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FEATURED PERSPECTIVES

Tax Reform for Americans Abroad

by Paula N. Singer

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Everyone agrees that our tax system needs to be simpler and fairer, and that, in our global economy, U.S international tax policy should not impede economic growth. As the debate proceeds about how our tax system should be reformed, that debate should include a discussion about how the principles of simplicity and fairness should apply to the personal income taxation of Americans living abroad as well as how the current tax policy for Americans abroad has been a factor in impeding America's economic growth.

The total number of overseas Americans is estimated to be between 4 million and 7 million. The number is difficult to estimate[1] because the total includes many "accidental citizens," the sons and daughters of foreign workers, students, and scholars who were born in the United States and moved home with their parents when they were still children.[2] Of the overseas Americans identified in a post-2008 election survey,[3] fully 72 percent had been living abroad for a long-term or indefinite period, and 40 percent had already been living abroad for 10 years or more. The number one reason for living abroad was marriage (29 percent); the second was employment (22 percent). As a group, their numbers are at least the size of a median state such as Kentucky (about 4 million residents).

For many years, a small dedicated group of overseas Americans has made an annual trek to Washington to present the case for simpler and fairer U.S. taxation of U.S. citizens and immigrants (popularly called "green card holders"). During Overseas Americans Week (March 30 through April 3), representatives of three major overseas citizen advocacy organizations — the Association of Americans Resident Overseas (AARO), American Citizens Abroad (ACA), and the Federation of American Women's Clubs Overseas Inc. (FAWCO)[4] — traveled to Washington again to meet with legislators and their staffers and key government agencies and departments to discuss their recommendations for reform on a number of tax-related topics.

Taxation of Americans Abroad

It is not possible to understand the recommendations presented by the overseas Americans groups without an understanding of how the United States imposes its income taxes on individuals as compared to other countries.

Unlike all other industrialized countries, the United States imposes worldwide *citizenship-based* taxation on

[1]The U.S. census was unable to make an accurate count in the last census, so no official data as to the number of overseas Americans is available.

[2]These U.S. citizens, who are also citizens of their home country, frequently relocate to the United States for study or work and begin complying with the U.S. residence-based tax rules for foreign nationals, unaware that they are subject to different tax rules as U.S. citizens.

[3]Overseas Vote Foundation, 2008 Post Election Overseas and Voter Survey, *available at* http://www.overseasvotefoundation.org.

[4]See http://www.aaro.org, http://www.aca.ch, http://www.fawco.org, and http://www.overseasamericansweek.com for information about these groups and their position papers.

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individuals. The United States also imposes worldwide taxation on its green card holders. All other industrialized countries impose worldwide *residence-based* taxation.[5] (The United States imposes residence-based taxation on foreign nationals who are not green card holders.)

As a result of these policies, nonresident U.S. citizens and green card holders remain subject to worldwide U.S. taxation while living abroad. Residents from other industrialized countries are no longer subject to worldwide taxation by their country of residence once they become nonresidents. Nonresident U.S. citizens may avoid worldwide U.S. taxation only by renouncing their U.S. citizenship. Nonresident green card holders may avoid worldwide U.S. taxation only by losing their green card status, either through abandonment or, more commonly, by having it revoked because America's immigration laws do not allow green card holders to maintain their status while living abroad indefinitely. Former U.S. citizens and former long-term green card holders (those who have had that status for any part of 8 of the 15 tax years before the year of loss of that status) are subject to the new section 877A exit tax if they meet either the net worth or five-year average tax liability requirement of section 877.

Because they remain subject to worldwide U.S. taxation while living abroad, U.S citizens and green card holders (collectively referred to hereafter as overseas Americans) may not avail themselves of U.S. tax treaties to reduce or eliminate worldwide U.S. taxes because of a saving clause that is included in all U.S. treaties.[6] They also may not use U.S. treaties to reduce or eliminate worldwide country-of-residence taxation because of provisions in the treaties requiring that U.S. citizens have a substantial nexus to the United States such as substantial presence or a permanent residence.[7] As a result, they may mitigate (but not necessarily avoid altogether) worldwide double taxation through foreign tax credits or the section 911 foreign earned income exclusions (or by not filing).

As a result of the U.S. tax policy of citizenship-based taxation, overseas Americans now face personal economic issues not faced by U.S. citizens and green card holders who live in the United States (collectively referred to hereafter as Americans). Congress can provide simpler and fairer tax treatment of overseas Americans in one of two ways:

- by adopting residence-based taxation, the norm in the industrialized world; or
- by adopting tax law changes that place overseas Americans on the same playing field as Americans living in the United States.

Residence-Based Taxation

The simplest solution to double worldwide taxation would be to adopt residence-based taxation. One proposal for changing to U.S.-residence-based taxation of individuals would require few changes to the tax code to implement:[8]

- Residency status of all individuals could be determined using the section 7701(b) substantial presence rules that now apply to foreign nationals who come to the United States to live and work or study.
- Nonresident U.S. citizens and green card holders could be subject to source-based U.S. taxation and withholding taxes under the rules that now apply to foreign nationals who are nonresident aliens under section 7701(b).
- The section 877A exit tax could be imposed with a change in residency status to nonresident rather than with the renunciation of U.S. citizenship or loss of green card status.
- U.S. citizens and green card holders on temporary assignment abroad would stay in the U.S. tax system for at least three years with their income from foreign labor excluded from income by an uncapped section 911 foreign earned income exclusion.
- An election to stay in the U.S. tax system would be available to those Americans who continue to have a nexus with the United States such as employees of U.S. companies or retirees with family in the United States.
- A one-time leaving-the-system payment for nonfiling Americans who have lived abroad for six years or more based on the exit tax and an estimate of taxes owed for the past six years would

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[5]For an overview of the residence-based tax rules of 42 industrialized countries, see the *Guide to Global Payroll Management*, 6th edition, published by the American Payroll Association. The 42 countries are Australia, Austria, Belgium, Canada, Chile, China (P.R.C.), Cyprus, the Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Italy, Jamaica, Japan, Kazakhstan, South Korea, Mexico, Morocco, the Netherlands, New Zealand, Norway, Pakistan, the Philippines, Portugal, Romania, Russia, the Slovak Republic, Spain, Sweden, Switzerland, Trinidad and Tobago, Tunisia, Ukraine, and the United Kingdom.

[6]*See, e.g.*, article 1(4) of the 2006 U.S. model treaty.

[7]*See, e.g.*, article 4(2) of the U.K.-U.S. tax treaty.

[8]For more details regarding this proposal, see Paula N. Singer, ''A Common-Sense Solution to Taxing U.S. Citizens and Immigrants Abroad,'' *Tax Notes Int'l*, Nov. 17, 2008, p. 555, *Doc 2008-23014*, or *2008 WTD 227-13*. The proposals were originally published in Cynthia Blum and Paula N. Singer, ''A Coherent Policy for U.S. Residence-Based Taxation,'' *Vand. J. Transnat'l L.*, Vol. 41, No. 3, May 2008. Residence-based taxation is not a new concept, having been proposed by departing Secretary of Treasury William Simon in January 1977.

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greatly simplify the administration of those Americans who exit the system.[9]

A residence-based system can only be effectively enforced using an entry/exit system (used by other countries for decades for tax enforcement). Congress mandated such a system following the 1993 World Trade Center bombing. Since the size of the illegal alien population cannot be controlled with only an entry system (45 percent of illegal aliens in the United States entered legally and overstayed),[10] an entry/exit system is inevitable.[11] When the mandated entry/exit system will be fully implemented, however, is not known.

Overseas Americans Proposals

Recognizing that a transition to residence-based taxation is a long-term solution, the overseas Americans groups have presented a series of tax reform proposals for the interim that would both obtain fairer treatment of overseas Americans as compared with Americans living in the United States while simultaneously simplifying their U.S. tax compliance obligations.[12]

Section 911 Exclusions

The original section 911 foreign earned income exclusion allowed Americans to live and work abroad without the additional economic burden of double taxation. Due to perceived tax abuses by a few very wealthy individuals, Congress set a $35,000 cap on section 911 exclusions in 1962 at a level that would limit the abuses but still allow middle-income Americans to work and compete overseas in the world economy. This intent is no longer met by the current limit ($87,600 in 2008). Only about 20 percent of overseas Americans who file Form 2555 to offset their foreign income from labor are fully protected by the current maximum exclusion amount. Had the section 911 cap of $35,000 been indexed to inflation, the 2008 maximum amount would have been $253,553.[13]

The section 911 foreign earned income exclusions were also a simplified means of avoiding double taxation as compared to the foreign tax credit regime. The IRS even makes available a Form 2555-EZ. Although the current FTC regime — which was designed by Congress for corporations but also imposed on individuals — has been simplified by Congress in recent years, it still remains incredibly complex for taxpayers and the IRS to administer. (IRS Publication 514, *Foreign Tax Credits for Individuals*, is 40 pages.)

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The FTC regime is administratively burdensome for both taxpayers and the IRS because of the requirement that U.S. taxpayers submit amended tax returns once their foreign taxes have been finalized, frequently years later, by a foreign government that operates an assessment system rather than a self-assessment (that is, voluntary compliance) system.

In 2005, with the passage of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Congress threw simplification to the wind with the modifications to section 911. The new section 911 housing exclusion is complicated not only by a new formula but also by its maximum housing costs for high-cost geographic areas (with periodic determination and redetermination by the IRS). The new ''stacking'' measure, which subjects the investment income of overseas Americans to tax at the rate that would have applied without the section 911 exclusions, also added significant complexity to the tax returns of overseas Americans as well as higher U.S. taxes on their investment income (including on their retirement savings). It is doubtful the TIPRA modifications have resulted in substantial net revenue to the United States considering the resulting change in taxpayer elections of section 911 and increased IRS administrative costs.

Overseas Americans residing in countries that impose income taxes have been terminating their section 911 elections in favor of using foreign tax credits when

[9]An exception from this tax could be allowed those accidental Americans who moved abroad as children who would be impossible to identify if they have not been issued a U.S. passport or filed a U.S. tax return.

[10]Forty-five percent is the ''guesstimate'' used by some immigration attorneys. A reliable estimate of overstays is unavailable. *See* Ruth Ellen Wasem, ''Nonimmigrant Overstays: Brief Synthesis of the Issue,'' CRS Report for Congress, May 22, 2006 (RS22446), p. 6. ''In 2004, the U.S. Government Accountability Office (GAO) attempted to estimate the nonimmigrant overstays using samples based upon three different methodologies. GAO concluded, 'three alternative data sources on illegal immigrants indicate varying — but uniformly substantial — percentages of overstays: 31%, 27%, and 57%.'''

[11]*See* letter of Paula N. Singer to Treasury Secretary Paul H. O'Neill, Mar. 28, 2002, *Doc 2002-10562, 2002 TNT 85-27*, outlining situations in which an entry/exit system could be used to further tax compliance for foreign national visitors.

[12]These proposals have been compiled from proposals made by the Americans abroad groups to members of Congress and the Joint Committee on Taxation in 2008 and 2009.

[13]Indexing the cap to inflation in the United States would not account for the differences in local buying parity caused by the devaluation of the U.S. dollar to foreign currencies that has occurred since 1962.

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such a change results in lower U.S. taxes. Americans relocating abroad for their employers are choosing not to elect the section 911 exclusions at the outset when foreign tax credits result in lower taxes.[14] While the TIPRA modifications do result in increased revenue from Americans abroad who are working in situations in which they pay no foreign income taxes,[15] many of these employment situations are on projects funded by the U.S. government with the ultimate result of moving U.S. funds from one U.S. government pocket to another.[16]

To eliminate the double taxation of overseas Americans and restore the original intent of section 911, the overseas Americans groups propose a reinstatement of the original unlimited foreign earned income exclusion. Alternatively, they propose return to the simpler pre-2006 section 911 policies with a maximum exclusion indexed for inflation (from the 1962 cap). Either change would be fair for overseas Americans as compared to Americans living and working in the United States who do not face double worldwide taxation.

Of equal importance, the proposed section 911 modifications would remove the competitive disadvantage facing American employees of multinational companies relative to foreign workers. The inadequacy of the section 911 cap over the years is without a doubt the primary reason for the low percentage of Americans working abroad as a percentage of the population as compared with other OECD countries, which now have on average more than three times more nationals abroad per capita than the United States.[17]

As a result of the cost disincentives for sending American employees on foreign assignments, American employees are prevented from gaining the necessary international experience required to compete in today's world markets and to form future leaders for the global economy. Consequently, U.S. companies become dependent on foreign citizens to fill positions requiring international experience for positions located both in the United States and abroad. This fact is illustrated by an unofficial 2008 survey of the number of overseas nationals as compared by nationals working for a multinational company that has historic locations in Sweden, France, and the United States: 250 out of 20,000 Swedes (1.25 percent), 109 out of 12,000 French nationals (0.91 percent) and 37 out of 10,000 Americans (0.37 percent).

The overseas Americans groups point out that an increased presence of Americans working overseas would also support a national effort to boost American exports and export-related jobs and lead to a lower trade deficit, which has exceeded $700 billion a year.[18] It is estimated that $1 billion of exports creates about 10,000 new domestic jobs and new tax revenues of $18 billion over 10 years, based on the historical relationship of taxes representing 18 percent of GDP.[19]

Retirement Accounts

Overseas American filers who elect section 911 foreign earned income exclusions to avoid double taxation are not allowed to contribute to a U.S. IRA if they have no taxable income. Even if they have taxable income, either because they choose to forgo section 911 or because their income from labor exceeds the section

[14]There is no way to measure the magnitude of change using published IRS statistics other than through the reduction of the number of tax returns with a Form 2555. The IRS does not publish statistics on tax returns with a foreign address and a Form 1116 foreign tax credit claim.

[15]Many of these overseas Americans are working in the Middle East, where the section 911 exclusions were both an incentive to work in difficult environments and a cost savings to U.S. businesses operating in these environments. U.S. government employees in similar nontax situations receive housing, cost of living, home leave transportation, and education allowances that are not subject to any taxation because of advantageous U.S. tax rules.

[16]The 1979 modifications to section 911 had a similar result. In a telex to then-Secretary of State Edmund Muskie, the USAID mission in Cairo stated:

> If [the] present campaign to enhance [the] U.S. competitive position overseas leads to reform of tax laws . . . AID can expect [the] elimination of tax-related salary costs. If taxation of allowances remains, however, [a] large amount of AID dollars will be siphoned off in U.S. taxes.

See Paula N. Singer, ''U.S. Tax Policy for Citizens and Immigrants Living Abroad Merits a Closer Look,'' *Tax Notes Int'l*, July 19, 2004, p. 283, *Doc 2004-14557*, or *2004 WTD 140-21*. The 1979 section 911 modifications were repealed retroactively in 1981 because of the evidence of their adverse economic impact on American exports.

[17]Data was provided by the statistical department of the OECD for 2000. The author participated in the 1980 repatriation of Arthur D. Little Inc.'s American employees working on overseas projects and their replacement with third-country nationals who were not taxed by their former countries of residence, and were, therefore, much less costly to employ abroad.

[18]Statistical evidence compiled by ACA from U.S. Department of Commerce information suggests a correlation between the decrease in American workers abroad over the past 35 years and the increase in the U.S. trade deficit. There never was a U.S. trade deficit before 1962, when the section 911 cap was added.

[19]PricewaterhouseCoopers, ''Economic Analysis of the Foreign Earned Income Exclusion,'' Nov. 7, 2005. Based on the U.S. Department of Commerce analysis of 2001 data where 640.2 billion of manufactured goods supported 7.5 million jobs or 11,542 domestic jobs per $1 billion of exports (source: U.S. Dept. of Commerce, Export-Related Jobs, 2001 and U.S. Department of Commerce, U.S. Foreign Trade Highlights; *available at*: http://www.ita.doc.gov/TD/Industry/OTEA/), PriceWaterhouseCoopers adapted the number of export-related jobs for changes in labor productivity and wages and estimated that each billion dollars of manufactured exports supported 9,531 domestic jobs in 2004 (p. 18).

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911 cap, their U.S. IRA will likely be taxed by their country of residence. Any foreign retirement account, although exempt from tax by their country of residence, will be subject to U.S. tax at relatively high rates because of the stacking modification of the section 911 exclusions.

In addition to these problems, currency fluctuations can create unrealized but taxable capital gains or losses within the retirement accounts, irrespective of the actual gains or losses when measured in local currency.

To provide fair treatment of overseas Americans as compared to Americans living in the United States, the overseas Americans groups propose the following:

- Allow taxpayers to count income excluded under section 911 in order to qualify for contributions to U.S.-based defined contribution plans, including IRAs.
- Allow long-term bona fide foreign residents (that is, five years or more abroad) to designate a foreign bank account as an IRA equivalent to be managed according to the limitations for a Roth or traditional U.S. IRA. The account could be identified and reported to the IRS with all contributions and distributions reported annually as proof of compliance with IRA restrictions and requirements.
- Allow foreign pensions to meet the requirements of a qualified plan without the need of a private letter ruling (estimated to cost more than $25,000).

Overseas Americans with contributions to foreign earned pensions have been historically subject to current taxation on these accounts because, although the pensions are qualified (that is, tax deferred) for country-of-residence tax purposes, they are *not* qualified for U.S. tax purposes. (Foreign defined benefit pension plans are also not qualified for U.S. tax purposes.) These foreign plans are now subject to the new section 409A provisions that set forth requirements for deferred compensation plans regarding timing of elections and distributions and funding. Deferred compensation plans not complying with section 409A are subject to an additional 20 percent tax penalty (imposed on the employee) as well as current taxation.

There are three exceptions that might provide limited relief to some overseas Americans covered by a nonqualified deferred compensation retirement plan:

- *Unused Section 911 Exclusion*. Overseas Americans claiming the section 911 exclusions may claim a foreign earned income exclusion equal to or less than the difference between the maximum section 911 exclusion for the calendar year and the amount actually excluded. No carryover of any excess is allowed. Because few of the millions of overseas Americans claim the exclusion (294,763 based on 2001 data released by the IRS in August 2004) and only about 20 percent of those are fully protected, this exception has little utility.
- *Broad-Based Foreign Retirement Plans*. Overseas Americans who are participants in a broad-based foreign deferred compensation plans and who are not eligible to participate in a U.S. plan, may exclude from income nonelective deferrals to the extent that the deferrals do not exceed the maximum deferral amount for the year as defined by section 415.
- *Income Tax Treaty Exception*. Overseas Americans who are tax resident in a country that has an income tax treaty with the United States (65 countries do), which includes provisions covering an arrangement under which contributions made by or on behalf of an individual are excludable for federal income tax purposes (few treaties do[20]), may exclude those contributions from income.

Many of the millions of overseas Americans might be unaware of the impact of these new rules on their retirement funds.

Functional Currency

Under current IRS rules, the gain or loss on sales of an asset denominated in foreign currency must be computed using the U.S. dollar exchange rate on the date of acquisition to determine the basis and the U.S. dollar exchange rate on the date of sale to determine the proceeds. As a result, each transaction includes either an unrealized exchange gain or an unrealized exchange loss. Overseas Americans must deal with the illogical results when selling a personal residence, converting retirement savings from stocks to bonds when nearing retirement, or selling assets for cash because of a death or family emergency.

This was the problem encountered by Carlos Quijano, who lived and worked in London and was paid in pounds sterling, when he sold his London home. Although he had the equivalent appreciation of $200,000, he paid U.S. taxes on a $300,000 gain. The $100,000 difference was caused by the change in the U.S. dollar exchange rate between the date he purchased his residence and the date he sold it 13 years later. Quijano was unable to convince either the IRS or the courts that he had paid $30,000 in tax on a gain that he never realized.[21] These phantom gains apply in many other situations such as payments on obligations such as rental leases and mortgages, while phantom

[20]Austria, Belgium, Canada, France, Germany, Iceland, Ireland, the Netherlands, South Africa, Sweden, and the United Kingdom. *See, e.g.*, article 18 of the U.K.-U.S. treaty.

[21]*See Quijano v. United States*, 93 F.3d 26 (1st Cir. 1996), affirming an unreported district court decision. The author represented Quijano.

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losses on these transactions are nondeductible because the transactions are personal.[22]

The overseas Americans groups propose that bona fide foreign residents be allowed to elect to use the currency of their country of residence as their functional currency to compute all capital gain/loss transactions before converting the result into U.S. dollars at the exchange rate on date of sale. Application of the foreign functional currency rule can be limited to overseas Americans who have been bona fide foreign residents for at least five years.

Under section 985, the functional currency of individuals is the U.S. dollar. There is an exception under section 989, which allows individuals to use a foreign currency as their functional currency only to compute net income or losses for qualified business units such as for rental properties and sole proprietorships. (Foreign subsidiaries of U.S. corporations are allowed to use the foreign currency for all of their transactions.) Such a change would be both simple to administer and based on economic reality rather than on the arbitrary movement of foreign exchange. In fact, the fisc would probably gain revenue on such a change in policy, since compliant taxpayers who are aware of the current rule consider the effect of the exchange movement when deciding to sell their liquid assets in the normal course of investing.

Retirement Distributions

Overseas Americans face economic impacts on their retirement distributions, both private and public, which are not faced by Americans living in the United States.

- *Distributions From Private Plans*. Unlike Americans living in the United States, overseas Americans are subject to double taxation on their retirement distributions. While foreign deferred compensation retirement plans historically have been treated as earned income for U.S. tax purposes, distributions from these plans are not considered earned income for purposes of section 911 foreign earned income exclusions. Overseas Americans may only use foreign tax credits to mitigate (but not necessarily avoid completely) the double taxation, thereby imposing on overseas American retirees the complex (and frequently costly) compliance with the FTC regime at a time when their means are limited.
- *Distributions From Public Plans*. Americans who have worked both in the United States and abroad might be vested in both U.S. Social Security and a foreign social welfare plan.[23] Because of their work history in each country, the sum of their retirement benefits could be considerably less than had they worked in one country throughout their career. (This is the case especially if the retiree was young when she worked in the United States.) Their retirement income will not equal the sum of their two vested benefits, however, because of a U.S. Social Security windfall elimination provision, which causes their vested U.S. Social Security benefits to be reduced because they are receiving a social security benefit from another social welfare plan. Distributions from public plans are also subject to double taxation, which may only be mitigated by foreign tax credits.

Although foreign tax credits may mitigate the effect of double income taxation, they do not account for other taxes that overseas Americans pay that are not borne by Americans living in the United States such as wealth taxes, VATs, and high taxes on gasoline and automobile purchases. None of these taxes are creditable for foreign tax credit purposes.

The overseas Americans groups recommend:

- treating foreign earned pension income as foreign earned income for purposes of section 911 exclusions; and
- eliminating the reduction of their Social Security benefits by distributions from their foreign social welfare plans.

Both proposals would greatly simplify the U.S. tax compliance obligations of overseas Americans while also preventing the dissipation of their retirement income.

Summary

In discussions about how to make our tax code simpler and fairer for Americans, Congress needs to consider how that can be accomplished for overseas Americans as well as for Americans living in the United States. Until the United States transitions to residence-based taxation (the norm in the industrialized world), Congress needs to modify current tax rules that impose complex compliance obligations on overseas Americans and treat them unfairly compared with Americans living in the United States. Proposals by the overseas American citizen-advocacy groups are both simple and fair, and would have the added benefit of greatly increasing the voluntary compliance of overseas Americans because of the greater protection from worldwide double taxation provided by their proposals. ◆

[22]Under Rev. Rul. 90-97, 1990-2 C.B. 187, the payoff of a foreign-denominated mortgage results in a taxable unrealized exchange gain. Losses on the payoff of a mortgage may not be used to offset unrealized gains on a sale because the losses are personal.

[23]Workers who are not fully vested under the rules of the country where they worked may, nevertheless, be eligible for a totalized retirement benefit if the United States has a Social Security agreement with that country.

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