



Citizenship-Based Taxation

Realities, Consequences & Recommendations

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A Civil-War Era Law:

- Citizenship-based taxation (CBT) was initiated during the Civil War.
- CBT was originally a symbolic gesture intended to penalize the wealthiest Americans who moved overseas in order to avoid both the draft and any financial obligations to support the war effort.

In the Modern World:

- Today, with the sole exception of Eritrea, the United States is the only country in the world to base world-wide taxation solely on citizenship.

Who is Directly Affected by CBT?



- American citizens
- resident outside the US
- taxed on income earned through work performed outside the US
- or taxed on interest or capital appreciation earned on non-US assets.



Included in the population affected by CBT are people who have never lived or worked in the US and who have no assets in the US.

The US recognizes that the country of residence has first right to tax US citizens living abroad.



Many overseas Americans pay higher taxes to their host countries than they would in the US, yet still owe US taxes due to differences between the countries' tax laws.

What is the Direct Fiscal Impact of CBT?



Estimation of the direct revenue collected from CBT is approximate:

- The IRS does not directly track non-resident filers
- Form 2555 (foreign earned-income exclusion) is not used by all non-resident filers.
- The majority of Form 1116 (foreign tax-credit) filers are US residents.

In 2006 (the latest data publicly available), Americans filing Form 2555 paid around \$4.2B in US taxes.

Over one-third of overseas residents filing Form 2555 owe no US taxes.



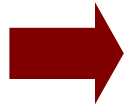
As a rough estimate, collections directly due to CBT account for less than 0.2% of total Federal revenues.



Who is Not Affected by CBT?



The tax treatment of US residents, citizens and non-citizens alike, is entirely independent of the question of CBT.



The policy of CBT has no bearing on US resident citizens who have set up foreign bank accounts for the deliberate purpose of evading taxes, and provides no benefit for their identification and prosecution.



Limited Benefits for Non-Resident Citizens



- Non-residents do not use US infrastructure.
 - Non-residents cannot claim Medicare.
 - Social Security benefits earned through working in the US are reduced if one later becomes eligible for a foreign pension.
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- The US provides neither personal protection to non-residents, nor protection of non-US property.
 - US Consular Services must be paid for by non-residents, at a profit to the State Department.
 - Evacuation from a foreign country is charged at full-fare commercial rates.
 - Carrying a US passport is more burdensome (due to visa requirements) and potentially more dangerous than carrying the passport of most other countries, none of which tax citizens on the sole basis of citizenship.

The Myth of Avoiding Double-Taxation



- Although consumption taxes are much larger in other countries, and US state sales taxes can be deducted, there is no credit or deduction allowed for foreign consumption taxes.
- There is no US tax credit or deduction allowed for foreign social security taxes.
- Self-employed Americans abroad must contribute to US social security and Medicare as well as foreign social security programs.
- Unlike for US residents, non-resident pension fund contributions are non-deductible; foreign employers' pension fund contributions are added to personal income.
- Foreign wealth taxes, analogous to capital gains tax, are deductible but not creditable; US capital gains tax must still be paid, with no offsetting credit.

Excessive Compliance Costs & Punishment for Non-Residents



- The volume of IRS regulations and filing procedures for non-residents is more than two times larger than that for residents.
- The restriction that the US dollar be used for IRS reporting, coupled with fluctuations in currency exchange rates, complicates calculation of US capital gains.
- There are currently only four IRS offices outside the US; professional tax advisors with expertise in international tax are rare and expensive.



Filing and compliance costs for non-resident US citizens are out of proportion with the associated tax revenues raised.



In cases of voluntary disclosure by previously non-compliant overseas citizens, the IRS response is unpredictable and sometimes confiscatory. Non-resident citizens have been assessed penalties amounting to a significant fraction of their total assets, even in cases where no tax was due.

Today's Reality: Americans Discouraged to Move Abroad



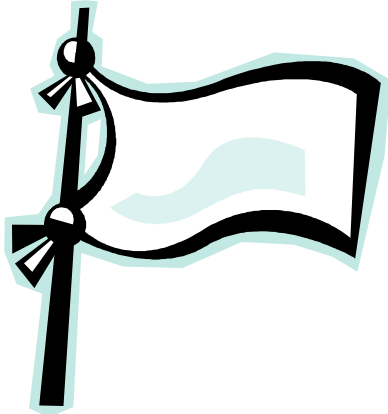
- For most Americans, re-location outside the country would result in a significant effective tax increase and risk-laden administrative burdens.

- For employers offering jobs outside the US, Americans cost significantly more to employ, in terms of both cash outlay as well as administrative burden.



CBT imposes formidable barriers for US citizens to live and work abroad. No other country imposes such impediments.

Unintended Consequence: US Retreat from Global Engagement



- Over a 20-year period, the number of US citizens employed by foreign subsidiaries dropped 50%, while total employment by these foreign subsidiaries grew by >45%.

- The total fraction of US citizens resident outside the US is considerably smaller as a percentage than for other modern industrialized countries.

	% of citizens resident outside the country
United States	<2
United Kingdom	10
France	4
Switzerland	10
Germany	8

- Among OECD countries, the total non-resident fraction of US citizens is less than one-seventh of the average.

Overseas Citizens Key to Supporting Exports



Both the GAO and the President’s Export Council concluded that “a large force of US citizens abroad is essential” in order to promote and service US products and operations.

American business leaders agree:

“GE recognizes the vital role played by our American citizens deployed overseas to ... help GE stay competitive in an ever more challenging international marketplace.”

- Jeffrey Immelt, Chairman and CEO – General Electric, Inc.

“In today’s fast-moving global economy, it is vital to our business to have the ability to send Americans overseas ... We support measures that make it easier for Americans to live and work abroad.”

- Dara Khosrowshahi, CEO – Expedia, Inc.

“We went (to China) to be a global player. If you want to beat the Chinese, you have to be in China. You can’t beat them from outside.”

- Glenn Tellock, CEO – Manitowoc Co.

AMERICANS ABROAD = US EXPORTS = JOBS AT HOME

Non-Resident Taxation & Exports – Lessons from 1976



The Tax Reform Act of 1976 caused a sharp cutback in employment of Americans abroad.

The Reform Act made taxable any reimbursements by US employers to their private-sector US expat staff.

A GAO survey of 145 US corporations indicated that 45% of private-sector expat workers planned to return to the US because of the tax change.

Industry leaders testified before Congress that the Reform Act was resulting in tax obligations in excess of total salary levels; export levels in several industries collapsed, never to recover.



A US trade surplus of \$12.1B in 1975 turned to a \$6.1B deficit in 1976, growing to a \$27.2B deficit in 1977. The US has not enjoyed a trade surplus since 1975, the year before tax changes sent overseas US workers back home.

Unintended Consequence: Damage to US Jobs & Exports



Other industrialized nations, including the UK, Germany, France, China, Russia, and Japan, maintain policies that actively encourage their citizens to live and work abroad.



By contrast, CBT reduces US export performance and job creation.

According to the Commerce Department,

\$1B lost exports = \$180M lost tax revenue = 6250 lost US manufacturing jobs

A Better Approach to Taxing Non-Resident Americans



Constructive alternatives to CBT are both necessary and possible.

One option: Tax US citizens residing abroad in the same manner as non-resident aliens. Impose a withholding tax on any US source income at the applicable treaty rate, including the following elements:

- Portfolio income (interest and dividends) paid by US companies. (The network of “qualified intermediaries” already in place for foreign investors could easily be adapted to distinguish non-resident US citizens.)
- Social security payments and US pension annuities. (To avoid penalizing low-income retirees, the withholding rate here might be scalable.)
- Income attributable to services performed in the US.
- US-sourced royalty payments.
- Rental income on US real estate, and income on disposition of US real estate.

Illustrative Example of the Non-Resident Alien Model



Under current law, a Swiss citizen owning US securities pays a 30% US withholding tax on any dividend collected, half of which can be refunded under the US-Swiss tax treaty.



Without CBT, the same would apply to a US citizen resident in Switzerland owning US securities. This adds revenue to the US Treasury, and the administrative system is largely already in place.



The US citizen in Switzerland would apply the US withholding tax as a credit against his Swiss taxes. (For a US citizen residing in a tax-haven country, there would be no recourse for recovering the withholding tax, as there is probably no bi-lateral tax treaty in place.)



The additional revenues collected through the withholding procedures would at least partially offset any revenue losses related to cancelling CBT.

Two Additional Recommendations



- 1. The GAO should issue a study on the expected net revenue impact of eliminating CBT combined with**
 - the treatment of bona fide overseas residents as foreigners, and
 - the associated increase in US exports and related domestic taxes.

- 1. Consideration should also be given to corresponding changes in estate taxation, in particular, the introduction of a sliding scale of estate tax rates that vary inversely with the number years spent as a bona fide overseas resident. This avoids an unjustifiable US estate tax on “accidental citizens” who have lived their entire lives abroad as dual-nationals, and simultaneously discourages wealthy Americans from moving abroad late in life to avoid US estate tax.**

For Further Information



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