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## A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals

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# A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals

*Cynthia Blum\**  
*Paula N. Singer\*\**

## ABSTRACT

*Taxation of the worldwide income of U.S. citizens has been a feature of the U.S. income tax since the Revenue Act of 1913. This Article proposes that the United States abandon its imposition of income tax based on citizenship and institute a new system for taxing individuals based solely on residence. This includes (1) a revised definition of "residency status" that would be based on physical presence and be monitored through an entry-exit system, (2) a proposal for an exit tax imposed on termination of residence with respect to unrealized appreciation accrued during the period of residence, and (3) new transitional treatment of residents who have left the United States within the past three years but have not yet made a decision to break off residential ties. These proposed rules are designed to achieve more uniform compliance, to reduce the administrative burden for U.S. taxpayers, and to facilitate IRS efforts to enforce U.S. tax obligations.*

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## I. INTRODUCTION

Taxation of the worldwide income of U.S. citizens has been a feature of the U.S. income tax since the Revenue Act of 1913.<sup>1</sup> Moreover, the United States has protected this basis for taxation in its negotiation of bilateral income tax treaties.<sup>2</sup> At the same time, very few countries have followed the U.S. approach of taxing nonresident citizens on worldwide income.<sup>3</sup> And a number of

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1. Underwood Tariff Act, Pub. L. No. 63-16, 38 Stat. 114 (1913). See Pamela Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 58 n.165 (1982); Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 454 (2007). In fact, Kirsch points out that "citizen-based income taxation of overseas Americans dates back to the Civil War." Kirsch, *supra*, at 449.

2. See *infra* note 7.

3. In 1995, the Joint Committee cited the Philippines and Eritrea as being in this category. STAFF OF THE J. COMM. ON TAXATION, 104TH CONG., BACKGROUND AND ISSUES RELATING TO TAXATION OF U.S. CITIZENS WHO RELINQUISH THEIR CITIZENSHIP AND LONG-TERM RESIDENT ALIENS WHO RELINQUISH THEIR U.S. RESIDENCY, JCX-16-95, 13 (Comm. Print 1995); see also STAFF OF THE J. COMM. ON TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION B-1 (Comm. Print 1995). However, the Philippines ended taxation of the worldwide income of its nonresidents in 1997. Kirsch, *supra* note 1, at 445 n.5. Many tax treaty partners have included provisions requiring U.S. citizens and green-card holders

commentators have questioned the wisdom of the approach, in light of the inherent difficulties of enforcing U.S. tax obligations of a nonresident citizen and the inherent potential for overlapping claims of taxation by the United States and the residence country.

This Article advocates eliminating citizenship as a basis for imposing U.S. taxation. Although the equitable arguments for imposing tax burdens on U.S. citizens living abroad have merit, administration of the rule is too difficult and expensive for taxpayers and the IRS, particularly in light of the need for remedies to prevent double taxation resulting from other countries' disparate rules. Citizenship-based taxation should be replaced with a more practical system of residence-based taxation. Residence would be determined largely through days of physical presence, monitored through an electronic entry-exit system at the borders. Residence jurisdiction would generally be deemed to continue during a temporary absence abroad for less than three years; however, an unlimited exclusion for foreign earned income would be permitted in this case. A taxpayer whose residence terminates would be taxed on the unrealized

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claiming treaty benefits to have "substantial presence" or some other nexus with the United States such as a permanent home or habitual abode. See Income Tax Convention art. 4(2), ¶ 1359.05, U.S.-Belg., Dec. 28, 2007, Tax Treaties (CCH); Protocol to U.S.-Sweden Income Tax Convention art. III, ¶ 8802, U.S.-Swed., Sept. 30, 2005, Tax Treaties (CCH); Income Tax Convention art. 4(2), ¶ 5201.04, U.S.-Japan, Nov. 6, 2003, U.S.-Japan, Tax Treaties (CCH); Income Tax Convention art. 4(2), ¶ 10,901.04, U.S.-U.K., July 24, 2001, Tax Treaties (CCH); Income Tax Convention art. 4(2), ¶ 2500.04, U.S.-Den., Aug. 19, 1999, Tax Treaties (CCH); Income Tax Convention art. 4(1), ¶ 8151.04, U.S.-Slovn., June 21, 1999, Tax Treaties (CCH); Income Tax Convention art. 4(1)(a), ¶ 11,103.04, U.S.-Venez., Jan. 25, 1999, Tax Treaties (CCH); Income Tax Convention art. 4(2)(c), ¶ 2801.04, U.S.-Est., Jan. 15, 1998, Tax Treaties (CCH); Income Tax Convention art. 4(2)(c), ¶ 5501.04, U.S.-Lat., Jan. 15, 1998, Tax Treaties (CCH); Income Tax Convention art. 4(2)(c), ¶ 5551.04, U.S.-Lith., Jan. 15, 1998, Tax Treaties (CCH); Income Tax Convention art. 4(1)(a), ¶4401.04, U.S.-Ir., July 28, 1997, Tax Treaties (CCH); Income Tax Convention, art. 4(1), ¶ 9403.04, U.S.-Thail., Nov. 26, 1996, Tax Treaties (CCH); Income Tax Convention art. 4(1)(a), ¶ 9101.04, U.S.-Switz., Oct. 2, 1996, Tax Treaties (CCH); Income Tax Convention art. 4(1)(c), ¶ 703.04, U.S.-Austria, May 31, 1996, Tax Treaties (CCH); Income Tax Convention art. 4(1)(c), ¶ 5701.09, U.S.-Lux., Apr. 3, 1996, Tax Treaties (CCH); Third Protocol to U.S.-Can. Income Tax Convention art. 3, ¶ 1914, U.S.-Can., Mar. 17, 1995, Tax Treaties (CCH); Protocol to U.S.-Port. Income Tax Convention art. 3, ¶ 7804, U.S.-Port., Sept. 6, 1994, Tax Treaties (CCH); Income Tax Convention art. 4(2)(a), ¶3001.05, U.S.-Fr., Aug. 31, 1994, Tax Treaties (CCH); Income Tax Convention art. 4(2)(c), ¶ 8103.04, U.S.-Slovk., Oct. 8, 1993, Tax Treaties (CCH); Income Tax Convention art. 4(2)(c), ¶ 2403.04, U.S.-Czech Rep., Sept. 16, 1993, Tax Treaties (CCH); Second Protocol to U.S.-Isr. Income Tax Convention art. II, ¶ 4604, U.S.-Isr., Jan. 26, 1993, Tax Treaties (CCH); Protocol to U.S.-Mex. Income Tax Convention art. 2, ¶ 5912, U.S.-Mex., Sept. 18, 1992, Tax Treaties (CCH); Protocol to U.S.-Spain Income Tax Convention art. 5, ¶ 8404, U.S.-Spain, Feb. 22, 1990, Tax Treaties (CCH); Protocol to U.S.-Tunis. Income Tax Convention art. II, ¶ 10,021, U.S.-Tunis., Oct. 4, 1989, Tax Treaties (CCH); Income Tax Convention art. 4(1), ¶ 2945.07, U.S.-Fin., Sept. 21, 1989, Tax Treaties (CCH); Protocol to U.S.-F.R.G. Income Tax Convention art. 2, ¶ 3210, U.S.-F.R.G., Aug. 29, 1989, Tax Treaties (CCH).

appreciation that accrued on the taxpayer's worldwide assets during residence.

Part II will begin by briefly describing the current rules for taxing U.S. citizens and residents and the arguments that have been made in favor of retaining citizenship-based taxation. Part III will then explain the rationale for eliminating citizenship-based taxation. The remainder of the Article will describe a proposed new system of taxation for individuals based solely on residence and the considerations entering into its design.

## II. THE CURRENT LAW AND THE CASE FOR CITIZENSHIP-BASED TAXATION

The United States imposes tax on the worldwide income of every U.S. citizen and every alien classified as a "resident alien" under § 7701(b) of the Code.<sup>4</sup> Under that provision, an alien is classified as a resident alien if the alien "is a lawful permanent resident" (i.e., a "green-card holder") at any time during the calendar year or meets the test of "substantial presence" for such year.<sup>5</sup> A U.S. citizen abroad may face overlapping taxation imposed by a foreign country based on residence in that country or his income having its source in that country, or both.<sup>6</sup> U.S. citizens are not generally permitted to avoid U.S. taxation by means of a U.S. treaty with another country in which they are residents; U.S. treaties block this through a "savings clause."<sup>7</sup> On the other hand, a U.S. citizen abroad may claim a limited exclusion for foreign earned income and, with respect to foreign-source nonexcluded income, may claim a credit against U.S. tax for foreign taxes paid or accrued.<sup>8</sup>

4. I.R.C. §§ 1, 61(a), 7701(b) (2000).

5. *Id.* § 7701(b).

6. *See id.* §§ 1, 61(a), 7701(b) (imposing by default a tax on the worldwide income of every U.S. citizen).

7. *See* U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, art. 1(4), *available at* <http://www.ustreas.gov/offices/tax-policy/library/model006.pdf> [hereinafter UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006]; U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 3-4, *available at* <http://www.ustreas.gov/offices/tax-policy/treaties.shtml> [hereinafter EXPLANATION OF THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006] (discussing savings clause in Article 1(4)).

8. I.R.C. §§ 901, 911. IRS statistics show that in 2001 "some 294,763 taxpayers reported over \$27 billion" of foreign earned income, "an increase of about 115 percent" from 1987. Lissa Redmiles, *Statistics of Income Studies of International Income and Taxes*, IRS SOI BULLETIN, Summer 2006, at 154, *available at* <http://www.irs.gov/pub/irs-soi/06sumbul.pdf>. The total amount of the earned income exclusion was about \$13.9 billion. *Id.*

The idea that an individual who has a strong connection with the United States should incur U.S. income tax on the basis of worldwide income has not generally been controversial;<sup>9</sup> if taxation is to be based on “ability to pay,” foreign-source as well as U.S.-source income must be taxed.<sup>10</sup> The more controversial question has been determining which individuals have a strong enough connection with the United States.<sup>11</sup> Recently, Professor Michael Kirsch has argued that the justification for taxing citizens abroad remains valid today and has even been strengthened by economic developments involving increased globalization.<sup>12</sup> Kirsch reviews the benefits afforded citizens residing abroad, such as “personal protection,” “property protection,” “right to vote,” “right to enter,” and “past benefits,” and concludes that these benefits “provide a basis for concluding that the United States is justified in exercising some type of taxing jurisdiction over those citizens.”<sup>13</sup> In addition, he argues that citizens abroad should be treated as “members of U.S. society” and thus subject to “ability to pay” taxation because their failure to renounce

9. See J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 309–12 (2001). They state that under the existing consensus,

individuals should be taken into account [as part of the group incurring worldwide taxation] if their connection with U.S. society is so substantial that fundamental fairness requires that their net incomes be compared with the net incomes of other U.S. residents for purposes of making an equitable allocation of the tax burden under an ability-to-pay system.

*Id.* at 309; see also Jeffrey M. Colón, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy*, 34 SAN DIEGO L. REV. 1, 10 (1997) (stating that in the case of U.S. citizens and residents, “worldwide income should be included in the tax base, since both U.S. and foreign source income equally affect a person’s ability to pay.”); David Tillinghast, *A Matter of Definition: “Foreign” and “Domestic” Taxpayers*, 2 INT’L TAX & BUS. L. 239, 240 (1984) (stating that “there is widespread agreement both within the United States and abroad . . . [that t]axpayers with a sufficiently close nexus to the jurisdiction to be considered ‘domestic’ should be taxed on their worldwide income.”).

10. Colón, *supra* note 9, at 8; Fleming et al., *supra* note 9, at 311.

11. See Fleming et al., *supra* note 9, at 309 (“[T]hose who continuously live year-round in the United States easily satisfy this standard but there is less clarity when the connection with the United States is less extensive”). They continue: “Congress has drawn lines to deal with this issue and one can debate whether the lines have been properly positioned.” *Id.* They point out that “one can entertain good faith doubts about whether an individual who is present in the U.S. for 183 days in one year, but is never in the U.S. any other year and has no ongoing U.S. ties is properly treated by IRC section 7701(b)(3) as a U.S. tax resident for the single year during which she was physically present in the United States.” *Id.* at 309 n.18. In addition, they note that “[o]bjections can . . . be raised to treating U.S. citizens as residents when they have not recently lived in the United States.” *Id.*

12. Kirsch, *supra* note 1, at 447.

13. *Id.* at 470–79. The Supreme Court rejected a challenge to taxation of foreign-source income of a nonresident citizen in *Cook v. Tait*, 265 U.S. 47 (1924). Professor Avi-Yonah suggests that “the opinion is weak.” Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 484 (2004).

citizenship “reflects a self-identification with the population of the United States (or the belief that the benefits of citizenship are worth the tax cost).”<sup>14</sup> Moreover, he notes that “[c]itizens living in the United States also view U.S. citizens living overseas as part of U.S. society, particularly in times of crisis.”<sup>15</sup> Finally, he concludes that “it is difficult to determine the extent, if any, that citizens living abroad bear a heavier overall tax burden than those living in the United States,” which might justify elimination of U.S. taxation.<sup>16</sup>

In making the case for citizenship-based taxation, Kirsch also argues that such taxation serves the goal of neutrality by “minimiz[ing] the role of taxes in a citizen’s residency decision.”<sup>17</sup> He recognizes, however, that “it might not be neutral with regard to a person’s decision to retain or surrender citizenship.”<sup>18</sup> He acknowledges the difficulties posed by citizenship taxation with respect to “compliance and enforcement” but points to a trend of improving enforcement and the fact that the actual degree of noncompliance is not known.<sup>19</sup> His final argument is that eliminating citizenship-based taxation might lead to residents believing that “citizens abroad ‘are getting away with something’” and “consequently los[ing] confidence in the tax system and the social norm of tax compliance.”<sup>20</sup>

### III. REJECTING CITIZEN-BASED TAXATION

Our disagreement<sup>21</sup> with Professor Kirsch about the wisdom of citizenship-based taxation centers<sup>22</sup> on issues of compliance and

14. Kirsch, *supra* note 1, at 481.

15. *Id.* at 483.

16. *Id.* at 488.

17. *Id.* at 490.

18. *Id.* at 493.

19. *Id.* at 495–501.

20. *Id.* at 502.

21. See Avi-Yonah, *supra* note 13, at 484, 486 (questioning whether the benefits provided by the United States to its citizens abroad are “really so great” and concluding “it is doubtful . . . whether the United States should continue to insist on taxing its citizens living overseas, especially since because of a combination of exemptions and credits (and enforcement difficulties) it collects little tax from them.”); Brainard L. Patton, Jr., *United States Individual Income Tax Policy as It Applies to Americans Resident Overseas*, 1975 DUKE L. J. 691, 730–35; Gann, *supra* note 1, at 59–69; Note, *Section 911 Tax Reform*, 54 MINN. L. REV. 823 (1969–1970); see also AMERICAN CITIZENS ABROAD, ELIMINATE CITIZENSHIP-BASED TAXATION, Apr. 27, 2005, available at [http://govinfo.library.unt.edu/taxreformpanel/comments/index8859.html?FuseAction=Home.View&Topic\\_id=3&FellowType\\_id=4](http://govinfo.library.unt.edu/taxreformpanel/comments/index8859.html?FuseAction=Home.View&Topic_id=3&FellowType_id=4); U.S. Citizens Overseas: Hearing Before the Subcomm. on International Operations of the H. Comm. on Foreign Affairs, 102d Cong. 65 (1991) (statement of the World Federation of Americans Abroad).

administrability. U.S. citizens overseas often face a difficult task in meeting their U.S. filing obligation and computing any tax owing. The IRS faces a difficult and relatively unrewarding task in seeking to remedy the significant noncompliance that likely occurs. As discussed below, the Authors contend that these problems seriously undermine the case for citizenship-based taxation.

### A. *The Taxpayer's Perspective*

The IRS provides very little in the way of on-site service for U.S. citizens overseas. Currently, the IRS has overseas offices only in London, Paris, and Frankfurt.<sup>23</sup> This makes it more difficult and

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22. The fact that U.S. census takers have been unable to identify nonresident citizens effectively means that many of the benefits detailed by Kirsch are not deliverable to the majority of nonresident citizens. A good example of a benefit that is not effectively delivered to nonresident citizens is their right to vote in federal elections. The New York Times reported recently that “over the last six years, the Defense Department has spent more than \$30 million trying to find an efficient way for American soldiers and civilians living abroad to vote in elections back home.” Ian Urbina, *Casting a Ballot Overseas is Sometimes No Sure Bet*, N.Y. TIMES, June 13, 2007, at A19. However, its web-based system, which is slow and confusing as well as plagued with security and privacy problems, “has left many of the five million [U.S. citizens] overseas uncertain that their vote will be counted” as the presidential primaries fast approach. *Id.* The article explains many of the problems associated with paper ballots, including changes in foreign addresses. *Id.* Such changes are a particular problem for the three million military personnel and their families because of their frequent redeployments around the world. *Id.* An election supervisor in Okaloosa County, Florida, noted that last year, “30 percent of all ballots she sent to voters overseas were returned because their mailing information had not been updated.” *Id.* The article notes that “[v]oters often wait until the last moment or get confused because rules and deadlines vary state to state,” and “[p]oor planning, legal challenges or technical problems often lead local election officials to send ballots abroad too late.” *Id.* For these reasons, “anywhere from a quarter to half of overseas voters fail in their attempt to vote,” according to experts at the National Defense Committee and the Overseas Vote Foundation. *Id.*

23. See INTERNAL REVENUE SERV. [IRS], PUBL'N 54, TAX GUIDE FOR U.S. CITIZENS AND RESIDENT ALIENS ABROAD: FOR USE IN PREPARING 2007 RETURNS 45 [hereinafter PUBLICATION 54] (listing phone numbers for offices in Frankfurt, London, and Paris); IRS, Contact My Local Office Internationally, [www.irs.gov/localcontacts/article/0,,id=101292,00.html](http://www.irs.gov/localcontacts/article/0,,id=101292,00.html) (last visited Mar. 29, 2008). The IRS also provides a (215) phone number and fax number for its Philadelphia office, which can be called from abroad; however, the numbers are not toll-free. *Id.* The telephone number is listed in Publication 54 but not in IRS, PUBL'N 593, TAX HIGHLIGHTS FOR U.S. CITIZENS AND RESIDENTS GOING ABROAD 11 (2008). Publication 593 and the IRS website provide times when taxpayers can call the embassy numbers on Monday through Friday: Frankfurt, 8:00 a.m.–4:00 p.m. CET; London, 9:00 a.m.– Noon GMT; Paris, 1:30 p.m.–3:30 p.m. CET. IRS, Contact My Local Office Internationally, *supra*. The IRS website also provides times when walk-in service is available at the embassies in London and Paris: 9:00 a.m.–4:00 p.m. and 9:00 – Noon, respectively. *Id.* There is a (787) number in Puerto Rico that can be called worldwide to reach the International Taxpayer Advocate. *Id.* Federal tax forms and publications are made available at U.S. embassies and consulates. PUBLICATION 54, *supra*; see also Paula N. Singer, *U.S. Tax Policy for Citizens and Immigrants Living Abroad Merits a Closer Look*, 34 TAX NOTES



expensive for overseas U.S. citizens to obtain IRS assistance in computing their taxes or resolving controversies.<sup>24</sup> In addition, overseas citizens find it harder and more expensive to obtain private tax preparation services, although multinational companies will often provide tax services for those employees moving overseas.<sup>25</sup> At the same time, overseas citizens will often face overlapping residence-based taxation on the part of the country in which they live.<sup>26</sup> Although they may be able to avoid double taxation by using the foreign earned income exclusion<sup>27</sup> and foreign tax credit,<sup>28</sup> they are nevertheless required to file a U.S. return and to determine the application of these relatively complex provisions. Moreover, many overseas taxpayers have misconceptions about the requirement to file returns when overseas.<sup>29</sup>

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INT'L 283, 291 (2004) (noting that there were twenty-eight overseas IRS offices in 1986 and five in 2004).

24. See *supra* note 23.

25. See *infra* note 43; James M. Yager, *Introduction to HR Tax Reimbursement Policies for Canada to U.S. Employee Relations* (1999), <http://www.grasmick.com/equalize.htm#Reimbursement> (last visited Mar. 29, 2008) (noting that many companies assist employees with tax preparation and ensure that employees receive the same compensation no matter the taxes to which they are exposed from working abroad).

26. Gann, *supra* note 1, at 44; see also HUGH J. AULT, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 368 (1997) (noting that using citizenship as a "basis for personal jurisdiction increases the possibility of overlapping claims for worldwide taxation").

27. See, e.g., Sharon Reier, *Uncle Sam Takes a Bite Out of Expatriate Incomes; Burden of New Tax Law Expected to Fall on the Middle Class and Semi-retired*, INT'L HERALD TRIB., May 26, 2006, at 19.

28. Avoiding double taxation of U.S.-source income by the United States and the citizen's resident country (both applying graduated rates) may require resort to a treaty provision. See U.S. DEPT. OF THE TREASURY, *UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006*, *supra* note 7, art. 23(4); *EXPLANATION OF THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006*, *supra* note 7, at 75-77. Under this provision, the residence country need not provide credit for U.S. tax paid in excess of the hypothetical reduced treaty rate (which would apply if the taxpayer were not a U.S. citizen), and the United States avoids double taxation by providing credit for the foreign tax paid to the extent of the difference between the applicable U.S. rate (computed without regard to the treaty) and the reduced treaty rate. *Id.* For example, assume that a U.S. citizen would be taxed by the United States on a U.S.-source dividend at a rate of 35%; the citizen resides in a treaty country, and the treaty (absent the savings clause) would provide for a reduced treaty rate of 15%. The United States imposes its tax of \$35 on a dividend of \$100; the other country (assuming its applicable tax rate is 40%) imposes a tax of \$40 but allows a credit of \$15; the United States grants a credit for \$20 (the difference between the U.S. rate of 35% and treaty rate of 15%). Thus, the net U.S. tax is \$15, and the net foreign tax is \$25. Under the treaty, the United States re-sources a sufficient portion of the dividend to foreign sources to allow the \$20 credit to be obtained. For further discussion, see Gann, *supra* note 1, at 48-58.

29. The GAO in 1985 recommended educating overseas citizens on several points of confusion, including the facts that they are not excused from filing by virtue of nonresidence, that filing is required to claim the foreign earned income exclusion and foreign tax credit, and that the foreign earned income exclusion is limited to income derived from services. Singer, *supra* note 23, at 290.

A particularly striking example of overseas U.S. citizens facing considerable burdens in becoming tax compliant are so-called "accidental citizens." Many of these are children born in the United States to noncitizen parents visiting the United States as workers on temporary assignment, as students, or as exchange visitors. They (and their parents) are frequently unaware of their status as U.S. citizens or their tax obligations on returning to their home country.<sup>30</sup> If they should become aware of their own noncompliance, they would likely see no reason to remedy it unless they plan to travel to the United States or they begin employment with a U.S. employer abroad. In that case, they would generally need to file back returns for a period of six years and would need to provide an explanation for late filing in order to use the § 911 exclusion on a late-filed return.<sup>31</sup>

### B. *The IRS Perspective*

The IRS is at a serious disadvantage in monitoring compliance by U.S. citizens overseas because of the lack of many of its usual sources of information.<sup>32</sup> As noted, it lacks a significant physical

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30. *Id.* at 292–93. The immigration service reported that there were approximately 593,000 international students, 134,000 exchange visitors, and 121,000 dependents of these individuals in the United States as of the end of April 2004. *Id.* at 293. Other "accidental citizens" include foreign-born children of U.S. citizens. See also Kimberly S. Blanchard & Natalie C. Maksin, *The Jobs Act's Individual Expatriation Provisions*, 105 TAX NOTES 1119, 1122 (Nov. 22, 2004) (describing the "not-atypical case" of a so-called "involuntary citizen" who "was born in the United States to English parents who happened to be here for a one-year student transfer program," but who spent the rest of her life in England). In the example, her parents obtained a U.S. passport for her, but she let it lapse by age twenty-two; neither the child nor the parents were aware that she was liable to U.S. taxation of worldwide income until, at age thirty, she joined an international accounting firm. *Id.* The authors note that she would be subject to § 877 if she chose to expatriate (assuming she met the "net worth" threshold due to an inheritance) and would not be eligible for any exception because she is not a minor and once had a U.S. passport. *Id.* at 1123. The authors conclude that "she would almost certainly decide not to expatriate and *not* to come into compliance with her U.S. tax obligations." *Id.*

31. See PAULA N. SINGER, INTERNATIONAL ASPECTS OF INDIVIDUAL U.S. TAX RETURNS 14, 25–26 (2007). Relief will generally be granted if the return is filed before the IRS discovers the failure to file and make the election, or in various other circumstances suggesting that the taxpayer has acted in good faith. *Id.* at 26; see also Jane A. Bruno, *Nonfilers of U.S. Tax Returns, How To Remedy the Situation (And Get Back in the Good Graces of the IRS!)*, <http://www.overseasdigest.com/odarticles/nonfilers1.htm> (last visited Mar. 29, 2008). Under current law, if such individuals choose to renounce citizenship for the future, they are potentially subject to the special tax regime of § 877 for the following ten years. I.R.C. § 877(a)(1). However, an exception to Section 877 is made if a minor, who becomes a citizen at birth and whose parents are not citizens, renounces citizenship before attaining the age of eighteen and a half, and was not present in the United States for more than thirty days during any one of the ten years preceding the renunciation. I.R.C. § 877(c)(3).

32. See David R. Tillinghast, *Issues of International Tax Enforcement*, in THE CRISIS IN TAX ADMINISTRATION 38, 39 (Henry J. Aaron & Joel Slemrod eds., 2004)

presence in foreign countries. In the case of overseas citizens, there is mandatory information reporting<sup>33</sup> for compensation paid by U.S. employers and investment income paid by U.S. payors but not for compensation paid by a foreign employer or income derived from foreign financial assets.<sup>34</sup> As a result, there may be no information in

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("[T]he largest single source of difficulty in administering the international aspects of the U.S. tax law is that a large part of the information the IRS needs is not directly available to it, by reason of jurisdictional limitations."). Tillinghast further explains that "[i]n a broad range of cases the IRS cannot require foreign persons to withhold U.S. tax or to provide information to it." *Id.* He also notes: "it is my understanding that the IRS does not systematically cross-check green cards or passports against filed returns to find persons outside the United States who are not filing." *Id.* at 39–40.

33. The higher rate of noncompliance for income not subject to withholding or information reporting is indicated in IRS statistics for the individual income tax reporting gap in 2001. See IRS, 2006 TAX GAP FIGURES, available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf).

34. See U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: NONFILING AMONG U.S. CITIZENS ABROAD—REPORT TO THE CHAIRMAN, COMMITTEE ON WAYS & MEANS 3, GAO/GGD-98-106 (May 1998) (noting that a major impediment to ensuring compliance is that "the income of U.S. citizens residing abroad is generally not subject to U.S. tax withholding or information reporting if it is derived from foreign employers or foreign financial investments.") [hereinafter GAO/GGD-98-106]. However, investment income of U.S. citizens and resident aliens has begun to be reported to the IRS by Qualified Intermediaries, i.e., foreign banks and other financial organizations that have entered into agreements with the IRS under the Section 1441 regulations that became effective January 1, 2001. *Id.* at 14. Of course, it is also true that taxpayers living in the United States may hold foreign financial assets, perhaps acquired in transactions conducted through the Internet, that are not reported to the IRS by the taxpayer or payor. See, e.g., Martin A. Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 34 TAX NOTES INT'L 898, 898 (2004). The Treasury has stated that in 2001 the approximate rate of compliance with the requirement of filing TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," was only 20%. *Id.* at 901. Sullivan notes that the 2001 tax information exchange agreement between the United States and the Cayman Islands does not provide for "automatic" information exchange. *Id.* at 903; see also *Offshore Tax Evasion: Hearing before the Senate Finance Committee* (May 3, 2007) (testimony of Prof. Reuven S. Avi-Yonah); Allen Kenney, *Deficient Data to Blame for Foreign Income Problems*, *Everson Says*, TAX NOTES TODAY, June 15, 2006, at 1 (noting that the 2005 report of the Treasury Inspector General for Tax Administration stated that IRS "fails to make good use of" information provided by twenty treaty partners about U.S. taxpayers; Everson explained that there are various problems with processing the data, including "missing U.S. taxpayer identification numbers; foreign language and currency issues; and mismatched tax years"). Just recently, the Treasury reported that filings of Form 90-22.1 have increased from 177,000 in 2001 to 287,000 in 2006. Martin A. Sullivan, *Offshore Account Compliance Rising, But Compliance Remains Low*, 115 TAX NOTES 1099, 1099 (June 18, 2007); see also Martin A. Sullivan, *Economic Analysis: Keeping Score on Offshore: U.K. 60,000, U.S. 1,300*, 116 TAX NOTES 23, 23 (July 2, 2007) (noting that the U.K.'s amnesty program for offshore accounts attracted many more applicants than the IRS program had). He concludes that

until the IRS gets data on offshore accounts as good as the [U.K. tax authorities are] getting from U.K. banks (as a result of production orders) and from EU banks (as a result of the savings directive), the U.S. effort to curtail offshore tax evasion is in a state of limbo.

IRS records about many overseas citizens. Nor does the IRS have available any other source of comprehensive data regarding the names and addresses (or even the numbers) of overseas citizens.<sup>35</sup> The U.S. Census Bureau has not included overseas citizens in the decennial census, and a 2004 effort to test the feasibility of such inclusion was not promising.<sup>36</sup> Although applications for a U.S. passport or its renewal are required to contain a taxpayer identification number, if any,<sup>37</sup> in many cases they do not.<sup>38</sup> Thus,

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Sullivan, *Economic Analysis*, *supra*, at 27. However, the IRS may have more potential avenues for discovering these assets. See Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, *supra*, at 905 (noting that “although foreign bank records may not be within the jurisdiction of U.S. law enforcement, there are many other related records that are,” such as “[d]omestic bank accounts and domestic businesses”). He explains that “somehow the money must get offshore” and “to be useful to a U.S. resident, somehow must get back,” and that the IRS can subpoena “phone and travel records.” *Id.* He also describes the IRS efforts in 2002 to obtain “credit card records of U.S. companies that draw funds from accounts in the Cayman Islands . . . for regular purchases in the United States.” *Id.* By contrast, a U.S. citizen living abroad could avoid credit card or other transactions in the United States that might trigger U.S. suspicion. *Id.* Overseas citizens would also be in a position to acquire “foreign-targeted” bearer obligations of U.S. issuers. See Stephen E. Shay, J. Clifton Fleming, Jr., & Robert J. Peroni, “What’s Source Got to Do With It?: Source Rules and U.S. International Taxation,” 56 TAX L. REV. 81, 127 (2002) (noting that there are “no meaningful protections against U.S. persons acquiring the bonds as beneficial owners in the secondary market”).

35. See *supra* note 22.

36. The U.S. Census Bureau was asked to consider including overseas citizens in the 2010 census, but its 2004 Overseas Enumeration test, conducted in France, Kuwait, and Mexico, suggested that this could not be done “with any degree of measurable certainty.” See *Counting Americans Overseas: Lessons Learned From the 2004 Overseas Enumeration Test*, Hearing Before the Subcomm. on Technology, Information Policy, Intergovernmental Relations, and the Census of the H. Comm. on Oversight and Government Reform, 108th Cong. (Sept. 14, 2004) (statement of Charles Louis Kincannon, Director, U.S. Census Bureau), available at <http://www.census.gov/Press-Release/www/2004/testimony9-14-04.html>. Mr. Kincannon noted that “[w]hile other attempts in the past were made to count the civilian population overseas, the Census Bureau has never included all Americans residing overseas in the totals for either reapportionment or redistricting.” *Id.* In this test, questionnaires were available online and in a number of locations; assistance in publicizing the test was provided by U.S. consulates and various clubs and organizations serving citizens overseas. *Id.* Preliminary results indicated that “the response was low by any standard,” that is, 3,100 questionnaires in France, 300 in Kuwait, and 2,000 in Mexico. *Id.* Some who did not respond “[c]it[ed] concerns about privacy and their taxes.” *Id.* Mr. Kincannon cited the absence of the type of Master Address List and mapping system that the Census Bureau has for the United States as well as the “lack of a field infrastructure to conduct non-response follow up.” *Id.* For further discussion of the 2004 test, see U.S. GEN. ACCOUNTING OFFICE, 2010 CENSUS: COUNTING AMERICANS OVERSEAS AS PART OF THE DECENNIAL CENSUS WOULD NOT BE COST-EFFECTIVE, REPORT TO THE SUBCOMMITTEE ON TECHNOLOGY, INFORMATION POLICY, INTERGOVERNMENTAL RELATIONS AND THE CENSUS, COMMITTEE ON GOVERNMENT REFORM, HOUSE OF REPRESENTATIVES, GAO-04-898 (Aug. 2004); U.S. GEN. ACCOUNTING OFFICE, OVERSEAS ENUMERATION TEST RAISES NEED FOR CLEAR POLICY DIRECTION, REPORT TO THE SUBCOMMITTEE ON TECHNOLOGY, INFORMATION POLICY, INTERGOVERNMENTAL RELATIONS, AND THE CENSUS, COMMITTEE ON GOVERNMENT REFORM, HOUSE OF REPRESENTATIVES, GAO-04-470 (May 2004).

37. See I.R.C. § 6039E(a)–(b)(1).

the IRS often lacks the information required to identify non-filers or to determine if income has been fully reported by those who do file.

It seems fairly clear that many<sup>39</sup> overseas citizens are not filing required tax returns. However, even if overseas citizens did file returns, it is not as clear whether they would owe a significant amount of tax, in light of the foreign earned income exclusion and foreign tax credit.<sup>40</sup> In addition, even if the IRS were able to identify cases where considerable additional tax is owed, it might not have the ability to collect the tax from an uncooperative taxpayer whose assets may be entirely overseas.<sup>41</sup> Therefore, even if the IRS were to have greater resources, it might not find it efficient to spend them in efforts to ensure compliance on the part of overseas citizens.

### C. *The Impact on the Case for Taxing Based on Citizenship*

In theory, citizenship-based taxation may have merit: it is arguable that U.S. citizens living abroad generally do receive significant benefits from their status as citizens, and fairness suggests that they should be taxed differently from a nonresident alien. Ideally, the U.S. tax system should not operate to provide a tax incentive for a citizen (or an alien)<sup>42</sup> to reside abroad. However,

38. GAO/GGD-98-106, *supra* note 34, at 11 (stating that 44% of the 303,000 passport records listing foreign mailing addresses received by the State Department in 1995 and 1996 that were reviewed by the GAO did not contain social security numbers). According to the Joint Committee on Taxation, "it is not uncommon" for individuals who relinquish U.S. citizenship "not to have a social security number." STAFF OF THE J. COMM. ON TAXATION, REVIEW OF THE PRESENT-LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP AND TERMINATION OF LONG-TERM RESIDENCY 89 (Feb. 2003).

39. The number of Forms 1040 for 1998 actually filed from overseas (not including Form 1040NR filed by nonresidents) was approximately 580,000. See STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at A-45. The most recent official estimate of the number of U.S. citizens residing abroad, compiled by the Bureau of Consular Affairs in July 1999, was 3,784,693. Bureau of Consular Affairs, *Private American Citizens Residing Abroad*, [www.pueblo.gsa.gov/cic\\_text/state/amcit\\_numbers.html](http://www.pueblo.gsa.gov/cic_text/state/amcit_numbers.html) (last visited Mar. 29, 2008). The estimate does not include military or nonmilitary employees of the U.S. Government and their dependents. *Id.*

40. In 1998, the General Accounting Office studied nonfiling among U.S. citizens overseas and concluded that "[d]ata on the number of U.S. taxpayers residing abroad and the number of returns they file are of uncertain reliability, and the amount of taxes that nonfilers would owe if they were to file is uncertain." GAO/GGD-98-106, *supra* note 34, at 2-3.

41. The IRS may request help from its treaty partners under the Exchange of Information and Administrative Assistance Article of an applicable income tax treaty. UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, *supra* note 7, at art. 26.

42. See Kirsch, *supra* note 1, at 490 (suggesting that resting taxation solely on residence would create an inappropriate incentive for U.S. citizens to reside abroad to avoid U.S. taxes). However, this argument seems to depend on rejection of the premise that the country of residence is in fact the country to which individuals have their strongest economic and social connection. If one accepts that premise, there would

practicality also needs to be taken into account. When U.S. citizens live overseas (and are potentially subject to overlapping taxation in their countries of residence), it is more difficult for the taxpayers to satisfy their obligations to file an accurate U.S. tax return, and it is more difficult for the IRS to determine whether filing obligations have been met. The result is most likely a high (but undeterminable) degree of noncompliance (particularly in the form of non-filing). Whether overseas citizens are tax compliant may depend on such factors as whether they are employed by a U.S. employer,<sup>43</sup> their degree of sophistication and financial resources, and their willingness to be compliant absent IRS monitoring; yet these factors are unrelated to any consideration of fairness in taxing a particular individual.<sup>44</sup>

If enforcement of tax obligations of U.S. citizens living abroad is haphazard and the rate of noncompliance is considerably higher than for citizens living in the United States, then the asserted goals of citizenship-based taxation are not being met. Many citizens living abroad are not paying a fair share of taxes in recognition of the

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seem to be nothing inappropriate in an individual choosing between potential countries of residence based on the level of economic and social benefits obtained by residence, including the level of taxes imposed. In that light, citizenship-based taxation could be viewed as simply an artificial means to block this natural competition between potential countries of residence. On the other hand, even if one accepts the premise of basing taxation on residence, a country would not want to create a tax incentive for individuals to terminate their residence on a merely *temporary* basis so as to shift tax liability on large items of already accrued income to a lower tax country.

43. See MIHIR A. DESAI, DEVESH KAPUR & JOHN MCHALE, WEATHERHEAD CENTER FOR INTERNATIONAL AFFAIRS, SHARING THE SPOILS: TAXING INTERNATIONAL HUMAN CAPITAL FLOWS 29 (2002), available at <http://casi.ssc.upenn.edu/about/Sharing%20the%20Spoils.pdf> (noting that the U.S. rules for taxing U.S. workers overseas “appear complex and onerous enough such that they may create significant compliance costs for individual taxpayers”). However, these authors note that “[m]ultinational firms . . . have largely internalized these compliance costs and leave their employees insulated from this tax treatment.” *Id.* They note that a “recent survey” found that “tax equalization is employed by more than 82.6[%] of U.S. firms with employees abroad” and that as a result, “the actual administrative burden on individuals . . . appears limited.” *Id.* at 30. However, the survey showed that 8.1% of the firms employed “tax protection” under which “employees bear the administrative costs of complying with host and home tax rules.” *Id.* Many small and medium-sized companies fail to provide tax advice or tax preparation assistance to their U.S. employees abroad. *Id.* at 29. These companies also frequently fail to understand the U.S. and foreign withholding and reporting obligations related to the employees’ remuneration (particularly benefits-in-kind), leaving the employees to their own devices (which may be evasion of their tax responsibilities in the United States or in their country of residence or both).

44. It also can depend on the U.S. dollar exchange rate with the local currency because all income amounts denominated in a foreign currency must be translated into U.S. dollars for U.S. tax return purposes, including the determination of whether the tax return filing threshold has been met for the year. Internal Revenue Service, U.S. Citizens and Resident Aliens Abroad - Filing Requirements, <http://www.irs.gov/businesses/small/international/article/0,,id=96796,00.html> (last visited Mar. 29, 2008).

benefits conferred by citizenship.<sup>45</sup> And citizens who are willing to ignore their U.S. tax obligations continue to have a tax incentive to move abroad.<sup>46</sup> Asserting citizenship-based taxation without adequate enforcement may harm the morale of citizens living in the United States who are subject to closer monitoring by the IRS.<sup>47</sup> Finally, those citizens living abroad who are compliant (whether because of a U.S. employer or because of a desire to be a good citizen) are subject to greater tax compliance burdens than citizens living in the United States; moreover, they suffer the additional unfairness that many other overseas citizens are avoiding the complications and expense of satisfying their U.S. tax obligations with impunity.

This Article argues that it is time for the United States to abandon citizenship-based taxation and to focus on the criterion of residence,<sup>48</sup> which is more likely to correspond to an individual's ability to comply and the IRS's ability to monitor compliance and which reduces the potential for overlapping taxation.<sup>49</sup>

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45. See *supra* note 39.

46. Professor Kirsch recognizes that “[t]o the extent the tax on citizens living abroad cannot be enforced, the equity and efficiency concerns discussed above may be moot.” Kirsch, *supra* note 1, at 496. On the other hand, Eric Toder suggests that reducing the tax gap by reducing the tax obligations of a group of noncompliant taxpayers does not necessarily result in greater fairness. See ERIC TODER, URBAN INST. & URBAN-BROOKINGS TAX POL’Y CTR., REDUCING THE TAX GAP: THE ILLUSION OF PAIN-FREE DEFICIT REDUCTION 19 (2007), available at <http://www.urban.org/publications/411496.html> (“A reform that some might think would make the tax system less fair—for example, reducing tax rates on business and investment income for high income taxpayers—could nevertheless lower the tax gap by reducing taxation of income sources with a high noncompliance rate.”).

47. Professor Kirsch acknowledges that “while tax compliance norms might be undermined if Congress eliminates citizenship-based taxation altogether . . . they might also be undermined if Congress imposes citizenship-based taxation and the IRS is viewed as failing to enforce it.” But he concludes that “the risks seem greater in the first instance.” Kirsch, *supra* note 1, at 502.

48. For an earlier proposal “to exempt the American citizen resident overseas from U.S. income tax jurisdiction,” see Patton, *supra* note 21, at 730–36. Under his proposal, the U.S. citizen overseas would prove that he has a foreign fiscal domicile, for example, through “two full years of bona fide residence” in a particular foreign country “coupled with the filing of local tax returns as a resident.” *Id.* at 733. He also notes the option of “imposing a special tax or deposit on departing citizens, as Canada does” in order to deal with those who “move overseas for the purpose of avoiding” U.S. tax. *Id.*

49. See Gann, *supra* note 1, at 69 (pointing out that elimination of citizenship-based taxation would “simplif[y] in several ways U.S. taxation and confor[m] it to the clear international preference for residence jurisdiction”).

#### IV. A PROPOSAL FOR TAXATION BASED ON RESIDENCE

##### A. *Defining Residence*

Part III concluded that U.S. taxation of worldwide income of individuals should be limited to those who can be considered residents of the United States (without regard to U.S. citizenship).<sup>50</sup> Under this approach, nonresidents would be taxed according to the rules that currently apply to individuals classified as nonresident aliens.<sup>51</sup>

This Part considers how to make the determination of who is a “tax resident” without undue complexity and uncertainty. The concept of “substantial presence,” already incorporated in § 7701(b), is the best tool for this purpose. This argument is based on the assumption that the United States will continue the process of implementing a new border control system that will greatly simplify the determination of an individual’s actual days of presence in the United States.

##### B. *How an Individual Becomes a Tax Resident*

The United States has already adopted the principle of worldwide taxation of aliens who are residents in the United States and has adopted a definition of residence for this purpose. Our proposal would seek to use the concepts already incorporated in the Code to craft a definition of “tax residence” applicable to citizens and aliens alike.<sup>52</sup>

Under current law, the U.S. tax treatment of aliens depends on whether they are “resident aliens” or “nonresident aliens,” as defined by § 7701(b). An alien is generally considered to be a resident alien if (a) he has been admitted by immigration authorities for permanent legal residence (that is, he has a “green card”) or (b) he meets the largely mechanical test of “substantial presence” based on days of actual presence in the current and two preceding calendar years.<sup>53</sup> Under the test, individuals are generally considered to be “substantially present” in the current calendar year if they are present for at least 31 days during the year and if a weighted average of their days of presence in the current and two preceding years is at

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50. See *supra* Part III.

51. See I.R.C. §§ 2(d), 871(a)–(b), 1441.

52. The rules would apply to U.S. nationals as well. These individuals born in American Samoa or the Commonwealth of the Northern Mariana Islands are not considered aliens under the U.S. immigration laws.

53. I.R.C. § 7701(b).



least 183 days.<sup>54</sup> However, days of presence in certain immigration categories for exchange visitors, students, or diplomats are disregarded, as is the presence of a daily commuter from Mexico or Canada.<sup>55</sup> Individuals who meet the weighted average test for substantial presence but are present for fewer than 183 days in the current year may avoid residency status if they establish that they have a tax home in a foreign country and a closer connection to that country than to the United States.<sup>56</sup>

The definition of residence under § 7701(b) was adopted by Congress in 1984 to replace a test for residence provided in Treasury regulations.<sup>57</sup> That test required a determination of "an alien's intentions with regard to the length and nature of his stay," i.e., whether he was "a mere transient or sojourner" in this country.<sup>58</sup> Congress concluded that this test "did not provide adequate guidance" and that "a more objective definition of residence" was needed.<sup>59</sup>

The substantial presence test can serve as the basic criterion for a workable definition of "tax residence" that would apply to citizens as well as aliens in a new tax system. Requiring all U.S. citizens (and green-card holders) to apply the 183-day test to determine tax-residency status may seem like a major new complication for taxpayers. In practice, however, the vast majority of citizens would have no difficulty determining that they are "tax residents" under the substantial presence test (since they have lived for many years in the United States and leave the United States, if at all, only for brief vacations or business trips). Moreover, those U.S. citizens who permanently reside abroad and make at most brief visits to the United States would also have no difficulty in determining their status as "tax nonresidents."

Of course, there would be a considerable number of U.S. citizens who would need to give more detailed consideration to their days of actual presence to determine tax-residency status. This in turn would appear to place a considerable burden on the IRS, which would have to rely on taxpayers to provide information in each case about the number of days that they have been present. This determination would not, however, be difficult for either the citizen or the IRS if an

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54. The weighted average consists of 100% of the days of presence in the current year, one-third of the days of presence in the first preceding year, and one-sixth of the days of presence in the second preceding year. *Id.* § 7701(b)(3)(A).

55. *Id.* §§ 7701(b)(5), (b)(7)(B).

56. *Id.* § 7701(b)(3)(B).

57. STAFF OF COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 463 (Comm. Print 1984) (citing former Treasury Regulation § 1.871-2).

58. *Id.*

59. *Id.* at 463-64.

entry-exit system is in place at this country's borders.<sup>60</sup> As a result of concerns about terrorism, Congress has been pressing the Department of Homeland Security to implement such a system.<sup>61</sup> While progress has not been as fast as many desire, eventual implementation of such a system is probably inevitable.<sup>62</sup> Under such a system, U.S. citizens would have their passports scanned upon entering or departing the country and Homeland Security would have a record of the accumulated days of presence for each citizen. This information could be transmitted to the IRS,<sup>63</sup> and, assuming that passport records contained a citizen's social security number,<sup>64</sup> the IRS could easily determine whether a citizen had met the 183-day test.

A mechanical test based on days of presence may not fully capture the degree of closeness of one's economic and social ties to the United States. For example, some sophisticated individuals would be able to avoid "substantial presence" by limiting their days of presence

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60. Without an entry-exit system, tax rules regarding individuals entering and exiting the United States do not work well. For example, when changes to IRC Section 877 were passed in 1996 for certain U.S. citizens who renounce their U.S. citizenship for tax avoidance purposes, an amendment was also added to the U.S. immigration laws providing that such U.S. citizens are excludable from the United States. See Act Sept. 30, 1996, P.L. 104-208, 110 Stat. 3009-641. The current immigration rule in 8 U.S.C. § 1182(a)(10)(E) states: "Any alien who is a former citizen of the United States who officially renounced United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States is inadmissible." Since the immigration service never implemented procedures to enforce this rule, these tax expatriates may reenter the United States as nonimmigrants. See *supra* note 30.

61. See generally *US-VISIT'S Role in Addressing U.S. Border Security Needs: Hearing Before House Subcomm. on Border, Maritime, and Global Counter-Terrorism* (2007) (joint statement of Robert A. Mocny, Dir. of US-VISIT Program & Robert Jacksta, Exec. Dir. of Traveler Security and Facilitation Office of Field Operations).

62. See generally *id.*; Press Release, Dept. Homeland Sec., Fact Sheet: Strengthening Border Security and Facilitating Entry into the United States, Moving Toward WHTI Implementation for Cross-Border Travel by Land and Sea (June 20, 2007); Larry Greenemeier, *Biometrics Slow to Check Exits*, INFORMATIONWEEK, July 9, 2007, at 24. (noting that "Congress repeatedly has called for biometric technology, beginning with the Patriot Act of 2001" and that "Homeland Security is promising by the end of next year to fully implement a biometric exit program to track that foreign nationals entering the country also leave it, if they're supposed to").

63. See Letter from Paula N. Singer to Paul H. O'Neill, Secretary, Dept. of Treasury (Mar. 28, 2002), available at Lexis, 2002 TNT 85-27 (outlining the situations in which an Entry/Exit System could be used to further tax compliance for foreign national visitors); see also BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER 17 (1995) (noting that a test such as the 183-day test "is probably enforceable in countries that exercise tight control over their borders," but is "extremely difficult for the tax authorities . . . to enforce . . . when many individuals are frequently entering and leaving the country without border checks").

64. This Article's proposal envisions stricter enforcement of the existing requirement in Section 6039E that all passport applications include a social security number. See *supra* notes 37-38 and accompanying text.

in each calendar year to 121 or less.<sup>65</sup> However, this is also true of the current law's test for determining the residence of an alien who does not hold a green card. It would be possible to give some special weight to ties of citizenship by modifying the "substantial presence" test so that the number of required days of presence is, for example, only 120 for citizens, and by providing that a U.S. citizen who maintains a U.S. dwelling is viewed as a resident.<sup>66</sup> This would, however, greatly complicate administration of the test. In addition, some avoidance is prevented by adopting special rules (described below) to deal with departures by individuals who have already had tax-residency status established under the substantial presence test.

Just as sophisticated individuals can avoid running afoul of the 183-day test, unsophisticated individuals may find it a trap for the unwary.<sup>67</sup> These individuals may also be considered residents of a foreign country with which they may have economic and social ties, resulting in double taxation on the basis of residence. Given the variety of tests for residence currently in use around the globe, it is not possible for the United States to achieve complete conformity with the tests of every other country. However, this Article contemplates that the United States, in giving up citizenship-based taxation, would also eliminate the savings clause from treaties. In this way, a U.S. citizen (or alien) who is classified as a resident in both the United States and a country that has a treaty with the United States could make use of the residency tie-breaker clause in U.S. treaties to prevent overlapping assertions of residence. To assist those living in nontreaty countries, it would be possible to include an exception to the substantial presence test, such as in current § 7701(b)(3)(B); this provision applies to an individual who is present in the United States for fewer than 183 days in the *current year* and establishes that he has a "tax home" and "closer connection" to a foreign country. It is not clear, however, that the need for such an exception is great enough to justify the additional efforts required on the part of the

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65. See ARNOLD & MCINTYRE, *supra* note 63, at 17 ("[m]any individuals with substantial economic ties to a country can plan around the 183-day test").

66. See *id.* at 18 (suggesting that "a facts-and-circumstances test that uses certain objective tests to establish presumptions may provide a good balance between certainty and fairness"). They suggest that, for example, there could be a presumption of residence for "[i]ndividuals having a dwelling in the country unless they also have a dwelling in another country." *Id.*; see also Ward M. Hussey & Donald C. Lubick, *Basic World Tax Code and Commentary*, 5 TAX NOTES INT'L 1191, 1202 (1992) (defining a domestic taxpayer as including "any individual who is domiciled in, or has a principal place of abode in, [the country], or who is present in [the country] on more than 182 days during the taxable year").

67. See ARNOLD & MCINTYRE, *supra* note 63, at 17 (stating that a country using such a test "is likely to catch unsophisticated and unadvised individuals, some of which may not in fact have very substantial ties to that country").

taxpayer and the IRS to administer it.<sup>68</sup> And a simple 183-day rule, without exceptions, will also be easier to communicate to visitors to the United States so as to help them to avoid unintended consequences.

“Lawful permanent residents,” like citizens and other aliens, should also be subject to the 183-day test to determine residence. The automatic treatment of green-card holders as resident aliens was adopted by Congress in the 1984 legislation because green-card holders “have rights in the United States that are similar to those afforded U.S. citizens (including the right to enter the United States at will).”<sup>69</sup> Consequently, “equity demands that they contribute to the cost of running the government on the same basis as citizens.”<sup>70</sup> Since this proposal would eliminate citizenship-based taxation, this justification for automatically treating green-card holders as residents is no longer valid. Moreover, the current law’s treatment of green-card holders<sup>71</sup> leads to uncertainty regarding those green-card holders who have not surrendered their cards, but because of excessive absences, may not actually be able to enter the United States with such status.<sup>72</sup> Enforcement of the 183-day test for green-card holders would also be simplified by use of the entry-exit system, which should include in its database the social security numbers for all green-card holders.

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68. See Closer Connection Exception Statement for Aliens, IRS Form 8840 (2007) (requesting thirty items of information over two pages).

69. See STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 464 (Comm. Print 1984).

70. *Id.*

71. Tillinghast, *supra* note 9, at 239–49 (arguing that the rules of current 7701(b) are “assertive, in the sense that they go beyond the kinds of rules which are applied by most countries”). He provides as an example the fact that “a person holding a U.S. ‘green card’ will be considered a resident if he sets foot in the U.S. for just one day, or, indeed, if he never sets foot in the U.S. but holds a ‘green card’ throughout the year.” *Id.*

72. Paula N. Singer, Letter to Editor, *Important Information for Those Considering Expatriation*, 106 TAX NOTES 374, 376 (Jan. 17, 2005); see also INTERNAL REVENUE SERV., BASIC TAX GUIDE FOR GREEN CARD HOLDERS, PUBL’N 4588, (2-2007).

[E]ven if the U.S. Citizenship and Immigration Service . . . no longer recognizes the validity of your green card because you have been absent from the United States for a certain period of time or the green card is more than ten years old, you must continue to file returns until there has been a final determination that is not subject to appeal that your green card has been revoked or abandoned.

### C. How an Individual Terminates Residence

The current law's reliance on citizenship and green-card status as bases for imposing worldwide taxation results for most individuals in considerable stability in their status for U.S. tax purposes. By contrast, if "substantial presence" were the sole determinant of an individual's tax-residency status in the United States, it could often happen that an individual alternates<sup>73</sup> between a year as a resident and a year as a nonresident on a frequent basis; this would lead to administrative complications for both the individual and the IRS.<sup>74</sup> Perhaps more importantly, individuals might deliberately plan to realize large, accrued investment gains in years in which they are classified as U.S. tax nonresidents. To avoid these problems, two additional rules are proposed: (1) individuals would generally continue to be classified as tax residents for three years after the last year in which they meet the substantial presence test<sup>75</sup> and (2) at the point that an individual's residency status ends, that individual would be required to file a final return, which would include the unrealized appreciation in the individual's worldwide assets that had accrued during the period of residence.

#### 1. The Three-Year Residence Retention Rule

Under this proposal, once individuals have met the substantial presence test for any taxable year, they will be deemed to have U.S. residence for the subsequent three<sup>76</sup> taxable years, even if they fail to

73. Under Code Section 7701(b)(10), an alien who had been treated as a resident alien for at least three consecutive calendar years, and who then ceases to be a resident alien but resumes residency status before the close of the third calendar year after the cessation, is subject to the application of Section 877(b) during the period of nonresidence. I.R.C. § 7701(b)(10) (2007).

74. In addition, dual-status years in which an individual was a resident for part of the year and nonresident for another part would be more frequent. For example, assume that an individual who was present in the United States for all of 2010 and 2011 and the first five months of 2012, then left on a foreign assignment on June 1, 2012 and returned on June 1, 2015; he would be classified as a U.S. resident in 2010, 2011, 2012, and 2015 under the substantial presence test, but not in 2013 and 2014. In 2012, he would be able to terminate his resident status on June 1, by showing that, after that date, his tax home was in the foreign country and he had a closer connection to that country. I.R.C. § 7701(b)(2)(B) (2000). In 2015, he would generally resume resident status on June 1, his first day of presence in the United States. I.R.C. § 7701(b)(2)(A)(iii) (2007). He would be subject to § 877(b) for his period of nonresidence. See *supra* note 73. For discussion of dual-status taxpayers and of residence start dates and termination dates under current law, see Singer, *supra* note 31, at 14, 49–55, 81–82.

75. See ARNOLD & MCINTYRE, *supra* note 63, at 18 (suggesting a presumption that "individuals who have established residence in a country cannot relinquish residenc[y] status until they have established residence status in another country").

76. Under the weighted average test, an individual departing for a foreign assignment will meet the substantial presence test for the year of departure unless the

satisfy the substantial presence test in any of those three years. If they do not return to the United States and satisfy the substantial presence test for any year within the three-year period, then at the end of the three years, their U.S. tax-residency status will terminate (unless an election is made to extend it).

During this three-year period of deemed residence, the United States would continue to require individuals to report their worldwide income (earned and unearned) on Form 1040 as a resident. Moreover, they would continue to be subject to self-employment tax if self-employed and would be subject to FICA taxes if employed by a U.S. employer. However, in recognition of the fact that these individuals have insufficient actual U.S. presence to satisfy the substantial presence test and that they are potentially liable for foreign income taxes, their U.S. tax obligations would be modified.

The current § 911 exclusion for foreign source earned income would be expanded<sup>77</sup> to include an unlimited<sup>78</sup> amount of foreign earned income. As a result, no separate housing exclusion would need to be computed, and expenses would not need to be prorated between excluded and nonexcluded earned income. In addition, most taxpayers would no longer have foreign-source income in the general limitation category and would need to compute the foreign tax credit solely with respect to passive income. The current rules for qualification under § 911<sup>79</sup> would be retained, including the requirement of a “tax home” abroad; however, either the “bona fide resident” test<sup>80</sup> or the 330-day test could be used by any individual.<sup>81</sup>

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individual departs before being present for at least thirty-one days. This assumes that the “closer connection” test is eliminated. See *supra* note 54 and accompanying text.

77. For discussion of a recent proposal to repeal Section 911, see STAFF OF J. COMM. ON TAXATION, THE U.S. INTERNATIONAL TAX RULES: BACKGROUND AND SELECTED ISSUES RELATING TO THE COMPETITIVENESS OF U.S. BUSINESSES ABROAD, JCX-68-03, July 14, 2003, at 43–46. For an argument in support of repeal, see Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975, 1008–10 (1997).

78. For others proposals for an unlimited exclusion, see Brian Knowlton, *New Bill Seeks To Ease Expat Income Taxes; U.S. Firms Would Benefit, Senator Says*, INTERNATIONAL HERALD TRIBUNE, June 16, 2006, at 5 (explaining that Senator Jim DeMint, a South Carolina Republican had introduced legislation to remove the cap and that support was expressed by Andy Sundberg, a director of American Citizens Abroad, and by Daniel Mitchell, a senior economist at the Heritage Foundation); *Impact of U.S. Tax Rules on International Competitiveness, Hearing Before the H. Ways & Means Comm.*, June 30, 1999 (statement of David Hamod, Executive Director, Section 911 Coalition), available at 1999 TNT 126-60 (stating that “[i]deally Congress should remove the limitations on the section 911 exclusion in order to give American workers an equal footing in the global marketplace” but realizing that this “may not be possible” at a time of budget constraints).

79. For a review of the development of these legislative tests, see Renee Judith Sobel, *United States Taxation of its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 119–46 (1985).

80. Use of this test could be considered somewhat confusing in that the individual would also be classified as a deemed U.S. tax resident.

Alternatively, the tests under the current law, which have spawned considerable litigation and uncertainty,<sup>82</sup> could be replaced with a new test that would be simpler and more certain in application. For example, taxpayers could be required to identify one or more periods<sup>83</sup> of twelve or more consecutive months<sup>84</sup> in which their presence in the United States does not exceed thirty-five days (including parts of days).<sup>85</sup> Satisfaction of this test could be easily

81. Under current law, a foreign national is permitted to use the "bona fide residence" test only if the foreign national is a resident of a treaty country with a nondiscrimination article. See Rev. Rul. 91-58, 1991-2 C.B. 340.

82. See Jeffrey Evans, 911: *The Foreign Earned Income Exclusion – Policy and Enforcement*, 37 VIRGINIA J. INT'L L. 891, 912–16 (1997) (reviewing judicial interpretation of "bona fide resident" test); Peroni, *supra* note 77, at 1009 ("[S]ection 911 adds complexity to the tax system. To take advantage of the provision, a taxpayer must meet a series of fact-oriented tests to establish his or her status as a 'qualified individual.'").

83. As under the current 330-day test, the taxpayer could be considered to be a qualified individual during overlapping twelve-month periods in which U.S. presence did not exceed thirty-five days. PUBLICATION 54, *supra* note 23, at 15.

84. This revision of the 330-day test to focus on days present in the United States would allow qualification to be determined by use of the entry-exit system. Under the test of the current law, the taxpayer must be in a foreign country or countries at least 330 full days during a twelve-month period. *Id.* at 14. The IRS takes the position that "[w]hen you leave the United States to go directly to a foreign country or when you return to the United States from a foreign country, the time you spend on or over international waters does not count toward the 330-day total." *Id.*

85. The rationale for the "bona fide residence" test and the 330-day test is apparently to ensure "sufficiently long periods of residence abroad to prevent high-income individuals such as artists and athletes from taking unfair advantage of the exclusions." Singer, *supra* note 23, at 287; see also Sobel, *supra* note 79, at 119–26 (describing legislative history). Sobel explains that in 1926 Congress adopted a provision "providing for the total exclusion of any foreign earned income for citizens who were nonresidents of the United States for at least six months during the taxable year." *Id.* at 119–20. To avoid "abuses of the system, with some taxpayers living abroad solely for tax evasion purposes," Congress in 1942 restricted qualification to "persons who were bona fide residents of a foreign country during the entire taxable year," who might be expected to be subject to tax in the foreign country. *Id.* at 121–22. In 1951, Congress liberalized the qualification rules; "[t]o induce people with technical knowledge to go abroad," Congress permitted qualification on the part of "persons who were physically present in a foreign country for seventeen months in an eighteen-month period." *Id.* at 123. However, in 1953, Congress expressed its concern that this provision, "designed to encourage men with technical knowledge to go abroad in order to complete specific projects[,] . . . has been subject to a great deal of abuse." S. REP. NO. 83-685, at 5 (1953). The Senate Report stated:

Some individuals with large earnings have seized upon the provision as an inducement to go abroad to perform services, which were customarily performed at home, for the primary purpose of avoiding Federal income taxes. It has also been ascertained that in many cases Americans taking advantage of this provision do not pay any income tax even to the foreign country or countries in which the income is earned. This is because they are not in a particular foreign country long enough to establish a residence or because the foreign country in question does not impose any income tax.

monitored through the information provided to the IRS from the entry-exit system.

Some would argue that an unlimited exclusion under § 911 for foreign earned income is too generous for cases in which the host country does not impose tax on the worker's compensation income. If desired, Congress could authorize the Treasury to provide a list of countries that impose significant tax on the income of detached workers and restrict use of the unlimited exclusion to workers in those countries.<sup>86</sup> On the other hand, one could argue that if residence is the proper basis for taxation of worldwide income and the substantial presence test is a fair measure of residence, an individual not satisfying that test should, in fairness, simply be treated as a nonresident taxable only on U.S.-source income. However, treating an individual as a nonresident in the first year in which the test is not satisfied would result in administrative complexity, due to possibly frequent changes of status (including "dual-status" years) and the need to impose an immediate exit tax to capture appreciation accrued during a terminated residency period. A reasonable

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*Id.* The Senate, and eventually the Congress, decided to retain the seventeen-month test but limited the exclusion for those qualifying under that test to \$20,000 per year. See Sobel, *supra* note 79, at 123–24. Sobel notes that some of the particular abuses brought to Congress's attention were "movie personalities" who "[b]y making films at various foreign locations . . . often were able to avoid meeting any minimum residence requirements and thereby avoided paying any income taxes" and so "refus[ed] to make films in the United States." *Id.* at 123. This resulted in loss of jobs for United States technicians, actors playing supporting roles, and extras, and objections from the U.S. film industry. *Id.* (citing 99 CONG. REC. 3078-79 (1953) (remarks of Rep. King)). In 1976, Congress reduced the exclusion limit for Section 911 to \$15,000. *Id.* at 126–27. In 1978, Congress limited the exclusion to "Americans living in camps in hardship areas or working for qualified domestic charities in lesser developed countries." *Id.* at 130. The Economic Recovery Act of 1981 reinstated the exclusion with a dollar limitation of \$75,000 (rising over time to \$95,000) for taxpayers under the bona fide residence test and the physical presence test. *Id.* at 142. The physical presence test was "liberalized" by replacing the seventeen-out-of-eighteen months rule with the 330-day test. *Id.* at 141–42. The 330-day test was designed to meet "the needs of construction and other industries that might require services of a specialist on a project for a year." *Id.* at 142. At the same time, the test was considered to require "a long enough period [of foreign presence] to prevent abuse by entertainers, athletes and the film industry." *Id.* (citing 1981-1982 *Miscellaneous Tax Bills, IV: Hearings on S. 408, S. 436, S. 598, and S. 867 Before the Subcomm. on Taxation and Debt Management Generally of the S. Comm. on Finance, 97th Cong. 282* (1981)); see STAFF OF J. COMM. ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, JCS-71-81, 43, available at <http://www.house.gov/jct/jcs-71-81.pdf> (stating that the dollar limit on the exclusion "is intended to prevent abuse of the exclusion, for example, by highly paid entertainers and athletes who might otherwise move abroad to avoid U.S. tax on their income").

86. See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 335 (2001) (criticizing the section 911 exclusion as unjustified and suggesting as a possible alternative an exclusion for "income earned in countries with tax rates comparable to ours by a person resident abroad for a full taxable year").



compromise is the rule providing for a three-year retention of deemed residence, combined with an unlimited exclusion for the foreign earned income of an individual qualified under § 911.<sup>87</sup>

Deemed tax residents employed by a U.S. employer would be subject to W-2 information reporting and would have FICA taxes withheld and paid by the employer. Self-employed individuals would be required to pay self-employment tax on their net self-employment income (unless an exemption under a U.S. social security agreement applies because coverage is in the country where services are performed). Although the IRS would be giving up income tax on foreign earned income in excess of the current § 911 exclusion, it would still be collecting social security taxes. For many individuals, social security taxes paid are greater than income tax liability. For example, this might be true of many individuals employed by U.S. contractors to provide support for U.S. troops in Iraq or elsewhere<sup>88</sup> and of many U.S. citizens going abroad as exchange visitors or relief workers.

In addition, deemed tax residents would continue to be responsible for U.S. income tax with respect to worldwide investment income.<sup>89</sup> Some would argue, however, that individuals with an

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87. See Gann, *supra* note 1, at 60 (noting that Section 911 “has been a political see-saw having been amended [by 1982] at least ten times since its first enactment in 1926”). She argues that “[t]hese amendments reflect political uncertainty about the citizenship basis for taxation.” *Id.* at 60–61. Thus, for example, “commentators [who] do not accept the citizenship basis for taxation . . . think not only is such a provision correct but that it ought to be extended to all income of all U.S. citizens residing abroad.” *Id.* at 61–62. She argues that a “significant barrier to the elimination of citizenship jurisdiction may [be] a reluctance to rely on residency jurisdiction alone because of anticipated administrative difficulty in determining which individuals are residents and because of possible enhancement of opportunities for tax avoidance and evasion.” *Id.* at 66. However, she notes that the latter concerns could be addressed with an exit tax like that of Canada. *Id.* at 68.

88. There is a large contingent of U.S. civilians working abroad in Iraq for contractors providing support services to the military. The *New York Times* states that there are “130,000 civilians supporting 160,000 United States soldiers and marines.” John M. Broder, *Filling Gaps in Iraq, Then Finding a Void at Home*, N.Y. TIMES, July 17, 2007, at A1. Broder notes that although some are highly paid, “many more earn relatively modest wages.” *Id.* He describes the experience of a forty-six year old Pakistani-American woman who was hired by KBR, then a subsidiary of Halliburton, to do laundry work in the Green Zone in Iraq while her husband worked as a welder at a base in Afghanistan. Under a thirteen-page contract, stating that “she would be working in a ‘potentially hazardous environment,’” she was to receive a “base salary of \$40,000 a year and the chance to make as much as \$80,000 with overtime, much of it tax free.” *Id.* at A-16. She and her husband expected to work for a year to clear their credit card debts and car loans exceeding \$35,000. *Id.* However, she came home severely injured. *Id.*

89. *But see* Peroni, *supra* note 77, at 1009–10 (contending that it is inconsistent to argue in favor of the current section 911 exclusion based on the insufficiency of the benefits of citizenship for U.S. citizens living abroad without also arguing for an expanded exclusion for all foreign source income of these individuals). Peroni rejects an “expanded section 911 exclusion” because it “would be difficult to administer and

unlimited foreign-earned-income exclusion would be able to avoid U.S. tax on their investment income to the extent that it is less than the personal exemption(s) and standard or itemized deductions. This could be avoided by keeping the current § 911 “stacking rule” subjecting unearned income to U.S. tax at the rate that would have applied without the exclusion, although this would make determination of the tax more complicated.

U.S. tax residents (including deemed tax residents) would continue to be subject to the current rules for tax withholding by U.S. payors. That is, their wages would be subject to withholding at graduated rates and benefits paid by pension plans, IRAs, or commercial annuities would be subject to mandatory withholding at graduated rates if the payment is delivered outside the United States; in addition, investment income would be subject to backup withholding—for example, if a valid taxpayer identification number is not provided.<sup>90</sup> These rules differ from the withholding and reporting rules for payments to “tax nonresidents”<sup>91</sup> (a category that would now include some U.S. citizens and green-card holders). Therefore, the currently used withholding certificates would have to be modified so that payors would be able to determine which treatment applies.<sup>92</sup> To encourage proper reporting of worldwide income by U.S. tax residents on Form 1040, including by deemed residents, the IRS could require these taxpayers to certify under penalties of perjury that worldwide income has been included in the return.

United States residents given a temporary foreign assignment by a U.S. employer would often welcome the opportunity to remain

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would require a careful formulation of the tests for ‘qualified individual’ status to prevent abuse of the exclusion.” *Id.* at 1010.

90. See INTERNAL REVENUE SERV., PUBL’N 505, TAX WITHHOLDING AND ESTIMATED TAX 1–10 (Rev’d Feb. 2007) [hereinafter PUBLICATION 505] (wage withholding); *id.* at 15 (pension benefits delivered outside U.S.); *id.* at 16 (backup withholding); see also Withholding Certificate for Pension or Annuity Payments, IRS Form W-4P, at 4 (2008); PUBLICATION 54, *supra* note 23, at 8.

91. For these taxpayers, U.S.-source income that is not effectively connected with a U.S. business, such as investment income (excluding capital gains) and U.S. social security benefits, would be subject to a flat 30% U.S. withholding rate under Section 1441 (subject to reduction or elimination by an applicable treaty). Wages or pension payments with respect to U.S. services would, however, be subject to withholding at graduated rates (absent treaty exemption). I.R.C. § 1441; see also INTERNAL REVENUE SERV., PUBL’N 515, WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN ENTITIES 17 (Rev. Apr. 2007) [hereinafter PUBLICATION 515] (withholding rates for various items of income); *id.* at 21 (withholding at graduated rates is allowed with respect to “the portion of a [pension] distribution that arises from the performance of services in the United States after December 31, 1986”); *id.* at 24 (graduated withholding for wages that are effectively connected with a U.S. business); see also Form W-4P, *supra* note 90, at 4.

92. Currently, Form W-8BEN is used to establish foreign status or to claim reduced withholding under a treaty. See PUBLICATION 515, *supra* note 91, at 8. Form W-8 is used by a U.S. person to avoid 30% nonresident alien withholding. *Id.*

residents for U.S. tax purposes so as to retain a U.S. benefits package, including pension<sup>93</sup> and social security coverage.<sup>94</sup> If a totalization agreement is in effect between the United States and the country where the foreign-assigned residents are working, they could claim status as detached workers (working abroad five years or fewer)<sup>95</sup> and avoid payment of possibly higher social security taxes in the other country. At the same time, § 911 would exclude all foreign earned income from U.S. tax, and the exit tax would not be triggered. Similarly, a green-card holder expecting to return to the United States after a temporary stay abroad might also find this regime appealing. To maintain the validity of his or her green card, such an individual would need to maintain contacts with the United States and could not claim resident status in a foreign country (and nonresident U.S. status) under a treaty tie-breaker rule.

Finally, deemed tax-residency status could be advantageous for some individuals who have resided in the United States throughout their working years but have chosen to retire in another country (either their ancestral country or a country where the cost of living is lower),<sup>96</sup> particularly if that country does not have an income tax treaty with the United States. These individuals may continue to receive U.S. social security payments, payments of pensions earned while working in the United States, and investment income from U.S. sources. As deemed tax residents,<sup>97</sup> they would continue to file a U.S. resident return and to pay tax under usual U.S. rules; under these rules, the amount of social security benefits included in gross income

93. See Conrad de Aenile, *Money Matters: Staying in Home Pension May Be Best Bet*, INTERNATIONAL HERALD TRIBUNE, May 25, 2002, at 20 (“[r]emaining in home social security systems and occupational and personal pension plans can produce a number of benefits, including lower tax bills and higher benefits at retirement”).

94. For a detailed discussion and analysis of social security coordination for workers who cross borders, see Allison Christians, *Taxing the Global Worker: Three Spheres of International Social Security Coordination*, 26 VA. TAX REV. 81 (2006).

95. See Social Security Online, U.S. International Social Security Agreements, [http://www.ssa.gov/international/agreements\\_overview.html](http://www.ssa.gov/international/agreements_overview.html) (explaining the “detached worker” rule).

96. Singer, *supra* note 23, at 292. Benefits payments were sent to 420,000 individuals abroad in 2002. *Id.*

97. This assumes they do not continue to satisfy the substantial presence test to qualify as residents. In general, unless retirees are retiring in one of the twenty-two countries with which the United States has a social security agreement, their social security benefits cannot be paid outside the United States after an absence of more than six full calendar months. SOC. SEC. ADMIN., PUBL’N NO. 05-10137, SOCIAL SECURITY: YOUR PAYMENTS WHILE YOU ARE OUTSIDE THE UNITED STATES 4 (Jan. 2006), available at <http://www.ssa.gov/pubs/10137.pdf> [hereinafter PUBLICATION 05-10137]. This result can be avoided if the individual returns and stays in the United States for at least thirty consecutive days (a full calendar month if the six-month period has run). *Id.* at 3–4, 6–7, 10. Green-card holders should return to the United States at least once a year in an effort to retain immigrant status. Paula N. Singer, Letter to the Editor, *Important Information for U.S. Immigrants Considering Expatriation*, 37 TAX NOTES INT’L 387, 390 (Jan. 31, 2005).

would range from zero up to 85%, depending on the amount of benefits and of adjusted modified gross income.<sup>98</sup> In contrast, if these individuals terminated U.S. tax residence and were unable to claim the benefit of a treaty, their U.S. source investment income would be taxed at a flat 30% rate and their social security benefits at a rate of 25.5%<sup>99</sup> (or 30% of 85%<sup>100</sup> of the benefits).<sup>101</sup> In addition, they would owe the exit tax (although there is an exemption for qualified pension plans). As discussed below, an option would be afforded to deemed tax residents to remain in that status indefinitely.

In some cases, however, individuals who have been residents for U.S. tax purposes but are now breaking off residential ties would prefer to make a clean break from U.S. tax-residency status. Such individuals should be able to do so, by filing their final tax returns (or at least an application for extension) within ninety days of their departure; on their return, these individuals would be required to report their income for their final year (or partial year) of residence as well as the exit tax, if any, as described below.<sup>102</sup>

## 2. Mark-to-Market Tax

This Article proposes that when a taxpayer's tax-residency status ends, he or she would be required to file a final resident return, in which the individual reports the unrealized gain accrued on his or her worldwide assets during the U.S. residence period.<sup>103</sup> To avoid application of the exit tax to appreciation accrued prior to an individual's becoming a U.S. resident, a taxpayer's basis for property

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98. See I.R.C. § 86(a)-(c) (2005); PUBLICATION 05-10137, *supra* note 97, at 28-29.

99. Only a small number of treaties would reduce this rate.

100. See I.R.C. § 871(a)(3) (2006); PUBLICATION 05-10137, *supra* note 97, at 29.

101. However, payment of pensions or other deferred compensation attributable to services performed in the United States after 1986 are classified as income effectively connected with a U.S. trade or business and would be taxed at graduated rates, even in the case of a nonresident alien. PUBLICATION 515, *supra* note 91, at 21. Most treaties provide an exemption from tax for private pensions and annuities. *Id.*

102. For a somewhat similar approach in Scandinavian countries, see INT'L FISCAL ASS'N, 2002 OSLO CONGRESS, CAHIERS DE DROIT FISCAL INTERNATIONAL, VOLUME LXXXVIII, THE TAX TREATMENT OF TRANSFER OF RESIDENCE BY INDIVIDUALS 31 (2002). These countries "deny non-residence status to temporary non-residents," but the rule essentially operates as a "reversal of the burden of proof." *Id.* For example, an emigrating Finnish citizen is considered a Finnish resident for a three-year period unless he "give[s] evidence that he has effectively cut off all substantial ties" with Finland. *Id.*

103. A similar proposal is made in Colón, *supra* note 9, at 25-46 (proposing a mark-to-market tax be applied whenever an individual shifts from residence-based tax, as a U.S. citizen or resident alien, to source-base taxation, as a nonresident alien). He argues that this would be preferable to the treatment of expatriation under Section 877. *Id.* at 27-33.

would be the property's fair market value at the time that the individual first became a U.S. resident.

Under this proposal, a taxpayer's residence status could end in one of two ways. In one situation, individuals who have departed the United States but retained tax-residency status under the three-year rule, described above, would cease to be residents if they failed to resume "substantial presence" in the United States at the end of the three-year period (or failed to elect an extension of the deemed residence period). In a second situation, individuals who are departing the United States and who have extinguished their residential ties to the United States could trigger termination of their resident status (without waiting for the end of the three-year retention period) by filing a final resident return, reporting the "exit tax," within ninety days of departure from the United States. Alternatively, individuals could trigger termination of their status as deemed residents by filing a claim of nonresidency status under a treaty tie-breaker rule.<sup>104</sup>

An "exit tax" on departing residents has long been employed in Canada<sup>105</sup> and is also employed in other countries. An exit tax applicable to relinquishment of citizenship or of long-term permanent resident status ("expatriation") has been considered in Congress on numerous occasions<sup>106</sup> and, in May 2008 as this Article went to press,

104. This claim is made on Treaty-Based Return Position Disclosure Under Section 6114 or Section 7701(b), IRS Form 8833, at 1 (Rev'd Aug. 2006). Similarly, under the current rules of Section 877, a long-term resident of the United States is viewed as expatriating if he "commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and . . . does not waive the benefits of such treaty applicable to residents of the foreign country." I.R.C. § 877(e)(1) (2007).

105. See, e.g., INT'L FISCAL ASS'N, *supra* note 102, at 193–96; CANADA REVENUE AGENCY, T4056(E) REV. 06, EMIGRANTS AND INCOME TAX 2006 (2006), available at <http://www.cra-arc.gc.ca/E/pub/tg/t4056/t4056-e.html>; STAFF OF J. COMM. ON TAXATION, *supra* note 38, at 148–51 (describing "exit taxes" in Australia, Canada, and Denmark, and much more limited versions in Germany and Singapore).

106. See STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 177 & n.543 (noting the various proposals and the fact that certain ones have been passed by the Senate). The report analyzes the proposals in the Clinton Administration's Fiscal Year 2001 Budget, in H.R. 3099, introduced in 1999 by Congressmen Rangel and Matsui, and in an amendment to H.R. 5063 passed by the Senate on October 3, 2002. *Id.* at 177–92; see also STAFF OF J. COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL 963–67 (Comm. Print 2000). For current legislative proposals, see *infra* note 107. For other discussions of an exit tax proposal, see Colón, *supra* note 9. See also Charles Bruce, Lewis Saret, Stephane Lagonico & Steve Trow, *The Exit Tax – A Perfectly Bad Idea*, 110 TAX NOTES 1225, 1225 (Mar. 13, 2006) (noting that the exit tax is "a bad idea for policy and technical reasons"); Eva Farkas-DiNardo, *Is the Nation of Immigrants Punishing Its Emigrants: A Critical Review of the Expatriation Rules Revised by the American Jobs Creation Act of 2004*, 7 FLA. TAX REV. 1, 39–42 (2005) (suggesting that Congress should "reconsider a mark-to-market expatriation regime"); Elisa Tang, *Solving Taxpatriation: "Realizing" it Takes More than Amending the Alternative Tax*, 31 BROOKLYN J. INT'L L. 615, 641–44 (2006) (recommending that section 877 be

was finally enacted as IRC § 877A.<sup>107</sup> Under prior law, Congress had imposed a special tax regime under § 877 on expatriating citizens and long-term green-card holders who relinquish residence; this special regime was applicable for the period of ten years after the expatriating act.<sup>108</sup> A report of the Staff of the Joint Committee on Taxation in 2003 expressed serious doubts about the enforceability of these rules (even with recommended improvements) because of the individual's limited contacts with the United States over the 10-year period.<sup>109</sup> An exit tax is designed to avoid these defects by imposing

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replaced with an mark-to-market regime); Richard A. Westin, *Expatriation and Return: An Examination of Tax-driven Expatriation By United States Citizens, and Reform Proposals*, 20 VA. TAX. REV. 75, 186–87 (2000) (arguing that it is a “troubled solution” to the problem of tax-motivated expatriation because “the person may be expatriating to a high tax jurisdiction” and because “implementing the tax is very difficult” in the case of a “determined tax evader”).

107. H.R. 6081, 110th Cong., § 301. See JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF H.R.6081, THE “HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008,” AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON MAY 20, 2008 (MAY 20, 2008). In 2007, the provision was included in H.R. 3997 and passed by the House and Senate. Heroes Earnings Assistance and Relief Tax Act of 2007, H.R. 3997, 110th Cong. § 305 (2007); Defenders of Freedom Tax Relief Act of 2007, H.R. 3997, 110th Cong. § 204 (2007); JOINT COMMITTEE ON TAXATION, DESCRIPTION OF H.R. 3056, TAX COLLECTION RESPONSIBILITY ACT OF 2007, at 7–16 (July 17, 2007). However, variations between the House and Senate versions of H.R. 3997 were not resolved.

108. For analysis of the interaction of Section 877 and treaties, see Internal Revenue Serv., Notice 97-19, 1997-1 C.B. 394, § VIII; STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 132–37. Based on language in the conference report for the Health Insurance Portability and Accountability Act of 1996, the Service takes the view that Section 877 overrides conflicting provisions of treaties in effect on August 21, 1996, but that this override applies only until August 21, 2006. Notice 97-19, *supra* note 108. Pre-1996 treaties are being updated by new treaties or protocols. See, e.g., Protocol to U.S.-Denmark Income Tax Convention, U.S.-Den., art. 1, ¶ 2500A, May 2, 2006, Tax Treaties (CCH); Protocol to U.S.-Finland Income Tax Convention, U.S.-Fin., art. 1, ¶ 2946, May 31, 2006, Tax Treaties (CCH); Protocol to U.S.-Germany Income Tax Convention, June 1, 2006, U.S.-Ger., art. 1, ¶ 3209, Tax Treaties (CCH); Income Tax Convention, Nov. 27, 2006, U.S.-Belg., art. 1.4, ¶ 1359.01, Tax Treaties (CCH) (all of which entered into force on December 28, 2007). For extensive provisions regarding the Section 877 limitations for former citizens and long-term residents, see Protocol to U.S.-Mexico Income Tax Convention, U.S.-Mex., art.1, ¶ 5908, Nov. 26, 2002, Tax Treaties (CCH); Income Tax Convention, Exchange of Notes, U.S.-U.K., ¶ 10,905, July 24, 2001, Tax Treaties (CCH).

109. STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 8. The report notes that the regime is not “effective with respect to individuals who are willing to wait the ten-year period prior to disposing of assets that would be subject to tax under the regime.” *Id.* It further explains that “any tax regime applicable to individuals who are no longer physically present in the country, and whose assets may no longer be situated in the country or under the control of any U.S. person, inevitably faces serious challenges of enforcement as a practical matter,” and “[t]his enforcement effort requires significant resources to be devoted to the few individuals who are subject to the alternative regime.” *Id.* It concludes that “careful consideration should be given as to whether the alternative tax regime . . . even as modified by [our] recommendations . . . can fully achieve the goals that the Congress intends to accomplish.” *Id.* For further criticism of these rules, see Colón, *supra* note 9, at 27–29

the tax at the point when the taxpayer is breaking off ties with the United States. As discussed below, there will still be significant enforcement issues, but it is more likely that mechanisms can be implemented to address them.<sup>110</sup>

The exit tax proposed in this Article would be similar to the recently enacted expatriation tax, except that the event triggering the proposed tax would be termination of an individual's residency status. The goal of the proposed tax would not be to punish relinquishment of U.S. resident status<sup>111</sup> but merely to provide a practical vehicle for ensuring that the U.S. tax on appreciation accrued during a period of residency is collected.<sup>112</sup> Since citizens are likely to change residence more often than they renounce citizenship, it might appear that the proposed exit tax would need to be applied frequently and would represent a huge burden on individuals and the IRS. However, there are a number of means to limit the burden imposed by such a tax. For example, an exemption for the first \$600,000 of net gain<sup>113</sup> would greatly reduce the reach of the tax.<sup>114</sup> Moreover, fairness would require that assets owned at the time that the person became a

(noting that the current system is "flawed" and less preferable than "mark-to-market"); Farkas-DiNardo, *supra* note 106, at 20–39; Tang, *supra* note 106, at 635–40; Westin, *supra* note 106, at 150–160.

110. See *infra* notes 125–26 and accompanying text.

111. But see Alice Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087, 1130 (1996) (arguing that a "punitive objective" was "at the root of the proposals" for imposing an exit tax on expatriation considered by Congress in 1995). However, she notes that in her article she "will generally confine [her] remarks to the treatment of expatriation by U.S. citizens" and not of long-term residents, in that "such expatriation [is] what is driving the current debate," and "the treatment of the relinquishment of residency status raises some issues that differ from those involving the relinquishment of citizenship and that are generally beyond the scope of this Article." *Id.* at 1093 n.19.

112. See Colón, *supra* note 9, at 28–29. Colón notes: "Congress has determined that U.S. citizens and residents should pay tax on their worldwide income. Because of the realization principle, however, gains accrued while a person was subject to residence basis taxation may escape taxation if the person expatriates and the gains are no longer taxed by the United States." *Id.*

113. The Clinton Fiscal Year 2001 proposal provided for an exclusion of \$600,000 of net gain (which could be doubled to \$1.2 million on a joint return if both spouses terminated citizenship). STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 179. Under the 2002 bill passed by the Senate, these amounts were to be increased for inflation after 2002. *Id.* at 185. The Rangel-Matsui proposal applied only to an individual whose average income tax liability over the previous five years exceeded \$100,000 or whose net worth exceeded \$500,000. *Id.* at 181.

114. See Tang, *supra* note 106, at 642 (taxing only above a threshold amount "would allay the perceived unfairness" of exit tax). However, in Canada, an emigrating taxpayer is required to provide a list of all property if the aggregate value is more than \$25,000. T4056E REV. 06, *supra* note 105, at 6; see also Colón, *supra* note 9, at 34 n.112 (noting that the exclusion of \$600,000 provided in proposed U.S. legislation is "clearly drawn from the exemption amount under the estate and gift tax," but "because the two taxes are conceptually different, there is no tax policy reason for using the same amount"). He suggests instead "a de minimis rule exempting persons with small incomes." *Id.* at 34.

resident should acquire a basis of their fair market value at that time.<sup>115</sup> As a result, only taxpayers whose assets appreciated by \$600,000 during their period of residence would be subject to the tax. In addition, some types of assets would be exempted. For example, an exemption would be provided for U.S. real property interests, the gain on which is taxable even to nonresidents, and for qualified pension plans.<sup>116</sup> The pension plan exemption is consistent with the policy of providing tax incentives for retirement and with the continuing jurisdiction to tax distributions from a U.S. pension paid to a nonresident alien<sup>117</sup> and avoids the need for valuation of the taxpayer's interest in a pension.<sup>118</sup> In addition, as under Canada's rules, an exclusion from the exit tax (and its reporting requirements) should be made for any item of personal-use property with a value of less than \$10,000.<sup>119</sup> Problems of liquidity would be addressed by allowing deferral of the tax liability until the earlier of the taxpayer's death or actual disposition of the appreciated property, provided that the taxpayer gives adequate security for eventual payment of the tax, such as a bond.<sup>120</sup> Since the objective is merely to ensure payment of

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115. See INT'L FISCAL ASS'N, *supra* note 102, at 197 (an individual establishing residency in Canada takes a basis for assets equal to fair market value at that date). However, an exception is made for "taxable Canadian property," such as Canadian real property, property used in carrying on a business in Canada, or shares of a private Canadian company; gain on the sale of Canadian taxable property is taxed to nonresidents as well as residents. *Id.* at 192. See STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 192 (noting that the AICPA commented that Clinton proposal and Rangel-Matsui bill should be amended to incorporate this feature).

116. Under the Fiscal 2001 Clinton proposal, there was an exemption for U.S. real property interests, for all interests in qualified retirement plans, and "subject to a limit of \$500,000, interests in certain foreign pension plans, as prescribed by regulations." STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 180. In addition, the Treasury was given authority "to except other property interests as appropriate." *Id.* However, under the bill passed by the Senate in 2002, in the case of an interest in a qualified pension plan, "an amount equal to the present value of the individual's vested, accrued benefit . . . is treated as having been received by the individual as a distribution under the plan on the day before the individual's citizen relinquishment." *Id.* at 188. Guidance for determining the present value is to be provided by the Treasury. *Id.*

117. See Colón, *supra* note 9, at 35-36 (stating that, "[i]n theory it is appropriate" to make exceptions for U.S. real property interests and retirement plans "because they will be taxed by the U.S. even though the owner is not subject to residence basis taxation"). Colón notes that proposed legislation requires mark-to-market treatment of "any interest" in a qualified retirement plan "attributable to contributions exceeding any limitation or violating any condition for tax-favored treatment" so that excessive contributions are not used to avoid the mark-to-market rules. *Id.* at 35 n.116. The United States, however, is willing to eliminate source-based taxation of pensions under a treaty. See 2006 U.S. MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, *supra* note 7, at art. 17(1)(a).

118. However, a version passed by the Senate in 2002 did not contain the exclusion and required a determination of present value. See *supra* note 116.

119. T4056E REV. 06, *supra* note 105.

120. See STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 180 (describing FY2001 Clinton proposal). Under the Rangel-Matsui bill and the 2002 Senate bill, the



tax on the appreciation accrued during the residency period rather than to penalize changes in residency, it may not be appropriate for the deferred tax liability to accrue interest.<sup>121</sup> The U.S. tax law generally incorporates a realization requirement,<sup>122</sup> and—apart from insuring collection, which is accomplished by security measures—there seems to be no reason to impose a heavier tax burden (in terms of present value) than would apply to continuing residents.<sup>123</sup>

Despite these measures designed to reduce the burden of an exit tax, some taxpayers might nevertheless find it unduly burdensome; this might be the case for individuals not certain of whether and when they intended to reestablish regular presence in the United States in the future. Individuals would have the option of avoiding exit tax by electing to retain resident status. As described above, a departing resident would generally have a three-year period of deemed tax residence. An individual could make an election to extend his or her deemed tax-residency status for additional periods, without triggering exit tax, provided that the election is made before deemed tax-residency status has ended. With this election, individuals would continue to be taxed by the United States on their worldwide income and to be required to file an annual U.S. resident tax return; they would also be subject to withholding from payments made to them by U.S. payors.<sup>124</sup>

payment becomes due no later than the time the individual dies. *Id.* at 182, 188. Under the 2002 Senate bill, the “deferred amount” is a “lien in favor of the United States on all U.S.-situs property owned by the individual.” *Id.* at 188–89. The AICPA suggested that adequate security should include “letters of credit from a U.S. financial institution or a withholding arrangement with a U.S. brokerage firm.” *Id.* at 193. In Canada, security is required if the tax from the deemed disposition is more than \$14,500. T4056E REV. 06, *supra* note 105. Acceptable forms of security include “bank letters or guarantee, bank letters of credit, and bonds from the Government of Canada or a province or territory.” *Id.* In addition, “[o]ther types of security may . . . be acceptable, such as shares in private or publicly traded corporations, certificates in precious metals, various other marketable securities, a charge or mortgage on real property, or valuable personal property.” *Id.*

121. In Canada, no interest charge is imposed for deferral of the liability. INT’L FISCAL ASS’N, *supra* note 102, at 195; T4056E REV. 06, *supra* note 105. However, the proposals considered by Congress with respect to expatriation of citizens have incorporated an interest charge. STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 180, 182, 188. Under the 2002 Senate bill, the interest rate is 2 points higher than the rate charged on individual underpayments. *Id.* at 188; *see also* Colón, *supra* note 9, at 35 (proposing an interest charge when tax is deferred).

122. *See, e.g.*, STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 195 (noting that “taxation of unrealized gains under the mark-to-market proposals . . . is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains”).

123. Treaty provisions should be considered to reduce the potential for double taxation when property that has been subject to the proposed U.S. exit tax is subsequently disposed of and the gain is taxed by a foreign country. *See, e.g.*, Income Tax Convention, U.S.-Can., art. XIII(7), ¶ 1903.13, Sept. 26, 1989, Tax Treaties (CCH).

124. Alternatively, as under the bill passed by the Senate in 2002, a departing resident could elect to remain taxable as a U.S. resident with respect to any property

In order to achieve adequate enforcement of the exit tax,<sup>125</sup> the IRS would need to take advantage of information provided under the entry-exit system that the Department of Homeland Security is in the process of implementing.<sup>126</sup> This information would allow the IRS to identify residents who are no longer “substantially present” and are thus in “deemed resident” status (unless residence status is relinquished through an IRS filing). The IRS should also develop a short (post-card sized) form that would have to be filled out by departing residents as part of the exit process. This form would replace the current Sailing Permit procedure for aliens, with which compliance is rare.<sup>127</sup> It would require information about a resident’s

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that would otherwise be subject to the mark-to-market regime. In this way, the tax would not be computed or due until the property was disposed of. However, security for eventual payment of the tax would have to be provided. See STAFF OF THE J. COMM. ON TAXATION, *supra* note 38, at 186.

125. In reviewing the 1995 Clinton Administration proposal for a mark-to-market tax imposed on expatriation, the Joint Committee staff noted:

Like present law, absent enforcement initiatives by the IRS, the proposal relies on the voluntary compliance of expatriating citizens. . . . The IRS may not learn about the expatriation until the individual has physically left the country. As under present law, absent administrative changes, the IRS will not know that an expatriate is liable for tax. . . . Physical separation from the United States may hinder the ability of the IRS to collect any tax owed. With notification, the IRS can attempt to determine whether an expatriate possesses any assets within the United States that could be seized to satisfy the tax liability. . . . [T]he IRS could coordinate with the Customs Service and the Immigration and Naturalization Service to detain noncompliant expatriates who attempt to re-enter the United States.

STAFF OF THE J. COMM. ON TAXATION, 104TH CONG., BACKGROUND AND ISSUES RELATING TO TAXATION OF U.S. CITIZENS WHO RELINQUISH THEIR CITIZENSHIP AND LONG-TERM RESIDENT ALIENS WHO RELINQUISH THEIR U.S. RESIDENCY, JCX-16-95, 18 (Comm. Print 1995); *see also* Bruce et al., *supra* note 106, at 1232 (arguing that “aspects of” the exit tax contained in H.R. 4297, passed by the Senate in February 2006, “as a practical matter, are frankly unenforceable”). He explains:

Since the tax is not actually collected before or at the time of expatriation, if it is not paid, it will in all likelihood have to be collected from an individual living outside the United States with assets outside the country. There is no mechanism for doing that. . . . Also, since the exit tax creates a deemed sale, often it will engender difficult valuation problems.

*Id.*

126. *See supra* notes 61 and 62.

127. STAFF OF THE J. COMM. ON TAXATION, 104TH CONG., BACKGROUND AND ISSUES RELATING TO TAXATION OF U.S. CITIZENS WHO RELINQUISH THEIR CITIZENSHIP AND LONG-TERM RESIDENT ALIENS WHO RELINQUISH THEIR U.S. RESIDENCY, JCX-16-95, 11 (Comm. Print 1995) (suggesting, as a modification to the 1995 mark-to-market proposals, that the sailing permit requirement under current Code section 6851(d) be replaced “with a new requirement to file a short-year tax return”). Under this modification, a departing resident would be required to “file a tax return within 90 days of the date that he ceases to be a U.S. resident and pay the relevant tax.” *Id.* The Joint Committee noted that

country of citizenship, visa status if not a U.S. citizen, addresses (both in the United States and abroad), and information regarding the time of the resident's expected return to the United States.

Many taxpayers who would be incurring the exit tax would have been living outside the United States as deemed residents for three years at the time their residences are terminated. This obviously would complicate the IRS's task of enforcing the exit tax, but at least (through the entry-exit system), the IRS would be able to identify which taxpayers were in deemed resident status and perhaps to collect useful information from the departure form (described above). Moreover, most individuals would have had some contacts with the United States during the three-year period of deemed tax residence, such as employment by a U.S. employer (including W-2 reporting), maintenance of a U.S. bank account, receipt of U.S.-source payments subject to withholding, or filing of a U.S. resident tax return. Assuming the IRS had a current address for the taxpayer, it would ideally send a reminder to any taxpayer who had been in deemed resident status for four years of the imminent termination of residency status and potential liability for exit tax.

## V. CONCLUSION

This Article proposes that the United States abandon its imposition of tax based on citizenship (and immigrant status) so as to conform to the nearly universal international consensus in favor of imposing worldwide taxation solely on the basis of residence. By taking this step, the United States would reduce the potential for overlapping U.S. and foreign taxation and eliminate the formal tax obligations of many U.S. citizens who have not lived in the United States in the recent past, do not file U.S. tax returns, and do not face

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Section 6851(d) and the regulations thereunder currently require any alien who physically leaves the country—regardless of the duration of the trip—to obtain a certificate from the IRS District Director that he has complied with all U.S. income tax obligations. . . . Compliance with this requirement is infrequent.

*Id.* However, some exceptions to this requirement are contained in Treas. Reg. section 1.6851-2. See U.S. DEP'T OF THE TREASURY, TAXPAYER BILL OF RIGHTS 3 AND TAX SIMPLIFICATION PROPOSALS, Apr. 1997, available at 97 TNT 74-9, at ¶¶ 180-83 (calling for repeal of the sailing permit requirement of IRC section 6851(d)). The Treasury states that "[v]irtually all departing aliens ignore this requirement." *Id.*; see also David T. Moldenhauer, *A Guide to U.S. Taxation of Foreign Business Travelers*, 106 TAX NOTES 705, 706 n.9 (Feb. 7, 2005) (noting that "as a practical matter, the IRS does not regularly post agents at airports to collect certificates of compliance from departing travelers"). The Treasury proposed that, instead of this requirement, "any alien resident of the United States who becomes a nonresident [be required] to file a tax return within 90 days of the date that he or she ceases to reside in the United States, and pay the relative tentative tax." U.S. DEP'T OF THE TREASURY, *supra* note 127.

any realistic prospect of IRS enforcement action. The Article then outlined the features of a new system for U.S. taxation of individuals based solely on residence. This includes (1) a revised definition of “residency status” that would be based on physical presence and would be monitored through an entry-exit system, (2) a proposal for an exit tax imposed on termination of residence with respect to unrealized appreciation accrued during the period of residence, and (3) new transitional treatment of residents who have left the United States within the past three years but have not yet made a decision to break off residential ties. These proposed rules are designed to achieve more uniform compliance, to reduce the administrative burden for U.S. taxpayers, and to facilitate IRS efforts to enforce U.S. tax obligations.

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