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TAX SIMPLIFICATION: THE NEED FOR CONSISTENT TAX TREATMENT OF ALL INDIVIDUALS (CITIZENS, LAWFUL PERMANENT RESIDENTS AND NON-CITIZENS REGARDLESS OF IMMIGRATION STATUS) RESIDING OVERSEAS, INCLUDING THE REPEAL OF U.S. CITIZENSHIP BASED TAXATION[1]

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by a client to participate in this project.

EXECUTIVE SUMMARY

This paper proposes to eliminate the U.S. citizenship based taxation and create a consistent exit tax system. The exit tax would apply to all long term residents of the U.S. who build up assets and wealth with significant unrealized gains and leave the U.S. to escape taxation. The complex web of the current U.S. tax law has made it nearly impossible for all but the most sophisticated U.S. citizens and lawful permanent residents ("LPRs") residing overseas to file complete and accurate tax returns. The proposal should bring consistency, tax simplicity for taxpayers residing outside the U.S., and do so in part by eliminating the U.S. citizenship based tax system, which is unique in the world, dates to the civil war and is inappropriate for the global world we live in.

The repeal of worldwide taxation of U.S. citizens and lawful permanent residents living overseas would include the following statutory revisions:

- Repeal of Section 911, the foreign earned income exclusion,
- Income tax residency defined and based on the current objective "substantial presence test" (i.e., 183 days) to be applicable to all persons regardless of nationality or immigration status;
- Estate tax residency (i.e., domicile) consistently applied to all persons regardless of immigration or citizenship status, based upon the current definition applicable to non-citizens as set forth in Treas. Reg. Section 20.0-1(b)(1);
- Comparable income, gift, estate and inheritance tax treatment would apply consistently under Sections 877, 877A and 2801, to all of the following persons who satisfy the US$2M net worth or US$124,000 average annual income tax tests–
  - U.S. citizens who cease to be U.S. residents;
  - Long-term lawful permanent residents of the United States, as defined in Section 877(e) who cease to be U.S. residents, and
  - All other long-term residents of the United States, regardless of their immigration status; i.e., those who have lived at least 8 taxable years during the period of 15 taxable years ending when they cease to continue to be a resident of the United States.

All of the above persons are collectively referred to herein as "Former Long Term Residents" and would become "covered expatriates" as defined in the statute; unless they made an election to continue to be taxed as a resident of the United States on a worldwide basis. In other words, the "exit tax" regime under Sections 877, 877A and 2801 would apply to all such persons similarly situated, including not only U.S. citizens and long term LPRs. It would also apply to any other person, irrespective of immigration status, who has lived a significant part of their life in the United States, built up wealth and assets, and then leaves to live overseas. The wealth created and earned by these Former Long Term Residents while living and working in the U.S., would be subject to U.S. income tax under the current "exit tax" regime and the gift and inheritance tax to U.S. residents.

U.S. citizenship, by itself, would cease to be the sole nexus for taxation. Residents of the U.S. would of course be subject to income tax on a worldwide basis. Similarly, persons domiciled in the U.S. would be subject to U.S. gift, estate and generation skipping transfer taxes on a worldwide basis. Finally, all Former Long Term Residents would be subject to the exit tax upon leaving the U.S.; unless they made an election to continue to be taxed on a worldwide basis.

Such a statutory reform would lead to significant tax simplification and provide the following additional benefits:

- Simplified tax administration by the IRS;
  - Generally eliminate income tax return filing requirements for nonresident citizens and nonresident LPRs (i.e., elimination of IRS Form 1040);
  - Repeal of Section 911 (i.e., eliminating the filing of IRS Form 2555), eliminating the filing requirements of hundreds of thousands of IRS Forms 2555;
  - Eliminating the need of foreign tax credit calculations for foreign resident U.S. citizens and nonresident LPRs (i.e., eliminating the filing requirements of possibly millions of IRS Forms 1116 for such persons);

- Eliminating information returns on nonresident citizens and nonresident LPRs (e.g., section 6038, 6038B, 6038D, 6039F, 6043A, 6046, 6046A:6046, 6046A, 6048, et. seq.; IRS Forms 5471, 8865, 3520, 3520-A, 926, 8938, etc.);[i] and
- Eliminate filing requirements of Treasury Form TD F 90-22.1 "Report of Foreign Bank and Financial Accounts" (the so-called "FBAR") under Title 31 for nonresident citizens and nonresident LPRs.

- Create a consistent and objective test of income tax residency applicable to all individuals, irrespective of citizenship or immigration status, based upon the existing days test ("substantial presence test"), that can be more easily enforced and monitored by the U.S. government by tracking the days of U.S. physical residency of entry in and exit out of the U.S.
- Create a more simplified law that would focus resources and efforts on tax compliance on foreign and international activities of U.S. resident taxpayers (instead of persons who do not reside in the U.S.) particularly with the assistance of future information to be collected via Chapter 4 of the Foreign Account Tax Compliance Act ("FATCA").
- Simplify the obligations and burdens of foreign financial institutions to collect information only for individuals who reside in the U.S. and are "resident aliens" as currently defined.
- Create a more consistent international norm of tax residency and taxation of worldwide income for only those persons who reside in the U.S.
- Increase revenue by application of Section 877A, through the immediate recognition of income for "covered expatriates" to extend consistently to all Former Long Term Residents, not just U.S. citizens (unless an election is filed to continue to be taxed on a worldwide basis and returns are filed annually).
- Increased tax revenue at the 40% tax rate from "covered gifts" to U.S. residents under Section 2801 from all Former Long Term Residents.
- Increased tax revenue at the 40% rate for all "covered bequests" under Section 2801 from Former Long Term Residents.
- Increased tax revenues by repeal of the foreign earned income exclusion and housing exclusion under Section 911.
- Revenue increases for withholding taxes on U.S. source "fixed, determinable, annual or periodic" ("FDAP") income payable to non-resident Former Long Term Residents (specifically citizens and LPRs) under Section 1441.
- Revenue increases for withholding tax on Social Security payments at the statutory rate of 25.5% (85% x 30%) to be applied to Former Long Term Residents pursuant to Sections 871(a)(3) and 1441.
- Create greater respect for the U.S. tax system, as a system based upon international norms of primary taxation on worldwide income where the individual resides (which is more easily understandable by taxpayers).
- Creation of a better legal framework for international tax enforcement of U.S. resident taxpayers (e.g., through FATCA) and a move away from the current law that cannot be effectively enforced against non-resident U.S. citizens and non-resident LPRs, which is itself a bad law.
- Allow the IRS to dedicate resources to international tax enforcement that will be more cost effective, productive and perceived as more fair and consistent.

The disadvantage of the proposed reform could include a loss of tax revenues from foreign resident U.S. citizens who have high incomes and generally have worldwide income subject to U.S. income taxation at a higher effective U.S. tax rate compared with the foreign taxes eligible for a foreign tax credit under Section 901. However, this should be further offset by the additional income tax collected under Section 877A and additional transfer tax under Section 2801 on covered gifts and bequests for high net worth U.S. citizens who do not elect to continue to be taxed on a worldwide basis.

The authors do not have the expertise to determine the net revenue effect of such a proposal; i.e., (A) the increased revenues from the repeal of Section 911, the increased revenues from the "exit tax" from expatriation for unrealized gains, future covered gifts and bequests from all Former Long Term Residents, increased withholding taxes on U.S. source income and increased withholding taxes on Social Security payments, compared to (B) the loss of revenues from U.S. income taxes for those U.S. citizens with high incomes with U.S. effective tax rates greater than the local income tax rate in the country of residence. Certainly, such a revenue analysis is necessary to better understand the possible impact of this proposal.

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DISCUSSION

1. BACKGROUND: CITIZENSHIP BASED TAXATION AND INCONSISTENT AND MORE FAVORABLE TAX TREATMENT FOR NON-CITIZENS

U.S. citizens are taxed on their worldwide income, regardless of where they might physically live.[8] This system of worldwide taxation of income (plus estate and gift tax transfers)[9] based only upon citizenship, regardless of source, seems odd to most individuals and tax advisors in other countries, since apparently all other countries of the world impose income taxation on worldwide income only if the individual is physically resident in a particular country (e.g., for a sufficient number of days).[10]

U.S. taxation of citizens has a long history going back to 1861 and the Civil War.[11] The concept of citizenship based taxation was upheld by the U.S. Supreme Court in the 1920s.[12] *See Cook v. Tait*,[13] where a U.S. citizen resided permanently and was domiciled in Mexico City with his Mexican citizen wife and the Court found that U.S. taxation of his Mexican source income was indeed constitutional. Notwithstanding the long history of U.S. citizenship based taxation, the authors view it as an anachronism in the 21st century since it is particularly difficult to administer and cannot be enforced effectively overseas.[14]

In addition to citizenship based taxation, the United States imposes what is a relatively more favorable tax regime on non-citizen individuals who have lived in the United States for many years (maybe most all of their lives in some cases) and then leave.[15] Long term residents of the U.S. who are not citizens or LPRs can obtain a much more favorable tax regime than citizens, since the wealth they generate during their professional and business lives in the United States can escape both (i) the U.S. "exit tax" on income from unrealized gains and (ii) the tax upon future covered gifts and bequests to U.S. residents.

For instance, a non-citizen can live in the U.S. for 20 years on an E-1 investor visa[16] and start a company in the U.S. where the stock he or she owns eventually becomes worth millions.[17] He or she can then simply leave the

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8 *See*, IRC § 61 and Treas. Reg. §§ 1.1-1(b) and 1.1-1(a)(1).

9 *See*, United States Congress Joint Committee on Taxation entitled *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (U.S.G.P.O., June 1, 1995), http://www.house.gov/jct/s-17-95.pdf.

10 *Id*, *see*, footnote 9 and Appendix B to the Joint Committee on Taxation report.

11 *See*, Avi-Yonah, The Case Against Taxing U.S. Citizens, University of Michigan Law School, Public Law and Legal Theory Working Paper Series Working Paper No. 190 March 2010.

12 *See*, U.S. Treasury Report, dated May 1998; "*Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside the United State and Related Issues.* "

13 65 US 47 (1924).

14 Most common law countries have adopted the so-called "revenue rule" including Canada, which also has a number of other legal rights afforded its residents that commonly make international tax enforcement ineffective. See, A. Bonham , *FATCA and FBAR Reporting by Individuals: Enforcement Considerations from a Canadian Perspective, canadian tax journal / revue fiscale* canadienne (2012) 60:2, 305 – 54.

15 *See*, IRC § 877(e) which is not applicable to former long term residents who have lived in the U.S. on any type of non-immigrant visa; but rather is only applicable to those with lawful permanent resident status.

16 The type of visa could be one of several types such as an E-1, E-2, O, P, TN visa, among others, which could allow the person to live most of their lives in the U.S. for immigration law purposes. *See for instance*, Immigration and Nationality Act ("INA") § 101(a)(15)(E) et. Seq

17 *See* case of Facebook founder Eduardo Saverin, who was a naturalized citizen and hence would have been subject to the exit tax under Sections 877 and 877A. *See,* The Washington Post, 18 May 2012, *Facebook co-founder Saverin tries to set record straight after tax-dodging accusations* http://articles.washingtonpost.com/2012-05-18/business/35454933_1_facebook-co-founder-eduardo-saverin-schumer-and-bob-casey-facebook-ipo
In the case of someone similarly situated, who lived in the U.S. while founding a U.S. company on a non-

U.S. and sell the stock of the U.S. company free from U.S. income taxation. Capital gains from the sale of U.S. personal property (including stock of U.S. corporations)[18] and interest income that is "portfolio" interest[19] is not subject to U.S. income taxation to the nonresident alien.

Hence, such an individual can escape all U.S. income tax and gift tax, even though he was a long-term resident in the U.S. while building up the value of the U.S. company and living within the U.S. with an E-1 visa. Current law allows such an individual to simply move out of the U.S. for a requisite number of days[20] and later sell the shares of the U.S. company without paying U.S. income tax on the gain (irrespective of the amount of the gain); as capital gains from the sale of U.S. personal property.[21] The sale would occur when he or she is now a nonresident alien.[22]

There seems to be no policy reason or benefit for imposing an "exit tax" on U.S. citizens and long term LPRs, without imposing the same type of tax on an individual who has created his or her wealth while living in the United States for many years the same as a citizen or LPR.[23]

(a) Large Population Overseas Affected

There are no precise statistics of how many U.S. citizens currently reside outside the United States, although an IRS report from 2011 stated that the "U.S. State Department estimates that 5.08 million Americans are living overseas (excluding military)."[24] The numbers are large[25], particularly when considering foreign born persons to one or

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immigrant visa, they would escape all such taxation under current law.

18 *See*, IRC §§ 864(b) and 871(a)(2).

19 *See*,. Joint Committee Report – TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN SENATE AMENDMENT 3310, THE "HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT," UNDER CONSIDERATION BY THE SENATE, February 23, 2010, p. 23; https://www.jct.gov/publications.html?func=startdown&id=3648

> "The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, portfolio interest, and gains derived from the sale of property. Since 1984, the United States has not imposed withholding tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States. Portfolio interest includes, generally, any interest (including original issue discount) other than interest received by a 10-percent shareholder, certain contingent interest, interest received by a controlled foreign corporation from a related person, and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business."

20 *See*, IRC § 7701(b)(3) where the individual can limit the number of days in the U.S. to avoid the "substantial presence test."

21 *See*, IRC §§ 864(b) and 871(a)(2).

22 *See*, IRC § 7701(b)(1)(B).

23 *See*, IRC §§ 7701(b)(1)(A)(i) and (b)(6). "Lawful permanent resident" ("LPR") is the technical term given by the federal income tax law, with reference to immigration law, to a person who generally has the right to permanently reside in the U.S. on a permanent basis; aka "a permanent resident."

24 *See*, IRS Wage and Investment Research and Analysis report from June 2011, *Understanding the International Taxpayer Market;* Awareness, Use, Preferences, and Filing Behaviors. www.irs.gov/pub/irs-utl/5_david_cico.pdf

25 *See,* Martin and Guardia, *Foreign Bank Account Reports—2011 Regulations Extend Rules to Many Unaware Persons*, Nov-Dec 2011, International Tax Journal, footnote 7, "In the mid-1990s, "The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens." See Joint Committee on Taxation Report, J.C.S. 12-96: General Explanation of Tax Legislation Enacted in The 104th Congress (Expatriation Tax Provisions (Secs. 511-513)). According to U.S. State Department data, there were 4.1 million U.S. citizens living abroad in 1999 (see Table 1). Nearly one-quarter (1 million) of these people lived in Mexico, while 687,000 were in Canada. Other countries with large numbers of Americans included the United Kingdom (224,000), Germany (211,000), Israel (184,000), Italy (169,000), Philippines

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more U.S. citizens who might have derivative citizenship. Many foreign born persons are automatically U.S. citizens, as a matter of law, under a complex web of immigration laws that grants derivative citizenship depending upon a number of factors (e.g., date of birth, nationality of one or both parents and the number of days one or more parent spent in the U.S. or a U.S. territory).[26]

(b) Compliance Challenges Facing International Taxpayers

There are numerous factors that contribute to low and poor compliance of U.S. citizens and lawful permanent residents[27] residing overseas; including (i) many persons may not be aware they are U.S. taxpayers by virtue of their citizenship, (ii) persons who have U.S. parents may not know they are U.S. citizens by virtue of derivative citizenship, (iii) there is limited data available to the IRS regarding U.S. citizens residing overseas, and (iv) valid tax assessments overseas have limited impact, etc.[28]

The Taxpayer's Advocate summarized well the problems with the current tax system applicable to international taxpayers (which includes U.S. citizens and LPRs residing outside the U.S.):

"■ the overwhelming complexity of international tax law;
■ the complexity and administrative detail of often duplicative international reporting requirements;
■ Steep penalties that may be disproportionate to tax liability;
■ the IRS's focus on international tax enforcement without adequate coordination or a corresponding increase in service; and
■ the lack of targeted taxpayer service for . . . [specifically including U.S. citizens and LPR residing overseas] which leads to confusion, errors, and higher compliance costs for this population."[29]

The authors' proposal will help simplify current law, reduce duplicative reporting requirements and allow the IRS to dedicate resources to taxpayers who reside in the United States as opposed to those individuals living overseas.

(c) Limited Amounts of Taxes Are Collected Against U.S. Citizens and LPRs Residing Overseas

There are several reasons why tax collections against this category of non-resident taxpayers are low. First, there appears to be relatively low compliance based upon a number of factors alluded to above:

(A) there is generally no withholding or information from foreign employers,

(B) the IRS cannot collect unpaid taxes against foreign assets, and

(C) U.S. liens and levies and seizures of foreign assets generally cannot be upheld in foreign countries.[30]

(105,000), Australia (103,000), France (102,000), and Spain (95,000). In fact, according to these State Department data, these ten countries contain about 70% of all U.S. citizens living abroad. Current estimates seem to be 4.1 million. See, ESTIMATION OF EMIGRATION FROM THE UNITED STATES by Jason P. Schachter, Ph.D. "There is currently no reliable estimate of the number of U.S. citizens living abroad. The U.S. State Department occasionally publishes data about U.S. nationals living abroad based on registrations at embassies and missions, but there are major questions concerning its validity.""

[26] *See*, INA §§ 301 and 309. 8 U.S.C. § 1431.

[27] "Green Card" is the informal or colloquial name given to the lawful permanent resident ("LPR") status of a non U.S. person. A green card is also known as a "alien registration card", or "Form I-551".

[28] *See*, U.S. Treasury Report, dated May 1998; "*Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside the United State and Related Issues.* "

[29] *See,* p. 130, Taxpayer Advocate Service — 2011 Annual Report to Congress — Volume One.

[30] *See,* GAO/GGD-98-106 *Nonfiling Among U.S. Citizens Abroad.* See, also, IRC Sections 6303

Importantly, the chapter 4 provisions of FATCA will not provide any specific remedy to the Internal Revenue Service or a better mechanism for collecting taxes against non-resident taxpayers regarding the above problems in the current law regarding overseas enforcement of taxes and tax collection.

The other significant reason why tax collections on overseas income are low is that there is simply a very small percentage of non-resident taxpayers living overseas who owe any U.S. income tax by applying current law. Current law provides for (A) a foreign earned income exclusion of US$95,100 (Section 911) and (B) a foreign tax credit against income subject to taxation in the foreign country (Section 901).[31] Hence, much of the foreign income is simply not subject to U.S. taxation under current law as it is exempt under the foreign earned income exclusion or not subject to tax after applying the foreign tax credit.

Statistically, the IRS reports that "Over 82 percent of total international taxpayers reported an adjusted gross income (AGI) of $50,000 or less as reported on Form 1040" and only about 9 percent had AGI of US$100,001 or more.[32] These statistics, along with earlier year statistics indicate that relatively little income tax is even due under current law, and hence there are a relatively small amount of taxes to be collected on U.S. citizens and LRS residing overseas due to Sections 911[33] and 901.

The level of over-all tax compliance by U.S. citizens and LPRs residing overseas is not clear, since only 334,851 total individual tax returns were filed in 2006 which incorporated the foreign earned income exclusion (IRS Form 2555) by non-resident U.S. taxpayers.[34] If there are approximately 5-7 million U.S. citizens residing overseas[35] (not even including LPRs who reside overseas) and 142 million total individual income tax returns filed annually[36] such a small number (i.e., 334,851) indicates that only a fraction of the total returns filed are filed by persons residing overseas; i.e., only about 2 tenths of one percent (0.24%) of the total income tax returns filed were by those residing overseas with the foreign earned income exclusion.

Total foreign earned income for the year 2006 for all tax returns worldwide (which necessarily means the taxpayer was residing overseas to be eligible for Section 911) reported US$36.7B, where about US$19.7B was

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6321 and 6331.
This GAO study also identified about US$19M a year in total income taxes owing for the years 1992-1995 for residents in Saudia Arabia. However, these amounts of taxes would likely be an anomaly compared with most other countries in the world which have an income tax system; i.e., making the U.S. citizen and LPR eligible for a foreign tax credit.

[31] *See,* Id. and various articles referenced herein which contain a good explanation of how this exclusion and credit works.

[32] *See*, footnote 24.

[33] The current foreign earned income exclusion is US$95,100, and hence only a small percentage of taxpayers are reporting total AGI over US$100,000.

[34] *See, SOI Tax Stats - Individual Foreign Earned Income/Foreign Tax Credit* http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Foreign-Earned-Income-Foreign-Tax-Credit These numbers for the year 2006 are even more interesting when one analyzes the foreign earned income exclusion taken. Canada had 30,067 returns filed versus Mexico with only 6,112 for the year 2006. *See* - http://www.irs.gov/pub/irs-soi/06in02ic.xls It seems that Mexico should at a minimum have more returns filed than Canada - or at least about the same, since the State Department estimates that more U.S. citizens (approximately 1+/- million live in that country). Both seem very low, if it is true that there are probably close to 1.5 to 2 million total U.S. citizens living in these two countries.

[35] *See,* p. 130 and footnote 11 of Taxpayer Advocate Report referenced in footnote 29 above – "Cf. IRS website, Reaching Out to Americans Abroad (Apr. 2009), and W&I Research Study Report, Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad."

[36] *See*, *SOI Tax Stats – All Returns [Individual]: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2010* http://www.irs.gov/PUP/taxstats/indtaxstats/10in14ar.xls . In 2006, there were a total of 138 million total individual income tax returns filed. See, *SOI Tax Stats – All Returns [Individual]: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2006*- http://www.irs.gov/pub/irs-soi/06in12ms.xls

excluded from U.S. taxation under Section 911 (as foreign earned income US$18.4B; and housing exclusion of US$1.3B).[37] This would leave some US$17B of income earned in foreign countries which could potentially be subject to U.S. income taxation (prior to any foreign tax credit application). However, it is possible that most all of this US$17B would not generate any significant income tax after applying the foreign tax credit under Section 901, which would reduce the actual U.S. income tax significantly.

There were a total of 2.9 million U.S. individual income tax returns with foreign tax credit Forms 1116 for 2006, with the total taxable income of US$78.7B and total tax of US$13.9B.[38] These taxable income amounts include both U.S. resident and non-resident taxpayers (presumably far more U.S. resident taxpayers than non-resident citizens are included since there are nearly 300 million U.S. residents and only 5-7 million non-resident citizens) who filed for and obtained a foreign tax credit under Section 901. This produces a global effective tax rate (foreign taxes on foreign taxable income) of 17.7% **[should there be a citation or explanation how the 17.7% was determined?]**.

Not surprisingly, countries such as the UK and Germany have much higher effective tax rates than countries such as Saudi Arabia and the UAE. Can one extrapolate and assume that the US$17B of income not subject to the foreign earned income exclusion above, should be subject to an average foreign tax credit at about a 17.7% rate?[39] Clearly, a more thorough analysis of potential loss of revenue needs to be made regarding this proposal to eliminate U.S. citizenship and LPR based taxation on persons residing outside the U.S. This potential revenue loss needs to be compared against what could be a significant increase in tax revenues, particularly for high net worth U.S. citizens residing overseas who do not elect to be taxed on a worldwide basis.

At the same time, a revenue analysis needs to be undertaken regarding the additional taxes that would be collected under Sections 877A, 2801 and 1441 as a result of the enactment of such a proposal.

2. PROPOSAL TO SIMPLIFY LAW

(a) Repeal of Foreign Earned Income Exclusion.

As explained above, this proposal requiring statutory revisions would repeal Section 911, the foreign earned income exclusion as it would no longer be relevant. U.S. citizens and LPRs residing overseas would no longer be subject to worldwide taxation merely based upon their U.S. citizenship or LPR status. They would only continue to be treated as a resident alien, IF, they elected to continue to be taxed on a worldwide basis. Accordingly, they would become subject to taxation like any other "non-resident alien" as defined by Section 7701.

(b) Consistent Tax Residency Rule for all Persons.

The test to determine whether U.S. citizens and LPR residing overseas would be taxed as a "resident alien" would be the same definition as currently exists in 7701(b)(1)(A)(ii); i.e., if they spend more than 122 days on average in the U.S. each year, they would be a "resident alien" and taxed on their worldwide income. In contrast, if they are not resident enough days in the U.S. (e.g., always less than 122 days per year), they would be a non-resident alien and be taxed on only their U.S. source income pursuant to Sections 871, 1441, 1445, 1446, et. seq. the same as a nonresident alien.

Similarly, in order to be consistent, estate tax residency (i.e., domicile) will need to be modified to apply consistently to all persons regardless of immigration or citizenship status, based upon the current definition applicable to non-citizens as set forth in Treas. Reg. Section 20.0-1(b)(1).

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[37] *See,* footnote 34.

[38] *See, SOI Tax Stats* http://www.irs.gov/pub/irs-soi/06in04aic.xls

[39] What if the total U.S. effective tax rate of that US$17B is, e.g., 25% (assuming some is long-term capital gains and qualified dividends)? Is 25% a reasonable effective rate (some at the 35% ordinary rate for those years and some at a 15% LTCG/qualified dividends rate)? Is the annual loss in revenue approximately US$1.25B (i.e., 7.4% **[7.3% or 7.35%?]** - which is 25% U.S. effective rate minus the 17.65% **[17.65% or 17.7%]** worldwide effective tax rate - MULTIPLIED by US$17B of income)?

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(c) Consistent Tax Treatment for Persons Residing Outside the U.S.

All U.S. citizens and LPRs residing overseas who do not meet the days test in the U.S. to be deemed a "resident alien", would become subject to U.S. income and withholding taxation the same as other non-resident aliens. Hence, the following income would be subject to U.S. taxation on an on-going basis:[40]

So-called "fixed or determinable annual or periodical" income ("FDAP") from sources within the U.S.;[41]

certain other types of non-FDAP income, including original issue discount (OID);[42]

Social Security payments to Former Long Term Residents at the statutory rate of 25.5% (i.e., 85% x 30%);[43]

capital gains derived from the sale or disposition of United States real property interests;[44]

income effectively connected with the conduct of a U.S. trade or business by such person;[45]

the partners' distributive share of a partnership's income effectively connected with a U.S. trade or business;[46] and

capital gains derived from the sale or exchange of patents, copyrights, secret processes, trade names, trade brands, franchises and similar property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold.[47]

This method of taxation would be consistent for all persons residing outside of the U.S. and would be revenue positive. In addition, to future taxation on U.S. sources of income, the Former Long Term Residents would become subject to U.S. taxation under the "mark to market" expatriation regime explained below.

(d) "Mark to Market" Taxation Consistently Applied for All Former Long Term Residents Upon Expatriation

In order to make such a residency based taxation system congruent with current law, this proposal would cause any U.S. citizen, long-term LPR and long-term non-U.S. citizen regardless of their immigration visa status (i.e. collectively referred to herein as Former Long Term Residents) to all be taxed similarly. In other words, all such Former Long Term Residents would[48] become a "nonresident alien" under this new definition of tax residency, and hence be deemed to be a "covered expatriate" as defined in Sections 877A(g) and 877(a)(2)(A), (B) or (C); **UNLESS** they made an election to continue to be taxed on a worldwide basis.

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[40] Nonresident aliens are generally taxed only upon income from U.S. sources. *See* IRC § 864. For instance, if a foreign investor who is not a tax resident of the U.S. invested in debt obligations of the German government which paid periodic interest, the interest would not be U.S. source and not subject to U.S. tax.

[41] *See*, IRC § 871(a)(1)(A). FDAP income includes most interest income (other than "original issue discount"), premiums, annuities, dividends, and other fixed or determinable annual or periodical gains, profits, and income from U.S. sources. Dividends from U.S. corporations, interest income from U.S. debtors, and royalty payments from U.S. licensees represent some of the most common forms of FDAP subject to U.S. withholding tax. The tax on these types of U.S. source income and gains (FDAP) is imposed at a withholding rate of 30 percent or lower income tax treaty rate, if applicable.

[42] *See*, IRC § 871(a)(1)(C).

[43] *See*, IRC §§ 871(a)(3) and 1441.

[44] *See*, IRC §§ 897 and 1445.

[45] *See*, IRC § § 864 and 871(b).

[46] *See*, IRC § 864, 871(b) and 875.

[47] *See*, IRC § 871(a)(1)(D).

[48] The exceptions of Sections 877A(g)(1)(B) would continue to be applicable.

Hence, U.S. citizens, long-term LPRs and all other persons who have lived in the U.S. for at least 8 of the last 15 years as a resident alien, "Former Long Term Residents," would become "covered expatriates" (UNLESS they made an election to continue to be taxed in the U.S. on a worldwide basis). Each of these persons would be subject to similar taxation by ceasing to be an income tax resident of the United States and hence would be subject to the 877A "mark to market" rules which would require them to pay U.S. tax on their net gain from the "deemed sale" of their worldwide assets.[49] They would be treated as if they sold all of their worldwide property and be subject to U.S. income taxation on the built in gain on such worldwide assets.[50]

Importantly all foreign resident U.S. citizen taxpayers, foreign resident LPRs and other Former Long Term Residents would be subject to the "mark to market" tax regime if they fail to certify, under penalties of perjury, that they have "met the requirements" under the federal tax law for the preceding five years.[51]

Similarly, gifts or bequests from Former Long Term Residents to U.S. residents would be subject to tax under Section 2801. This provision provides that "covered gifts" or "covered bequests" are subject to tax at the highest rate under Section 2001(c), which is currently 40%. Importantly, the current provisions of Section 2801 which taxes gifts and bequests to any U.S. citizens and U.S. residents would need to be modified to impose such taxation only upon any U.S. residents (which would exclude U.S. citizens residing overseas).

3. CONCLUSION

This paper proposes to eliminate U.S. citizenship based taxation and create a consistent exit tax system. The "mark to market" exit tax would apply to all long term residents of the U.S. who build up assets and wealth with significant unrealized gains and leave the U.S. to escape taxation. The complex web of the current U.S. tax law has made it nearly impossible for all but the most sophisticated U.S. citizens and lawful permanent residents residing overseas to file complete and accurate tax returns.

The proposal should bring consistency, greater tax simplicity for taxpayers residing outside the U.S., a new revenue source for "mark to market" taxation on all Former Long Term Residents and do so in part by eliminating the U.S. citizenship based tax system, which is unique in the world, dates to the civil war and is inappropriate for the global world we live in.

[49] *See*, Sections 877A(a)(1) and (2).

[50] This income tax regime currently applies to those who (i) renounce their U.S. citizenship (or "green card" holders who abandon their green card status -provided they have had it for at least 8 of the last 15 years), (ii) have a net worth of US$2M or more, or U.S. income tax liability greater than $124,000 - adjusted for inflation, and (iii) those who fail to certify their compliance with the U.S. tax law for the last 5 years (irrespective of their income or assets).

[51] *See,* Section 877(a)(2)(C). All such taxpayers (irrespective of wealth or assets) will be required to file IRS Form 8854 – Initial and Annual Expatriation Statement and certify they have satisfied the requirement of the federal tax law for the preceding five years, which will have the effect of enabling the IRS to better identify all U.S. citizens and LPRs residing outside the U.S. Any failure to satisfy this requirement will cause the foreign resident U.S. citizen, LPR and other Former Long Term Resident to continue to be a U.S. "resident alien" and subject to U.S. income taxation on their worldwide income (without the benefit of the foreign earned income exclusion under Section 911).

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III. CONCLUSION 9

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[i] *See*, IRC Sections 6038, 6038B, 6038D, 6039F, 6043A, 6046, 6046A:6046, 6046A, 6048, *et seq.* and Title 31, Sections 5321, *et. seq.*

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TYPE OF INTERNATIONAL TRANSACTION	IRS/TREASURY FORM
Ownership or signature authority over a foreign bank account	**TD F 90-22.1** – Report of Foreign Bank and Financial Accounts ("FBAR")
Receipt of large gifts from foreign persons (including inheritances from foreign estates)	**IRS Form 3520** - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
Ownership interest in a foreign corporation	**IRS Form 5471** - Information Return of U.S. Persons With Respect to Certain Foreign Corporations
Ownership interest in a foreign partnership	**IRS Form 8865** - Return of U.S. Persons With Respect to Certain Foreign Partnerships
Transfers of certain interests in a foreign partnership	**IRS Form 8865** - Return of U.S. Persons With Respect to Certain Foreign Partnerships
Transfers to a foreign trust	**IRS Form 3520** - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
Distributions from a foreign trust	**IRS Form 3520** - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
Transfers of assets to a foreign corporation	**IRS Form 926** - Return by a U.S. Transferor of Property to a Foreign Corporation
Officers and directors of certain foreign corporations	**IRS Form 5471** - Information Return of U.S. Persons With Respect to Certain Foreign Corporations
Ownership interest in and transfer of certain foreign disregarded entities	**IRS Form 8858** - Information Return of U.S. Persons With Respect To Foreign Disregarded Entities
U.S. citizens who renounce their citizenship and certain lawful permanent residents who abandon immigration status;	**IRS Form 8854** - Initial and Annual Expatriation Statement
Annual return of activities of a foreign trust with a U.S. owner	**IRS Form 3520-A** - Annual Information Return of Foreign Trusts with a U.S. Owner
U.S. citizens who have specified foreign financial assets in a foreign country	**IRS Form 8938** - Statement of Specified Foreign Financial Assets

A summary of potential penalties are set out below, and may help taxpayers identify if they might have a transaction or item that should be reported on an information return:

IRS/TREASURY FORM	POTENTIAL PENALTY EXPOSURE FOR FAILURE TO FILE AND REPORT INTERNATIONAL TRANSACTION

TD F 90-22.1 – Report of Foreign Bank and Financial Accounts ("FBAR")	US$10,000 for each failure to file 50% of the account balance for failure to file or US$100,000; civil penalty Up to $500,000 and up to 10 years in prison; criminal penalty
IRS Form 3520 - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	Up to 25% of the value of the tax-free gift or inheritance received from the foreign person
IRS Form 5471 - Information Return of U.S. Persons With Respect to Certain Foreign Corporations	US$10,000 for each failure to file; up to US$50,000 in total penalties
IRS Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships	US$10,000 for each failure to file
IRS Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships	US$10,000 for each failure to file
IRS Form 3520 - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	Up to 35% of the value of the transfer of properties to the foreign trust (even if the transfers are income tax-free)
IRS Form 3520 - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	Up to 35% of the value of the distributions of properties received from the foreign trust (even if the distribution is not subject to income tax)
IRS Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation	10% of the value of the property transferred up to US$100,000 maximum
IRS Form 5471 - Information Return of U.S. Persons With Respect to Certain Foreign Corporations	US$10,000 for each failure to file
IRS Form 8858 - Information Return of U.S. Persons With Respect To Foreign Disregarded Entities	US$10,000 for each failure to file
IRS Form 8854 - Initial and Annual Expatriation Statement	Various
IRS Form 3520-A - Annual Information Return of Foreign Trusts with a U.S. Owner	5% of the gross value of the trust assets (even if there is no taxable income)

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