**Elimination of citizenship-based taxation**

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Citizenship-based taxation (CBT) is the imposition of taxes by a country on income not generated there, or on assets not located there, from an individual who does not live there, only because the individual is defined as a citizen of the country. The United States is the only country in the world that uses CBT (with the infamous exception of Eritrea). This document explains why CBT is not justified, and suggests how it should be eliminated from the US tax code.

**Summary:**

- The benefits of citizenship for nonresidents are minimal and do not incur any cost to the government, therefore citizenship should not be used as a criterion for taxation;
- Main implementation: replace "citizen or resident" and "nonresident alien" with "resident" and "nonresident", everywhere in the tax code;
- Definition of residence: substantial presence test with current exceptions, or left for regulations, plus election to be treated as resident;
- Exemptions for dependents, estate and gift taxes: no restriction based on residence either;
- Foreign earned income exclusion: kept, for those who elect residence;
- Exit tax: none, or based on current expatriation tax (with current exceptions, plus adjustment of thresholds for inflation, exclusion of certain types of assets, no interest, redetermination at realization of gains, and adjustment of basis at start of residence), or based on current tax after move to US territories;
- Consistency: eliminate ban on former citizens, tax on transfers from former citizens, retaliation on citizens of specific countries, "sailing permit", publication of names of former citizens, and Report of Foreign Bank and Financial Accounts (FBAR);
- These suggestions consist of erasing words and sections from current law, without adding virtually anything, thus simplifying the tax code.

## 1. Invalid justification of CBT

Three criteria may be used to define the international scope of taxation of individuals: source, residence and citizenship. Source-based or territorial taxation means that the government taxes the income generated in its territory, under the idea that individuals benefit from the infrastructure provided by the government of the area where their income is generated. Residence-based taxation means that the government taxes the income of residents of its territory, under the idea that individuals benefit from the services provided by the government of the area where they live, regardless of where their income is generated. Citizenship-based taxation (CBT) means that the government taxes the income of citizens of the country, under the idea that citizens benefit from that government, regardless of where they reside or where their income is generated.

All countries and territories that tax income use only territorial and/or residence-based taxation, with the only two exceptions being the United States and Eritrea, which also use CBT.[1] The Eritrean "diaspora tax" has been condemned by the United Nations as a form of extortion, so it is not a valid example.[2] The US government's justification for CBT is the alleged "benefits of citizenship" regardless of where the person lives.[3] As explained below, this justification is not valid either.

US citizens who live abroad do not receive any benefit from the US government other than the few benefits for which they pay directly, such as a US passport and other consular services. In fact, the Bureau of Consular Affairs is financially neutral, earning practically the same revenue from fees as its cost of operation.[4] US citizens obviously cannot benefit from the protection or infrastructure provided by the US government when they are physically abroad. US Social Security benefits are only available to those who contributed to it, and reduced for those who already receive similar benefits from another country.[5] Medicare and Medicaid do not pay for health care outside the United States.[6-7] Individuals who do not reside in the United States are not allowed to sponsor foreign relatives for US immigration, and in any case immigration procedures are paid through fees.[8] Even in the rare cases of US assistance in evacuating US citizens from a troubled country, they are normally sent a bill afterwards to pay for the cost of the evacuation.[9-10] US citizens abroad do have the unrestricted right of return, but it does not incur absolutely any cost to the government until the person actually exercises that right, in which case the person would become a US resident, taxed regardless of citizenship. Therefore, there is no benefit of citizenship abroad that requires funding from taxes.

Besides, all of the "benefits of citizenship" cited above are not actually due to citizenship, but nationality. US nationals without citizenship (people born in American Samoa) can also use a US passport and consular services, and have the unrestricted right of return, in the same way as US citizens, but they are taxed as aliens in the US tax code.[11] The only right indeed available exclusively to citizens is the right to vote in federal elections, but the 24th amendment to the US constitution prohibits the dependence of this right on taxation.

Therefore, citizenship is not a valid criterion to define taxation. It should be erased from the US tax code, leaving only taxation based on source and residence. The rest of this document suggests how to implement this idea.

## 2. CBT in the US tax code

### 2.1 Approaches to eliminate CBT

The US tax code subjects citizens and resident aliens to worldwide taxation and a large number of reporting requirements, and nonresident aliens only to taxation of US items, mostly by withholding without filing. The tax code makes this distinction by using the terms "citizen or resident" and "nonresident alien" in numerous places. To eliminate CBT, these terms should be simply replaced with "resident" and "nonresident", respectively, wherever they appear. This change should apply to the entire tax code, including income, payroll, estate and gift taxes, as well as all reporting requirements.

Due to the numerous instances of these terms throughout the entire tax code, it may be tempting to leave the code as it is and only add or modify a section dealing only with nonresident citizens. For example, the current code already allows nonresident citizens to exclude some kinds of foreign income from US taxation, up to a certain limit, by filing the appropriate forms (foreign earned income exclusion). To implement CBT, such exclusion could be allowed for any kind of foreign income, and unlimited. The problem with this apparently easy implementation is that it would still require nonresident citizens to file US tax forms every year, including various reports of foreign income and assets, when such requirement would be useless as none of these foreign items would be subject to US taxation. In addition, such approach would add unnecessary complexity to the tax code.

Another tempting implementation would be an overriding section that declares that nonresident citizens are treated as nonresident aliens for tax purposes. This approach would eliminate both taxation and filing requirements for nonresident citizens, but its overriding nature would also add unnecessary complexity to the tax code. In sum, CBT should be eliminated by not referring to nonresident citizens at all.

**2.2 Definition of residence**

For the income tax, the US tax code currently treats aliens as residents if they are permanent residents according to immigration law (green card), or if they are physically present in the United States for a significant amount of time (substantial presence test, at least 183 days in a weighted average over 3 years). There are exceptions for foreign diplomats, students, teachers and trainees, and for involuntary stays due to medical conditions. For estate and gift taxes, the code does not define residence for aliens, and regulations define it as domicile.

The elimination of CBT requires a definition of residence for all individuals. The current substantial presence test may be used, applied to citizens and aliens alike. The test could also be simplified to 183 days in one year instead of the complex weighted average. Alternatively, the tax code could leave the definition of residence to regulations.

Similar to citizenship, permanent residence according to immigration law (green card) is a permission to reside indefinitely in the United States, but it does not necessarily reflect actual residence. There are legal exceptions that allow permanent residents to remain abroad for long periods. Therefore, if CBT is eliminated, permanent resident status should also be eliminated from the definition of residence in the tax code. The substantial presence test is sufficient.

The current exceptions for some classes of aliens and for medical conditions should be maintained, as individuals in these situations are not considered residents. Likewise, US citizens or permanent residents who are abroad as US government employees or members of the US military may be considered US residents, as they are considered in other US laws. Additionally, due to the long historical use of CBT, possible ignorance of the elimination of CBT, and to accommodate rare situations where US residence for tax purposes might be beneficial while living abroad, US citizens and permanent residents abroad should be allowed to elect to be taxed as US residents, by simply filing the regular tax returns for residents.

**2.3 Exemptions for dependents, estate and gift taxes**

For credits and exemptions that depend on the citizenship or residence of individuals other than the taxpayer, such as dependents and spouse, it is easier to remove the restrictions based on citizenship or residence altogether, instead of restricting them to residents only.

For estate and gift taxes, there is currently a very large disparity between the exemptions for citizens and residents ($5.43 million in 2015, indexed for inflation) and for nonresident aliens ($60,000, fixed).

The exemption for nonresident aliens may be increased by an estate tax treaty, but the United States only has such treaties with 17 countries. The current exemption of $60,000 has remained constant since 1977, which seems to be an oversight. As CBT is eliminated, the higher exemption should be available for any individual, instead of being restricted to residents only.

In addition, there is an unlimited exemption of the estate and gift taxes for spouses, but only if the receiving spouse is a US citizen. This requirement should also be removed altogether.

### 2.4 Foreign earned income exclusion

The current tax code allows nonresident citizens to exclude their foreign "earned income" (salaries and self-employment income) from US taxation, up to an annual limit ($100,800 in 2015, indexed for inflation). As CBT is eliminated, this exclusion would become mostly irrelevant, but if nonresident citizens are allowed to elect to be taxed as US residents, the exclusion should remain available for them, so they may choose the entire current system if they wish.

### 2.5 Exit tax

The current tax code imposes an expatriation tax on unrealized gains of an individual who loses US citizenship. Aliens who lose US permanent residence after having it for 8 years are also similarly subject to the tax, but other aliens who terminate US residence are not. There are also exceptions for some nonresident citizens and minors. The purpose of this tax is to prevent significant avoidance of US tax by expatriation, on gains accumulated during the period of citizenship or residence by individuals with significant connection to the United States.

If CBT is eliminated, the expatriation tax should be eliminated as well, for simplicity. Alternatively, it could be modified and turned into an exit tax, applied to termination of US residence, but only for individuals who are already subject to the current tax (citizens and aliens with permanent residence but not other aliens, and keeping the current exceptions). However, since the current expatriation tax has an extensive potential for excessive or double taxation, several conditions are necessary to avoid these problems in a similar exit tax:

- Any net worth and tax liability thresholds should both be indexed for inflation;
- US real estate, future US pensions and US tax-deferred accounts should not be subject to the exit tax, because such items are still subject to US tax when paid to nonresidents;
- Foreign real estate and future foreign pensions should not be subject to the exit tax either, because such items are usually acquired or earned as nonresidents;
- If deferred, payment of the exit tax should not be subject to interest;
- If the individual elects, the exit tax on unrealized capital gains should be redetermined when the gains are realized, replaced with the part of the realized gains proportional to the period of residence, credited with any foreign tax paid on the same gains, and any expatriation tax previously paid in excess of the redetermined tax should be refunded to the individual;
- The basis of assets already owned by individuals who become residents should not be lower than their fair market value at the start of residence, not only for the exit tax but also for the regular capital gains tax.

Another alternative would be to apply to US residents who become nonresidents a system similar to the current rules of taxation of capital gains of US citizens or residents who move to US territories. Under the current rules, individuals who move to US territories and have unrealized capital gains are not subject to an exit tax. Instead, part of the gains, once realized, are taxed by the US. The taxable portion depends on the type of asset, the value at the time of the move, and the length of residence in the US and in the territory while the person held the asset. This option, as applied to nonresident citizens, would have the following rules:

- At the time of the move, there would be no exit tax;
- Gains of US real estate would be taxed by the US when sold, as normally done for nonresidents;
- Gains of foreign real estate would not be taxed by the US;
- For "marketable securities", part of the gain, up to the market value at the time of the move, would be taxed by the US when sold;
- For other assets, part of the gain, proportional to the amount of time for which the person held the asset as a US resident, would be taxed by the US when sold;
- In the previous two cases, the tax should be credited with a foreign tax paid on the same gains.

In either of these options, the exit tax should only apply to actual termination of residence. At the time CBT is eliminated, citizens already nonresident would stop being subject to US tax on worldwide income, but not due to their own action. The only purpose of the exit tax is to prevent tax avoidance, so applying it to individuals who have not taken any action in that sense is not justified.

The current tax code also includes a provision where US citizens or residents are taxed on the inheritance or gifts from individuals previously subject to the expatriation tax. This provision does not allow the very high exclusion available for the normal estate and gift taxes, thus it is excessive, resulting in significantly higher taxes than if expatriation had not occurred. The expatriation tax on unrealized capital gains already prevents any tax avoidance, so this additional provision is not justified. It should be fully eliminated and not replaced with a version for former residents.

### 2.6 Related provisions

As a consequence of eliminating CBT, some provisions in the tax code and in related laws should be entirely eliminated as well, for consistency:

- "Reed amendment": bans individuals who renounced US citizenship to avoid US taxation from entering the United States;
- Tax on inheritance and gifts from former citizens (described above);
- Retaliation against other countries through higher taxes on their citizens (not necessarily residents);
- "Sailing permit": requires that aliens, but not citizens, file a partial tax return before they leave the United States (even for temporary trips).

Another reason for eliminating these provisions is that none of them are actually implemented or enforced.

As part of the current expatriation tax, there is a provision that requires the publication of names of individuals who terminate US citizenship, or permanent residence after 8 years, in the Federal Register. This publication serves absolutely no purpose, and would be even more irrelevant if CBT is eliminated. Therefore, this provision should also be entirely eliminated as well.

Finally, citizenship should also be irrelevant for the Report of Foreign Bank and Financial Accounts (FBAR). This reporting requirement could also be eliminated altogether as it is redundant with another report required by the tax code.

## 3. Conclusion

The United States should abolish CBT by erasing the references to citizenship in the tax code. A few other provisions should be entirely eliminated for consistency. As a result, the tax code would also become simpler and shorter.

## 4. Relevant sections of law

The sections of law listed below refer to the Internal Revenue Code, title 26 of the United States Code, except as otherwise noted.

General uses of "citizen or resident" and "nonresident alien": 2(b)(2)(B), 2(b)(3)(A), 2(d), 5(a)(1), 5(a)(3), 22(f), 25A(g)(7), 26(b)(2)(L), 32(c)(1)(D), 32(c)(2)(B)(iii), 33, 36(d)(1), 36A(d)(1)(A)(i), 63(c)(6)(B), 79(d)(3)(B)(iv), 105(h)(3)(B)(v), 125(j)(4)(B)(iv), 153(2), 167(e)(4)(A)(ii), 168(g)(4)(G), 170(p)(5), 176, 222(d)(5), 303(a)(2), 402(e)(2), 403(b)(12)(A), 404A(e)(2)(A), 404A(g)(1)(A), 406(a), 406(a)(2), 407(a)(1), 407(a)(1)(A), 410(b)(3)(C), 414(q)(8), 483(e)(4), 505(b)(2)(E), 545(c), 565(e), 641(b), 667(e), 668(a)(4), 672(f)(1), 679(a)(4)(A), 679(a)(5)(A), 860G(b), 861(a)(3), 861(a)(3)(A), 861(a)(3)(C)(i), 861(a)(3)(C)(ii), 863(c)(2)(B), 864(b)(1), 864(b)(1)(A), 864(b)(1)(B), 864(c)(1)(A), 864(c)(1)(B), 864(c)(4)(B), 864(c)(5)(A), 864(c)(6), 865(g)(1)(A)(i)(I), 865(g)(1)(A)(i)(II), 865(g)(2), 865(g)(3), 871(a)(1), 871(a)(1)(C)(i), 871(a)(1)(C)(ii), 871(a)(2), 871(a)(3), 871(b)(1), 871(c), 871(d)(1), 871(f)(1)(A)(i), 871(f)(1)(B), 871(f)(2)(A), 871(h), 871(k)(2)(B), 871(n)(1), 871(n)(5), 871(n)(6), 871(n)(7), 872(a), 872(b), 872(b)(3), 872(b)(3)(A), 872(b)(3)(B), 872(b)(4), 872(b)(5), 873(a), 874(a), 874(b), 874(c), 875(1), 875(2), 876(a), 879(a), 879(b), 884(e)(4)(A)(i), 884(e)(4)(A)(ii), 887(a), 893(a)(1), 894(b), 897(a)(1), 897(a)(1)(A), 897(a)(2)(A), 897(g), 897(h)(1), 897(h)(4)(A)(ii), 897(h)(5)(B)(i), 897(h)(5)(B)(iii), 897(h)(5)(B)(iv), 897(j), 901(b)(1), 901(b)(2), 901(b)(3), 901(b)(4), 906(a), 906(b)(1)(A), 906(b)(3), 911(d)(1)(A), 911(d)(1)(B), 932(a)(1)(A)(i), 933(2), 934(b)(2), 936(h)(4)(B), 958(b)(1), 988(a)(3)(B)(i), 993(d)(4)(C)(ii), 996(g), 1235(e), 1291(e)(2), 1361(b)(1)(C), 1361(c)(2)(A)(i), 1361(c)(5)(B)(iii), 1361(d)(3)(B), 1402(a)(6), 1402(a)(8), 1402(b), 1402(c)(2)(C), 1411(e)(1), 1441(a), 1441(b), 1441(b)(2)(D), 1441(c)(4), 1441(c)(6), 1441(d), 1441(e), 1444, 1471(c)(2)(B)(ii), 2001(a), 2053(d)(1), 2101(a), 2103, 2104(a), 2104(c), 2105(a), 2105(c), 2105(d)(1), 2106(a), 2106(b), 2208, 2209, 2501(a)(2), 2501(b), 2501(c), 2501(d)(2), 2511(a), 2663(2), 3121(b), 3121(b)(4), 3121(f), 3121(l)(1), 3231(d), 3306(c), 3306(m), 3401(a)(5), 3401(a)(6), 3401(a)(8)(A)(i), 3401(a)(8)(A)(ii), 3401(a)(8)(B), 3401(a)(8)(C), 3401(a)(8)(D), 3401(d)(2), 3402(f)(6), 3402(l)(3)(A)(ii), 3402(q)(2), 3405(e)(1)(B)(iii), 3405(e)(13), 4372(a), 4372(e), 4404(2)(A), 4404(2)(B), 4980B(g)(1)(C), 5000A(d)(1), 6012(a), 6012(a)(5), 6012(c), 6013(a)(1), 6013(g)(1), 6013(g)(2), 6013(g)(3), 6013(g)(4)(B), 6013(h), 6013(h)(1)(A), 6013(h)(1)(B), 6017, 6018(a)(1), 6018(a)(2), 6038A(c)(3), 6038D(h)(2), 6039C(d), 6042(b)(2)(A)(ii), 6044(b)(2)(B), 6046(a)(1)(A), 6046(d), 6046(e), 6048(a)(3)(A)(iii), 6049(b)(2)(C)(v), 6049(b)(5)(A), 6072(c), 6091(b)(1)(B)(ii), 6091(b)(1)(B)(iii), 6091(b)(1)(B)(iv), 6096(a), 6103(h)(5), 6231(a)(1)(B)(i), 6401(b)(2), 6428(e)(3)(A), 6654(e)(2)(C), 6654(j), 7408(d), 7456(b), 7701(a)(30)(A), 7701(a)(39), and section 5314(a) of title 31.

Definition of residence: 7701(b).

Uses of citizenship or residence concerning people other than the taxpayer: 23(d)(3)(C), 23(e), 24(c)(2), 72(w), 101(j)(5)(B), 152(b)(3), 1041(d), 2056(d), 2056A, 2523(i).

Exemptions on estate and gift taxes depending on citizenship or residence: 2032A(a)(1)(A), 2056(d), 2056A, 2057(b)(1)(A), 2057(f)(1)(C), 2057(g), 2102(b)(1), 2102(b)(2), 2102(b)(3)(A), 2201(b)(1), 2505(a), 2513(a)(1), 2522(a), 2522(b), 2523(i), 6018(a)(2), 6166(a)(1).

Foreign earned income exclusion: 911.

Current expatriation tax rules: 2(d), 871(n)(2), 877, 877A, 2107, 2501(a)(2), 2501(a)(3), 2501(a)(5), 2511(b), 2801, 6039G, 7701(a)(50).

Current capital gains tax rules for US citizens or residents who move to US territories: section 1.937-2(f) of title 26 of the Code of Federal Regulations.

"Reed amendment": section 212(a)(10)(E) of the Immigration and Nationality Act, codified as section 1182(a)(10)(E) of title 8 of the US Code.

Tax on inheritance and gifts from former citizens: 2801.

Retaliation against other countries through higher taxes on their citizens: 5(a)(2), 871(n)(3), 871(n)(4), 891, 896, 901(c), 2014(h), 2108.

"Sailing permit": 6851(c), 6851(d).

Publication of names of former citizens: 6039G.

FBAR: sections 5314 and 5321(a)(5) of title 31 of the US Code.

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