most cases it is not tax mitigation.

The estimates of U.S. citizens abroad do not include the unknown number of individuals abroad who are technically U.S. citizens under U.S. nationality law but who have little or no connection to the United States and may not even be aware that they are U.S. citizens. This typically arises due to one of two sets of circumstances. The first is where an individual acquires U.S. citizenship at birth under the *jus soli* principle ("birthright citizenship") but leaves the United States as a young child and has little or no further contact with the United States. The second is where an individual, one or both of whose parents is a U.S. citizen, automatically acquires U.S. citizenship by descent but grows up outside the United States. Such an individual may not even be registered as a U.S. citizen, with the result that both the United States and the individual are unaware of the individual's citizenship status. These individuals can be considered accidental citizens, and in many cases they are also unaware citizens ("accidental and unaware citizens"). Finally, the category of unaware citizens can be said to include individuals who believed that they had lost their U.S. citizenship under prior law only to discover subsequently that the United States still, or again, considers them to be U.S. citizens.

In addition, there are an unknown and untracked number of LPRs abroad who are still considered U.S. tax residents even though in many cases they have lost the right under the immigration laws to live in the United States.

Finally, it is worth noting that the noncitizen spouses and children of U.S. citizens are directly affected by the operation of the U.S. tax system.

Analysis of the Current Situation

Justification for taxation

Most scholars consider the primary basis for taxation, particularly for worldwide taxation, to be the benefits obtained from the jurisdiction asserting taxation. However, the overwhelming majority of U.S. expatriates receive few if any benefits from the United States while abroad; most of the benefits of U.S. citizenship are coterminous with residence and therefore end the moment U.S. person moves abroad. For long-term citizen expatriates and accidental and unaware citizens, the right to move to or visit the United States without restriction is probably the only substantial benefit of their citizenship status. It is difficult to justify worldwide taxation of nonresident U.S. citizens on this basis, not least because this is no more than the equivalent right enjoyed by expatriates of other countries. Needless to say, this benefit does not apply to long-term expatriate LPRs, who in most cases have lost their right to live in the United States under the immigration laws.

Taxation can also be justified if it is based on sufficient economic contacts with the taxing jurisdiction. However, the United States has an open economy, and the U.S. activities of U.S. persons abroad generally could be conducted on the same basis if they were not U.S. persons. Furthermore, at least in the case of long-term expatriates and accidental and unaware citizens, there generally is limited economic contact in any case.

There is therefore little benefits or economic nexus justification for the taxation of U.S. expatriates on a worldwide basis.

The horizontal equity argument in favor of taxing U.S. persons abroad in substantially the same manner as U.S. residents also does not stand up to scrutiny. The argument requires that the former be comparable to the latter. This is usually assumed uncritically, but in fact the benefits argument suggests that this is not the case.

U.S. expatriates, and in particular long-term expatriates not affiliated with the U.S. government and accidental and unaware citizens, should be compared not to U.S. residents but to nonresident aliens. But for their citizenship or immigration status, they would be treated like nonresident aliens, i.e. generally taxed at a flat rate of thirty percent on U.S. source income that is not effectively connected with a U.S. trade or business and at the regular graduated rates on income that is effectively connected with a U.S. trade or business, including income from personal services and gain from the sale of real property interests in the United States. Most capital gains would not be taxable unless they are fixed or determinable annual periodic income or effectively connected with a U.S. trade or business. Needless to say, the foreign source income of nonresident aliens is not taxed by the United States. In most cases expatriates could engage in the same economic activities in the United States as nonresident aliens without paying the higher taxes for which residents are liable. The difference between the taxes imposed on nonresident aliens and those imposed on U.S. expatriates constitutes part of the "citizenship penalty" paid by U.S. citizens abroad.

Compliance, Enforcement, the Cost of Enforcement and the Tax Gap

There is a high degree of noncompliance by nonresident U.S. persons with their U.S. tax obligations. Although the number of foreign returns is unknown because the Internal Revenue Service (the "IRS") does not track this information, probably only about a third of known U.S. expatriate citizens file returns. Estimates of the total number of foreign returns suggest that the majority of those who do file have an affiliation with the U.S. government or a U.S. employer.

This low degree of compliance can be attributed to two factors. First, at least until recently, many expatriates were genuinely unaware of their U.S. tax obligations, and of course accidental and unaware citizens by definition generally do not worry about U.S. tax laws. Second, there appears to be a great deal of deliberate noncompliance, in many cases because the individuals in question consider that their taxation by the United States is fundamentally unfair.

It is very difficult to enforce the worldwide taxation of expatriates. Except where income is reported to the IRS by a U.S. employer, foreign wage income information generally is not available to the IRS. Currently, information regarding investment and other income is sometimes provided by foreign governments, but not necessarily in a form that is useful to the IRS. This means that the IRS must rely on self-reporting by the U.S. persons themselves. Thus, for nonresidents, particularly those with little connection to the United States, U.S. tax compliance is largely voluntary. Investigating the tax affairs of most expatriate tax filers would be a time consuming and expensive process. Investigating nonfilers, most of whom are unknown to the IRS, would be extremely difficult.

The argument has been made that FATCA and increased information exchange will make it easier to enforce worldwide taxation. Although FATCA, and the threat of FATCA, have certainly led to greater information reporting and compliance, serious structural noncompliance and enforcement difficulties remain. The cost of enforcing worldwide taxation against all known U.S. persons abroad would be very high.

This is relevant particularly as there is likely to be relatively little increase in revenue from the full enforcement of worldwide taxation of U.S. expatriates. Given the problems with calculating the number of U.S. persons abroad and the lack of knowledge about the locations and average incomes per country of U.S. persons abroad, it is impossible to estimate the international individual income tax gap with any degree of reliability. Nonetheless, the IRS has estimated that four-fifths of U.S. taxpayers abroad owe no taxes due to the operation of the FTC and FEIE. It is thus likely that the international individual income tax gap is small.

Devaluation of U.S. Citizenship

Expatriates are being driven to renounce their U.S. citizenship. According to the quarterly reports published in the Federal Register pursuant to Section 6039G of the Internal Revenue Code (the "Code"), only about 18,500 individuals have renounced their U.S. citizenship or relinquished their LPR status since those reports began to be published This number is almost certainly an undercount. Records issued by the Federal Bureau of Investigation in connection with the National Instant Criminal Background Check System, reports by foreign governments and published comments by expatriates suggest that the actual numbers are considerably higher. In addition, the reports are replete with errors that undermine their credibility.

Anecdotal evidence strongly suggests that many U.S. citizens abroad are "hiding" their U.S. citizenship by acquiring and exercising another citizenship, by not registering their children as U.S. citizens and by taking other steps to limit their interactions with the United States.

Even more important than the number of individuals renouncing U.S. citizenship or even the number choosing not to exercise their U.S. citizenship is the symbolic nature of these actions. U.S. citizenship was and still is a highly sought after prize for many individuals; the numbers of immigrants to and people who naturalize in the United States is clear evidence of this. But ironically and unfortunately, even tragically, U.S. citizenship has become a burden for those abroad for any length of time. U.S. citizens abroad are being forced, by the U.S. tax and financial regulatory regimes outlined above, to consider whether they can afford to continue to be U.S. citizens and whether they want their children to be U.S. citizens. This is unprecedented in U.S. history and should deeply trouble anyone concerned with the value and meaning of U.S. citizenship.

Proposed Regime

Worldwide taxation of U.S. persons abroad is difficult to justify, has largely failed and would likely raise relatively little additional revenue even if it could be enforced properly. It is therefore time to adopt a new approach.

The United States should adopt residence based taxation for individuals. Specifically, the Code should be amended to provide that worldwide taxation is imposed on the basis of residence in the United States, not citizenship. While nonresident, U.S. persons would be treated like nonresident aliens. They would cease to file returns on foreign source income, and their U.S. source income would be subject to withholding at source. The statutory thirty percent withholding rate would apply, regardless of any otherwise applicable treaty rate, but U.S. persons abroad would be allowed to elect to file U.S. returns and pay tax at the regular graduated rates. Tax and financial reporting requirements otherwise applicable to U.S. taxpayers, including those related to the FBAR and FATCA regimes, would not apply. U.S. government employees and military personnel abroad would not be treated as having lost their U.S. residence.

In addition, a Section 877A type departure tax for those who take up or abandon U.S. tax residence should be added to the Code as Section 877B. Under Code Section 877B, an individual would be considered to have disposed of most of his or her property at its fair market value on the day he or she departed from or arrived in the United States and then re-acquired the property for the same amount immediately thereafter. Those departing would pay tax on the deemed gain. Those arriving would receive a step up in basis so that they would not pay U.S. tax on gain that accrued before they became a U.S. resident.

Residence would be determined using either the bona fide residence rules or the substantial presence rules. For individuals departing the United States, the change in residence status would occur either in the year of departure or at a reasonable later point thereafter such as after three years abroad, and the departure tax would be triggered at that point. Both approaches can be justified, and each has its advantages. Immediate treatment of those departing as nonresident would allow for the elimination of the FEIE and FHE regimes and much complexity in the current system, and it would insure that those who intend to emigrate on a long-term or permanent basis are not subject to U.S. taxation longer than can be justified. However, it would arguably make the U.S. tax system under-inclusive by also eliminating from U.S. worldwide taxation individuals who only intend to be abroad for a limited period. Treating expatriates as nonresident only after three years of nonresidence would protect short-term expatriates from the departure tax but would be over-inclusive in continuing to tax on a worldwide basis those individuals who intended to expatriate on a long-term or permanent basis as of the date of their departure from the United States. It would also require the retention of the current regime, as both the current and proposed regimes would have to run in parallel. Finally, it would mean that departure from and entry in to the United States would be treated differently, as presumably those coming to the United States would continue to be subject to U.S. taxation on a worldwide basis beginning in the year of arrival. On balance, it seems preferable for the change in residence status to occur in the year of departure. In any case, the proposed regime should not be elective, in order to prevent egregious tax planning and because this would require the retention of the current system in addition to the proposed regime.

Having become nonresident, U.S. citizens would be deemed to be U.S. resident, and therefore taxed on a worldwide basis, for any year during which they were present in the United States for 91 days or more. This would prevent the abuse of residence based taxation by U.S. citizens who continue to spend extended periods of time in the United States after their nominal emigration.

U.S. persons already living abroad at the time of the enactment of Code Section 877B would be treated as having departed the United States on the date of their actual departure and would be treated as nonresident from the date of departure or the relevant later point, as discussed above. They would be subject to the departure tax on the value of their assets at the time they became nonresident, not the value of those assets at the point Code Section 877B came into effect. No amnesty would be extended to any U.S. persons abroad with regard to any U.S. tax liability or obligation that was incurred or should have been fulfilled prior to the coming into force of residence based taxation.

In order to minimize the anomaly of "nonresident LPRs," the definition of resident alien for the purposes of taxation would be aligned with the rules under Title 8 of the United States Code, and

LPRs would be checked every 5 years for compliance with the requirements of the immigration law for maintaining permanent residence. Those who ceased to be permanent residents would simultaneously lose their LPR status and be subject to the departure tax regime. The Code Section 877A exit tax could be limited to renunciations of citizenship, as the loss of LPR status would be covered by Code Section 877B.

Advantages of the Proposed Regime

The proposed regime would simplify U.S. tax law by eliminating the FEIE regime and ending the application of the FBAR and FATCA regimes to U.S. persons abroad.

It would eliminate the onerous tax and reporting consequences of U.S. citizenship for those outside the United States, many of whom have little connection with the United States.

It would make the U.S. tax system more equitable by correlating the payment of taxes to the United States with the receipt of benefits from residence in the United States.

It would end the embarrassing situation of U.S. citizens seeking to renounce or hide their U.S. citizenship.

It would also have beneficial neutrality and competitiveness effects. It would place U.S. expatriates in the same tax and competitive position as other expatriates and end the perverse incentive for many U.S. employers to hire foreigners abroad instead of U.S. persons abroad. By providing a step up in basis for individuals taking up residence in the United States, the departure tax regime would eliminate the existing disincentive to immigrate for many foreign individuals who might otherwise move to the United States and contribute positively to its economy and society.

The rules governing the taxation of U.S. persons abroad were designed largely without consideration of their effects on U.S. expatriates, and the principle of worldwide taxation of U.S. persons abroad was established when there were few U.S. expatriates. The latter is no longer the case, and due to globalization and increasing economic opportunity overseas, especially in Asia, the number of U.S. expatriates, and with it the number of accidental and unaware citizens, can be expected to increase. In the absence of corrective action, both the injustices and the difficulties associated with the worldwide taxation of U.S. persons abroad will increase.

I would be pleased to respond to any questions you may have.

Very truly yours,

Bernard Schneider
Enclosure