



Making
the Case
for a
Switch to
**Residency
Based
Taxation**

Tax Reform for Americans Abroad

Residency Based Taxation is a system of taxation where a nation imposes tax on income generated within its borders. Citizens of a nation with Residency Based Taxation pay tax on income in the place where their 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. Non-resident Americans face taxation by the U.S. a) regardless of where their income is generated, b) no matter where they live (and for no matter how long they have lived there), and c) except 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.

The U.S. tax system is known as Citizenship Based Taxation and it causes enormous hardship for Americans living abroad. They strongly favour a switch from Citizenship Based Taxation to Residency Based Taxation for these reasons.

- **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 which puts Americas abroad seeking jobs and starting businesses at a competitive disadvantage.
- Although the *Foreign Earned Income Exclusion* ensures that a large amount of ordinary income is not subject to U.S. tax, investment income does not qualify for the exemption. In fact, there are a number of income types left out of the exclusion. These **income streams are often double-taxed**; 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.
- **Types of income that are subjected to double or punitive tax treatment** include, amongst others:
 - ✓ foreign retirement savings plans
 - ✓ capital gains
 - ✓ non-qualified non-U.S. pension plans
 - ✓ social welfare payments from foreign governments
 - ✓ bequests to surviving foreign spouses

Americans abroad advocacy groups have been speaking to Congress for many years about remedies for these tax code injustices with no success. Implementing RBT would sweep all these problems away with minimal effort required by Congress.

- The community of Americans living abroad suffers from the misunderstanding, the misperception and the simple ignorance of Congress (and regulators). The vast majority of the 9 million Americans abroad are ordinary, working class Americans who moved abroad in order to pursue a family relationship, an education, or a job, and decided to remain. **Research¹ confirms that they are not wealthy "fat cats" and "high rollers" living overseas in order to game the international tax system.** In fact, most Americans abroad live in 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 these forms is frightening in its complexity and often requires the assistance of a specialist tax return preparer experienced in dealing with the tax issues of U.S. non-resident taxpayers. For non-resident

¹ <https://www.finance.senate.gov/imo/media/doc/Att%202%20Democrats%20Abroad%202014%20FATCA%20Research%20Report1.pdf>

taxpayers, **preparing tax forms with declarations of income earned abroad is inordinately costly, confusing and frightening, 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 U.S. embassies and consulates - are ignorant, misinformed or confused about U.S. tax filing and reporting rules and obligations. **Americans abroad do not have easily accessible advice and support from the IRS in order to file returns accurately and in a timely manner.** Given the Administration’s planned \$239m budget cut to Treasury it is difficult to believe that expanded funding to and support from the IRS is forthcoming.
- **Globalization and the integration of economies will continue to increase the number of Americans living abroad** and enduring the burden of double taxation and complex and costly tax filing and reporting. Inadvertent IRS neglect and tax code mistreatment will continue to haunt Americans families and business owners abroad, not to mention the impaired access to financial products brought on by foreign account and financial asset reporting.
- Companies that hire Americans to fill jobs in other countries normally provide extra compensation to their American employees for the purpose of meeting their U.S. tax obligation. This is known as “tax equalisation” and **it makes Americans more expensive to hire than those of other nationalities and thus less competitive.**
- 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 nor with onerous tax and financial account reporting requirements which convey the suspicion that Americans abroad are tax dodgers and money launderers.
- Citizenship Based Taxation creates serious tax enforcement difficulties for the IRS. Mandatory taxpayer-provided reports on foreign bank and other financial accounts can be used by the IRS to enforce taxation of foreign-sourced income (as well as to address other financial crimes such as money laundering). These reports carry heavy penalties for compliance failures. The burden of tax filing under Citizenship-Based Taxation is, therefore, compounded by the financial account reporting that supports its enforcement.

Americans living outside the U.S. need Congress to understand that filing abroad is costly, frightening, unjust and in need of urgent reform.

Democrats Abroad has published research undertaken in September 2017 with data and testimonies that demonstrate the hardship Citizenship Based Taxation causes for Americans abroad. Please see our report, **“Can We Please Stop Paying Twice? – Reforming the U.S. Tax Code for Americans Abroad”** at www.democratsabroad.org/taxation . It underscores the importance to these ordinary American families and small business owners living outside the U.S. of a switch to Residency Based Taxation.

We are working with Representative Holding who has taken the initiative to develop a proposal to enact a form of Residency Based Taxation. We ask Congress give due consideration to his draft, particularly if it is determined to be revenue-neutral, bereft of deliberate tax evasion loopholes and helpful to the majority of Americans genuinely residing abroad. As soon as draft legislation is ready we look forward to working with members of Congress to perfect the bill.

Please contact Carmelan Polce at TaxationTF@democratsabroad.org for more information.

