

RESIDENCY BASED TAXATION

FREQUENTLY ASKED QUESTIONS

MAY 2017

1. What is Residency Based Taxation?

Residency Based Taxation (or RBT) is a system of taxation where a nation imposes tax on income generated within its border on those who have residency within its borders. Citizens of a nation with Residency Based Taxation pay tax on income in the place where the income was generated. If they live and generate income abroad then their offshore income is taxed abroad and not taxed by the nation of their citizenship.

All developed nations have a system of Residency Based Taxation except the United States. The United States is the only country other than North Korea and Eritrea which taxes its citizens on their income regardless of where it is generated, no matter where they live (and for no matter how long they have lived there) and, but for a limited number of international bilateral treaties for the avoidance of double taxation, regardless of whether they are also taxed on the same income in their country of residence. This system is known as Citizenship Based Taxation (or CBT).

Because the United States taxes citizens, whereas other countries tax residents, Americans living abroad face potential taxation by more than one jurisdiction: the United States and their country of residence (and/or where the income is generated).

2. Why does the United States tax citizens on their worldwide income if no other developed nations do?

The United States government first began taxing citizens' income to raise revenue for the Civil War. At that time, the government imposed a higher rate of taxation on the U.S. income of Americans abroad as a penalty for living abroad, where they were deemed to be evading their service to the nation during the war. In later legislation, the taxation of non-resident U.S. citizens was expanded to include their worldwide income, with the justification being broadly that taxation was the citizens' duty to the nation and just payment for the privilege of citizenship.

Citizenship Based Taxation was challenged in the United States Supreme Court in 1924. In *Cook v. Tait* the Supreme Court ruled in favor of the constitutionality of Citizenship Based Taxation, again on the basis that Americans derive benefits from their U.S. citizenship regardless of where they choose to locate themselves or their assets. The law has not been challenged in the courts or debated in Congress since.

3. What has Democrats Abroad been doing to advocate for Residency Based Taxation?

Democrats Abroad has supported Residency Based Taxation for decades. Since before our official recognition by the Democratic National Committee in 1976, Democrats Abroad has fought to limit the taxation of Americans abroad, not simply supporting a change to Residency Based Taxation, but also for the expansion of the earned income exclusion in § 911 of the Internal Revenue Code. Our quadrennial

platforms have explicitly called for the use of Residency Based Taxation since 1996. At our Congressional Door Knocks over the years, we have had innumerable discussions on Capitol Hill about Residency Based Taxation. Our members, however, have yet to see the legislative results we have been working for over the past few decades.

Now that Congress is contemplating comprehensive tax reform as a legislative priority we have an opportunity to push hard for Residency Based Taxation to be included in the package of tax reforms.

4. Why is Residency Based Taxation important now?

For the first time since the 1980's, the GOP-lead Congress stands a chance of moving a comprehensive package of corporate and personal tax reforms to the floor. Americans abroad groups are responding aggressively to this opportunity to present Residency Based Taxation as a reform to be included in the package.

See also #6 - Arguments in support of RBT

5. What can Americans abroad do to support the campaign for Residency Based Taxation?

Democrats Abroad (in collaboration with other organizations advocating in support of Americans living abroad) is waging a grassroots campaign in support of Residency Based Taxation. We encourage activists to call, write and email elected officials backing this reform. See the *Residency Based Taxation-Campaign In A Box*.

6. Why should Congress support Residency Based Taxation (RBT)? What are our most persuasive arguments?

On principal, Congress should support RBT for these reasons:

- Because of the combination of Citizenship Based Taxation by the United States and Residency Based Taxation by the rest of the World, **non-resident Americans face taxation in both the jurisdiction where we live and in the United States.** The United States is essentially alone in taxing citizens on their worldwide income.
- Although the Foreign Earned Income Exclusion ensures that a large amount of ordinary income is not subject to U.S. tax, investment (unearned) income does not qualify for the exemption. In fact, there are a number of revenue streams left out of the exclusion. These **revenue types are potentially double-taxed** in the U.S. as well as in the taxpayer's country of residence/where the income is generated. The Foreign Tax Credit (for taxes paid in the non-resident citizen's country of residence) often does not zero out taxes owed to the United States.
- **Revenue streams subjected to double or punitive tax treatment** include: foreign retirement savings plans, capital gains, non-qualified non-U.S. pension plans, social welfare payments and bequests to surviving foreign spouses.
- The community of Americans living abroad suffers from the misunderstanding, the misperception and the simple ignorance of Congress (and regulators). The

vast majority of us are ordinary, working class Americans who moved abroad in order to pursue a family relationship, an education or a job, and we decided to remain. **We are, therefore, not wealthy “fatcats” living overseas in order to game the international tax system.** In fact, most Americans abroad live in wealthy, high-tax countries with a higher overall tax burden than the U.S.

- U.S. taxpayers declare income earned abroad on forms designed to capture a lot of information about the source of the earnings, especially investment income. Preparing and filing the forms often requires the assistance of a specialist tax return preparer experienced in dealing with the tax issues of U.S. non-resident tax declarers. For non-resident tax declarers, **preparing tax forms with declarations of income earned abroad is very complex, time-consuming, stressful and costly,** even when no tax is due.
- IRS outreach to Americans abroad about tax compliance has been woefully inadequate over time. As a result many Americans abroad – including officials in United States embassies and consulates - are ignorant, misinformed or confused about U.S. tax filing and reporting obligations.
- Globalization and the integration of economies will continue to increase the number of Americans living abroad and enduring the burden of double taxation, complex and costly filing and reporting, inadvertent IRS neglect and tax code mistreatment, not to mention the impaired access to financial products brought on by foreign account and financial asset reporting.
- The complexity and cost of tax filing and reporting from abroad makes it more difficult for American and foreign-owned companies to hire Americans for their offshore operations and makes it more difficult for Americans to find work and enter business partnerships abroad.
- CBT creates serious tax enforcement difficulties. In order to enforce worldwide taxation of non-resident citizens the United States imposes onerous reporting requirements on them - reports on foreign bank and other financial accounts (even if there are no taxes owed) – which carry heavy penalties for compliance failures. The unintended adverse impacts of financial account reporting on Americans living abroad include: impaired access to a diversified supply of financial products, weakened access to employment and business partnership opportunities, stress in relationships with non-U.S. domestic partners who hold joint accounts and an increase in U.S. citizenship renunciations or those contemplating renunciation. **The burden of CBT tax filing is, therefore, compounded by the financial asset reporting established for CBT enforcement.**
- Americans abroad are ambassadors of American culture and values and promoters of U.S. interests and business enterprise. This is a meritorious service to the nation and not one that should be rewarded with discriminatory tax treatment and onerous tax and financial reporting requirements which convey the suspicion that Americans abroad are tax dodgers and money launderers.

7. Who in Congress supports RBT? Who do we need to ask to support RBT?

As of this date there is no Congressional bill proposing the establishment of Residency Based Taxation. Until a bill is introduced in the 115th Congress and cosponsors are added, we will continue reaching out to Senate and House members explaining this is an urgent legislative priority of the overseas constituents. Our May 2017 Door Knock featured dozens of discussions on Capitol Hill, each one including a strong pitch for support for RBT. We will be following up that outreach with a grassroots campaign in support of RBT in June (See *RBT Campaign In A Box*) wherein members will be encouraged to reach out to their members of Congress to support RBT.

In addition to generating awareness of the problems caused for Americans abroad by Citizenship Based Taxation and support for Residence Based Taxation amongst members of Congress at large, our outreach should target the members of the House Ways & Means Committee's [Subcommittee on Tax Policy](#) and the Senate Finance Committee's [Subcommittee on Tax and IRS Oversight](#).

8. What are the current arguments in favour of Citizenship Based Taxation (CBT) that we need to overcome?

For the reasons outlined in #6, Democrats Abroad believes that CBT is wrong as a matter of both principle and a matter of policy. There are a few academic papers on the subject that make these **arguments in favour of CBT**:

- Because non-residents receive benefits from the United States government (travel on a U.S. passport, pass on U.S. citizenship to children born abroad, gain access to the US for certain noncitizen family members, re-enter the U.S. at will, work in the U. S., and receive personal and property protection from the U.S. whilst abroad) they should pay U.S. tax. (“Fair payment” argument.)

Rebuttal: The United States is not unique in providing these benefits to their overseas citizens and other countries do so without taxing their offshore income. Also, with the exception of voting, non-resident citizens pay a fee for these services. Further, non-resident Americans do not use a range of public services (schools, roads) and lose access to a variety of social welfare programs when they move abroad.

- Taxation is the social obligation we bear for being part of the U.S. Community. We have, as it were, a moral obligation to support our fellow citizens. (The “social obligation theory” of taxation.)

Rebuttal: This is perhaps the most convincing justification for CBT (amongst a selection of unconvincing arguments) however, the problem for cross-border citizens becomes *which* fellow citizens do we have the obligation to support because we have a connection to more than one (and possibly more than two).

- The right to vote in federal elections obligates the citizen to pay taxes in order to ensure that voters bear the economic consequences of their political participation.

Rebuttal: Voting would not have served as the original justification for taxing non-resident citizens on their world-wide income since non-resident citizens were only granted the right to vote by absentee ballot in 1975.

Non-resident citizens do not lose or relinquish their vested interest in the U.S. upon relocating abroad; they may have property and very often have family remaining in the U.S. and they may intend to return to the U.S. at some point.

Although voting from abroad by absentee ballot has been improved markedly over the last decade, it still presents many challenges that make it difficult for Americans abroad to vote and less likely for their vote to be counted.

Most other countries allow non-resident citizens to vote even though they do not tax non-resident citizens on their foreign sourced income.

In some countries non-resident citizens are entitled to parliamentary representation, whereas no seat in Congress is allocated to non-resident Americans.

- It promotes neutrality in taxpayer's choice of where to reside, as the citizen pays taxes no matter where he/she lives and *has no motivation to move abroad for lower taxes.*

Rebuttal: Research indicates that for non-resident Americans taxes are not an important factor in the decision about where to reside; the main motivators are family, jobs and education.

Those for whom tax is a deciding factor are likely to be persons that nations would like to attract for their skills or wealth. Whilst CBT may discourage Americans from leaving the US, CBT may also discourage attractive immigrants from moving to the US and becoming naturalised citizens. Tax and skilled immigration policy may, therefore, be at odds with each other, putting the U.S. at a competitive disadvantage to other nations also interested in attracting skilled foreign workers.

The tax and compliance barriers CBT imposes on movements to and from the United states suggest that it undermines the value that we place on free movement itself.

9. What does Democrats Abroad believe a move Citizenship Based Taxation to Residency Based Taxation would look like?

Democrats Abroad has no fixed view on the implementation model for RBT. We support the work being done by American Citizens Abroad, which is engaging a DC policy-modelling firm to build a Residency Based Taxation proposal that is revenue-neutral to the federal government. Such a proposal could then be introduced into any package of tax reforms with no negative impact on the overall package.

We would support an RBT structure that is straightforward, bereft of loopholes for tax cheats and modest in its qualifying criteria for taxpayers who seek an exemption from U.S. tax filing.