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VIEWPOINTS

The Case Against Taxing Citizens

by Reuven S. Avi-Yonah

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The bipartisan tax reform bill recently introduced by Sens. Ron Wyden, D-Ore., and Judd Gregg, R-N.H., proposes to abolish IRC section 911.[1] That section, which exempts U.S. citizens living overseas from tax on the first $80,000 of earned income, is indeed anomalous in the context of a tax on all income ''from whatever source derived,'' and has been subjected to criticism.[2] However, there is a reason section 911 has been in the code since the 1920s: In its absence, citizenship-based taxation becomes completely unadministrable. Rather than continuing the long argument over section 911, Congress should therefore reexamine the basic premise: Should the U.S. continue to tax its citizens who live permanently overseas?[3]

In my opinion, the answer is no. The U.S. is the only country in the world to base worldwide taxation solely on citizenship.[4] Historically, this rule was created at a time when the income tax applied only to the rich and when some of the rich moved overseas to avoid the draft. We do not have a draft any more, the income tax applies to the middle class, and many more U.S. citizens live permanently overseas for nontax reasons. In a globalized world, citizenship-based taxation is an anachronism that should be abandoned.

There are three arguments that can be made in favor of taxing citizens living permanently overseas, but all of them are weak. The benefits argument is that U.S. citizenship by itself confers benefits that justify taxation. But those benefits cannot be compared to the benefits derived from living in the United States, and are identical to the benefits provided by other countries that do not tax their citizens living overseas.

The ability-to-pay argument is that U.S. citizens are part of a community and should contribute their fair share to the pool of income that is redistributed across the community. But we must in practice give the country of residence the primary right to tax nonresident citizens, and therefore their income is mostly not available for us to redistribute.

The administrability argument is that citizenship is an administrable proxy for domicile. But it is a very imperfect proxy, and we already have an administrable

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[1] Bipartisan Tax Fairness and Simplification Act of 2010 (S. 3018), section 114 (proposed IRC section 7875(9), terminating section 911 after Dec. 31, 2010). For S. 3018, see *Doc 2010-3973* or *2010 TNT 36-47*.

[2] *See, e.g.,* Walter A. Slowinski and B. John Williams Jr., ''The Formative Years of the Foreign Source Earned Income Exclusion: Section 911,'' 51 *Taxes* 355 (1973); Philip F. Postlewaite and Gregory E. Stern, ''Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal,'' 65 *Va. L. Rev.* 1093 (1979); Renee Judith Sobel, ''United States Taxation of Its Citizens Abroad: Incentive or Equity,'' 38 *Vand. L. Rev.* 101 (1985).

[3] For recent articles arguing in favor of retaining the current tax on the basis of citizenship, see Michael Kirsch, ''Taxing Citizens in a Global Economy,'' 82 *NYU L. Rev.* 443 (2007); Edward A. Zelinsky, ''Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile,'' unpublished ms. (2010). For an argument on the other side on administrability grounds, see Cynthia Blum and Paula N. Singer, ''A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals,'' 41 *Vand. J. Transnat'l L.* 705 (2008).

[4] Eritrea is sometimes mentioned as another one, but it is unclear that it actually taxes nonresident citizens. The Philippines used to tax nonresident citizens until 1995, but no longer does so. *See* Kirsch, *supra* note 3; Joint Committee on Taxation, ''Review of the Present-law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency,'' JCS-2-03, p. 79 (Feb. 2003), *Doc 2003-3954*, *2003 WTD 31-18*.

basis for residence-based taxation in the physical presence rule. Citizenship-based taxation, on the other hand, is in practice unadministrable and will become even more so if section 911 is repealed.

The rest of this article develops these points in greater detail. Section I discusses the history of citizenship-based taxation and shows that it is rooted in a very different era than today, when residency imposed greater obligations and taxation was limited to the rich and when relatively few U.S. citizens lived overseas. Section II addresses the benefits argument and concludes that the benefits of U.S. citizenship do not justify worldwide taxation. Section III raises the ability-to-pay argument and shows that it is a weak basis for citizenship-based taxation. Section IV discusses the administrability issues and argues that they strongly support repeal of citizenship-based taxation. Section V concludes by arguing that in the era of globalization, citizenship-based taxation is an anomaly that should be abandoned, and explains some of the simplification potential that results.[5]

I. History

Citizenship-based taxation of Americans living overseas began during the Civil War. The original Civil War income tax from 1861 was imposed only on residents and on the U.S.-source income of nonresident citizens.[6] The tax on nonresident citizens was imposed at a higher rate and with no exemption amount.[7] In 1864, the tax was amended to apply to the income of ''every person residing in the United States, or of any citizen of the United States residing abroad,'' regardless of whether the income arose ''in the United States or elsewhere.''[8] The application of the U.S. tax to citizens living overseas continued until the Civil War income tax expired in 1872, was revived in the aborted income tax of 1894, and finally was incorporated into the ''modern'' income tax of 1913.[9]

What was the rationale of taxing citizens living overseas? The original enactors of the provision must have known it would be very difficult to enforce, and in fact negligible tax was collected even from the U.S.-source income of citizens living overseas during the Civil War.[10] The application of tax to citizens living overseas was a symbolic gesture: At a time of severe national crisis, when citizens living in the U.S. were expected not just to pay tax but also to serve in the military and potentially die for their country (or at least pay for a substitute), the perception of rich citizens living overseas was too much for Congress to bear. As stated by a senator who served as a manager in the conference committee that adopted the 1861 tax law (taxing nonresident citizens at a higher rate):

> We do not desire that our citizens who have incomes in this country . . . should go out of the country, reside in Paris or elsewhere, avoiding the risk of being drafted or contributing anything personally to the requirements of the country at this time, and get off with as low a tax as everybody else . . . If a man draws his income from our public debt, or from property here, and resides in Paris, skulking away from contributing his personal support to the Government in this day of its extremity, he ought to pay a higher income tax.[11]

Citizenship-based taxation is in practice unadministrable and will become even more so if section 911 is repealed.

The same rhetoric was eventually applied to taxing nonresident citizens on their worldwide income. Sen. George Hoar stated in 1894 that:

> There are a great many people, I am sorry to say, who go abroad for that very purpose [of avoiding tax], and some of them went abroad during the late [Civil War]. They lived in luxury, at the same time at less cost, in a foreign capital; they had none of the voluntary obligations which rest upon citizens, of charity, or contributions, or supporting churches, or anything of that sort, and they escaped taxation.[12]

The origin of U.S. taxation of nonresident citizens should thus be understood as stemming from a period in which only the rich paid the income tax (the $800

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[5]I do not discuss arguments based on efficiency or neutrality because:

- they cut both ways — neutrality is violated when tax influences either the decision to move overseas or the decision to abandon U.S. citizenship; and
- in the case of individuals I believe the decision to move is usually motivated primarily by nontax considerations.

See Kirsch, *supra* note 3.

[6]Act of Aug. 5, 1861, ch. 45, sec. 49, 12 Stat. 292, 309.

[7]*Id.*

[8]Act of June 30, 1864, ch. 173, sec. 116, 13 Stat. 223, 281.

[9]Act of Aug. 27, 1894, ch. 349, sec. 27, 28 Stat. 509, 553; Act of Oct. 3, 1913, ch. 16, sec. II(A)(1), 38 Stat. 114, 166.

[10]Kirsch, *supra* note 3, footnote 32 (from 1863 to 1865 U.S. citizens living overseas paid $230,470 of $84,015,918 of income tax collected, or 0.003 percent).

[11]Kirsch, *supra* note 3, at 451.

[12]*Id.* at 453.

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exemption excluded the vast majority of resident citizens), against the background of the most severe crisis in the history of the country, and at a time when resident citizens could be drafted and when the likelihood of dying in the service of our country was the highest it has ever been in the history of the United States. In that context, it is understandable that Congress would want to appear to impose an equal tax burden on resident and nonresident citizens, since the nonresident citizens were few in number and likely to be residing overseas for the purpose of avoiding both the draft and the tax. As Hoar implicitly acknowledged, there was in practice no hope of collecting tax from nonresident citizens, and ''they escaped taxation'' even though the tax nominally applied to them.

In 1924, the Supreme Court upheld the taxation of nonresident citizens in *Cook v. Tait*.[13] The case involved a native citizen of the U.S. who lived permanently in Mexico and derived his income from real and personal property located in Mexico. The taxpayer argued that the U.S. lacked jurisdiction to tax because both residence jurisdiction and source jurisdiction were lacking. The Court rejected the argument because:

> [T]he foundation of [plaintiff's argument] is the fact that the citizen receiving the income, and the property of which it is the product, are outside of the territorial limits of the United States. These two facts, the contention is, exclude the existence of the power to tax. Or to put the contention another way, as to the existence of the power and its exercise, the person receiving the income, and the property from which he receives it, must both be within the territorial limits of the United States to be within the taxing power of the United States. The contention is not justified. . . . In *United States v. Bennett*, 232 U.S. 299, the power of the United States to tax a foreign built yacht owned and used during the taxing period outside of the United States by a citizen domiciled in the United States was sustained.[14]

This analysis is of course fatally flawed: The plaintiff did *not* argue that ''both'' residence and source jurisdiction must apply for the U.S. to have jurisdiction to tax; he argued that either one *or* the other must exist. Moreover, the case relied upon by the Court supports the taxation of residents on foreign-source income, not the taxation of nonresident citizens. But the Court upheld the power to tax nonresident citizens because of the benefits provided them by the U.S. government: ''the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete'' by taxing the nonresident citizen.[15]

Cook v. Tait permits Congress to tax nonresident citizens, but does not require it to do so. The history of U.S. taxation of nonresident citizens is a dubious basis from which to argue, as Prof. Kirsch does, that the practice should continue.[16] The application of the income tax to nonresident citizens stemmed from a great national crisis in which resident citizens were expected not just to pay tax but also to risk their lives for their country. At the same time, nonresident citizens were likely to be few in number, rich (or else they would not be subject to tax), and suspected of living overseas to avoid both the draft and the tax.

None of these conditions apply today. The U.S. is not in crisis, there is no draft, and hundreds of thousands of U.S. citizens live permanently overseas for reasons that have nothing to do with taxation.[17] In many cases, they are citizens merely because they were born here, have left the country when they were young, and are blissfully unaware of their tax obligations. In many more cases, they choose or are assigned to live overseas because of the opportunities of globalization. Under these 21st-century circumstances, do we still have a good reason for taxing citizens living permanently overseas?

Kirsch argues that the answer is yes because of the benefits afforded nonresident citizens by virtue of their citizenship, and because citizens are part of a community and should be subjected to tax on ability-to-pay grounds.[18] Prof. Zelinsky rejects these arguments but argues that citizenship is an administrable proxy for domicile, which justifies taxation.[19] In the next three sections I will argue that none of these reasons for taxing nonresident citizens are persuasive.

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[13]265 U.S. 47 (1924).

[14]265 U.S. 55.

[15]265 U.S. 56.

[16]Kirsch, *supra* note 3.

[17]We have no idea how many U.S. citizens live overseas. The GAO conducted an experimental study of expatriate population in three randomly selected countries in 2004 in an attempt to start counting expatriates in the 2010 census, and concluded that it ''would not be cost effective'' to do so; it refers to the Census Bureau's acknowledgment that currently ''no accurate estimate exists'' on the number of Americans abroad. The several reports to Congress by the Census Bureau and the GAO on this issue do not even attempt to give a range or an estimate of the number of Americans overseas. *See* U.S. Government Accountability Office, Report to the Subcommittee on Technology, Information Policy, Intergovernmental Relations and the Census, Committee on Government Reform, House of Representatives, ''2010 Census — Counting Americans Overseas as Part of the Decennial Census Would Not Be Cost-Effective,'' GAO-04-898 (Aug. 2004).

[18]Kirsch, *supra* note 3.

[19]Zelinsky, *supra* note 3.

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II. The Benefits Argument

Kirsch lists the following benefits accorded to nonresident citizens: personal protection, property protection, right to vote, right to enter, and past benefits.[20]

As Zelinsky observes, none of these benefits seems sufficient to justify taxation.[21] The protection afforded by the U.S. to its nonresident citizens and their property is rarely invoked and when it is invoked is frequently ineffective. For example, as shown by recent Supreme Court cases involving foreign citizens on death row, the right to consular assistance when a citizen is accused of a crime in a foreign country is frequently not used at all or used too late to be effective.

The right to vote argument is upside down. It is legitimate to argue that nonresident citizens must be given the right to vote because they are subject to U.S. tax, although even that ''no taxation without representation'' tradition is sometimes ignored (just ask D.C. residents and resident aliens). But it does not follow that because nonresident citizens vote they must be taxed. Moreover, many countries do not allow nonresident citizens to vote because they do not fully bear the consequences of their votes, and it would be legitimate for the U.S. to follow that route if it stopped taxing nonresident citizens, as it does for residents of Puerto Rico.[22]

The right to enter is a tenuous basis for taxation. Having U.S. citizenship overseas does give you the peace of mind that you can enter the U.S. at any time, but before it is exercised this option seems a weak basis for such a heavy price as worldwide taxation. It is true that many nonresident aliens would like to obtain U.S. citizenship, and worldwide taxation can be seen as a ''price'' to be paid for it, but that is because they want to live and work in the U.S., not because of citizenship per se.

Finally, even Kirsch acknowledges that the past benefit argument is weak. Nonresident citizens may or may not have received benefits from the U.S. while living there; in many cases they left at too young an age to receive significant benefits, and in other cases they lived in the U.S. long enough to pay tax for their benefits.

To see why the benefits argument for taxing nonresident citizens is wrong, one should compare the benefits conferred by citizenship to the benefits conferred by residency to U.S. residents. The latter are much more significant. U.S. residents benefit from first-class government protection, the rule of law, an outstanding educational system, and the many opportunities of a free market economy. These benefits are the reason the U.S. is still the top choice of immigrants from other countries, and they are all paid for by tax dollars. Nonresident citizens do not receive these benefits or at best receive them in a much weaker form.

The benefits conferred by the government on residents are a major argument in favor of taxing them on worldwide income, whether they are citizens or not. In recent years, there have been abundant instances of U.S. residents evading tax by hiding their money overseas. Why is that wrong? It is wrong because U.S. residents live in a democracy and vote for a certain level of taxation and the benefits that ensue. They do not choose to live in the Cayman Islands and to receive the benefits commensurate with that country's level of taxation. As long as U.S. residents choose to live in the U.S., they should pay tax on their worldwide income, because that tax supports the benefits they receive. If they choose to live permanently elsewhere, they receive far fewer benefits and should not have to pay tax on foreign-source income.

As long as U.S. residents choose to live in the U.S., they should pay tax on their worldwide income, because that tax supports the benefits they receive.

Finally, the same benefits cited by Kirsch as supporting taxation of nonresident citizens (protection of self and property, right to vote, right to enter, past benefits) are also afforded to nonresident citizens by every other major democracy, and yet no other country taxes its nonresident citizens. It is hard to argue that the protections of U.S. citizenship are significantly more valuable than those of EU or Swiss citizenship — in fact, in many places carrying a U.S. passport is more burdensome (because of visa requirements) and potentially more dangerous than an EU or Swiss passport. If the other democracies do not impose worldwide taxation on their nonresident citizens because of the benefits they provide, it is unclear why we should exact such a high price for our benefits.

Many nonresident citizens hold or can easily obtain a foreign passport, and the consequence of taxing them differently than other advanced democracies is an incentive to abandon their U.S. citizenship. The result

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[20]Kirsch, *supra* note 3.

[21]Zelinsky, *supra* note 3.

[22]The United Kingdom, Switzerland, Ireland, Israel, India, Chile, and Greece are among the democratic countries that do not allow most nonresident citizens to vote, while Canada only allows them to do so if their nonresident status has lasted for five years or less. *See* http://aceproject.org/epic-en/CDTable?question=VO004.

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has been a long series of enactments designed to penalize tax-motivated expatriation, which have generally been ineffective.[23] As discussed below, abandoning taxation of nonresident citizens could lead to significant simplification and reduction of administrative costs, which probably exceed the revenue collected from nonresident citizens.

III. The Ability-to-Pay Argument

Taxation of U.S. residents on worldwide income is justified on ability-to-pay grounds. Horizontal equity requires equal taxation of a person earning $100 in U.S.-source wages and a person earning $100 in foreign-source interest income, and vertical equity requires higher taxation of a person earning $100 in U.S.-source wages and $100 in foreign-source interest income than a person earning only $100 in U.S.-source wages.

Ability-to-pay taxation is justified as a way to support the government with the least sacrifice (because of the declining marginal utility of money) and as a way of achieving redistribution. But justifying the progressive income tax on ability-to-pay grounds does not answer the question, whose ability to pay should be taken into account?

The ability-to-pay argument for taxing nonresident citizens is that they are part of a community with resident U.S. citizens and therefore should share in the tax burden imposed on that community. This argument could be appealing if we only taxed citizens. But of course we, like every other country, also tax resident aliens, even though they do not vote, because they are a part of the relevant community. If we taxed only on the basis of citizenship, the U.S. would be full of former citizens carrying passports of other countries but living permanently in the U.S.

Moreover, we are not truly able to tax citizens living overseas on an ability-to-pay basis. In the case of the poorer ones, in many instances we do not even know they exist, and they may not know that they are citizens — hence the inability to count them in the decennial census.[24] In the case of most of the richer ones, we need to concede the primary right to tax them to their country of residence (which gets the ''first bite at the apple'') and to either exempt their income from taxation or grant a foreign tax credit. Thus, their income is not available to be taxed by us because it has already been taxed by another country. We should not base a broad rule such as ability-to-pay taxation of nonresident citizens on the relatively few cases of citizens living overseas in countries that have no or low income taxes.

IV. The Administrability Argument

Zelinsky, after acknowledging that the traditional benefits and ability-to-pay rationales for taxing nonresident citizens are weak, advances a new and ingenious argument: Citizenship is an administrable proxy for domicile.[25]

It is true that many countries base their worldwide tax on residents in part on fiscal domicile. Domicile is a standard, not a rule, and is embodied in the tax treaties (including U.S. tax treaties) as a tiebreaker in cases of dual residency.[26] As defined in the treaties, domicile requires the weighing of several factors, including where the taxpayer's ''permanent home'' is, her ''habitual abode,'' her ''centre of vital interests,'' and her ''nationality.'' Except for nationality (citizenship), all of these terms are not defined and tax administrations take different approaches to defining them.

Zelinsky correctly notes that the fiscal domicile standard is hard to administer, and in fact the U.S. abandoned this standard in its federal law in 1984 and replaced it with a physical presence rule (discussed below). But his suggestion that citizenship be used as a proxy for domicile is misplaced, because it is so clearly overbroad.

For citizens who are U.S. residents, there is no need to base taxation on citizenship because they would be taxed on worldwide income as residents. For nonresident citizens, citizenship is a poor proxy for domicile because so many of them live permanently overseas and do not have any of the other indicia of U.S. domicile other than citizenship. At the extreme, citizenship-based taxation applies to someone who was born in the U.S. but has no other U.S. connections at all and may even be unaware that he is a U.S. citizen.

If we are looking for an administrable definition of residency, we already have one in the physical presence test. Unlike corporations, individuals cannot be in more than one place at the same time, and therefore we and every other country base residency on physical presence, which is easily monitored using entry and exit records. With some exceptions, any individual who is physically present in the U.S. for over half a year (183 days) is subject to worldwide taxation regardless of citizenship status.

The argument against basing residency solely on physical presence is that it encourages individuals to ''count days'' and maintain their permanent home in the U.S. while being absent for enough days to escape

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[23]IRC section 877, recently supplemented by the more effective IRC section 877A. Despite these provisions, an increasing number of citizens expatriate. *See* Helena Bachmann, ''Why Most U.S. Expatriates Are Turning In Their Passports,'' *Time Magazine*, Apr. 20, 2010.

[24]GAO report, *supra* note 17.

[25]Zelinsky, *supra* note 3.

[26]*See* U.S. model, article 4 (2006).

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worldwide taxation. Therefore, we also count days in previous years, so that it is not possible to be in the U.S. 182 days in every year and avoid residency status. Because physical presence is perfectly administrable, administrability is not an argument for taxing nonresident citizens.

In fact, administrability is perhaps the strongest argument for not taxing nonresident citizens. Imagine for a moment that section 911 is repealed (as Wyden, Gregg, and many critics have advocated). In that case every U.S. citizen living permanently overseas would in theory be subject to full tax on the first dollar of income, and would need to claim the foreign tax credit (if applicable) to prevent dual taxation.

Even with the current resources of the IRS, the only nonresident citizens we are likely to tax in this scenario are temporary expatriates working for U.S. multinationals. In other cases, the only way to administer the tax is to condition the renewal of U.S. passports on reporting the tax ID number to the IRS so they can check if returns have been filed. This system works in many cases today because section 911 ensures that many nonresident citizens do not owe any U.S. tax and are therefore willing to file returns. If they had to actually pay tax, many of them might simply forgo renewing their U.S. passports, since they usually have other passports as well. I doubt the IRS could catch most of them under that scenario. A law that cannot be enforced is a bad law.

As a practical matter, taxing nonresident citizens is possible because:

- some of them work for large U.S. employers who aid the IRS in enforcing the tax; and
- most others do not owe any U.S. tax because of section 911.

Although there are no data I am aware of, I am doubtful we collect much tax from nonresident citizens living permanently overseas.[27] The cost of what we do collect is used to administer section 911, a complex provision that imposes significant transaction costs on both taxpayers and the IRS.

As Blum and Singer have argued, the taxation of nonresident citizens is unadministrable.[28] Attempting to tax them, today as in 1864, imposes a burden on the IRS that it is unable to meet. The result is a statute that is not complied with in a large number of cases, that imposes heavy transaction costs on those taxpayers that do comply, and that is saved from being ignored by a complicated provision (IRC section 911) that could be drastically simplified or abandoned if we did not tax nonresident citizens.

V. Conclusion

Taxation of nonresident citizens is a relic of the past that is ripe for abandonment. Historically, it stems from the outrage felt during the Civil War at draft dodgers. It has been with us ever since, even though we no longer have a draft, and even though no other country in the world (with the possible exception of Eritrea) taxes nonresident citizens. The only way we can maintain the fiction that we actually tax most of our nonresident citizens is by enacting complicated credit and exclusion provisions that are difficult to administer and are frequently ignored in practice. For someone who acquired U.S. citizenship by being born here and has lived almost his entire life overseas, filing tax returns and complying with sections 901 and 911 must be a highly unlikely proposition even if no tax burden would likely result.

If we did not tax nonresident citizens, we could abolish section 911. We could also abolish IRC section 877, which has proven ineffective in deterring tax-motivated expatriations, and simply apply the new IRC section 877A (the exit tax on expatriation) to individuals abandoning U.S. residency, like most countries do. Finally, we could give up on the ''savings clause'' in our tax treaties, which we insist upon to enable us to tax nonresident citizens but that we may well have to pay a price for in treaty negotiations.

None of the traditional arguments for taxing nonresident citizens are persuasive. The benefits provided to nonresident citizens are much weaker than the benefits provided to residents (whether citizens or aliens) and are identical to the benefits provided by other countries that do not tax nonresident citizens. The ability-to-pay argument fails because we need to concede primary taxing jurisdiction to the residence country, so that most of the income of nonresident citizens is unavailable for redistribution. And the administrability argument goes in the opposite direction: Taxation of nonresident citizens is both unadministrable in many cases and in others imposes heavy transaction costs. Finally, abandoning taxation of nonresident citizens could lead to significant simplification benefits.

The main reason we continue to tax nonresident citizens is history — it's a tradition that is 150 years old, and a significant part of American tax exceptionalism. But just as we joined the rest of the world in adopting corporate-shareholder integration, it is time for us to relinquish this part of our history and update our taxation to fit the globalized world of the 21st century, in which more and more U.S. citizens should be able to move overseas in pursuit of economic opportunity without being incentivized to relinquish their citizenship. ◆

[27] *See* JCT report, *supra* note 4.

[28] Blum and Singer, *supra* note 3.

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