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ARTICLES

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WORLDWIDE TAXATION OF UNITED STATES CITIZENS LIVING
ABROAD – IMPACT OF FATCA AND TWO PROPOSALS

*J. Richard (Dick) Harvey, Jr.**

1. INTRODUCTION, PURPOSE OF ARTICLE, AND INTENDED AUDIENCE

The United States currently taxes its citizens on their worldwide income.¹ For United States citizens resident in the United States, this is usually not a big deal; their income is earned in the United States and not taxed by other countries. The same cannot be said for U.S. citizens living abroad. The worldwide taxation of their income has historically created compliance burdens and the potential for double taxation.

Because of these concerns, coupled with the fact that the United States is the only developed country with a worldwide system of taxation for individuals, some commentators have suggested the United States should adopt residence-based taxation.² The common theme of these proposals is that citizens resident in the United States would continue to be taxed on their worldwide income while citizens living abroad would be treated as nonresident aliens. Nonresident aliens are only subject to U.S. tax on income or assets with a clear U.S. connection.³

These proposals historically have been unsuccessful for a number of reasons, including: (i) U.S. citizens living abroad have little political clout, (ii) the worldwide tax system has been a fixture of U.S. tax law for over 100

* Copyright 2013 by J. Richard (Dick) Harvey, Jr. The date of this article is March 1, 2013. Since August 2010 the author has been the Distinguished Professor of Practice, Villanova University School of Law and Graduate Tax Program. Immediately prior to joining the Villanova faculty he was the Senior Advisor to IRS Commissioner Doug Shulman and worked significantly on the development of FATCA, other international issues, and Schedule UTP. Professor Harvey joined the IRS upon retiring from a Big 4 accounting firm as a Tax Partner and Leader of the U.S. Banking and Capital Markets Tax Practice. Professor Harvey also served in the United States Treasury Department's Office of Tax Policy during the drafting and implementation of the 1986 Tax Reform Act.

¹ I.R.C. § 61(a) (West 2013). In addition, the United States also taxes the worldwide income of resident aliens defined as (i) lawfully admitted permanent residents (i.e., so-called Green Card holders), and (ii) aliens who meet a substantial presence test. Since the issues they face are similar, this article will generally use the term "U.S. citizens" to refer to both United States citizens and lawfully admitted permanent residents.

² See, e.g., Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 VA. TAX REV. 1, 1 (2012); Cynthia Blum & Paula N. Singer, *A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals*, 41 VAND. J. TRANSNAT'L L. 705, 705 (2008); Reuven S. Avi-Yonah, *The Case Against Taxing Citizens*, (Univ. of Mich. Pub. Law, Working Paper No. 190, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1578272.

³ I.R.C. §§ 871, 2103 (West 2013).

years,⁴ and (iii) the U.S. government could collect less tax revenue. Has anything changed that could result in a different result? The short answer is *possibly*.

First, the Foreign Account Taxpayer Compliance Act's ("FATCA") March 2010 enactment further complicated the tax burdens of American citizens living abroad.⁵ For example, many foreign financial institutions are blaming FATCA's reporting obligations for their refusal to provide necessary financial services to U.S. citizens.⁶ In addition, FATCA requires all U.S. citizens, including those living abroad, to report more information on their non-U.S. financial assets.⁷ As would be expected, U.S. citizens living abroad can have a substantial number of non-U.S. financial assets.

Second, there is significant discussion in Washington, D.C. about changing the worldwide tax system for corporations to a territorial system.⁸ It is not beyond the realm of possibility that Congress could consider totally abandoning the worldwide tax system for both corporations and individuals.⁹

Finally, three groups representing U.S. citizens abroad, collectively known as Citizens Abroad ("CA"), have jointly made a relatively comprehensive legislative proposal to adopt a residence-based tax system for individuals ("CA Proposal").¹⁰

Given this brief introduction, there are several purposes for writing this article, including

- Provide background on the taxation of U.S. citizens living abroad and the issues they face, including the recent enactment of FATCA;

⁴ Citizenship based taxation dates back to the civil war. See Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 449 n.17 (2007).

⁵ Foreign Account Taxpayer Compliance Act ("FATCA"), Pub. L. 111-147, § 501(a) (2010). For background that led to FATCA, see J. Richard Harvey, Jr., *Offshore Accounts: An Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. 471 (2012), available at <http://ssrn.com/abstract=1969123>.

⁶ See J. Richard Harvey, Jr., *FATCA – A Report From the Front Lines*, 136 TAX NOTES 713 (2012), available at <http://ssrn.com/abstract=2122491>.

⁷ See, e.g., I.R.S. Form 8938 (Nov. 2012).

⁸ See Press Release, H. Comm. on Ways & Means, Camp Releases International Tax Reform Discussion Draft (Oct. 26, 2011), available at <http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=266168> (last visited Mar. 1, 2013). Currently U.S. corporations are taxed on their worldwide income. A territorial system would only tax U.S. corporations on income earned from activity in the United States.

⁹ However, a change for corporations would seem substantially more likely than a change for individuals.

¹⁰ The three groups are American Citizens Abroad, Association of Americans Resident Overseas, and Federation of American Woman's Clubs Overseas, Inc. These three groups will collectively be referred to in this article as CA. See also CA Proposal, *infra* note 126; see *infra* Section 5 for a detailed discussion of the CA Proposal.

- Explore whether certain U.S. citizens still have a motivation under current law to surrender their citizenship (i.e., expatriate);
- Discuss whether FATCA should result in the United States adopting a residence-based tax system;
- Make two recommendations to address the issues faced by U.S. citizens living abroad – one proposal applies if the United States retains a worldwide tax system, while the other applies if a residence-based system is considered; and
- Briefly describe the CA Proposal and provide observations.

The article is intended for various audiences, including: government policy makers, U.S. abroad and others advocating change, and interested students and academics. The article is divided into several sections: Section 2, Background; Section 3, Analysis and Discussion; Section 4, Two Proposals; Section 5, Proposal by CA; and Section 6, Summary and Conclusions.

The Background section is intended for those with little or no knowledge of the subject matter. More knowledgeable readers should focus on the rest of the article, especially the proposals in Sections 4 and 5.

2. BACKGROUND

This section discusses several background issues that may be important for readers to understand, including the taxation of U.S. citizens compared to the taxation of nonresident aliens (Section 2.1) and the taxation of U.S. citizens that expatriate (Section 2.2). In addition, Section 2.3 summarizes categories of U.S. citizens living abroad.

2.1. Taxation of U.S. Citizens Compared to the Taxation of Nonresident Aliens

2.1.1. General

For income tax purposes, U.S. citizens are taxed on their worldwide income with a foreign tax credit to minimize or eliminate the impact of double taxation.¹¹ Nonresident aliens generally do not incur U.S. tax unless they have (i) U.S. source income or (ii) income in connection with a U.S. trade or business.¹² The former can be subject to a 30% withholding tax,¹³ while the

¹¹ See, e.g., I.R.C. § 61(a), 901 (West 2013).

¹² I.R.C. § 871 (West 2013).

¹³ The 30% rate can be reduced or eliminated by a tax treaty between the United States and a foreign country. However, there are many exclusions whereby no tax is imposed on U.S. source income (e.g., portfolio interest exemption in I.R.C. § 871(h)(1) (West 2013)).

latter is subject to normal graduated tax rates. For estate and gift tax purposes, U.S. citizens are subject to tax on their net worth, wherever located.¹⁴ Nonresident aliens are only taxed on assets situated in the United States.¹⁵

Given these significant differences in taxation, it can be very important for a nonresident alien to avoid becoming a resident alien for U.S. tax purposes. Similarly, a U.S. citizen living abroad may surrender their citizenship to reduce or eliminate any future U.S. tax.

2.1.2. Definition of Resident vs. Nonresident Aliens

The discussion below is important to understand when evaluating the CA Proposal in Section 5 (i.e., the proposal uses the substantial presence test in I.R.C. § 7701(b)(3) for determining whether a U.S. citizen living abroad should be entitled to nonresident taxation).

The United States currently taxes both citizens and resident aliens on their worldwide income. Resident aliens are defined in I.R.C. § 7701(b) to include (i) lawfully admitted permanent residents (i.e., so-called green-card holders) and (ii) aliens who meet the substantial presence test in I.R.C. § 7701(b)(3).¹⁶ Substantial presence is generally defined as (i) being present in the United States for at least 31 days during the current calendar year and (ii) that the weighted average number of days present in the United States during the current and the prior two calendar years exceeds 183 days.¹⁷

The practical effect of the weighting factor is that an alien can be present in the United States for 121 days on average, each calendar year, and avoid being classified as a resident alien subject to U.S. tax on their worldwide income.

There are several exceptions to this general rule, but the most significant is that an alien can be present in the United States for up to 182 days during a calendar year if the alien can establish (i) they have a tax home in a foreign country, and (ii) they have a closer connection to that foreign country than the United States.¹⁸

¹⁴ I.R.C. §§ 2001(a), 2031(a) (West 2013). Thus, assets located outside the United States are subject to estate tax.

¹⁵ I.R.C. § 2103 (West 2013).

¹⁶ I.R.C. § 7701(b)(1)(A)(iii) also allows a “first year election” for an alien who technically does not meet other qualification requirements. (West 2013).

¹⁷ Weighting is based on a multiplier of 100% for the current year, 33.33% for the first preceding year, and 16.67% for the second preceding year.

¹⁸ I.R.C. § 7701(b)(3)(B) (West 2013).

2.1.3. Income Tax Exemptions (I.R.C. § 911)

A qualified individual may elect to exclude earned income and excess housing costs from gross income. Since the housing cost exclusion is complicated, it will not be discussed.¹⁹ For 2013, the earned income exemption amount is \$97,600.²⁰ However, this exclusion only applies for income tax purposes; it does not apply to employment taxes.²¹

A qualified individual is generally defined as (i) a citizen of the United States who has been a bona fide resident of a foreign country or countries for an uninterrupted period, which includes an entire taxable year, or (ii) a citizen or resident of the United States present in a foreign country or countries during at least 330 full days during a 12-consecutive-month period.²²

It should be noted there was no cap (i.e., there was an unlimited exclusion) on the earned income exemption from 1926 to 1962. After 1962, there generally has been a cap of varying amounts.²³

2.1.4. Estate and Gift Tax

U.S. citizens are subject to estate tax on a worldwide basis (i.e., the net value of their estate is taxed regardless of where the property is located).²⁴ Gifts are also subject to a gift tax on a worldwide basis (i.e., no matter where the assets or recipients are located).²⁵ A foreign tax credit is allowed for foreign estate, inheritance, legacy, or succession taxes paid to a foreign country for property situated in that foreign country.²⁶ A foreign tax credit is generally not allowed for gift taxes.²⁷

Nonresident aliens are only subject to the estate tax with respect to property within the United States.²⁸ The definition of property within the United States, however, is relatively narrow. For example, it does not include bank deposits and certain other obligations.²⁹ For gift tax purposes,

¹⁹ See I.R.C. § 911(c) (West 2013).

²⁰ Per I.R.C. § 911(b)(2)(D)(ii) (1986), the amount is indexed for inflation. The 2013 amount per Rev. Proc. 2012-41, I.R.B. 435 § 3.17.

²¹ I.R.C. § 911(a) (1986). However, international social security agreements (i.e., Totalization Agreements) may prevent double taxation. See *U.S. International Social Security Agreements*, SSA, http://www.ssa.gov/international/agreements_overview.html#a0=11 (last visited May 30, 2013).

²² I.R.C. § 911(d)(1) (West 2013).

²³ Kirsch, *supra* note 4, at note 72.

²⁴ I.R.C. § 2103 (West 2013).

²⁵ I.R.C. § 2501(a) (1986).

²⁶ I.R.C. § 2014(a) (1986).

²⁷ *But see* I.R.C. § 2501(a)(3)(B) (1986).

²⁸ I.R.C. § 2103 (1986).

²⁹ I.R.C. § 2105(b) (2010).

nonresident aliens are only taxed on the transfer of tangible property. Intangible property is generally not taxed.³⁰

In summary, like the income tax, there is a clear incentive, with the estate and gift tax, to avoid being taxed as a U.S. citizen or resident alien.

2.1.5. Compliance Burdens on U.S. Citizens Living Abroad

U.S. citizens living abroad face a number of tax compliance burdens not faced by their fellow citizens resident in the United States. The following are among the additional burdens:³¹

- Requirement to file a U.S. income tax return with very complex calculations, including: foreign currency translation,³² the foreign tax credit,³³ and the excess housing cost exclusion.³⁴
- High probability of filing at least one foreign income tax return, and possibly more.
- Very high probability of reporting foreign assets on both (i) the FBAR form,³⁵ and (ii) IRS Form 8938,³⁶ the latter of which is required by FATCA.³⁷
- Reporting on miscellaneous other forms³⁸ that have a higher probability of applying to taxpayers located outside the United States.

In addition to the tax filing burdens listed above, the implementation of FATCA has created some very practical financial issues. Specifically, many foreign financial institutions are blaming FATCA for their refusal to provide necessary financial services to U.S. citizens.³⁹ For example, some foreign financial institutions are closing the bank and custody accounts of U.S. citizens and permanent residents because the foreign financial institutions hope to avoid the FATCA reporting obligations.

³⁰ I.R.C. § 2501(a)(2) (1986).

³¹ Schneider, *supra* note 2, at 1–2; NAT'L TAXPAYER ADVOCATE, *infra* note 94.

³² See, e.g., I.R.C. § 985 (West 2013).

³³ See generally I.R.C. §§ 901-09 (West 2013).

³⁴ I.R.C. § 911(c) (West 2013).

³⁵ I.R.S. Form TD F 90-22.1 (Jan. 2012). This form is entitled Report of Foreign Bank and Financial Accounts ("FBAR").

³⁶ I.R.S. Form 8938 (Nov. 2012).

³⁷ FATCA, Pub. L. 111-147, § 501(a) (2010). For a comparison of the two forms, see *Comparison of Form 8938 and FBAR Requirements*, IRS, available at <http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements> (last visited May 29, 2013); *Reporting Foreign Accounts to IRS*, GAO, available at <http://www.gao.gov/assets/590/588921.pdf> (last visited May 29, 2013).

³⁸ See, e.g., I.R.S. Form 5471 (Dec. 2012); I.R.S. Form 8865 (2012).

³⁹ See Harvey, *supra* note 6, at 715.

FATCA also requires all U.S. citizens, including those living abroad, to report more information on their non-U.S. financial assets.⁴⁰ As would be expected, United States citizens living abroad can have a substantial number of non-United States financial assets. Failure to carefully follow these reporting obligations can result in significant penalties and an indefinite extension of the statute of limitations. See Section 3.5 for a discussion of whether FATCA justifies a change by the United States from a worldwide to a residence-based tax system.

2.2. Taxes on U.S. Citizens that Expatriate

Since the United States has a worldwide income and estate/gift tax system for U.S. citizens, Congress has historically been concerned U.S. citizens would expatriate⁴¹ primarily for tax reasons. As a result, many tax law provisions have been enacted over the years to deter tax-motivated expatriation.⁴² The latest revision was in 2008,⁴³ when two new internal revenue code sections were added: I.R.C. § 877A and I.R.C. § 2801. Both are described below.

2.2.1. Deemed Mark-to-Market Exit Tax (I.R.C. § 877A)

Prior to the enactment of I.R.C. § 877A, it was relatively easy for U.S. citizens to expatriate and avoid taxation of income and gains accrued during their period of U.S. citizenship. I.R.C. § 877A attempts to address this concern by requiring “covered expatriates” to treat all property⁴⁴ as sold for its fair market value on the day before their expatriation.⁴⁵ Thus, unrealized gain is deemed realized subject to a *de minimis* exemption (e.g., \$668,000⁴⁶ in 2013).

In 2013, a covered expatriate is generally defined as an individual that meets *any* of the following three criteria:⁴⁷

⁴⁰ See, e.g., I.R.S. Form 8938 (Nov. 2012).

⁴¹ Expatriation would entail a U.S. citizen giving up his U.S. citizenship or Green Card.

⁴² For more information, see Bradford Craig, Note, Congress, Have a Heart: Practical Solutions to Punitive Measures Plaguing the Heart Act’s Expatriate Inheritance Tax, 26 TEMP. INT’L & COMP. L.J. 69 (2012).

⁴³ Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624.

⁴⁴ I.R.C. § 877A(c) (2008) excludes certain property (i.e., deferred compensation, tax deferred account, and interests in a nongrantor trust) that special rules are provided for in I.R.C. § 877A(d)–(f) (2008).

⁴⁵ I.R.C. § 877A(a)(1) (2008).

⁴⁶ I.R.C. § 877A(a)(3)(A) (2008) requires annual adjustment for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435 § 3.16.

⁴⁷ I.R.C. § 877A(g)(1)(A) (2008), referring to I.R.C. § 877(a)(2) (1986).

- More than \$155,000 of average annual net income tax for the 5 taxable years preceding the date of expatriation.⁴⁸
- \$2 million of net worth at the date of expatriation.
- Failure to certify compliance with the U.S. tax laws for the 5 taxable years preceding the date of expatriation.

There are two very limited exceptions to the definition of a covered expatriate.⁴⁹ The first is for certain dual citizens, defined as:⁵⁰

- An individual who, at birth, became a citizen of both the United States and another country,
- On the date of expatriation, the individual is a citizen of, and is taxed as a resident of, the same other country, and
- The individual has been a resident of the United States for no more than 10 taxable years during the 15 taxable years prior to the date of expatriation.

Note that if a U.S. citizen obtained citizenship in foreign country A at birth, has never set foot in the United States, but now lives in foreign country B, they will not qualify under this very limited dual citizen exception.⁵¹

The second exception is for children becoming adults. In order to qualify for this exception, a U.S. citizen must:⁵²

- Relinquish their citizenship before attaining the age of 18½, and
- Have been a resident of the United States for no more than 10 taxable years before they surrender their citizenship.

The practical issue with this exception is that very few 18-year-olds are cognizant of tax and immigration issues in general, let alone the potential need to relinquish U.S. citizenship by the time they are 18½.

Although there are many other technicalities to this expatriation, or exit, tax, one worth noting is that individuals can make an election to defer the tax on a property-by-property basis until the property is sold.⁵³ If the election is

⁴⁸ Per I.R.C. § 877(a)(2) (1986), the amount is indexed for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435 § 3.15.

⁴⁹ See *infra* Section 4.3 for suggestions on how these two exceptions could be expanded to include other sympathetic cases.

⁵⁰ I.R.C. § 877A(g)(1)(B)(i) (2008).

⁵¹ See *id.*

⁵² I.R.C. § 877A(g)(1)(B)(ii) (2008).

⁵³ I.R.C. § 877A(b) (2008).

made, the individual will be charged interest and must provide adequate security that the tax will be paid (e.g., a security bond).⁵⁴

See Section 3.2 for a discussion of whether I.R.C. § 877A meets its objectives (i.e., taxing unrealized gains earned while a U.S. citizen). (2008). In summary, it does, subject to valuation and enforcement issues.

2.2.2. Inheritance Tax (I.R.C. § 2801)

Prior to the enactment of I.R.C. § 2801 in 2008, it was also relatively easy to avoid the U.S. estate and gift tax by expatriating. I.R.C. § 2801 partially addressed this concern by adopting an inheritance tax that is applicable to the same covered expatriates defined for purposes of the exit tax in I.R.C. § 877A.⁵⁵ Specifically, if a U.S. citizen or resident receives a gift or bequest from a covered expatriate, a tax at the highest rate under the estate tax is imposed on the fair market value.⁵⁶ The recipient pays the tax; thus, it is an inheritance tax, not an estate tax.

Other noteworthy provisions within I.R.C. § 2801 include:

- The provision is applied to both direct and indirect gifts and bequests, including those through domestic and foreign trusts.⁵⁷
- Tax is reduced by any gift or estate tax paid to a foreign country with respect to the covered gift or bequest.⁵⁸ Based upon the statutory language, however, it would appear that other inheritance taxes would not be creditable.⁵⁹

See Section 3.2 for a discussion of whether I.R.C. § 2801 eliminates the estate and gift tax incentive to expatriate. In short, there can still be an incentive to expatriate if the anticipated recipients of the bequests or gifts are neither U.S. citizens nor U.S. residents.

2.3. Categories of U.S. Citizens Abroad

⁵⁴ I.R.C. § 877A(b)(4) (2008). Security can be in the form of a bond, or other form of security meeting United States Treasury requirements.

⁵⁵ I.R.C. § 2801(f) (2008).

⁵⁶ I.R.C. §§ 2801(a)–(e) (2008).

⁵⁷ I.R.C. § 2801(e) (2008).

⁵⁸ I.R.C. § 2801(e)(4)(B)(ii) (2008).

⁵⁹ Inheritance taxes are more common than the estate tax imposed by the United States. *See* Joint Comm. on Taxation, 108th Cong., Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship & Termination of Long-Term Residency 153 (Comm. Print 2003).

Like any group of individuals, from a tax policy perspective there are various subgroups of U.S. citizens living abroad⁶⁰ that one might conceivably treat differently. The first subgroup would be those citizens abroad on a short-term basis (i.e., intending to return to the United States within the foreseeable future). This subgroup includes those who are overseas for education, travel, and/or temporary work assignments.

The second group would be citizens who are overseas on a long-term basis (i.e., not intending to be resident in the United States for the foreseeable future). There are potentially several ways to characterize individuals within this subgroup. For example, they could be characterized as including individuals who

- **Have a U.S. passport** (individuals who almost certainly know they are U.S. citizens),⁶¹ or
- **Never had a U.S. passport** (individuals who may reasonably not know they are U.S. citizens).

Individuals could also be characterized by the degree of contact they have had with the United States. For example,

- **Significant contact** refers to individuals who were born in the United States to U.S. parents and have spent a substantial amount of their life in the United States, and
- **Insignificant contact** refers to individuals who have spent little or no time in the United States, but were either (i) born in the United States to foreign parents or (ii) born outside the United States to U.S. parents.

As discussed in Section 2.2.1, Congress has provided two very narrow exceptions to the Section 877A exit tax for certain dual citizens and young adults who have spent most of their lives outside the United States. See Section 4.3 for a discussion of why these exceptions should be expanded.

Finally, since the United States is the only major country taxing its citizens on a worldwide basis,⁶² it should be noted that many U.S. citizens living abroad do not understand they have a U.S. tax filing obligation. These citizens may have inadvertently subjected themselves to significant penalties.

3. Analysis and Discussion

⁶⁰ For a more comprehensive discussion, see Schneider, *supra* note 2, at § II.

⁶¹ However, it is possible that a parent could obtain a passport for a child without a child's knowledge.

⁶² See, e.g., Schneider, *supra* note 2, at 1.

This section discusses several topics, including: tax issues facing U.S. citizens abroad (Section 3.1); whether U.S. citizens still have a motivation to expatriate (Section 3.2); arguments for and against worldwide taxation (Section 3.3); the political landscape (Section 3.4); and whether FATCA justifies a change to residence-based taxation (Section 3.5). Proposals to address the issues facing U.S. citizens living abroad are not discussed in this section, but rather in Sections 4 and 5.

3.1. Selected Tax Issues Facing U.S. Citizens Abroad

A U.S. citizen living abroad faces many potential issues not faced by a fellow citizen resident in the United States. The major potential issues include:⁶³

- **Higher overall tax burden** – Income can be taxed two or more times (e.g., first by the country where the income is earned, second by the foreign country of residence, and third by the United States).⁶⁴ In order to minimize double taxation the United States allows a foreign tax credit (“FTC”), but the FTC is generally not allowed for certain major foreign taxes (e.g., value added tax and social security/payroll taxes).⁶⁵
- **Insufficient income exclusion** – Earned income can be excluded from the U.S. return, but the exclusion is relatively low (e.g., \$97,600 in 2013).⁶⁶ In addition, there is no specific exclusion for passive income, even a *de minimis* amount.
- **Substantial annual tax compliance responsibilities** – These include (i) the requirement to file a U.S. income tax return with complex calculations (e.g., foreign exchange, FTC, and the excess housing cost exemption); (ii) the likelihood that at least one foreign income tax return will also need to be filed; and (iii) annual U.S. reporting obligations for foreign assets (i.e., FBAR form and I.R.S. Form 8938).⁶⁷
- **Difficulty obtaining routine financial services** – The introduction of FATCA has resulted in many foreign financial institutions closing the

⁶³ For a more comprehensive discussion, see Schneider, *supra* note 2, and NAT’L TAXPAYER ADVOCATE, *infra* note 94.

⁶⁴ In most cases, one would expect the source country and the foreign country of residence to be the same. However, that is not always the case.

⁶⁵ See, e.g., I.R.C. §§ 61(a), 901-02 (West 2013).

⁶⁶ I.R.C. § 911(b)(2)(D) (1986); I.R.S. Notice 2013-31, § 2.

⁶⁷ See, e.g., I.R.S. Form 8938 (Nov. 2012); I.R.S. Form TD F 90-22.1 (Jan. 2012).

deposit and investment accounts of U.S. citizens living abroad or, alternatively, offering sub-optimal financial products.⁶⁸

In addition, some U.S. citizens may not know they are U.S. citizens.⁶⁹ Other U.S. citizens may not understand they have a U.S. filing obligation since worldwide taxation is not the norm overseas. Both may have unknowingly subjected themselves to significant penalties for failure to file an income tax return and an FBAR form.

3.2. U.S. Citizens Still Have a Motivation to Expatriate

Given the issues discussed in Section 3.1 above, there clearly is a motivation for U.S. citizens to consider expatriation. However, there are two code sections potentially standing in their way to this “Promised Land”. As summarized in Section 2.2, I.R.C. § 877A and I.R.C. § 2801 were enacted in 2008 to make it more costly for U.S. citizens to surrender their citizenship, assuming they had the wherewithal and inclination to do so. I.R.C. § 877A and I.R.C. § 2801 are only applicable to covered expatriates,⁷⁰ and provide the following:

- **I.R.C. § 877A** – Imposes a mark-to-market regime on the day before expatriation with the result that all unrealized income above \$668,000⁷¹ is realized.
- **I.R.C. § 2801** – Imposes an inheritance tax on U.S. citizens and U.S. residents who inherit or are gifted money by a covered expatriate.⁷²

Despite potential administrative and enforcement issues, these two code sections should substantially reduce the incentive for U.S. citizens to expatriate for tax reasons. However, as described below, the incentive is not completely eliminated, especially for those individuals attempting to minimize or avoid the U.S. estate and gift tax.

- **Income tax** – I.R.C. § 877A ensures that all income earned while an individual is a U.S. citizen is subject to tax in the United States.⁷³

⁶⁸ I.R.C. § 63(a) (West 2013); *see generally* Harvey, *supra* note 6.

⁶⁹ For further discussion, *see supra* Section 2.3.

⁷⁰ *See supra* Section 2.2.1, but it is generally defined as an individual with at least (i) \$2 million of net worth or (ii) \$155,000 of average annual income tax in the past 5 years. I.R.C. § 877(a)(2) (1986); Rev. Proc. 2012-41, I.R.B. 435, § 3.15.

⁷¹ *See* I.R.C. § 877A(a)(3)(A) (2008), where the amount is annually indexed for inflation.

⁷² I.R.C. § 2801(a) (2008).

⁷³ As a practical matter, there may be valuation issues and it is not crystal clear whether the IRS will be informed of all individuals giving up their citizenship. Nevertheless, U.S. citizens

Since income earned after expatriation will escape U.S. taxation, there still is a motivation to expatriate for individuals expecting substantial future income. Nevertheless, from a tax policy perspective, the United States should not be entitled to tax income truly earned when an individual is no longer a U.S. citizen.

- **Estate and gift tax** – I.R.C. § 2801 substantially eliminates the incentive to expatriate for those individuals planning to ultimately bequeath or gift their assets to U.S. citizens or U.S. residents. If, however, a covered expatriate's recipients are neither U.S. citizens nor U.S. residents at the time of the bequest or gift, the I.R.C. § 2801 inheritance tax is avoided.⁷⁴ Thus, an expected future recipient can surrender their U.S. citizenship prior to receipt and avoid the inheritance tax. For a covered expatriate who is merely wealthy, as opposed to ultra-wealthy, this strategy may be difficult to execute because of a recipient's need to retain a substantial presence in the United States (e.g., to work).⁷⁵ For the ultra-wealthy, this may be less of an obstacle.

In summary, there still is a motivation for wealthy U.S. citizens, especially the ultra-wealthy, to surrender their citizenship to avoid the U.S. estate and gift tax. From a tax policy perspective, this suggests Congress may want to consider various proposals, including:

- **Deemed mark-to-market for estate tax purposes** – Given I.R.C. § 877A already requires a mark-to-market calculation, such a calculation could be used to determine the hypothetical estate tax due if the covered expatriate died on the day immediately prior to expatriation.⁷⁶ Similar to I.R.C. § 877A, this deemed estate tax could be deferred, with interest and subject to security,⁷⁷ until the underlying property is ultimately sold. In addition, Congress could decide to only apply this deemed estate tax to very large estates (e.g., over \$25 to \$50 million).

This proposal raises at least two potential tax policy issues. The first is similar to the discussion above surrounding the income tax.

expatriating and following the law should not escape taxation on income earned while in the United States.

⁷⁴ I.R.C. § 2801(a) (2008) (naming a U.S. resident or citizen as a recipient).

⁷⁵ See I.R.C. § 7701(b) (2006) (for substantial presence).

⁷⁶ The tax calculated in I.R.C. § 877A would be subtracted from the deemed value of the covered expatriate's estate.

⁷⁷ Requiring security could make enforcement of a deemed estate tax more certain than the current inheritance tax that is effectively on the honor system.

Specifically, there still would be an incentive for a U.S. citizen to expatriate if they anticipated a material increase in their net worth before death.⁷⁸ In these cases, expatriation would remove the future increase in net worth from U.S. taxes. But again, similar to the income tax analysis above, from a tax policy perspective one would be hard pressed to argue the United States is entitled to tax the future accretion of net wealth for an individual who is no longer a citizen.

The second policy issue could be more troubling to some. Specifically, when combined with IRC § 877A, this deemed estate tax proposal could result in more tax for a United U.S. citizen who expatriates versus a citizen who does not expatriate. For example, a U.S. citizen who does not expatriate will be subject to estate tax but can escape taxation on any unrealized gains at the time of death.⁷⁹ In contrast, under this proposal, an expatriate is effectively taxed on both his unrealized income (per IRC § 877A) and net worth at the time of expatriation, per the deemed estate tax.

One counter-argument could be that Congress has already crossed this bridge by enacting I.R.C. § 877A. Another counter-argument is, if an ultra-wealthy individual wants to expatriate, he surrenders the right to take advantage of the step-up in basis upon death.⁸⁰ Personally, I believe Congress should consider a deemed estate tax for those ultra-wealthy citizens that expatriate. Nevertheless, if Congress is persuaded that a deemed estate tax upon expatriation is not appropriate, then another option is discussed immediately below.

- **Higher of I.R.C. § 877A tax or the deemed estate tax** – Another option would be to require the higher of the two taxes, but not both. Thus, to the extent an expatriate would have a greater tax due under the deemed estate tax than he would under current law I.R.C. § 877A, the expatriate would pay the higher tax. This could be a significant deterrent for those U.S. citizens considering expatriation that have

⁷⁸ In order to provide an economic benefit, the future appreciation of net worth would need to be in excess of the interest rate charged to defer the deemed estate tax.

⁷⁹ The exclusion of unrealized gain at death is a major loophole in the current U.S. income tax that could be the subject of a completely separate paper. Suffice it to say that ultra-wealthy U.S. taxpayers (e.g., Steve Jobs) have avoided income tax on a very high percentage of the wealth they created during their lifetime. Reasonable policy makers can disagree on whether an estate and gift tax is appropriate, but this author sees no reason to allow unrealized gains to escape income taxation at the time of death.

⁸⁰ Said differently, they did not meet the necessary criteria (i.e., death as a U.S. citizen) to obtain a stepped-up basis upon death (i.e., tax basis to heir is increased to the fair market value of the asset at the date of death).

relatively modest amounts of unrealized gain and would therefore escape relatively unscathed by I.R.C. § 877A.

- **Expand existing I.R.C. § 2801** – The definition of recipients subject to inheritance tax could be expanded to include a former U.S. citizen or resident (e.g., a U.S. citizen at the time of expatriation, or some suitable period prior to expatriation, by the covered expatriate). Such a proposal would make it more difficult for a wealthy U.S. citizen to expatriate and avoid the inheritance tax in I.R.C. § 2801, but it would not be impossible. For example, the obvious way to plan around such a rule would be to have the expected recipients surrender citizenship prior to the wealthy donor's expatriation. In addition, such a proposal would add to the significant enforcement issues already surrounding I.R.C. § 2801. Because of these issues, either of the two deemed estate tax proposals discussed above would be preferable.

In summary, after the effective date of I.R.C. § 877A and I.R.C. § 2801, there still can be substantial estate and gift tax benefits for U.S. citizens surrendering their citizenship.⁸¹ Although the absolute number of U.S. citizens that could practically benefit may be low, the tax dollars at stake could be high (i.e., billions of dollars). Thus, if Congress wants to further discourage expatriation by U.S. citizens, it should consider the above proposals.

3.3. Major Arguments For and Against Worldwide Taxation

There already exists a great deal of scholarship on this subject.⁸² The arguments for a worldwide system basically boil down to:

- U.S. citizens living abroad receive benefits from being a citizen.
- If a residence-based system is adopted, it could allow wealthy U.S. citizens to shift their residence overseas to avoid U.S. tax but still retain U.S. citizenship.

The arguments against a worldwide system include:

- The United States is the only developed country that taxes its citizens on a worldwide basis.
- The tax compliance burdens on U.S. citizens abroad are excessive.

⁸¹ There also can be income tax benefits to the extent the individual expects substantial income after expatriation. However, in theory, the mark-to-market regime of I.R.C. § 877A should capture all unrealized gain at the date of expatriation, subject to valuation issues.

⁸² See generally Schnedier, Blum & Singer, Avi-Yonah, *supra* note 2; Kirsch, *supra* note 4.

- The FTC may not fully compensate for the tax burden imposed by other countries.
- U.S. citizens are encouraged to surrender their citizenship to avoid worldwide taxation.
- U.S. citizens may be at a competitive disadvantage when pursuing jobs overseas.⁸³

All of these arguments have some merit and, therefore, reasonable policy makers may have different views as to the correct policy. Personally, it is troubling to see previously proud U.S. citizens surrendering their citizenship to avoid the administrative and financial burdens of being a U.S. citizen.

From a tax policy perspective, I am most concerned about two issues. First, I am very sympathetic to the annual tax compliance burdens currently faced by U.S. citizens living abroad, especially those

- Without substantial economic resources to pay for the needed tax preparation assistance, or
- Who have relatively minor amounts of passive income (i.e., substantially all of their income is earned and presumably taxed in their country of residence).

Second, the adoption of a residence-based tax system could encourage wealthy U.S. citizens to shift their permanent residence overseas in an effort to avoid U.S. tax. For example, if an ultra-wealthy U.S. citizen moves their residence to a low-tax or no tax jurisdiction (i.e., a tax haven) jurisdiction, they could completely eliminate any future U.S. tax obligation. To the extent this occurred, it would reduce tax revenue and create a fairness issue (i.e., further solidify the perception held by many that the wealthy may not be paying their fair share).

Given these two concerns, the real-world question becomes: Is there a legislative proposal that addresses both concerns and has a realistic chance of being enacted, given the current political landscape?

3.4. Political Landscape

One could describe today's political landscape by various adjectives, including dysfunctional, polarized, selfish, infantile, and others not suitable for a legal publication. Nevertheless, most would agree the following two tax policy issues are consuming a lot of oxygen in Washington, D.C.:

⁸³ In a world where jobs are important, the hiring of a U.S. citizen abroad could potentially result in one less U.S. citizen being unemployed in the United States.

- **Trillion dollar annual budget deficits** – If a proposal to change the existing worldwide tax system loses substantial revenue, the probability of passage is very low.
- **The wealthy should pay their fair share of taxes** – Fairness has been a constant theme of many in Washington, D.C. The practical consequence being that any proposal will need safeguards aimed at making sure the wealthy do not avoid paying their fair share – whatever this term means.

Any legislative proposal aimed at U.S. citizens living abroad will clearly need to address these two inter-related concerns. Is it possible? Yes, but it will not be easy.

Before discussing potential proposals in Sections 4 and 5, a quick discussion surrounding FATCA is needed.

3.5. Does FATCA⁸⁴ Justify Changing to Residence-Based Taxation?

Prior to FATCA's enactment, U.S. citizens abroad faced a myriad of issues briefly summarized in Section 3.1. The practical impact of FATCA has been to create additional problems for U.S. citizens living abroad, including

- Difficulty obtaining basic financial services,⁸⁵ and
- The need to complete two forms for foreign financial assets (i.e., FBAR form and IRS Form 8938).⁸⁶

Thus, a legitimate question is whether FATCA is the straw that should break the proverbial camel's back and result in the United States abandoning its system of worldwide taxation for individuals.

In short, my response is "no". The major practical problems of FATCA can be adequately addressed through more targeted changes. For example, the difficulty obtaining basic financial services should, over time, be substantially reduced through the following measures:

- **Intergovernmental agreements and regulations surrounding FATCA's implementation** – Because of concerns expressed by U.S. citizens abroad, the United States Treasury has inserted a provision

⁸⁴ See *supra* Section 3.5 for background on FATCA.

⁸⁵ See, e.g., § 1471(b)(3) (2010).

⁸⁶ For a comparison of the two forms, see *Comparison of Form 8938 and FBAR Requirements*, IRS, available at <http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements> (last visited on Mar. 1, 2013).

in the model intergovernmental agreements conditioning certain benefits on foreign financial institutions not discriminating against U.S. citizens.⁸⁷

- **Movement towards a multilateral FATCA system** – Currently some foreign financial institutions (“FFIs”) are attempting to address their own FATCA problems by excluding U.S. citizens from their customer base.⁸⁸ This may be a rational response when the United States is the only country with a FATCA regime and U.S. customers comprise a small percentage of the FFIs’ customer base. However, as FATCA ultimately spreads around the world, FFIs will need to bite the proverbial bullet by adopting adequate customer due diligence procedures and FATCA reporting systems. When this occurs this should eliminate any incentive to discriminate against U.S. citizens living abroad.

The administrative complexity associated with filing both the FBAR form and IRS Form 8938 should be addressed by either combining or otherwise coordinating the forms. If legislative or regulatory changes are needed to make this a reality, such changes should be pursued.⁸⁹

In summary, although FATCA is not a justification for adopting residence-based taxation, it can be a catalyst for encouraging discussion of how U.S. citizens abroad should be taxed. Section 4 outlines two proposals for addressing the issues facing U.S. citizens abroad. One proposal assumes the existing worldwide tax system is retained, while the second assumes a residence-based system.

4. Two Proposals

As stated in Section 3.3, I have significant sympathy for the annual tax compliance burden of U.S. citizens living abroad. However, I am also very concerned about wealthy U.S. citizens, especially those with material passive income, moving abroad under a residence-based tax system to avoid U.S. tax. This latter concern is based upon both fairness and tax revenue concerns.

First, it is not fair for wealthy U.S. citizens to make their fortune in the United States and then move abroad to avoid substantial U.S. taxes. However,

⁸⁷ For a brief description, see Mark J. Mazur, *Treasury Responds to Congressman’s FATCA Concerns*, 2012 TAX NOTES TODAY 248-23 (Dec. 21, 2012).

⁸⁸ See Harvey, *supra* note 6, at 715.

⁸⁹ For example, changes may be needed to conform the due dates of each form. In addition, although IRS processes both forms, the FBAR form is technically under Title 31 (related to anti-money laundering/terrorist financing), while IRS Form 8938 is under Title 26 (related to taxes). Thus, there may need to be changes to allow the sharing of information if the forms are combined or coordinated.

as discussed in Section 4.3, I am less concerned about U.S. citizens that have (i) already moved abroad while the United States has a worldwide tax system, and have (ii) continued to meet their U.S. filing obligations. Any fully-informed, law-abiding⁹⁰ U.S. citizen would clearly not have moved abroad to avoid U.S. taxes.

Second, a proposal could lose substantial tax revenue if it allows wealthy U.S. citizens to accomplish two previously unattainable goals simultaneously: maintaining their U.S. citizenship, while eliminating or significantly reducing their future U.S. tax liability.

If tax policy makers have similar concerns, it would appear there are two basic alternatives for attempting to address many of the issues facing U.S. citizens abroad:

- Keep the current worldwide system, but (i) increase income exemptions, (ii) greatly simplify the current annual tax filing obligations, and (iii) continue efforts to make sure routine financial services are available to U.S. citizens living abroad.
- Adopt a residence-based system, but one with very tough rules designed to prevent tax avoidance. Variations could include (i) stringent rules on U.S. citizens visiting the United States coupled with an *ironclad* departure tax, and/or (ii) an exception for U.S. citizens resident in a tax haven.⁹¹

Both of these two general alternatives will be discussed in more detail in Section 4.1 and Section 4.2 below.

4.1. Keep Worldwide System but with Changes

U.S. citizens abroad may prefer a residence-based system, but obtaining a change will be difficult given the potential fairness and tax revenue concerns coupled with the existence of a worldwide tax system in the United States for over one hundred years. As an alternative, Congress could provide substantial relief to U.S. citizens within the existing worldwide tax system by enacting some or all of the following:

⁹⁰ There may be some U.S. citizens that moved abroad hoping to evade U.S. tax because of the practical difficulties the IRS has identifying such taxpayers. I have no sympathy for these U.S. citizens.

⁹¹ Individuals resident in a tax haven could still be subject to U.S. tax on a worldwide basis.

- **Increase the \$97,600 earned income exemption**⁹² – In today's world, \$97,600 is not a lot of earned income. One would hope many U.S. citizens living abroad with earned income are earning substantially more. Thus, it may be reasonable to substantially increase this exemption. An exemption of \$300,000 to \$400,000 should ensure that substantially all earned income of U.S. citizens abroad would be exempt from U.S. tax. Plus, to the extent the vast majority of U.S. citizens abroad with significant earned income likely live in relatively high tax jurisdictions, the revenue cost of this proposal may be manageable,⁹³ but see Section 4.4 for further discussion.
- **Provide a *de minimis* passive income exemption** – One of the goals of this overall proposal is to eliminate or greatly simplify the annual tax filing requirements for the vast majority of U.S. citizens living abroad. In order to accomplish this objective, it would be reasonable to annually exempt from U.S. taxation a *de minimis* amount of passive income (e.g., \$50,000 to \$100,000). This exemption could be limited to only foreign-source passive income, or it could be applied to both U.S.- and non- U.S.-source passive income. If limited to just foreign-source income, it may have the undesirable effect of effectively encouraging U.S. citizens abroad to avoid investing in U.S.-source income.
- **Eliminate or greatly simplify the U.S. income tax return filing requirements** – Given the complexity and cost of preparing an annual income tax return for a U.S. citizen living abroad, one has to question whether a tax return is necessary when clearly there is no U.S. income tax liability. For the 2009 tax year, only 9% of taxpayers living abroad had a tax liability after application of (i) the FTC and (ii) the I.R.C. § 911 earned income exemption.⁹⁴

The above proposals to increase the income exemption were partially designed to allow for either the elimination of the income tax filing obligation or a significant simplification. Significant simplification could include:

- **Simple certification that all income is below the exemption level** – If income levels are below the exemption

⁹² Per I.R.C. § 911(b)(2)(D)(ii) (1986), the amount is indexed for inflation. The 2013 amount is per Rev. Proc. 2012-41, I.R.B. 435, § 3.17.

⁹³ Said differently, under current law the FTC should eliminate the U.S. income tax.

⁹⁴ NAT'L TAXPAYER ADVOCATE, 1 *2011 Annual Report to Congress* 156 fig.1.8.2, available at http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_1.pdf.

levels, U.S. citizens living abroad should only need to file a one-page statement signed under penalties of perjury that their income is below the exemption amounts and they qualify for the exemption.⁹⁵ A complete U.S. income tax filing would still be required for U.S. citizens living abroad with income above the exemption levels. Since the income for individuals over the exemption levels would be relatively high, finding and affording the necessary tax advice should be less of an issue.

- **Simple certification that all income is taxed in a designated high-tax country** – A U.S. citizen could certify under penalties of perjury they paid tax on all of their income to a designated high-tax country.⁹⁶ They would also be required to disclose their foreign tax identification number. One issue with this proposal is that it would require the IRS to maintain a list of countries qualifying for high tax status. Hopefully this would not be too burdensome, but it would be necessary.

If Congress does seriously consider any of the above simplifications, it should condition the simplification on a U.S. citizen meeting his U.S. income tax filing and reporting obligations for some specified prior period (e.g., 3 to 6 years). If a U.S. citizen had not previously met these obligations, but owes little or no tax, a simplified certification may also be useful.

- **Combine or coordinate the FBAR⁹⁷ and IRS Form 8938⁹⁸ filing obligations⁹⁹** – Given there is significant overlap of the information requested on these two forms, they should be combined. One possibility would be to have Part 1 of a combined form disclose foreign assets that are common to both filing requirements. Part 2 could then address those disclosures required under the current FBAR

⁹⁵ A variation might be to file a one page statement, but require that gross income be disclosed.

⁹⁶ A variation would be to also require disclosure of gross income and possibly the amount of income tax paid to the foreign country. If the IRS wanted to selectively audit taxpayers, they could request information from the foreign tax administrator.

⁹⁷ I.R.S. Form TD F 90-22.1 (Jan. 2012).

⁹⁸ I.R.S. Form 8938 (Nov. 2012).

⁹⁹ See, e.g., I.R.S. Form 8938 (Nov. 2012); I.R.S. Form TD F 90-22.1 (Jan. 2012). Although the IRS processes both forms, the FBAR form is technically under the Title 31 (anti-money laundering/terrorist financing) while IRS Form 8938 is under Title 26 (tax). Thus, there may need to be legislative or regulatory changes to allow the sharing of information if the forms are combined or coordinated.

form, but not required in Form 8938. Part 3 could then address those disclosures required under the current Form 8938, but not required under the FBAR form. If one form is not possible, at a minimum the forms could be coordinated (i.e., information shown on one form need not be shown on the other because of incorporation by reference) and have the same due date.

- **Continue efforts to ensure routine financial services are available** – Given FATCA has created some practical problems,¹⁰⁰ the United States Treasury should continue pressuring foreign countries and foreign financial institutions to ensure U.S. citizens living abroad have suitable access to routine financial services. In the long-run, this problem should decrease as the world hopefully moves toward a multilateral FATCA regime. In the short-run, however, it could be a problem in selected markets.
- **Provide an exemption from employment taxes** – Currently the earned income of U.S. citizens abroad can be subject to U.S. employment taxes, even though it is exempt from U.S. income tax.¹⁰¹ Given many countries impose their own employment taxes on earned income, one has to question whether it makes sense for the United States to also impose employment taxes. Options for Congress could include: (i) exempting earned income from employment taxes to the extent of the earned income exemption; (ii) giving U.S. citizens abroad a choice of whether to participate in the social security/Medicaid system; or (iii) expanding the list of countries with international social security agreements (i.e., Totalization Agreements).

Adoption of all the above proposals would allow U.S. citizens to (i) maintain their citizenship, (ii) substantially reduce their U.S. tax compliance burdens, and (iii) reduce the possibility of double taxation. If Congress does not want to adopt all of the proposals (e.g., those that could lose tax revenue), it could nevertheless greatly simplify income tax filings through a simple certification process as outlined above. As summarized in the National Taxpayer Advocate's 2011 Annual Report to Congress, 91% of U.S. taxpayers abroad in 2009 did not have tax liabilities after application of the FTC and earned income exclusion.¹⁰²

¹⁰⁰ See generally Harvey, *supra* note 6.

¹⁰¹ However, international social security agreements (i.e., Totalization Agreements) may prevent double taxation. See I.R.C. §911(a) (1986); see also *U.S. International Social Security Agreements*, *supra* note 21.

¹⁰² NAT'L TAXPAYER ADVOCATE, *supra* note 94, at 156 fig.1.8.2.

Finally, the above proposals would not address complexities resulting from the U.S. estate and gift tax. Such complexities are not the primary purpose of this article, but with an estate tax exemption over \$5 million (\$10 million for couples) adjusted for inflation, the U.S. estate tax should only be applicable to the relatively wealthy.

Although this article is not intended to discuss the complexities of the estate and gift tax, §3.2 discussed the potential estate and gift tax benefits that still exist for U.S. citizens who surrender their U.S. citizenship. Congress may want to further reduce the benefits by enacting a deemed estate tax as proposed in §3.2. Such a change could be a stand-alone change to address fairness, or it could be used to raise revenue to pay for increased exemptions for U.S. citizens living abroad (see §4.4 for more discussion).

The next section of this article discusses the other major alternative for addressing issues faced by U.S. citizens living abroad (i.e., the adoption of a residence-based tax system).

4.2. Adopt Residence-Based System with Safeguards

Given there is significant discussion about abandoning the worldwide tax system for U.S. corporations, it is possible Congress may consider something similar for individuals (i.e., changing to a residence-based tax system consistent with the rest of the world). Although such action is very unlikely, stranger things have happened in Washington, D.C.

In my view, the main advantage and disadvantage of the United States changing to a residence-based tax system are as follows:¹⁰³

- **Advantage** – allows U.S. citizens to eliminate their U.S. income tax filing obligation while maintaining U.S. citizenship.
- **Disadvantage** – could result in fairness and tax revenue issues to the extent U.S. citizens are allowed to move their residence out of the United States in order to avoid U.S. taxes.

If Congress does seriously consider changing to a residence-based tax system, most members of Congress will need to be satisfied that there are safeguards in place to ensure the disadvantage does not outweigh the advantage.

As a practical matter, it is only the wealthy that likely have the resources to move their residence out of the United States for tax purposes. This could be wealthy U.S. citizens living on investment or retirement income, or possibly wealthy entrepreneurs or executives that have the freedom to select

¹⁰³ See *supra* Section 3.3 for a more complete list of advantages.

where they reside. Although this may be a relatively small group of U.S. citizens, they can have very high profiles and could potentially avoid substantial U.S. taxes.

In order to substantially minimize the chances of this occurring, Congress may want to consider the following:

- **Impose significant restrictions on visiting the United States** – If U.S. citizens can avoid U.S. tax by being a nonresident, but still retain substantial contact with the United States, there could be a public uproar. There is room for reasonable debate as to what “substantial contact” might be, but retaining a residence in the United States or visiting the United States for a significant number of days during a calendar year would cause concern for most. For example, if Congress were to adopt the definition of nonresident in I.R.C. § 7701(b)(3),¹⁰⁴ a U.S. citizen could visit the United States for as many as 182 days a year. A substantially lower number of days visited would be more appropriate (e.g., 45–60 days).¹⁰⁵
- **Adopt an ironclad departure tax regime** – I.R.C. § 877A and I.R.C. § 2801 were adopted to discourage U.S. citizens from giving up their citizenship.¹⁰⁶ Because the United States currently has a worldwide tax system, it is not necessary to apply these two code sections to U.S. citizens who have moved or are in the process of moving their permanent residence abroad. In addition, as discussed in Section 3.2, I.R.C. § 2801 may not completely compensate for the estate and gift tax applicable to U.S. citizens taxed on a worldwide basis. As a result, if Congress decides to adopt a residence-based tax system,¹⁰⁷ it should:
 - **For income tax purposes** – I.R.C. § 877A should be generally applied to U.S. citizens who will, in the future, be taxed on a resident basis.¹⁰⁸ Application of I.R.C. § 877A will be necessary to make sure U.S. citizens do not avoid U.S. income tax on unrealized income earned while the United States had a worldwide system of taxation.
 - **For estate/gift tax purposes** – I.R.C. § 2801 should be applied to minimize the possibility that U.S. citizens avoid

¹⁰⁴ For additional discussion, *see supra* Section 2.1.2.

¹⁰⁵ However, exceptions could be made for family emergencies and health related issues.

¹⁰⁶ For additional discussion, *see supra* Section 2.2.

¹⁰⁷ It is possible that a residence-based tax system could be applied for the income tax, but not the estate and gift tax.

¹⁰⁸ However, for a discussion of existing U.S. citizens living abroad, *see infra* Section 4.3.

U.S. estate and gift tax on their net worth accumulated while the United States had a worldwide tax system.¹⁰⁹ In addition, strong consideration should be given to a deemed estate tax as described in Section 3.2, especially for those U.S. citizens currently resident in the United States.

- **Minimum time period living abroad to qualify** – Adoption of a residence-based system would necessitate determining who should qualify for nonresident treatment. In addition to imposing significant restrictions on visiting the United States, it would also be appropriate for U.S. citizens to have lived overseas for a specified period of time before they qualified (e.g., 2 or 3 years). For example, a U.S. citizen living abroad should only qualify for nonresident treatment if (i) he has lived overseas for at least 2 to 3 years and (ii) his intent is to live outside the United States permanently.

In addition to the above proposals, a special tax haven rule could be considered in either of two following circumstances:

- **General tax haven exception** – Congress may want to exclude U.S. citizens resident in a designated tax haven from residence-based taxation. Rather, those citizens would continue to be taxed on a worldwide basis. A tax haven should be defined broadly to include special tax regimes designed to attract wealthy retirees.
- **Departure tax regime not expanded** – If a departure tax regime is not extended to cover U.S. citizens leaving the United States worldwide tax system, a special tax haven rule will be essential. Said differently, failure to include a special tax haven rule, coupled with the lack of a departure tax, would create a significant incentive for wealthy U.S. citizens to live outside the United States.

The definition of a tax haven would be subject to debate, but any country that imposes little or no income tax on U.S. citizens should qualify.

In summary, if Congress decides to adopt a residence-based system for individuals there should be very tough rules designed to prevent tax avoidance, including stringent rules on U.S. citizens visiting the United States coupled with (i) an *ironclad* departure tax, or (ii) an exception for U.S. citizens resident in a tax haven.

¹⁰⁹ For additional discussion, *see infra* Section 4.3.

4.3. Should U.S. Citizens Already Living Abroad Get Special Treatment?

U.S. citizens living abroad that have met their prior U.S. tax obligations are very unlikely to have moved overseas for tax reasons.¹¹⁰ Thus, it may be appropriate for Congress to (i) consider some form of relief to either the current law exit tax in I.R.C. § 877A and I.R.C. § 2801 (i.e., assuming a worldwide tax system is retained), or (ii) a modified exit/departure tax (assuming a residence-based system is adopted).

Since the fact patterns are different depending upon whether the United States retains a worldwide tax system or adopts a residence-based system, the two will be discussed separately below.

4.3.1. Worldwide System Retained

If Congress retains the worldwide tax system, but provides income tax relief as proposed in Section 4.1, many U.S. citizens with substantial income or net worth may still feel the need to surrender their citizenship to avoid future U.S. taxes.¹¹¹ Thus, one question is whether there are any additional categories of U.S. citizens who should qualify for relief from I.R.C. § 877A or I.R.C. § 2801.¹¹²

The short answer is “yes” for those U.S. citizens living abroad who have had very little contact with the United States. Specifically, it would be reasonable to expand the I.R.C. § 877(g)(1)(b) exceptions to the definition of “covered expatriate” for U.S. citizens who

- Never had a U.S. passport and have lived outside the United States for some period of time (or significant percentage of their life), or
- Spent very little or no time during their life in the United States and were either
- - (i) born in the United States to foreign parents, or
 - (ii) born abroad to U.S. parents.

If Congress is inclined to provide relief to some or all of the above more sympathetic cases, the next question is whether to also provide relief to other

¹¹⁰ Given the United States currently has a worldwide tax system, U.S. citizens currently living abroad have likely increased their tax burden by living overseas.

¹¹¹ Their income still exceeds the proposed I.R.C. § 911 exemptions and/or their net worth could trigger a future I.R.C. § 2801 tax (or a deemed estate tax).

¹¹² This includes the proposed tightening of the inheritance tax in I.R.C. § 2801 to better mimic the estate tax.

U.S. citizens currently living abroad who have spent a substantial percentage of their life living abroad. Reasonable people could disagree on the answer.

Assuming Congress expands the income exemptions available to U.S. citizens living abroad and simplifies their annual U.S. filing and reporting obligations, I personally would not provide additional exceptions to the definition of covered expatriate beyond the more sympathetic cases discussed above. Reasons include:

- These individuals currently living abroad who have spent a substantial percentage of their life living abroad are highly likely to have known they were U.S. citizens.
- These individuals will have already received substantial annual income tax relief will have already been provided.
- The estate tax includes relatively generous exclusions (e.g., \$5 million plus per individual and \$10 million for a couple).
- If relief is provided, one would expect many wealthy U.S. citizens living abroad to take advantage of that relief, thus creating a potential loss in tax revenue (i.e., both income and estate/gift tax).

In summary, some sympathetic cases exist that are not already exempted from the definition of covered expatriate under current law. For U.S. citizens that have had a significant connection with the United States during their lifetime, an exemption does not seem warranted. However, if Congress wants to compromise, they could agree to one of the following:

- Exempt a certain percentage (e.g., 50%) of unrealized gain under I.R.C. § 877A for those U.S. citizens that have been living abroad for some specified period of time.
- If Congress accepts the proposal to tighten the inheritance tax in I.R.C. § 2801 to better mimic the estate tax, it could exempt U.S. citizens who have been living abroad for some specified period of time at the date of enactment.
- Some combination of the above two measures.

4.3.2. Residence-Based System Adopted

If Congress adopts a residence-based tax system and adopts a departure tax of some type,¹¹³ Congress will face a similar issue to the one discussed in Section 4.3.1. Specifically, should there be relief from the departure tax for certain U.S. citizens that have been living abroad for a period of time?

¹¹³ See *supra* Section 4.2.

My suggestion on how Congress should analyze the need for exceptions to any future departure tax is similar to that in Section 4.3.1. Thus, at a minimum, relief would be appropriate for U.S. citizens who

- Never had a U.S. passport and have lived outside the United States for some period of time (or significant percentage of their life), or
- Spent very little or no time during their life in the United States and were either
 - (i) born in the United States to foreign parents, or
 - (ii) born abroad to U.S. parents.

As discussed in Section 4.3.1, I personally would not provide relief for other U.S. citizens even though they have spent substantial time living overseas. However, reasonable people could disagree on this conclusion. A possible compromise could be similar to that discussed at the end of Section 4.3.1 (e.g., exempt a certain amount of unrealized gain determined under I.R.C. § 877A, or exempt the application of a deemed estate tax).

4.4. Budget Impact

As discussed in Section 3.4, the impact of any legislative proposal on the United States' budget deficit will be crucial. Legislative change will therefore need to be approximately revenue-neutral or will need to raise tax revenue. Given this concern, a brief analysis of the proposals in Section 4.1 and Section 4.2 on the United States' tax revenue is warranted.

4.4.1. Worldwide System Retained¹¹⁴

The Joint Committee of Taxation ("JCT")¹¹⁵ will clearly estimate a revenue loss from increasing the earned income exemption and providing a *de minimis* exemption for passive income. However, the revenue loss may not be that material. Under current law, 91% of U.S. citizens living abroad are reportedly not paying *any* U.S. tax because of the current earned income exemption.¹¹⁶ An additional 3% are not paying tax because of the FTC.¹¹⁷

¹¹⁴ See *supra* Section 4.1 for a description of the proposal.

¹¹⁵ The Joint Committee on Taxation ("JCT") is the official revenue estimator for tax legislation.

¹¹⁶ NAT'L TAXPAYER ADVOCATE, *supra* note 94, at 156 fig.1.8.2.

¹¹⁷ *Id.*

If the income exemptions for U.S. citizens living abroad were substantially increased, presumably (i) the 3% not paying tax because of the FTC would be unaffected by the proposal and, (ii) at most, an additional 6% of U.S. citizens living abroad would no longer pay U.S. income tax. However, without knowing the current composition of this 6% (i.e., what percentage of individuals and dollars of tax are attributable to those with income above and below the proposed exemption levels), it is difficult to estimate the revenue impact.

The proposal also suggests eliminating payroll taxes on earned income up to the earned-income-exemption amount. Current law subjects U.S. citizens living abroad to U.S. employment taxes on earned income qualifying for the I.R.C. § 911 exemption.¹¹⁸ Thus, this proposal will also result in some lost tax revenue.

Given these potential revenue losses, the obvious question is what can be done to get the proposal closer to revenue neutrality. Options for raising revenue (or reducing revenue loss) could include:

- **Implementing a tax haven exception** – Do not allow the enhanced income exemptions for U.S. citizens resident in a tax haven or income from tax haven jurisdictions.
- Imposing a cliff on the enhanced income exemptions (i.e., once a taxpayer goes over the exemption amount, they lose the exemption) – Alternatively, the earned and passive income exemptions could be phased down to zero as income increases over the exemption amount.
- **Eliminating the housing exemption in I.R.C. § 911(c)** – This could also be justified on simplification grounds if the earned income exemption is materially increased.
- **Enacting a congressionally-sanctioned voluntary disclosure initiative** – Allow certain sympathetic U.S. citizens living abroad to voluntarily disclose tax liabilities with minimal penalties. The IRS currently has a voluntary disclosure program that has been very successful,¹¹⁹ but one suspects many U.S. citizens abroad have not participated in the IRS program for various reasons.¹²⁰
- **Not exempting any earned income from the payroll tax** – Retaining current law should not result in reduced payroll tax collections. Alternatively, U.S. citizens could be provided a choice;

¹¹⁸ U.S. citizens resident in certain countries can avoid double tax through an international social security agreement (i.e., Totalization Agreement). See *U.S. International Social Security Agreements*, *supra* note 21.

¹¹⁹ See I.R.S. News Release IR-2012-64 (June 26, 2012).

¹²⁰ CA estimates there are at least three million U.S. citizens abroad who are currently not compliant with U.S. tax laws. See CA Proposal, *infra* note 126, at 18, ex. I.

for example, some might opt to pay payroll tax so as to minimize the loss of revenue.

- **Expanding I.R.C. § 2801 to mimic the estate tax**¹²¹ – Congress may want to adopt this proposal anyway to address the expatriation by high profile citizens who want to avoid the estate and gift tax.

Although JCT's revenue estimators would need to evaluate the above alternatives, one hopes the list provides enough ammunition to provide revenue-neutral relief to U.S. citizens living abroad.

4.4.2. Residence-Based System Adopted¹²²

If Congress were to adopt a residence-based system with no departure tax, the lost tax revenue should be greater than the revenue lost from retaining a worldwide system with increased exemptions, a payroll tax exemption, and simplified filing obligations. Reasons include:

- **Income tax** – In a residence-based system the foreign income of nonresident U.S. citizens would totally escape U.S. income taxation. In a worldwide system, some foreign income would still be taxed (e.g., those U.S. citizens living in a lower-taxed country with foreign income above the substantially increased exemption thresholds).¹²³ In addition, in a residence-based system, U.S. source-passive income will generally escape U.S. In a worldwide system, U.S. source income would be taxed.
- **Estate/Gift tax** – In a worldwide tax system, the net worth of all U.S. citizens living abroad would be subject to estate and gift tax.¹²⁴ In a residence-based system, only certain assets located in the United States would be subject to estate and gift tax.

The above two revenue losses may be somewhat reduced by an increase in the United States' withholding taxes on U.S. citizens living abroad. For example, if a U.S. citizen currently has earned income from U.S. sources that is also taxed in his country of residence, he may not pay any U.S. tax after taking the FTC into consideration. Under a resident-based system, such income would be subject to U.S. tax. One doubts, however, that many citizens

¹²¹ See *supra* Section 3.2.

¹²² See *supra* Section 4.2.

¹²³ Admittedly, it is not clear how much of this tax the IRS actually collects, but it collects some.

¹²⁴ I.R.C. §§ 2001(a), 2031(a) (West 2013).

living abroad would have substantial earned income from the United States that would be subject to withholding tax.

In addition, if behavioral considerations are taken into account, it would be reasonable to further assume

- Nonresident U.S. citizens would likely divest themselves of any assets that could result in either U.S. income or estate/gift tax, and
- Many wealthy U.S. citizens currently resident in the United States would attempt to obtain a permanent residence abroad to reduce their U.S. tax burden. This would be especially attractive as they would not need to surrender their citizenship.

In summary, after considering behavioral considerations, adoption of a residence-based tax system without a departure tax could be a major tax revenue loser. Thus, if Congress adopts a residence-based tax system, it seems clear that Congress must seriously consider some or all of the safeguards discussed in Section 4.2:

- An ironclad departure tax regime.
- Significant restrictions on visiting the United States.
- A tax haven exception.
- A minimum time period living abroad to qualify.

Additional tax revenue could be generated through a congressionally-mandated voluntary disclosure initiative similar to that described in Section 4.4.1 above.

I will defer to JCT as to whether a revenue-neutral proposal could be crafted over the typical ten-year budget period, but my suspicion is it could be. The reason is that such a proposal would likely include large one-time transition revenue sources (e.g., voluntary disclosure initiative and Departure Tax). However, over the long-term, tax revenue is likely to decrease from the adoption of a residence-based tax system.

5. Proposal by Citizens Abroad

As briefly discussed in Section 1, various organizations representing U.S. citizens living abroad¹²⁵ have recently made a legislative proposal advocating the adoption of a residence-based tax system, referred to as the CA

¹²⁵ For further discussion of CA, see *supra* note 10.

Proposal.¹²⁶ Section 5.1 briefly describes the major provisions of this proposal while Section 5.2 provides some observations.

5.1. Description

The CA Proposal includes several of the concepts discussed in Section 4.2.¹²⁷ The centerpiece is a change to a residence-based tax system for both income and estate tax purposes.¹²⁸ Nonresident taxation would be applicable to U.S. citizens and Green Card holders who are *qualifying nonresidents* of the United States and obtain a *Departure Certificate*.¹²⁹ If a U.S. citizen living abroad wanted to continue being taxed on a worldwide basis, he could fail to obtain a Departure Certificate.¹³⁰

The definition of a qualifying nonresident has several key components. Specifically, the individual:

- Has been resident overseas for at least 2 years.¹³¹
- Has met the I.R.C. § 7701(b)(3) substantial presence test¹³² (i.e., allowing a nonresident U.S. citizen to visit the United States for up to 182 days in some cases, 121 days in others).¹³³
- Is not resident in a tax haven (the CA Proposal does state however that “[c]lassification of countries as tax havens should be the rare exception” and should apply to “only countries where the tax laws have been designed to attract rich foreigners with fiscal privileges.”(emphasis omitted)).¹³⁴
- Is not a U.S. military member or a member of the U.S. diplomatic service.¹³⁵

¹²⁶ For the complete CA Proposal, see Am. Citizens Abroad (“CA”) et al., *Residence-Based Taxation: A Necessary and Urgent Tax Reform* (Overseas Am. Week, Working Paper Jan. 2013), available at <http://www.overseasamericansweek.com/documents/2013/oaw2013rbttaxpositionfinal.pdf>.

¹²⁷ This author had absolutely no involvement in developing the CA Proposal.

¹²⁸ See CA Proposal, *supra* note 126, at 3.

¹²⁹ See *id.*

¹³⁰ The ability to effectively make an election has tax revenue consequences since one would expect taxpayers to choose the option that is most beneficial to them and therefore should lose tax revenue.

¹³¹ The proposal technically states that Congress “may determine” a two year rule is necessary for “certain types of temporary overseas mandates.” CA Proposal, *supra* note 126, at 3.

¹³² For details of the substantial presence test, see *supra* Section 2.1.2.

¹³³ CA Proposal, *supra* note 126, at 7.

¹³⁴ CA Proposal, *supra* note 126, at 8.

¹³⁵ CA Proposal, *supra* note 126, at 3.

In order to obtain a Departure Certificate, an individual must do the following:

- **Become current on IRS filings for the past 3 years** – This requires payment of taxes, interest, and underpayment penalties, but there is no criminal prosecution or penalty for failure to file the FBAR form and IRS Form 8938 (i.e., effectively a congressionally-mandated voluntary disclosure initiative).
- **Pay a departure tax on U.S. residents moving overseas** – This tax is patterned after I.R.C. § 877A and, therefore, imposes a deemed sale at fair market value for most capital assets at the date of departure. The *de minimis* exceptions are similar to I.R.C. § 877A, but for purposes of determining a covered expatriate the net worth threshold is increased from \$2 million to \$5 million. Most importantly, the Departure Tax is *not* applicable to individuals who have resided overseas for over 2 years and are compliant with their U.S. filing obligations for the past 3 years.

After paying any back taxes and a departure tax (if applicable), the major practical effects of the CA Proposal on U.S. citizens permanently living abroad would include:

- Income would be taxed as if they were nonresident aliens (i.e., only U.S. source income would be taxed, but even then certain exclusions like the portfolio interest exemption would apply¹³⁶).
- FBAR and FATCA reporting obligations could be avoided.
- There would be no U.S. employment taxes.
- Estate and gift taxation as if they were nonresident aliens (i.e., only applying to assets with situs in the United States, but even then certain exclusions would apply¹³⁷).

Finally, the CA Proposal estimates its proposal would decrease the United States' budget deficit by \$33 billion over 10 years – composed of the following:

- **\$23 billion** – Excess of annual taxes collected under the nonresident system versus the residence-based system.¹³⁸

¹³⁶ See *supra* note 13.

¹³⁷ See *supra* note 29.

¹³⁸ This result is not very intuitive and the author is not sure he agrees. For more discussion, see *infra* Section 5.2.

- **\$3 billion** – Payment of back taxes, interest, and underpayment penalties to allow participation in the nonresident tax system (i.e., congressionally-mandated voluntary disclosure initiative).
- **\$4 billion** – Departure tax.
- **\$3 billion** – Reduction in IRS administrative and enforcement costs.

Observations on the CA Proposal are in Section 5.2, immediately below.

5.2. Observations

The CA Proposal is relatively comprehensive and, if accepted by Congress, would represent a *grand slam home run* for U.S. citizens living abroad. In effect, U.S. citizens that have been living abroad for at least 2 years would

- No longer be subject to U.S. income tax on worldwide income;
- Avoid U.S. estate and gift tax, except for certain U.S. situs assets;
- Retain their U.S. citizenship and the right to visit the United States in some cases for up to 182 days a year, and in others for 121 days; and
- Avoid the payment of any departure tax.

Given the ability of U.S. citizens to transform their investment portfolios by converting U.S. source assets to foreign source assets, it is safe to say that many would never pay another dime of U.S. tax. It will be interesting to see how this proposal is greeted by lawmakers in Washington. Like any proposal, some lawmakers will be supportive, and others could be totally outraged.

Section 4.2 discussed key issues for Congress to consider if it seriously plans to adopt a residence-based tax system. The following is a list of those key issues and how the CA Proposal compares.

- **Imposing significant restrictions on visiting the United States** – Since the CA Proposal adopts the substantial presence test in I.R.C. § 7701(b)(3), it effectively allows U.S. citizens abroad to visit the United States for up to 182 days in some cases, and on average 121 days a year in other cases.¹³⁹ Personally, I believe this is too generous and would suggest a maximum of 45–60 days.¹⁴⁰ Congress will need to form its own opinion.

¹³⁹ For discussion of the substantial presence rule of § 7701(b)(3), see *supra* Section 2.1.2.

¹⁴⁰ There is a limited exception for certain family emergencies.

- **Adopting an ironclad departure tax** – Conceptually, the CA Proposal moves in this direction by extending the I.R.C. § 877A departure tax to cover U.S. citizens wanting to be taxed on a non-residence basis. However, the CA Proposal provides a very generous exception for *all* U.S. citizens that have been living abroad for at least two years. In addition, the CA Proposal does not propose to tighten the I.R.C. § 2801 inheritance tax by imposing a deemed estate tax. Thus, there will be a major incentive for ultra-wealthy U.S. citizens to move their residence out of the United States in order to avoid U.S. estate and gift tax.

I would not be so generous.¹⁴¹ One option would be to prospectively tighten IRC § 2801 by including a deemed estate tax applicable to the ultra-wealthy (e.g., net worth in excess of \$25 to \$50 million). This provision could be applied to all U.S. citizens seeking to be taxed on a non-residence basis, or just to U.S. citizens currently resident in the United States who desire to be taxed on a non-resident basis.

- An alternative option would be to only apply residence-based taxation for income tax purposes, and not estate tax purposes. Said differently, U.S. citizens living abroad would still be subject to U.S. estate and gift tax on a worldwide basis. However, this option could be difficult for the IRS to practically enforce and, thus, the deemed estate tax would seem the better option.

Finally, I agree the exceptions to the I.R.C. § 877A exit tax need to be broadened for certain U.S. citizens, but completely exempting U.S. citizens that have been living abroad for an extended period of time may not be appropriate.¹⁴² A compromise might be to only tax some percentage of the I.R.C. § 877A deemed mark-to-market gain. Again, Congress will need to reach its own conclusion.

- **Having a tax haven rule** – Again, CA embraces this concept in its proposal, but states that it wants the rule to apply “rarely.”¹⁴³ Given the lack of an ironclad departure tax in the , the tax haven rule should apply more broadly (e.g., to any country that taxes U.S. citizens at less than some specified income tax rate).
- **Having a maximum time period for living abroad to qualify** – The CA Proposal seems to understand this general concept, but leaves it to Congress to determine whether it is appropriate. In addition, the CA Proposal seems to allow U.S. citizens to immediately qualify for

¹⁴¹ See *supra* Section 4.2.

¹⁴² For my reasoning, see *supra* Section 4.3.

¹⁴³ CA Proposal, *supra* note 126, at 8.

nonresident treatment if they have no intention of returning to the United States. A bright line rule, as opposed to an intent rule, may be better for both the IRS and U.S. citizens. For example, it may be more appropriate to require at least two or three years of permanent residence overseas before a U.S. citizen living abroad could qualify for nonresident treatment.

Finally, given the CA Proposal boldly projects \$33 billion of additional tax revenue over 10 years, the following very brief comments may be of interest:¹⁴⁴

- **Generally** – Despite an exhibit providing more detail on the estimate, it appears to be very much a back-of-the-envelope calculation. Given CA's resources this is not a surprise, but one would expect JCT to do a substantially more thorough estimate.
- **\$7 billion of transition revenue (i.e., Departure Tax and back taxes, interest, and penalties)** – Clearly some transition revenue would be raised. I will defer to JCT as to whether the CA estimate of \$7 billion is reasonable (it could be).
- **\$23 billion increase in annual tax revenue** – In short, this was a surprising estimate. Most would expect an annual revenue loss, not a revenue gain. This would especially be the case if behavioral reactions, like shifting an investment portfolio from U.S. source to foreign source, are taken into account. In addition, the CA Proposal is effectively elective. Presumably those that would be negatively impacted by a residence-based system would elect to continue in the worldwide tax system.

Although not crystal clear to this observer, it seemed the key assumptions behind the large revenue estimate are that there would be little or no behavioral response and that, under existing law, many U.S. citizens living abroad have not been paying U.S. tax on U.S. source income. In effect, this latter assumption seems to imply many U.S. citizens abroad may be either committing tax evasion¹⁴⁵ or are currently eliminating U.S. tax with a FTC that will not be available if they are taxed as a nonresident. No doubt some of this could exist, but the CA Proposal suggests there could be a very material amount.

¹⁴⁴ CA Proposal, *supra* note 126, at 15.

¹⁴⁵ Or at the very least they are totally ignorant of their obligation to pay U.S. tax on U.S. source income.

- **Reduced Estate Tax Collections** – There was no indication the estimate considered the impact of a residence-based tax system on estate and gift tax revenue. Given there are millions of U.S. citizens living abroad that are currently subject to U.S. estate and gift tax, and given the proposal basically allows these U.S. citizens to avoid future estate and gift tax, one would expect some estate and gift tax revenue to be lost.

In summary, if Congress considers adopting a residence-based system for U.S. citizens living abroad, the CA Proposal could be part of the discussion. In concept it includes many, but not all, of the design features that would need to be considered. However, one suspects many members of Congress will not support the CA Proposal once they better understand its details. Specifically, the proposal could lose revenue and allow wealthy U.S. citizens to avoid substantial future U.S. taxes by virtue of either moving their permanent residence overseas, or by already residing overseas.

6. Summary and Conclusions

Since the United States taxes its citizens on a worldwide basis, U.S. citizens living abroad face significant compliance burdens and the possibility for double taxation. These burdens have been further complicated by the enactment of FATCA in March 2010. For example, many foreign financial institutions are blaming FATCA's reporting obligations for their refusal to provide necessary financial services to U.S. citizens living abroad. In addition, FATCA requires all U.S. citizens, including those living abroad, to report more information on their non- U.S. financial assets than what they are currently required to report.

Because of these burdens, CA have made a legislative proposal to adopt a residence-based tax system for individuals.¹⁴⁶ They claim their proposal will decrease the budget deficit by \$33 billion over 10 years. In addition, other commentators have suggested that the United States should adopt a residence-based tax system.

Given there are various legislative proposals to change the worldwide tax system for corporations to a territorial system, it is not beyond the realm of possibility Congress could consider totally abandoning the worldwide tax system for both corporations and individuals.¹⁴⁷ Thus, this article has attempted to provide background and analysis on a number of topics relating to U.S. citizens living abroad. The main conclusions are as follows:

¹⁴⁶ See *supra* Section 5.1 for a description of the CA Proposal.

¹⁴⁷ However, a change to a territorial system for corporations would seem much more likely than a change to a residence-based system for individuals.

- **The issues faced by U.S. citizens living abroad are significant**¹⁴⁸ – Issues include substantial tax compliance responsibilities, potential for higher overall tax burden, and difficulty obtaining routine financial services.
- **Certain U.S. citizens still have an incentive under current law to expatriate**¹⁴⁹ – As demonstrated by the high profile expatriation of Eduardo Saverin, co-founder of Facebook, Inc.,¹⁵⁰ current tax law still potentially allows wealthy U.S. citizens to minimize their estate and gift tax by expatriating. The 2008 enactment of an inheritance tax in I.R.C. § 2801 was a step in the right direction, but Congress should consider a deemed estate tax for ultra-wealthy U.S. citizens that expatriate (e.g., net worth over \$25 to \$50 million).
- **FATCA does not justify changing to a residence-based tax system**¹⁵¹ – There are more targeted ways of addressing the FATCA-related problems (e.g., through intergovernmental agreements and combining or coordinating the FBAR form and IRS Form 8938).
- **Legislative action is appropriate to address issues faced by U.S. citizens living abroad** – If possible, Congress should consider legislative action. Relief can be provided by either modifying the existing worldwide tax system, or adopting a residence-based system.
 - **If the worldwide tax system is retained,**¹⁵² Congress could provide significant relief by (i) substantially increasing the IRC § 911 earned income exemption (e.g., \$300,000 to \$400,000); (ii) providing a *de minimis* exemption for passive income (e.g., \$50,000 to \$100,000); and (iii) greatly simplifying or eliminating the U.S. tax filing requirement for citizens living abroad with no tax liability. Additional relief could be provided by eliminating U.S. payroll taxes on earned income below the IRC § 911 exemption. Various revenue offsets are suggested to minimize or eliminate a material loss in tax revenue.¹⁵³

¹⁴⁸ See *supra* Section 3.1 for more discussion.

¹⁴⁹ See *supra* Section 3.2 for more discussion.

¹⁵⁰ See Danielle Kucera et al., *Facebook Co-Founder May Gain Choosing Singapore over U.S.*, BLOOMBERG, May 11, 2012, available at <http://www.bloomberg.com/news/2012-05-12/facebook-co-founder-may-gain-choosing-singapore-over-u-s.html> (last visited Mar. 1, 2013).

¹⁵¹ See *supra* Section 3.5 for more discussion.

¹⁵² See *supra* Section 4.1 for more discussion.

¹⁵³ See *supra* Section 4.4.1 for more discussion.

- **If a residence-based tax system is adopted,**¹⁵⁴ the major concern will be wealthy U.S. citizens resident in the United States shifting their permanent residences overseas to minimize U.S. taxes. Thus, appropriate safeguards are needed to minimize fairness issues and a loss of tax revenue. Appropriate safeguards include: (i) an ironclad departure tax; (ii) significant restrictions on visiting the United States; (iii) adoption of a tax haven rule, especially if the departure tax is not ironclad; and (iv) a two- to three-year minimum time period living abroad before a U.S. citizen can qualify for nonresident treatment. In addition, a congressionally-authorized voluntary disclosure initiative may be needed to bring certain taxpayers into compliance and to raise tax revenue.
- **Although relatively comprehensive, the CA Proposal has deficiencies**¹⁵⁵ – If enacted, this proposal would represent a *grand slam home run* for U.S. citizens currently living abroad. In effect, they could retain their U.S. citizenship and visit the United States for 121 to 182 days, but effectively avoid ever paying another dime of U.S. tax. In addition, wealthy U.S. citizens currently living in the United States could have a significant incentive to adopt a permanent residence overseas. Finally, it is questionable how the CA Proposal would decrease the deficit by \$33 billion.

Overall, I am very sympathetic to the issues facing U.S. citizens abroad and believe Congress should take action. Action could be taken to modify the existing worldwide tax system, or to adopt a residence-based system.

Although this article addresses both possibilities, my strong suspicion is that Congress will not adopt a residence-based tax system for individuals because of fairness and tax revenue concerns. The more likely course of action may be to pursue changes within the existing worldwide tax regime, including an increased I.R.C. § 911 earned income exemption, a *de minimis* exemption for passive income, and a significant simplification in income tax filing obligations. Even if the income exemptions are not increased, a significant simplification in filing obligations would be a major step in the right direction.

¹⁵⁴ See *supra* Section 4.2 for more discussion.

¹⁵⁵ See *supra* Section 5.2 for more discussion.

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)
ISSUES FOR FUND MANAGERS

Kenneth E. Werner *

INTRODUCTION

The Foreign Account Tax Compliance Act, commonly referred to as FATCA, is an important development in the United States' efforts to combat tax evasion by U.S. persons holding investments in offshore accounts. The U.S. federal income tax system relies on voluntary compliance from taxpayers. With improvements in international communications and the associated globalization of the world economy, U.S. taxpayers are more comfortable investing abroad.¹ Unfortunately, this increased comfort with foreign investment creates a higher risk of some taxpayers attempting to evade U.S. tax by hiding money in offshore accounts.² FATCA is an attempt to reduce this risk.

To accomplish this, FATCA provides for:

- Extending the scope of the United States' information-reporting regime to include foreign financial institutions ("FFIs") that maintain U.S. accounts;³
- Imposing increased disclosure obligations on certain nonfinancial foreign entities ("NFFEs") that present a high risk of U.S. tax avoidance;⁴ and

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¹ The information technology revolution, vis-à-vis the Internet, dramatically reduced the costs associated with coordinating complex supply, production, and distribution networks across a geographically disperse area. See Geoffrey Garrett, *The Causes of Globalization*, 33 COMP. POL. STUD. 941, 966 (2000).

² See *id.* at 941 (noting that the information technology revolution makes it increasingly difficult for governments to control cross-border capital flows).

³ See I.R.C. § 1471 (West 2013).

⁴ See I.R.C. § 1472 (West 2013).

- As an enforcement mechanism, tax withholding on FFIs and NFFEs that do not comply with the reporting and other requirements of FATCA.⁵

The provisions of FATCA will affect all non-U.S. investment funds, as well as all U.S. investment funds that either have foreign entities as investors or transact business with foreign entities. After providing some background, this article addresses what non-U.S. investment funds will have to do to comply with FATCA to avoid the withholding taxes it imposes.

I. BACKGROUND

FATCA was enacted in 2010 as a part of the Hiring Incentives to Restore Employment Act.⁶ The provisions contained in FATCA have amended the Internal Revenue Code of 1986, as amended, by adding “Chapter 4,” which is comprised of sections 1471–1474.⁷ Generally, FATCA requires FFIs to identify and disclose their U.S. account holders or become subject to a 30% U.S. withholding tax with respect to any payment of U.S. source-fixed or determinable annual or periodic income and proceeds from the sale of equity or debt instruments of U.S. issuers (referred to as “withholdable payments”).⁸

By requiring FFIs to identify and disclose the income of their U.S. account holders, it is likely that FATCA will help combat tax evasion when implemented. However, significant concerns have been raised about the cost of compliance relative to the extra revenue expected to be generated for the United States Department of the Treasury (“Treasury Department”).⁹ In addition, it may be impossible for non-U.S. financial institutions (or U.S. financial institutions doing business abroad) to comply with FATCA while also complying with the privacy laws of their home jurisdictions. To address these issues, the Treasury Department has instituted an intergovernmental approach, which, as will be discussed below, streamlines reporting and avoids the possibility of FATCA compliance conflicting with the laws of those jurisdictions which agree to this approach. In addition, extensive final regulations issued on January 17, 2013 (the “Final Regulations”) somewhat

⁵ See I.R.C. §§ 1471–1474 (West 2013).

⁶ Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 17 (2010).

⁷ See I.R.C. §§ 1471–1474 (West 2013).

⁸ I.R.C. § 1471 (West 2013).

⁹ See, e.g., Robert W. Wood, *FATCA Carries Fat Price Tag*, FORBES, Nov. 30, 2011, <http://www.forbes.com/sites/robertwood/2011/11/30/fatca-carries-fat-price-tag/>.

ease the burdens compared to those that would have applied under prior proposed regulations on FFIs in jurisdictions in which this approach does not yield an agreement.¹⁰

The Final Regulations, which are in conformance with previously issued notices on the subject, provide that no withholding is required under FATCA for any payments made prior to January 1, 2014.¹¹ In addition, no withholding is required with respect to payments made under a “grandfathered obligation” or any gross payments from the disposition of such an obligation.¹² A “grandfathered obligation” is defined in the Final Regulations as any obligation that is outstanding on January 1, 2014.¹³ However, these dates have both subsequently been extended to July 1, 2014.¹⁴ Various other transitional rules apply to certain types of payments made to certain types of entities.¹⁵ For example, FATCA does not require withholding on the gross proceeds from the sale or other disposition of property of a type that can produce U.S. source interest or dividend income if the sale or disposition occurs prior to January 1, 2017.¹⁶

In February 2012, the Treasury Department issued a joint statement from the United States, France, Germany, Italy, Spain, and the United Kingdom regarding an intergovernmental approach for improving international tax compliance and implementing FATCA.¹⁷ The proposed intergovernmental approach is intended to remove certain legal complications to FATCA compliance and reduce the financial burden to FFIs in countries which choose to enter into intergovernmental agreements with the United States concerning FATCA.¹⁸

The Treasury Department has announced that it is engaging with more than fifty jurisdictions around the world to negotiate intergovernmental

¹⁰ T.D. 9610, 2013-15 I.R.B. 765.

¹¹ Treas. Reg. § 1.1471-2(a)(1) (2013).

¹² Treas. Reg. § 1.1471-2(b) (2013).

¹³ *Id.*

¹⁴ Notice 2013-43, 2013-31 I.R.B. (2013).

¹⁵ *E.g.*, Treas. Reg. § 1.1471-2(a)(4)(ii) (2013).

¹⁶ Treas. Reg. § 1.1473-1(a)(1) (2013).

¹⁷ Press Release, U.S. Dep’t of the Treasury, Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom Regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA (Feb. 7, 2012), <http://www.treasury.gov/press-center/press-releases/Documents/020712TreasuryIRSFATCAJointStatement.pdf>.

¹⁸ *Id.*

agreements concerning FATCA.¹⁹ Not surprisingly, these negotiations include the jurisdiction that is probably home to the greatest number of non-U.S. investment funds, the Cayman Islands, with which the Treasury Department “is actively engaged in a dialogue towards concluding an intergovernmental agreement.”²⁰

II. MODEL AGREEMENTS

Subsequent to the release of the joint statement, the Treasury Department released a joint communiqué with France, Germany, Italy, Spain, and the United Kingdom introducing two forms of model agreements, reciprocal and nonreciprocal agreements, for countries that want FFIs in their jurisdictions to be able to report FACTA information directly to their home jurisdictions, rather than to the Internal Revenue Service (“IRS”).²¹ These have come to be known as the “Model 1” agreements (the reciprocal agreement is Model 1A and the nonreciprocal agreement is Model 1B).²² The nonreciprocal model agreement differs from the reciprocal model agreement only in that it does not provide for the IRS to send certain information on U.S. accounts held by residents of the partner country to that FATCA partner.²³ The United Kingdom entered into the first Model 1A agreement on September 12, 2012,

¹⁹ Press Release, U.S. Dep’t of the Treasury, US Engaging with More than 50 Jurisdictions to Curtail Offshore Tax Evasion (Nov. 8, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1759.aspx>.

²⁰ *Id.*

²¹ Press Release, U.S. Dep’t of the Treasury, Joint Communique by France, Germany, Italy, Spain, the United Kingdom and the United States on the Occasion of the Publication of the “Model Intergovernmental Agreement to Improve Tax Compliance and Implement FATCA” (July 25, 2012), <http://www.treasury.gov/press-center/press-releases/Documents/joint%20communique.pdf>; *Resource Center: Foreign Account Tax Compliance Act (FATCA)*, U.S. DEP’T OF THE TREASURY, <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx> (last updated June 11, 2013, 2:02 PM) [hereinafter *FATCA Resource Center*].

²² *FATCA Resource Center*, *supra* note 21.

²³ Compare U.S. DEP’T OF THE TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT TO IMPROVE TAX COMPLIANCE AND TO IMPLEMENT FATCA art. 2–3 (2013), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Reciprocal-Model-1A-Agreement-Preexisting-TIEA-or-DTC-5-9-13.pdf> [hereinafter *RECIPROCAL MODEL 1A AGREEMENT*], with U.S. DEP’T OF THE TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT TO IMPROVE TAX COMPLIANCE AND TO IMPLEMENT FATCA, PREEXISTING TIEA OR DTC art. 2–3 (2013), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Nonreciprocal-Model-1B-Agreement-Preexisting-TIEA-or-DTC-5-9-13.pdf> [hereinafter *NONRECIPROCAL MODEL 1B*].

followed to date by Denmark, Mexico, Ireland, Norway, Spain, and Germany.²⁴

Additionally, the Treasury Department released joint statements with Japan and Switzerland announcing a forthcoming set of “Model 2” agreements with those countries.²⁵ Under the Model 2 agreements, unlike the Model 1 agreements, FFIs will still have to report the required information directly to the IRS.²⁶ The Treasury Department issued a template for Model 2 agreements in September of 2012, and Switzerland entered into the first Model 2 agreement on February 14, 2013.²⁷

The reciprocal model agreement (Model 1A) will be available only to jurisdictions meeting two criteria: 1) the jurisdiction must have an income tax treaty or tax-information exchange agreement with the United States and 2) the jurisdiction must have robust protections in place to ensure that shared information remains confidential.²⁸ The nonreciprocal model agreement (Model 1B) is available to countries with which the United States has not already established income tax treaties or tax-information exchange agreements, or for countries that do not have a record of stringent protections and practices to ensure that the information remains private and is only used

²⁴ *FATCA Resource Center*, *supra* note 21.

²⁵ *FATCA Resource Center*, *supra* note 21; Press Release, U.S. Dep’t of the Treasury, Joint Statement from the United States and Japan Regarding a Framework for Intergovernmental Cooperation to Facilitate the Implementation of FATCA and Improve International Tax Compliance (June 21, 2012), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Joint-Statement-US-Japan-06-21-2012.pdf>; Press Release, U.S. Dep’t of the Treasury, Joint Statement from the United States and Switzerland Regarding a Framework for Cooperation to Facilitate the Implementation of FATCA (June 21, 2012), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Joint-Statement-US-Switzerland-06-21-2012.pdf>.

²⁶ U.S. DEP’T OF THE TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT FOR COOPERATION TO FACILITATE THE IMPLEMENTATION OF FATCA (2013), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Model2-Agreement-Preexisting-TIEA-or-DTC-5-9-13.pdf> [hereinafter MODEL 2 AGREEMENT, PREEXISTING TIEA OR DTC]; U.S. DEP’T OF THE TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT FOR COOPERATION TO FACILITATE THE IMPLEMENTATION OF FATCA (2013), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Model2-Agreement-No-TIEA-or-DTC-5-9-13.pdf> [hereinafter MODEL 2 AGREEMENT, NO TIEA OR DTC].

²⁷ *FATCA Resource Center*, *supra* note 21.

²⁸ Press Release, U.S. Dep’t of the Treasury, Treasury Releases Model Intergovernmental Agreement for Implementing the Foreign Account Tax Compliance Act to Improve Offshore Tax Compliance and Reduce Burden (July 26, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx>.

for tax purposes.²⁹ Whether a country's protections are "robust" enough will be determined by the IRS on a case-by-case basis.³⁰

Both reciprocal and nonreciprocal Model 1 agreements establish a framework for bilateral agreements between the United States and foreign countries under which the FFI operating in a foreign country that becomes a FATCA partner may report the required FATCA information to the relevant tax authority of the FATCA partner instead of to the IRS, who will then transmit this information to the IRS under their agreement.³¹ The Model 2 agreements, on the other hand, merely allow FFIs in foreign jurisdictions which adopt these agreements to report required information to the IRS.³² Entities in those jurisdictions will have to enter into FFI agreements with the IRS.³³

The Model 1 agreements provide that the eligibility for home-country reporting is based on the location of a financial institution's relevant branch, not where the financial institution is incorporated or is otherwise a tax resident.³⁴ For example, a German branch of a bank incorporated in France would report to the German tax authority under the intergovernmental agreement between the United States and Germany rather than to the French tax authority under the intergovernmental agreement between the United States and France.

Since it is likely that most non-U.S. investment funds will be located in jurisdictions which enter into a Model 1 agreement with the United States,³⁵ the remainder of this article will focus on what such funds will have to do to comply with the terms of these agreements (which are identical for Model 1A and Model 1B agreements).

²⁹ *Id.*

³⁰ *Id.*

³¹ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 2, § 1; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 2, § 1.

³² MODEL 2 AGREEMENT, PREEXISTING TIEA OR DTC, *supra* note 26, at art. 2, § 1; MODEL 2 AGREEMENT, NO TIEA OR DTC, *supra* note 26, at art. 2, § 1.

³³ MODEL 2 AGREEMENT, PREEXISTING TIEA OR DTC, *supra* note 26, at art. 3, § 1; MODEL 2 AGREEMENT, NO TIEA OR DTC, *supra* note 26, at art. 3, § 1.

³⁴ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(l); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(l).

³⁵ As will be seen in the discussion below, there is a significant benefit to being an FFI in a jurisdiction that enters into a Model 1 agreement, most important being eliminating any legal risk in complying with FATCA. Thus, it is unlikely that any jurisdiction that is host to a significant fund industry will fail to enter into such an agreement. Funds located in jurisdictions that do not enter into Model 1 agreements, or at least Model 2 agreements, may well relocate.

A. *Article 1 of the Model 1 Agreements Provides Definitions for the Agreements.*

A “Financial Institution” is defined to cover various types of entities, including an “Investment Entity.”³⁶ An “Investment Entity” is defined as

any Entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:

- (1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
- (2) individual and collective portfolio management; or
- (3) otherwise investing, administering, or managing funds or money on behalf of other persons.³⁷

The above terms are to be interpreted “in a manner consistent with similar language set forth in the definition of ‘financial institution’ in the Financial Action Task Force Recommendations.”³⁸

The definition of “Investment Entity” potentially includes both investment funds (whose customers would be their investors) and investment fund managers (whose customers would be the funds and, indirectly, their investors). However, the United Kingdom’s HM Revenue and Customs, in issuing its interpretation of the United Kingdom intergovernmental agreement with the United States concerning FATCA, has stated in its initial assessment that compliance for FATCA reporting should be centralized in the investment manager for a fund, even though it views the fund, as the holder of the assets, to be the financial institution.³⁹

³⁶ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(g); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(g).

³⁷ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(j); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(j).

³⁸ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(j); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(j).

³⁹ See HM Revenue and Customs, Implementing the UK-US FATCA Agreement, at 10–11 (Sept. 18, 2012),

Many investment funds managed by U.S. investment managers are set up with a “master-feeder” structure. This usually involves a non-U.S. master fund, which is in turn owned by at least two feeder funds, a U.S. limited partnership and a non-U.S. entity that is treated as a corporation for U.S. federal income tax purposes. In addition, there may be an intermediate entity, treated as a partnership for U.S. federal income tax purposes, which is owned by the non-U.S. feeder and a general partner affiliated with the fund manager (commonly referred to as a “mini-master”), which in turn owns an interest in the master fund.⁴⁰ In this case there would be two or three FFIs; the master fund, the non-U.S. feeder fund, and the mini-master fund, if applicable.

A “[FATCA Partner] Financial Institution” is “(i) any Financial Institution resident in [FATCA Partner], but excluding any branches of such Financial Institution that are located outside [FATCA Partner], and (ii) any branch of a Financial Institution not resident in [FATCA Partner], if such branch is located in [FATCA Partner].”⁴¹ Thus, the location of an investment entity, not its residence, determines whether it will have the benefit of an intergovernmental agreement concerning FATCA.

The term “Financial Account” is defined to mean, in the context of an investment fund, an account maintained by such fund, and includes “any equity or debt interest (other than interests that are regularly traded on an established securities market)” in the investment fund.⁴² An “Account Holder” is “the person listed or identified as the holder of a Financial Account by the Financial Institution that maintains the account.”⁴³

As will be discussed below, the due diligence a fund will be required to undertake to determine whether fund investors are “Specified U.S. Persons”

http://www.ico.org.uk/about_us/consultations/~media/documents/consultation_responses/HMRC_consultation_implementing_UK-US_FATCA_Agreement_20120918.ashx. As noted in the consultation document, this is consistent with the position of the IRS, in Notice 2011-34, that the IRS was considering allowing a fund manager to act on behalf of the funds he or she manages in entering into and complying with FFI Agreements.

⁴⁰ This is generally done primarily for U.S. tax purposes, as it allows the incentive amounts allocated to the general partner to retain their character (e.g., as long-term capital gain, subject to lower maximum income tax rates than ordinary income) for income tax purposes, as opposed to all the incentive amounts being subject to tax as ordinary income if paid as a fee by the non-U.S. feeder.

⁴¹ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(l); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(l).

⁴² RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(s)(l); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(q)(l).

⁴³ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 1, § 1(ee); NONRECIPROCAL MODEL 1B, *supra* note 23, art. 1, § 1(aa).

(as defined below) calls for different rules to apply to “Preexisting Accounts.” A “Preexisting Account” means “a Financial Account maintained by a Reporting [FATCA Partner] Financial Institution as of December 31, 2013,”⁴⁴ however, the Treasury Department intends to change this date to June 30, 2014.⁴⁵

FATCA reporting requirements apply to “U.S. Reportable Accounts.”⁴⁶ A “U.S. Reportable Account” means a Financial Account, maintained by a Reporting [FATCA Partner] Financial Institution, and held by one or more “Specified U.S. Persons,” or by a non-U.S. entity with one or more “Controlling Persons” that is a “Specified U.S. Person.”⁴⁷ “Notwithstanding the foregoing, an account will not be treated as a U.S. Reportable Account if such account is not identified as a U.S. Reportable Account after application of the [required] due diligence procedures” set forth in “Annex I” of the Model 1 agreements, as discussed in Part II(E) below.⁴⁸

A “Specified U.S. Person” means a “U.S. Person,” with a number of exceptions.⁴⁹

⁴⁴ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 1, §1(aa); NONRECIPROCAL MODEL 1B, *supra* note 23, art. 1, § 1(y).

⁴⁵ Notice 2013-43, 2013-31 I.R.B. (2013).

⁴⁶ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 2; NONRECIPROCAL MODEL 1B, *supra* note 23, art. 2.

⁴⁷ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 1, § 1(dd); NONRECIPROCAL MODEL 1B, *supra* note 23, art. 1, § 1(z).

⁴⁸ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 2; NONRECIPROCAL MODEL 1B, *supra* note 23, art. 2.

⁴⁹ These exceptions are:

- (i) a corporation the stock of which is regularly traded on one or more established securities markets;
- (ii) any corporation that is a member of the same expanded affiliated group, as defined in section 1471(e)(2) of the U.S. Internal Revenue Code [“Code”], as a corporation described in clause (i);
- (iii) the United States or any wholly owned agency or instrumentality thereof;
- (iv) any State of the United States, any U.S. Territory, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing;
- (v) any organization exempt from taxation under section 501(a) of the [Code] or an individual retirement plan as defined in section 7701(a)(37) of the [Code];
- (vi) any bank as defined in section 581 of the [Code];
- (vii) any real estate investment trust as defined in section 856 of the [Code];
- (viii) any regulated investment company as defined in section 851 of the [Code] or any entity registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-64);
- (ix) any common trust fund as defined in section 584(a) of the [Code];
- (x) any

The term “U.S. Person” means a U.S. citizen or resident individual, a partnership or corporation organized in the United States or under the laws of the United States or any State thereof, a trust if (i) a court within the United States would have authority under applicable law to render orders or judgments concerning substantially all issues regarding administration of the trust, and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust, or an estate of a decedent that is a citizen or resident of the United States.⁵⁰

The above terms are to be interpreted in accordance with the Code.⁵¹

In the case of the typical fund structure described above, the master fund would have U.S. Reportable Accounts for the U.S. feeder fund (a Specified U.S. Person) and the mini-master fund (a non-U.S. entity with a Controlling Person that is a Specified U.S. Person (the owners of the general partner), if applicable). The mini-master fund, if applicable, would have a single U.S. Reportable Account for its general partner, and the non-U.S. feeder would have to determine whether or not it had U.S. Reportable Accounts.⁵²

“Controlling Persons” means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any

trust that is exempt from tax under section 664(c) of the [Code] or that is described in section 4947(a)(1) of the [Code]; (xi) a dealer in securities, commodities, or derivative financial instruments (including notional principal contracts, futures, forwards, and options) that is registered as such under the laws of the United States or any State; or (xii) a broker as defined in section 6045(c) of the [Code].

RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(gg); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(cc).

⁵⁰ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(ff); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(bb).

⁵¹ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 2; NONRECIPROCAL MODEL 1B, *supra* note 23, art. 2.

⁵² While some non-U.S. feeder funds limit investors to non-U.S. investors, many permit U.S. tax-exempt investors to invest.

other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions.⁵³

The term “Controlling Persons” is to be interpreted “in a manner consistent with the Financial Action Task Force Recommendations.”⁵⁴

[A] “U.S. Source Withholdable Payment” means any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States. Notwithstanding the foregoing, a U.S. Source Withholdable Payment does not include any payment that is not treated as a withholdable payment in relevant U.S. Treasury Regulations.⁵⁵

B. *Article 2 of the Model 1 Agreements*

Article 2 of the Model 1 agreements contains the “Obligations to Obtain and Exchange Information with Respect to Reportable Accounts.”⁵⁶ It outlines the information that is to be obtained and exchanged by the reporting FATCA Partner Financial Institutions (“RPFIs”) as to their U.S. Reportable Accounts.⁵⁷

Each RFPFI will have to report the following with respect to each U.S. Reportable Account:

⁵³ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 1, § 1(nn); NONRECIPROCAL MODEL 1B, *supra* note 23, art. 1, § 1(ii).

⁵⁴ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, art. 1, § 1(nn); NONRECIPROCAL MODEL 1B, *supra* note 23, art. 1, § 1(ii).

⁵⁵ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 1, § 1(jj); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 1, § 1(ff).

⁵⁶ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 2; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 2.

⁵⁷ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 2; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 2.

- The name, address, and U.S. taxpayer identification number of each Specified U.S. Person that is an Account Holder of such Financial Account;
- The account number (or equivalent);
- The name and identifying number of the RFPFI; and
- The account balance or value as of the end of the relevant calendar year or other appropriate reporting period, or if the Financial Account was closed during such year, immediately before closure.⁵⁸

For RFPFIs that are investment funds, they will also need to report the total gross amount paid or credited to the Account Holder with respect to the Financial Account during the calendar year or other appropriate reporting period with respect to which the RFPFI is the obligor or debtor, including the total amount of any redemption payments made to the Account Holder in the specified reporting period.⁵⁹

C. *Article 3 of the Model 1 Agreements*

Article 3 of the Model 1 agreements details the “Time and Manner of Exchange of Information.”⁶⁰ Notably:

- The amount and characterization of the payments made regarding U.S. Reportable Accounts can be determined by the tax law of the FATCA partner country;
- The currency in which the amount is denominated must be noted;
- All information to be obtained and exchanged begins for 2014 and is for all subsequent years, with some exceptions detailed in the agreements;⁶¹

⁵⁸ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 2 § 2; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 2, § 2.

⁵⁹ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 2, § 2(a)(7); NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 2, § 2(g).

⁶⁰ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 3; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 3.

⁶¹ As indicated above, tax withholding does not start until July 1, 2014, and, as indicated below, reporting is delayed until 2015; records for such reporting have to be maintained starting for calendar year 2014. Notice 2013-43, 2013-31 I.R.B. (2013).

- The RFPFI is not responsible for including the taxpayer identification number if it is not in its records, but should include the relevant person's date of birth if available;
- The information from Article 2 must be exchanged within nine months of the calendar year to which it relates; and
- FATCA partner country authorities will enter agreements with the United States regarding the enactment of legislation and procedures for the implementation of the Model 1 Agreements.⁶²

D. *Article 4 of the Model 1 Agreements*

Article 4 of the Model 1 agreements details the "Application of FATCA to the FATCA Partner Financial Institutions."⁶³ Notably:

- Each RFPFI will report all of the required information annually to its own governmental tax agency as well as the name of and total amount of payments made to "Nonparticipating FFIs" (a Nonparticipating FFI is a foreign Financial Institution that has not entered into an FFI agreement with the IRS, is not resident in a jurisdiction that has entered into an intergovernmental agreement with the United States, and is not an exempt beneficial owner);
- Each RFPFI must comply with registration requirements of its respective jurisdictions;
- Each RFPFI must withhold 30% of any U.S. Source Withholdable Payment to any Nonparticipating FFI when it is acting as a qualified intermediary (for purposes of Section 1441 of the Internal Revenue Code) that has elected to assume primary withholding responsibility, or is a foreign partnership that has elected to act as a withholding foreign partnership;
- When not acting as a qualified intermediary or withholding foreign partnership, each RFPFI that makes a payment to, or acts as an intermediary with respect to a U.S. Source Withholdable Payment to a Nonparticipating FFI, must provide any immediate payor of

⁶² RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 3, §§ 1–6; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 3, §§ 1–6.

⁶³ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 4; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 4.

such U.S. Source Withholdable Payment with the information required for withholding and reporting; and

- The United States will not require a RFPFI to withhold tax on any recalcitrant account holder⁶⁴ or to close the account if appropriate documentation is provided.⁶⁵

E. *Annex I of the Model I Agreements*

Annex I of the model agreements details the due diligence obligations for identifying U.S. Reportable Accounts.⁶⁶ These obligations vary depending on whether the account is an account for an individual or entity, whether it is a Preexisting Account, and the size of the account.

1. Accounts Held by Individuals

a. Preexisting Accounts

With respect to Preexisting Accounts that are held by individuals, if the account balance does not exceed \$50,000 as of June 30, 2014, unless and until such account becomes a “High Value Account” (as described below), no due diligence or reporting is required.⁶⁷ For Preexisting Accounts held by individuals with account balances in excess of \$50,000 as of June 30, 2014, but not in excess of \$1,000,000 (referred to as “Lower Value Accounts”), an investment fund must review all of the electronically-searchable data maintained by the fund for any of the following U.S. indicia:

⁶⁴ A “recalcitrant account holder” is defined in Treas. Reg. § 1-1471-d(6) (2012) as certain Account Holders in FFIs who fail to provide required information (or a valid waiver allowing the FFI to report under foreign law). The Final Regulations require withholding with respect to such Account Holders (Treas. Reg. Sec. 1-1471-a (2012)), but this is not required under the Model I agreements. See RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 4, § 1; see also NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 4, § 1.

⁶⁵ RECIPROCAL MODEL 1A AGREEMENT, *supra* note 23, at art. 4, §§ 1–2; NONRECIPROCAL MODEL 1B, *supra* note 23, at art. 4, §§ 1–2.

⁶⁶ U.S. DEP’T OF THE TREASURY, ANNEX I: DUE DILIGENCE OBLIGATIONS FOR IDENTIFYING AND REPORTING ON U.S. REPORTABLE ACCOUNTS AND ON PAYMENTS TO CERTAIN NONPARTICIPATING FINANCIAL INSTITUTIONS (2013), <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-AnnexI-to-ModelI-Agreement-5-9-13.pdf> [hereinafter ANNEX I TO MODEL I AGREEMENT].

⁶⁷ *Id.* at art. II, § A(1), as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

- Any identification of the account holder as a U.S. citizen or resident;
- An unambiguous indication that the account holder had a U.S. place of birth;
- A current U.S. mailing or residence address for the account holder (including a U.S. post office box or “in-care-of” address);
- A current U.S. telephone number for the account holder;
- The existence of standing instructions to transfer funds to an account in the United States;
- A currently effective power of attorney or signatory authority which the account holder has granted to a person with a U.S. address; or
- A “hold mail” address that is the sole address the fund has on file for the account holder.⁶⁸

If any of the above U.S. indicia are discovered in the electronic search, then the investment fund can choose to either simply treat the account as a U.S. Reportable Account, or the investment fund can elect to determine if any of certain specified exceptions apply.⁶⁹ A self-certification (or other documentary evidence) may not be relied on for purposes of any of the exceptions if the fund knows or has reason to know that it is incorrect or unreliable.

If the U.S. indicia found in the electronic search unambiguously indicate that the account holder had a U.S. place of birth, then the fund does not need to treat the account as a U.S. Reportable Account if it obtains (or has previously reviewed and maintained a record of) all of the following:

- A self-certification that the account holder is neither a U.S. citizen nor a U.S. resident for tax purposes (IRS Form W-8 can be used for this purpose);
- A government-issued identification evidencing that the account holder is a citizen or national of a country other than the United States (such as a non-U.S. passport); and
- Either a copy of the account holder’s Certificate of Loss of Nationality of the United States, or a reasonable explanation of (a) the reason the account holder does not have such a certificate

⁶⁸ *Id.* at art. II, § B(1).

⁶⁹ *Id.* at art. II, § B(3).

despite renouncing U.S. citizenship, or (b) the reason the account holder did not obtain U.S. citizenship at birth.⁷⁰

If the U.S. indicia found in the electronic search is a current U.S. mailing address or a U.S. telephone number(s) that is the sole telephone number(s) associated with the account, the fund does not need to treat the account as a U.S. Reportable Account if it obtains (or has previously reviewed and maintained a record of) the self-certification and government-issued identification described above.⁷¹

If the U.S. indicator found in the electronic search is a standing instruction to transfer funds to an account maintained in the United States, the fund does not need to treat the account as a U.S. Reportable Account if it obtains (or has previously reviewed and maintained a record of) the self-certification described above and acceptable documentary evidence establishing the account holder's non-U.S. status.⁷²

If the U.S. indicator found in the electronic search is a currently effective power of attorney or signatory authority that the account holder has granted to

⁷⁰ *Id.* at art. II, § B(4)(a).

⁷¹ *Id.* at art. II, § B(4)(b).

⁷² ANNEX I TO MODEL I AGREEMENT, *supra* note 66, at art. II, § B(4)(c).

[A]cceptable documentary evidence includes any of the following:

1. A certificate of residence issued by an authorized government body (for example, a government or agency thereof, or a municipality) of the jurisdiction in which the payee claims to be a resident.
2. With respect to an individual, any valid identification issued by an authorized government body (for example, a government or agency thereof, or a municipality), that includes the individual's name and is typically used for identification purposes.
3. With respect to an Entity, any official documentation issued by an authorized government body (for example, a government or agency thereof, or a municipality) that includes the name of the Entity and either the address of its principal office in the jurisdiction (or U.S. Territory) in which it claims to be a resident or the jurisdiction (or U.S. Territory) in which the Entity was incorporated or organized.
4. With respect to a Financial Account maintained in a jurisdiction with anti-money laundering rules that have been approved by the IRS in connection with a QI agreement (as described in relevant U.S. Treasury Regulations), any of the documents, other than a Form W-8 or W-9, referenced in the jurisdiction's attachment to the QI agreement for identifying individuals or Entities.
5. Any financial statement, third-party credit report, bankruptcy filing, or U.S. Securities and Exchange Commission report.

Id. at art. VI, § (D).

a person with a U.S. address, a “hold mail” address that is the sole address the fund has on file for the account holder, or a U.S. telephone number(s) (if the account also has a non-U.S. telephone number associated with it), the fund does not need to treat the account as a U.S. Reportable Account if it obtains (or has previously reviewed and maintained a record of) the self-certification described above or acceptable documentary evidence establishing the account holder’s non-U.S. status.⁷³

The review of Preexisting Accounts held by individuals that are “Lower Value Accounts” for U.S. indicia must be completed by December 31, 2015.⁷⁴ If, subsequent to such review, there is a change in circumstances that associates one or more of the above-described U.S. indicia with such an account, then the account must be treated as a U.S. Reportable Account, unless an above-described exception applies.⁷⁵

The due diligence requirements are more extensive for Preexisting Accounts held by individuals if the balance of the account exceeds \$1,000,000 as of June 30, 2014, or as of December 31 of any subsequent year.⁷⁶ These accounts are referred to as “High-Value Accounts.”⁷⁷

For Preexisting Accounts held by individuals that are High-Value Accounts, electronically-searchable data must be reviewed for U.S. indicia in the same manner as for Lower Value Accounts.⁷⁸ No paper record search is required if the fund’s electronically-searchable data includes all of the following:

- The nationality or residence address of the account holder;
- The currently-on-file residence and mailing address of the account holder;
- The currently on file telephone number(s) of the account holder, if any;
- Whether the account holder has given any standing instructions to transfer funds in the account to another account;
- Whether there is a current “in-care-of” or “hold mail” address for the account holder; and

⁷³ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. II, § B(4)(d).

⁷⁴ *Id.* at art. II, § C(1).

⁷⁵ *Id.* at art. II, § C(2).

⁷⁶ *Id.* at art. II, § D, as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

⁷⁷ *Id.*

⁷⁸ *Id.* at art. II, § D(1).

- Whether the account holder has given any power of attorney or signatory authority for the account.⁷⁹

If any of the foregoing information is not electronically-searchable, then, with respect to Preexisting Accounts maintained for individuals which are High-Value Accounts, the fund must review its current master file for the account holder. To the extent that the information is not contained in such a master file, the fund must review the following documents obtained within the last five years:

- The most recent documentary evidence collected with respect to the account;
- The most recent account-opening documentation (e.g., the subscription agreement of the investor);
- The most recent documentation obtained pursuant to AML/KYC Procedures⁸⁰ or for other regulatory purposes.
- Any current power of attorney or signature authority forms; and
- Any current standing instructions to transfer funds to another account.⁸¹

In addition to the electronic and paper record search (if required), Preexisting Accounts maintained for individuals that are High-Value Accounts must be treated as U.S. Reportable Accounts if the fund's relationship manager assigned to such an account has actual knowledge that the account holder is a Specified U.S. Person.⁸²

The enhanced review procedures for Preexisting Accounts that are High-Value Accounts as of June 30, 2014 must be completed by December 31, 2014.⁸³ If a Preexisting Account becomes a High Value Account after June 30, 2014, the enhanced review procedures for such an account must be completed within six months after the last day of the calendar year in which it becomes a High-Value Account.⁸⁴ If there is a change in circumstances

⁷⁹ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. II, § D(3).

⁸⁰ These are the customer due diligence procedures of the fund pursuant to the anti-money laundering or similar requirements of the fund's jurisdiction of residence to which the fund is subject.

⁸¹ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. II, § D(2).

⁸² *Id.* at art. II, § D(4).

⁸³ *Id.* at art. II, § E(1).

⁸⁴ *Id.* at art. II, § E(2).

subsequent to the initial review that results in one or more U.S. indicia being associated with the account, then the account must be treated as a U.S. Reportable Account, unless an exception applies.⁸⁵ In addition, for High-Value Accounts, the fund must implement procedures to ensure that each relationship manager identifies any changes in circumstances for accounts for which he or she is responsible.⁸⁶

b. New Accounts

Accounts for individuals newly admitted as investors in investment funds are all subject to the same due diligence requirements, regardless of account value.⁸⁷ The fund must obtain a self-certification from the account holder as to whether the account holder is a U.S. citizen or resident.⁸⁸ For non-U.S. citizens or residents, an IRS Form W-8 will be the preferred method to obtain this self-certification. U.S. citizens or residents must provide their taxpayer identification number, and an IRS Form W-9 will be the preferred method to obtain the required taxpayer identification number.⁸⁹ If a Form W-8 is obtained, the fund must confirm its reasonableness based on the other information it obtained when accepting the individual as an investor, including any documentation collected pursuant to “AML/KYC Procedures.”⁹⁰

If, after the initial determination with respect to a new individual investor, there is a change in circumstances which causes the fund to know or have reason to know that the self-certification obtained from an alleged non-U.S. investor is incorrect or unreliable, the fund must obtain a new self-certification.⁹¹ If it is unable to do so, then it must treat the account as a U.S. Reportable Account, and must report the information described in Part II(B) above.⁹²

⁸⁵ *Id.* at art. II, § E(4).

⁸⁶ *Id.* at art. II, § E(5).

⁸⁷ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. III.

⁸⁸ *Id.* at art. III, § B.

⁸⁹ *Id.* at art. III, § C.

⁹⁰ *Id.* at art. III, § B. “AML/KYC Procedures” means the customer due diligence procedures that the fund has adopted pursuant to anti-money laundering or similar requirements to which the fund is subject. *Id.* at art. VI, § B(1).

⁹¹ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. III, § D.

⁹² *Id.*

2. Accounts Held by Entities

a. Preexisting Accounts

Similar to Preexisting Accounts maintained for individuals, the requirements for due diligence with respect to Preexisting Accounts maintained for entities depends on the size of the account. However, there are only two categories for entities, one requiring no due diligence and the other requiring the due diligence outlined below, rather than the three categories (no due diligence, some due diligence, and more extensive due diligence) for individuals.⁹³

Unless a fund elects otherwise, Preexisting Accounts maintained for entities with account balances that do not exceed \$250,000 as of June 30, 2014, are not required to be reviewed or reported unless and until the account balance exceeds \$1,000,000.⁹⁴ Preexisting Accounts maintained for entities that have an account balance in excess of \$250,000 as of June 30, 2014, or for such accounts with account balances that do not exceed \$250,000 as of June 30, 2014, but later exceed \$1,000,000, must be reviewed as set forth below.⁹⁵

Only Preexisting Accounts that are either held by one or more entities which are Specified U.S. Persons, or held by Passive NFFEs⁹⁶ with one or more Controlling Persons who are U.S. citizens or residents, will be treated as U.S. Reportable Accounts.⁹⁷ However, accounts held by Nonparticipating FFIs are subject to aggregate reporting of payments as described in Part II(D) above.⁹⁸

In determining the status of a Preexisting Account maintained for an entity that is subject to review, the fund must review information maintained by it for regulatory or customer relationship purposes (including any information collected pursuant to AML/KYC Procedures) to determine if such information shows a U.S. place of incorporation or organization, a U.S. address, or other indication that the entity is a U.S. Person.⁹⁹ If the information maintained by the fund indicates that the entity is a U.S. Person,

⁹³ *Id.* at art. IV.

⁹⁴ *Id.* at art. IV, § A, as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

⁹⁵ *Id.* at art. IV, § B, as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

⁹⁶ A "Passive NFFE" is a non-U.S. entity that is not a Foreign Financial Institution, and that does not meet any of the criteria outlined in *id.* at art. VI, § B(4).

⁹⁷ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. IV, § C.

⁹⁸ *Id.*

⁹⁹ *Id.* at art. IV, § D(1)(a).

then it must be treated as a Specified U.S. Person, unless an exception applies. The fund does not need to treat the entity as a U.S. Person if it obtains a self-certification from the entity that it is not a Specified U.S. Person (preferably on IRS Form W-8), or if the fund reasonably determines that the entity is not a Specified U. S. Person based on other information in its possession or that is publicly available.¹⁰⁰

Next, the fund must review the same information to determine whether the entity for which the account is maintained is a Financial Institution.¹⁰¹ If the entity is a Financial Institution, then the account maintained for it is not a U.S. Reportable Account.¹⁰²

If the fund determines that an entity or the relevant branch of an entity is a Financial Institution that is resident in a jurisdiction that has entered into an intergovernmental agreement with the United States to facilitate the implementation of FATCA,¹⁰³ then no further review or reporting is generally necessary with respect to the account.¹⁰⁴ However, if the Financial Institution has engaged in substantial noncompliance with its obligations under the intergovernmental agreement entered into between the United States and its jurisdiction, the Financial Institution must be treated as a Nonparticipating FFI, subject to aggregate reporting.¹⁰⁵

If the Financial Institution that holds the account is not resident in a jurisdiction that has entered into an intergovernmental agreement with the United States to facilitate the implementation of FATCA, then it must be treated as a Nonparticipating FFI, subject to aggregate reporting, unless an exception applies. Such a Financial Institution will not be treated as a Nonparticipating FFI by a Fund if either (i) the Fund obtains a self-certification that it is a deemed-compliant FFI, an exempt beneficial owner, or an excepted FFI¹⁰⁶ (once again, a Form W-8 will be the preferred method of obtaining this certification), or (ii) the FFI provides its FATCA-identifying

¹⁰⁰ *Id.* at art. IV, § D(1)(b).

¹⁰¹ *Id.* at art. IV, § D(2).

¹⁰² *Id.* at art. IV, § D(2)(b).

¹⁰³ The IRS maintains a list of all such jurisdictions. *Resource Center, FATCA - Archive*, U.S. DEP'T OF THE TREASURY (Mar. 5, 2012, 9:00 P.M.) <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx>.

¹⁰⁴ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. IV, § D(3)(a).

¹⁰⁵ *Id.* at art. IV, § D(3)(b). The IRS will make available a list of all such Financial Institutions. *Id.* at art. V, § 2(b).

¹⁰⁶ These terms are all defined in the Final Regulations.

number as a participating FFI or registered deemed-compliant FFI, and the fund verifies this number on a list to be published by the IRS.¹⁰⁷

If the fund determines that an entity that holds a Preexisting Account is neither a U.S. Person nor a Financial Institution, then it must determine (i) whether the entity has Controlling Persons, and if so, whether any of them is a citizen or resident of the United States, and (ii) whether the entity is a Passive NFFE.¹⁰⁸ For purposes of determining who the Controlling Persons of an entity are, the fund may rely on information collected and maintained pursuant to its AML/KYC Procedures.¹⁰⁹ For purposes of determining whether a Controlling Person of an entity is a citizen or resident of the United States for tax purposes, the fund may similarly rely on information collected and maintained pursuant to its AML/KYC Procedures if the account balance maintained for the entity does not exceed \$1,000,000.¹¹⁰ If the account balance exceeds \$1,000,000, then a self-certification from the Controlling Person (Form W-8 or W-9 will be a preferred method for obtaining this) must be obtained.¹¹¹

If the entity has a Controlling Person who is a citizen or resident of the United States for tax purposes, then the fund must determine if the entity is a Passive NFFE. Alternatively, the fund can first determine whether the entity is a Passive NFFE, and if not, the fund does not need to make any determination with respect to Controlling Persons.¹¹² Unless the fund can reasonably determine that the entity is not a Passive NFFE based on information it has in its possession or that is publicly available, the fund must obtain a self-certification (once again, a Form W-8 or W-9 can be used for this purpose) from the entity to determine its status.¹¹³

The review procedures for Preexisting Accounts maintained for entities that have an account balance that exceeds \$250,000 as of June 30, 2014, must be completed by December 31, 2015.¹¹⁴ If a Preexisting Account with an account balance that does not exceed \$250,000 as of June 30, 2014, exceeds \$1,000,000 as of December 31 of a subsequent year, the review procedures for such an account balance must be completed within six months after the end of

¹⁰⁷ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. IV, § D(3)(c).

¹⁰⁸ *Id.* at art. IV, § D(4).

¹⁰⁹ *Id.* at art. IV, § D(4)(a).

¹¹⁰ *Id.* at art. IV, § D(4)(c)(1).

¹¹¹ *Id.* at art. IV, § D(4)(c)(2).

¹¹² *Id.* at art. IV, § (D)(4).

¹¹³ ANNEX I TO MODEL 1 AGREEMENT, *supra* note 66, at art. IV, § D(4)(b).

¹¹⁴ *Id.* at art. IV, § E(1), as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

the calendar year in which the account balance exceeds \$1,000,000.¹¹⁵ If, subsequent to the initial review, there is a change in circumstances with respect to such an account that causes the fund to know or have reason to know that the self-certification or other documentation associated with an account is incorrect or unreliable, the fund must re-determine the status of the account holder in accordance with the procedures described above.¹¹⁶

For all entity accounts that are opened on or after July 1, 2014 (and thus are not Preexisting Accounts), the fund must determine whether the account holder is (i) a Specified U.S. Person, (ii) a Financial Institution (or branch of a Financial Institution) located in a jurisdiction that has entered into an intergovernmental agreement with the United States to facilitate the implementation of FATCA, (iii) a participating FFI, a deemed-compliant FFI, an exempt beneficial owner, or an excepted FFI (all as defined in the Final Regulations), or (iv) an NFFE.¹¹⁷

A fund may determine that an account holder is an NFFE that is not a Passive NFFE, or a Financial Institution (or branch of a Financial Institution) located in a jurisdiction that has entered into an intergovernmental agreement with the United States to facilitate the implementation of FATCA, if the fund makes a reasonable determination that the account holder has such status based on information in the fund's possession or that is publicly available.¹¹⁸ In all other cases, the fund must obtain a self-certification from the account holder to establish its status.¹¹⁹

CONCLUSION

Both the Final Regulations and the intergovernmental agreements provide a great degree of certainty with respect to what funds need to do to comply with FATCA. Unfortunately, however, until the jurisdiction in which a foreign investment fund is located enters into an intergovernmental agreement with the United States, such fund cannot be sure what it will need to do in order to comply with FATCA. In the worst case scenario, if such a jurisdiction does not enter into an intergovernmental agreement, the fund may not be able to comply with FATCA, even if it is otherwise willing to do so,

¹¹⁵ *Id.* at art. IV, § E(2), as modified by Notice 2013-43, 2013-31 I.R.B. (2013).

¹¹⁶ *Id.* at art. IV, § E(3).

¹¹⁷ *Id.* at art. V, § A.

¹¹⁸ *Id.* at art. V, § B.

¹¹⁹ ANNEX I TO MODEL I AGREEMENT, *supra* note 66, at art. V, § C.

because doing so may violate the laws of the jurisdiction in which it is located.¹²⁰ If a fund is located in a jurisdiction that does not enter into an intergovernmental agreement and the fund is able to comply with FATCA under the laws of such jurisdiction, the fund will still have to enter into an FFI agreement with the IRS and report the information required by that agreement to comply with FATCA.¹²¹

While no fund will relish complying with the additional requirements of FATCA, the above discussion indicates that, at least for funds located in jurisdictions which enter into intergovernmental agreements with the United States, such requirements are clearly set out and will not be prohibited under the laws of such jurisdictions. There is time to implement procedures both to perform due diligence on Preexisting Accounts and to prepare to require the information that will be needed with respect to new accounts before reporting first becomes required. While this will not occur until 2015, funds should take action now to ensure that they will have the necessary records to do the required reporting with respect to funds that are identified as U.S. Reportable Accounts, since that reporting will start with the 2014 calendar year.

¹²⁰ For example, Switzerland has strict laws requiring its financial institutions to maintain secrecy concerning their account holders, which would have created FATCA compliance for Swiss financial institutions had Switzerland not entered into an intergovernmental agreement with the United States.

¹²¹ See, e.g., Agreement for Cooperation to Facilitate the Implementation of FATCA, U.S.-Switz., art. 3, § 1(a), Feb. 14, 2013, U.S. DEP'T OF THE TREASURY.

TAXING UNCERTAINTY: ELECTRONIC COMMERCE

Laura Crockett *

INTRODUCTION

In the expanding world of electronic commerce and Internet transactions, and with the advent of cloud computing¹ and three-dimensional printers,² the traditional tax rules that were “designed for concrete transactions and not virtual ones” yield results beyond their original intent.³

U.S. multinational corporations follow tax rules and gain results that were surely not contemplated by the legislators who enacted them, and save approximately \$30 to \$60 billion annually through legal structures that take advantage of jurisdictions that have low or no nominal or effective tax rates.⁴ In particular, corporations in the e-commerce world can easily benefit from the

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¹ Cloud computing is a “model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.” NAT’L INST. OF STANDARDS & TECH., SPECIAL PUBL’N 800-145, *THE NIST DEFINITION OF CLOUD COMPUTING 2* (2011), available at csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf.

² Three-dimensional printers use a technique called additive manufacturing, which allows a printer to build a physical item out of materials such as plastic and metal. See generally Peter Jensen-Haxel, Comment, *3d Printers, Obsolete Firearm Supply Controls, and the Right to Build Self-Defense Weapons Under Heller*, 42 *GOLDEN GATE U. L. REV.* 447, 450–56 (2012) (describing how 3D printers operate and explaining how firearms may be generated with 3D printers).

³ Shamik Trivedi, *Cloudy Outlook for State, VAT Taxation of Online Computing*, 2012 *TAX NOTES TODAY* 220-15 (Nov. 13, 2012).

⁴ See *Hearing on International Tax Reform Before the H. Comm. on Ways & Means*, 112th Cong. 5 (2011) (testimony of Martin A. Sullivan, ed. & Economist, *TAX ANALYSTS*) [hereinafter *Hearing on International Tax Reform*] (citing Martin A. Sullivan, *Transfer Pricing Costs U.S. at Least \$28 Billion*, 2010 *TAX NOTES TODAY* 54-3 (Mar. 22, 2010), and Kimberly A. Clausung, *The Revenue Effects of Multinational Firm Income Shifting*, 2011 *TAX NOTES TODAY* 61-9 (Mar. 28, 2011)).

resources and tax incentives these jurisdictions offer because of their unique mobility.⁵

The Internet provides a platform for e-commerce companies to interact with customers and suppliers globally where e-commerce companies provide “intangible goods and services” through a virtual network.⁶ Taxing authorities face challenges with the taxation of virtual transfer of goods and services⁷ and regulators have struggled to amend the U.S. tax code, which was created before e-commerce businesses existed, to effectively tax e-commerce transactions.⁸ Piecemeal changes to the tax code leave open unintended tax gaps,⁹ and create uncertainty around how to tax certain e-commerce transactions.¹⁰

Recent revisions to the U.S. Internal Revenue Code and proposed legislation aimed at illegal tax evasion will not remedy the uncertain taxation of e-commerce companies because they focus on information reporting requirements.¹¹ The U.S. Government should revise the taxation rules rather than create additional information reporting requirements to address the outdated rules’ uncertain and ineffective application to e-commerce companies. Lowering the U.S. corporate income tax rate and possibly imposing an electronic transaction tax on e-commerce goods and services may alleviate the problem.

Part I of this article provides an overview of why e-commerce companies present a unique challenge to U.S. taxation and how U.S. multinational e-commerce corporations use low-tax jurisdictions to reduce their world-wide tax bill. Part II observes the effects of e-commerce companies’ use of low-tax jurisdictions on the U.S. tax base and considers economic effects, including potential economic benefits of such jurisdictions. Part III examines the efforts of the Foreign Account Tax Compliance Act (FATCA) and the proposed Stop

⁵ See Arthur J. Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 MINN. L. REV. 1171, 1195 (2001).

⁶ *Id.* at 1173.

⁷ See Trivedi, *supra* note 3.

⁸ See Cockfield, *supra* note 5, at 1173.

⁹ See Adrian J. Sawyer, *Electronic Commerce: International Policy Implications for Revenue Authorities and Governments*, 19 VA. TAX REV. 73, 77 (1999) (stating that “electronic commerce creates numerous policy hurdles and opportunities in international law.”).

¹⁰ For example, the cloud computing industry “on track to reach \$150 billion in worldwide sales by 2014,” calls for re-examining traditional U.S. tax rules as applied to e-commerce. See Trivedi, *supra* note 3.

¹¹ See I.R.C. §§ 1471–1474 (West 2013).

Tax Haven Abuse Act and Cut Unjustified Tax Loopholes Act (CUT Loopholes Act) in addressing some of the tax issues exacerbated in the e-commerce world and concludes that these measures will not adequately address the e-commerce taxation issue. Part III considers possible solutions to the taxation of e-commerce businesses, including a reduction in the U.S. corporate tax rate and an electronic transaction tax.

I. BACKGROUND

A. *Overview of E-commerce*

E-commerce is broadly described as “the practice of buying and selling goods and services through online consumer services on the Internet.”¹² For example, e-commerce encompasses selling physical products through on-line ordering, providing downloadable content, and providing other services.¹³ A typical e-commerce transaction is illustrated by the following hypothetical situation:¹⁴

An individual in Virginia downloads software from a website for a free sixty-day trial. He uses the software for fifty days and then decides to purchase an unrestricted version of the software. He submits payment electronically through an electronic payment service, and receives an authorization code for the software. The software that he purchased was developed by a company incorporated in the Cayman Islands with employees in the Netherlands. He downloads the software from a server located in the state of Maryland. The purchaser found the software through a web browser, supplied by any one of a number of foreign or domestic companies.

This scenario raises questions such as whether there is a taxable transaction, what good or service is sold, when the transaction is taxable, and whether the United States or foreign jurisdictions have the right to tax the transaction.¹⁵ Under current U.S. taxation rules, the United States does not tax

¹² BLACK’S LAW DICTIONARY 589 (9th ed. 2009).

¹³ Sawyer, *supra* note 9, at 75–76.

¹⁴ This fact situation is based on a scenario from David E. Hardesty’s treatise. See DAVID E. HARDESTY, ELECTRONIC COMMERCE: TAXATION & PLANNING ¶ 1.01 (2012), available at Westlaw 58625.

¹⁵ See *id.*; OFFICE OF TAX POLICY, DEP’T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 76 n.28 (2000) [hereinafter DEFERRAL OF INCOME], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf> (acknowledging that “Treas. Reg. § 1.861-18 provides that a

an e-commerce transaction when a sale is made from a foreign company to a U.S. customer, unless the foreign company's income is effectively connected to a U.S. trade or business.¹⁶ Therefore, the determination of whether the U.S. Government will collect income tax in the scenario above depends on whether the server in the state of Maryland or the web browser indicates that the electronic payment service provider or the software provider earned income effectively connected to a U.S. trade or business, and also depends on certain features of the business group structure.¹⁷

B. *Overview of Low-Tax Jurisdictions*

Low-tax jurisdictions include jurisdictions with no taxes, such as the Cayman Islands, or low nominal tax rates, such as Ireland, and those with higher nominal rates but with the ability to get rulings that result in low effective tax rates, such as Luxembourg.¹⁸ Low-tax jurisdictions also exist within countries, such as special economic zones in China.¹⁹ These low-tax jurisdictions offer low tax rates to attract investors and corporations that would otherwise pay higher tax rates in their home countries.²⁰

1. Historical Overview of Low-Tax Jurisdictions

U.S. companies' use of low-tax jurisdictions grew during the 1950s and 1960s with the growth of foreign business and increase in domestic tax rates.²¹ In the early 1960s, the U.S. Government took steps to reduce tax deferral in such jurisdictions because the jurisdictions provided an incentive for U.S. businesses to shift income and operations abroad.²² The U.S. Government

transfer of a computer program is treated as: (a) the transfer of a copyright right; (b) the transfer of a copyrighted article; (c) the provision of services; or (d) the provision of know-how, based on all the facts and circumstances of the transaction" but also noting that there is still difficulty in characterizing digital products).

¹⁶ See I.R.C. §§ 881, 882 (West 2013).

¹⁷ The income could also be subject to U.S. federal income tax if the income is subject to the subpart F rules. See I.R.C. §§ 951–965 (West 2013).

¹⁸ See James R. Hines, Jr., *Tax Havens* 1 (Office of Tax Policy Research, Working Paper No. 2007-3, 2007).

¹⁹ *Id.*

²⁰ *Id.*

²¹ See DEFERRAL OF INCOME, *supra* note 15, at 8.

²² These steps are generally referred to as the subpart F rules. See DEFERRAL OF INCOME, *supra* note 15, at 12.

justified the steps based on an economic principle of tax neutrality and economic efficiency.²³ Tax neutrality exists where corporate tax rates are the same in different taxing jurisdictions “assuming roughly equivalent government services.”²⁴ Tax neutrality in the e-commerce context means that the tax policy of the jurisdiction does not “interfere with the choice of the most efficient method of undertaking” electronic transactions.²⁵ With the rise of e-commerce in the 1990s and advances in technology, e-commerce companies had greater opportunity to shift operations or aspects of the business to low-tax jurisdictions.²⁶

2. Low-Tax Jurisdictions for U.S. Multinationals Engaged in E-commerce

Corporate taxpayers providing goods and services over the Internet pose a unique challenge to the current U.S. international taxation rules.²⁷ Companies engaged in e-commerce can operate from nearly any place in the world and serve customers globally.²⁸ For example, software created by

²³ See *Revenue Act of 1962: Hearings on H.R. 10650 Before the S. Comm. on Finance, 87th Cong. pt. 1 at 95* (statement of Hon. Douglas Dillon, Sec’y of the Treasury) [hereinafter *Hearings on H.R. 10650*] (stating that “[t]he President’s recommendations on the tax treatment of foreign income and investment all support the general principles of equity and neutrality.”); *Message from the President of the United States Relative to our Federal Tax System: Hearing on H.R. 140 Before the H. Comm. on Ways & Means, 87th Cong. 6* (1961), reprinted in H. COMM. ON WAYS & MEANS, 90TH CONG., LEGISLATIVE HISTORY OF H.R. 10650 OF THE REVENUE ACT OF 1962, pt. 1 at 146 (1967) (stating that “to the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset.”).

²⁴ *Hearings on H.R. 10650, supra* note 23, at 173 (stating “Neutrality is a fundamental principle of taxation in the United States. The purpose of neutrality is to promote equity and the most efficient possible allocation of existing resources. Ideally corporate tax rates should be everywhere the same, assuming roughly equivalent government services. We cannot control foreign tax rates and the fact that they may contribute to inequities. But we can prevent the American tax structure from contributing to the artificial diversion of funds to low-tax areas, by taxing the income of our overseas subsidiaries at the same rates as are applicable to income earned at home. The burden of proof for not following the general principle of tax neutrality should be on those who wish to continue a departure from that neutrality.”).

²⁵ Sawyer, *supra* note 9, at 84.

²⁶ See DEFERRAL OF INCOME, *supra* note 15, at 59, 75–76.

²⁷ See Sawyer, *supra* note 9, at 74.

²⁸ Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized* 9 (Office of Tax Analysis, Working Paper No. 103, 2011).

someone in the United States can be downloaded onto a computer in Europe from a company with headquarters in Bermuda.²⁹ With legislation that favors e-commerce, coupled with low statutory tax rates, countries such as Bermuda attract e-commerce businesses that may otherwise remain in the United States.³⁰ To attract these businesses, most low-tax jurisdictions “have sophisticated telecommunications equipment, individuals who service this equipment, and facilities to host the server.”³¹ Consequently, the infrastructure and technology available in such jurisdictions makes it easier for e-commerce companies to operate in foreign jurisdictions while maintaining certain U.S. connections, such as U.S. customers or an American brand name.

The rise of virtual stores and services means that the “physical location of the provider of goods and services is...more difficult to determine.”³² Additionally, questions relevant to taxing authority may be unclear.³³ For example, questions arise as to the place of performance, place of use, consumption, or disposition of electronic products and services, and the classification of income received by e-commerce companies.³⁴ This uncertainty means that these companies may more easily lessen their tax burden through low-tax jurisdictions. Although some tax planning strategies employed by e-commerce companies are identical to strategies employed by other companies, the technologies and business models of e-commerce companies generally allow the planning strategies to be “accomplished more easily and effectively than in traditional commerce.”³⁵

²⁹ See HARDESTY, *supra* note 14.

³⁰ Kevin Jones, *Bermuda Curries E-commerce Favor*, INTER@CTIVE WEEK, Oct. 12, 1998, at 41, available at Bus. Source Complete, EBSCO (quoting William Woods, C.E.O. of the Bermuda Stock Exch., “We’re already a good place to do business from a tax standpoint and from our financial infrastructure[.]... Now, with intellectual property and other regulatory moves, we’re going to make it advantageous to do e-commerce in Bermuda.”).

³¹ Cockfield, *supra* note 5, at 1195.

³² See DEFERRAL OF INCOME, *supra* note 15, at 75.

³³ See *id.*

³⁴ For example, a payment received for digital products could be “treated as payments for a good, a right or a service.” *Id.* at 76.

³⁵ See *id.* at 77.

C. *Taxation of U.S. Multinationals*

The U.S. statutory federal corporate income tax rate of 35%,³⁶ or an average rate of 39.2% when including average effective state and local tax rates, staggers above the average statutory rate of 27.8% in other Organisation for Economic Co-operation and Development (OECD) countries.³⁷ This disparity encourages U.S. multinational corporations to locate business offshore or shift income to a lower tax jurisdiction.³⁸ For example, in the last three years, at least ten large U.S. public companies moved their incorporation addresses to a foreign country,³⁹ despite tax laws designed to minimize the effectiveness of such transactions.⁴⁰

The U.S. Government taxes worldwide income of companies resident or incorporated in the United States.⁴¹ However, the U.S. Government does not tax the income of foreign corporations unless the income earned by the foreign corporation is effectively connected with a U.S. trade or business.⁴² Therefore, absent anti-deferral rules discussed below, U.S. owners of foreign corporations generally may defer paying tax on income earned by the foreign corporations until the earnings are repatriated to the United States.⁴³ Subsidiary foreign corporations may pay little or no local tax on their earnings and the U.S. owner benefits from deferring the U.S. tax, possibly indefinitely, because of the time

³⁶ I.R.C. § 11 (West 2013) (35% federal statutory corporate income tax rate applies to incomes over \$18,333,333).

³⁷ See EXEC. OFFICE OF THE PRESIDENT, DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 2 & n.1, 12 (2012) (recognizing that the U.S. statutory federal income tax rate of 35% does not reflect the domestic production activities deduction, which can reduce the effective tax rate for corporations with certain domestic activities).

³⁸ See *id.* at 7.

³⁹ See John D. McKinnon & Scott Thurm, *U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Reincorporate Overseas, Saving Big Sums on Taxes*, WALL ST. J., Aug. 28, 2012, available at <http://online.wsj.com/article/SB10000872396390444230504577615232602107536.html>.

⁴⁰ See I.R.C. § 7874 (West 2013) (imposing tax on inversion gains of expatriated entities and deeming certain foreign corporations to be treated as domestic corporations).

⁴¹ I.R.C. §§ 11, 61 (West 2013).

⁴² I.R.C. §§ 881, 882 (West 2013).

⁴³ See I.R.C. § 1001 (West 2013); DEFERRAL OF INCOME, *supra* note 15, at ix. The Office of Tax Policy considered the purpose of subpart F of the Internal Revenue Code and how these rules restrict the general deferral of U.S. income tax on U.S. owners of controlled foreign corporations. Subpart F of the Internal Revenue Code restricts the general deferral of U.S. income tax on U.S. owners of controlled foreign corporations in certain situations such as the sale of foreign base company income. See I.R.C. § 954 (West 2013).

value of money principles and the effective rate of return on invested cash that would, if repatriated, be subject to U.S. tax.⁴⁴ The United States previously provided a “repatriation holiday” that allowed companies to repatriate earnings at a reduced tax rate.⁴⁵ This precedent may encourage companies to wait to repatriate earnings in anticipation of future repatriation holidays. The United States also allows a U.S. corporation to offset repatriated earnings with the foreign income tax paid on foreign income to “provide relief from double taxation,”⁴⁶ but the foreign tax credit rules are complex and often result in an inability to use the credits.⁴⁷

D. *Recent Efforts to Address the Use of Low-Tax Jurisdictions*

The U.S. Government has not effectively addressed e-commerce companies’ incentive to legally shift income and operations to low-tax jurisdictions. It has relied mostly on tax information exchange agreements to address concerns regarding such jurisdictions.⁴⁸ In the last two years, new legislation has been passed or proposed to address the use of low-tax jurisdictions, including the FATCA, the proposed Stop Tax Haven Abuse Act, and the proposed CUT Loopholes Act.⁴⁹

⁴⁴ See DEFERRAL OF INCOME, *supra* note 15, at ix. Under time value of money principles, a dollar of tax paid presently is more valuable than a dollar paid at a later time. STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 11.01 (1999), available at Westlaw 630281.

⁴⁵ See American Jobs Creation Act, H.R. 4520, 108th Cong. § 422(a) (2004) (outlining the temporary dividends received deduction).

⁴⁶ Foreign Tax Credits Audit Guidelines, IRM 4.61.10.1 (May 1, 2006) (summarizing the purpose of the Foreign Tax Credit and Internal Revenue Code sections regarding foreign tax credits).

⁴⁷ See Bret Wells, “Territorial” Tax Reform: Homeless Income Is the Achilles Heel, 12 HOUS. BUS. & TAX L. J. 1, 45 (2012).

⁴⁸ See Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 CONN. L. REV. 675, 700–04 (2012) (describing filing requirements of Reports of Foreign Banks and Financial Accounts (“FBAR”), FATCA, and other tax information exchange agreements); Itai Grinberg, *Beyond FATCA: An Evolutionary Moment for the International Tax System* 6 (Jan. 27, 2012) (unpublished working paper) (on file with Georgetown University Law Center), available at http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1162&context=fwps_papers (describing automatic information exchange and exchange of information provisions in bilateral tax treaties).

⁴⁹ See CUT Loopholes Act, S. 2075, 112th Cong. pmb. (2012); Stop Tax Haven Abuse Act, S. 1346, 112th Cong. pmb. (2011); FATCA, S. 1934, 111th Cong. (2009); FATCA, H.R. 3933, 111th Cong. (2009).

1. Foreign Account Tax Compliance Act (FATCA)

FATCA, enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, aims to counter unlawful offshore tax evasion by U.S. persons, including corporations.⁵⁰ FACTA requests foreign financial institutions (FFI) to enter voluntarily into an information sharing agreement with the Internal Revenue Service (IRS) and report information about U.S.-held foreign bank accounts.⁵¹ If an FFI fails to enter into agreement with the IRS, then that FFI will generally be subject to withholding tax on certain U.S. source payments starting July 1, 2014.⁵²

2. Proposed Stop Tax Haven Abuse Act and CUT Loopholes Act

The proposed Stop Tax Haven Abuse Act aims to “restrict the use of offshore tax havens and abusive tax shelters.”⁵³ The proposed Stop Tax Haven Abuse Act employs a presumption strategy that would effectively treat a U.S. person as being in control of an entity located in an “offshore secrecy jurisdiction” when that U.S. person engages in certain transactions with that entity.⁵⁴ The proposed CUT Loopholes Act aims to “close unjustified corporate tax loopholes.”⁵⁵ The proposed CUT Loopholes Act is primarily based on the proposed Stop Tax Haven Abuse Act and employs the same general strategy of increasing reporting requirements.⁵⁶

⁵⁰ See I.R.C. §§ 1471–1474 (West 2013); Press Release, IRS, Treasury and IRS Issue Guidance Outlining Phased Implementation of FATCA Beginning in 2013 (July 14, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=242164,00.html>.

⁵¹ *Id.*

⁵² *Id.*; I.R.S. Notice 2013-43 (July 12, 2013).

⁵³ Stop Tax Haven Abuse Act, S. 1346, 112th Cong. pmb. (2011).

⁵⁴ Hedda Leikvang, *Piercing the Veil of Secrecy: Securing Effective Exchange of Information to Remedy the Harmful Effects of Tax Havens*, 45 VAND. J. TRANSNAT'L L. 293, 321 (2012) (citing Stop Tax Haven Abuse Act, S. 506, 111th Cong. § 101(a) (2009)).

⁵⁵ Cut Unjustified Tax (CUT) Loopholes Act, S. 2075, 112th Cong. pmb. (2012).

⁵⁶ See Press Release, United States Senate, Levin, Conrad Introduce CUT Tax Loopholes Act (Feb. 7, 2012), [hereinafter CUT Loopholes Act Press Release], available at <http://www.hsgac.senate.gov>.

II. ANALYSIS

E. *Issue: The U.S. Tax Code Inadequately Addresses E-commerce Companies' Legal Use of Low-Tax Jurisdictions*

The international tax system developed in the 1920s could not anticipate the virtual and global features of e-commerce transactions.⁵⁷ Although the U.S. Government has modified the international taxation rules since they were first created, the rules have not adequately addressed the taxation of e-commerce companies.⁵⁸

E-commerce presents a global taxation issue because companies can freely and easily choose where to locate, including in low-tax jurisdictions,⁵⁹ without limiting access to customers. This mobility affects any taxing jurisdiction that wants to tax e-commerce. With this mobility, the primary taxing jurisdiction may be unclear,⁶⁰ and U.S. e-commerce companies have a tax incentive to shift income and operations to low-tax jurisdictions to mitigate the relatively high corporate income tax rate imposed in the United States.⁶¹ Technology allows the employees of an e-commerce corporation to locate physically outside the corporation's jurisdiction of incorporation and both suppliers and customers also may be located in different jurisdictions.⁶² This mobility and ease of cross-border transactions in e-commerce allow e-commerce businesses to more easily earn income that is not subject to U.S. federal income tax, regardless of where their employees work or where their customers reside.⁶³

⁵⁷ See Rifat Azam, *E-Commerce Taxation and Cyberspace Law: The Integrative Adaptation Model*, 12 VA. J.L. & TECH. 5, 11–16 (2007).

⁵⁸ See Rifat Azam, *Global Taxation of Cross-Border E-Commerce Income*, 31 VA. TAX REV. 639, 652 (2012) [hereinafter Azam *Cross-Border*].

⁵⁹ Sawyer, *supra* note 9, at 91.

⁶⁰ See Aldo Forgiione, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE U. L. REV. 719, 726–27 (2003) (stating that “[t]he application of static residency rules for tax purposes is increasingly difficult in a digital economy” and “[s]o as long as tax authorities place great emphasis on the residency of the taxpayer, there will be a gradual diminution of the tax base of many industrialized countries and the loss of significant tax revenues.”).

⁶¹ See DEFERRAL OF INCOME, *supra* note 15, at 76.

⁶² See *id.*

⁶³ See *id.*

1. Use of Foreign Corporations to Defer Federal Corporate Income Tax

U.S. multinationals often conduct their foreign business through foreign corporations, and these foreign earnings are generally not subject to U.S. tax.⁶⁴ Therefore, it would appear that a U.S. multinational can legally reduce its tax liability by acquiring or forming a foreign corporation in a low-tax jurisdiction and benefit from the deferral of U.S. income taxes on business income earned in that jurisdiction.⁶⁵ However, when such a foreign corporation is a “controlled foreign corporation” (CFC)⁶⁶ that is subject to the subpart F rules, deferral may not be achieved.⁶⁷

The subpart F regime introduced in 1962 attempts to capture some income earned in low-tax jurisdictions by deeming it distributed to certain of its U.S. owners,⁶⁸ but the regime does not necessarily address certain active businesses in such jurisdictions.⁶⁹ The subpart F provisions are difficult to apply to e-commerce businesses due to the remote supply of services and difficulty in assigning a “place of performance” and “place of use, consumption, or disposition” with respect to digital goods and services.⁷⁰ Subpart F also focuses on passive income thought to be easily moveable across jurisdictions but generally does not address active trade or business income.⁷¹ E-commerce companies have trade or business income, which can easily be earned in any jurisdiction in a way that once was considered only possible with passive income.⁷² Therefore, the current subpart F regime does not

⁶⁴ See *id.* at ix.

⁶⁵ This does not include income subject to U.S. taxation under subpart F, which focuses mostly on passive income earned by a controlled foreign corporation, but also encompasses certain foreign based sales income. See *id.* at 14, 77.

⁶⁶ A controlled foreign corporation is a foreign corporation in which 50% or greater of the vote or value of that foreign corporation is owned by U.S. shareholders. I.R.C. § 957 (West 2012). A U.S. shareholder of a foreign corporation is defined as a U.S. person who owns 10% or more of the total voting power of the foreign corporation. I.R.C. § 951(b) (West 2013).

⁶⁷ See DEFERRAL OF INCOME, *supra* note 15, at vii.

⁶⁸ See I.R.C. §§ 951–965 (West 2013).

⁶⁹ See DEFERRAL OF INCOME, *supra* note 15, at 73.

⁷⁰ See *id.* at 76.

⁷¹ Subpart F does not generally address active trade or business income, mostly focusing on passive income such as rent, royalties, and interest, but subpart F does cover active insurance and financing income. See I.R.C. § 954 (West 2013).

⁷² See DEFERRAL OF INCOME, *supra* note 15, at 76.

address the issues raised by e-commerce companies' use of low-tax jurisdictions in their active trade or business.

An e-commerce company could form CFCs in a low-tax jurisdiction and then relocate software development activities to that jurisdiction.⁷³ If that relocation is effective,⁷⁴ income from sales of the software by the CFC to third party customers generally will not be currently taxable by the U.S. Government.⁷⁵ Alternatively, a CFC could purchase software from its U.S. parent and "add substantial value to the software" such that the sale of software creates royalty income to the CFC that is not subject to subpart F rules.⁷⁶ If instead the CFC licensed the U.S.-developed software to customers without adding substantial value, then the licensing revenue generally would be subject to U.S. federal income tax under the subpart F rules.⁷⁷

2. Other E-commerce Strategies to Decrease U.S. Income Tax

A group of e-commerce companies can use the "check-the-box"⁷⁸ rules to create favorable corporate tax structures. The check-the-box rules allow certain entities to elect their classification as a taxable corporation or a disregarded entity for U.S. federal income tax purposes.⁷⁹ A foreign corporation electing treatment as a disregarded entity is considered a hybrid entity, viewed as a corporation for local (foreign country) purposes, but a disregarded entity for U.S. federal income tax purposes.⁸⁰ For example, assume a Cayman Islands subsidiary of a U.S. corporation forms a U.K. company that elects treatment as a disregarded entity. For U.S. income tax purposes, the U.K. entity is not treated as separate from its Cayman Island parent, so the U.K. entity's income is deemed earned by its Cayman Island

⁷³ See *id.* at 77.

⁷⁴ Intangibles transferred from a U.S. company to a foreign corporation may be treated as a deemed royalty, taxable to the U.S. company. See I.R.C. § 367(d) (West 2013).

⁷⁵ See DEFERRAL OF INCOME, *supra* note 15, at 77. However, there are situations where "regular and continuous sales of the software into the United States by the CFC would...create a U.S. trade or business," but these situations may be avoided by taking certain measures, such as advertising "solely on the Web" or delivering products to U.S. customers digitally. *Id.* at 78.

⁷⁶ See *id.* at 78 (citing Treas. Reg. § 1.954-2(d)(1)(i)).

⁷⁷ See Treas. Reg. § 1.954-2(d)(3).

⁷⁸ DEFERRAL OF INCOME, *supra* note 15, at 68 (citing Treas. Reg. §§ 301.7701-1 -3 (West 2013)) (allowing many entities to elect to be treated as associations taxable as corporations, partnerships, or disregarded entities (i.e., branches)).

⁷⁹ Treas. Reg. § 301.7701-3 (West 2013).

⁸⁰ See DEFERRAL OF INCOME, *supra* note 15, at 62, 68.

parent in the Cayman Islands, a lower tax jurisdiction than the U.K.⁸¹ However, the United Kingdom views the U.K. subsidiary as a corporation subject to U.K. taxes. If the U.K. entity pays a royalty to the Cayman Island parent, the U.K. entity reduces its taxable base for U.K. income tax purposes, but the United States disregards this payment. Therefore, the royalty payment reduces U.K. income tax liability but the royalty income remains in the low-tax jurisdiction.

E-commerce companies can also use transfer pricing to create favorable corporate tax structures. Transfer pricing involves setting prices for intercompany transactions such as sales of goods or services between a U.S. parent corporation and its foreign subsidiaries, and the transfer pricing rules require that such transfers are at terms that would govern such a transfer between unrelated parties.⁸² Absent transfer pricing rules, multinationals engaged in e-commerce could freely shift intellectual property (IP) and the income it generates to low-tax jurisdictions through transfer pricing and cost sharing arrangements.⁸³ The transfer pricing rules that specifically concern transferring IP require that IP development costs be shared based on specific cost sharing rules.⁸⁴ Even with the transfer pricing and cost sharing rules, U.S. multinational corporations engaged in e-commerce can still shift IP and associated income to lower income tax jurisdictions, and benefit from lower taxes.⁸⁵

E-commerce companies also use various loan structures in connection with low-tax jurisdictions to reduce their U.S. (and foreign) income tax liability.⁸⁶ These loan structures involve third party and intercompany loans in combination with an entity structure that incorporates disregarded foreign entities and CFCs or back-to-back loans with multiple CFCs.⁸⁷ For example, a U.S. parent corporation may deduct interest paid to its foreign subsidiary,

⁸¹ Treas. Reg. § 301.7701-3 (West 2013).

⁸² See I.R.C. § 482 (West 2013).

⁸³ See Azam *Cross-Border*, *supra* note 58, at 655 (stating that transfer pricing “strategies are available to all kind of businesses but they are much more available and valuable to e-commerce businesses.”).

⁸⁴ CYM H. LOWELL AND PETER L. BRIGER, US INTERNATIONAL TRANSFER PRICING ¶ 5.08 (1999), available at Westlaw 257470; see Treas. Reg. § 1.482-7 (West 2013).

⁸⁵ See Sawyer, *supra* note 9, at 91.

⁸⁶ See generally Amy S. Elliot & Marie Sapire, *Senator Calls Out Microsoft, Hewlett-Packard for Offshore Tax Practices*, TAX NOTES TODAY 184-1 (Sept. 21, 2012).

⁸⁷ See *id.* (explaining that the HP loans were structured as a series of back-to-back loans from multiple CFCs).

thereby reducing the parent's U.S. taxable income.⁸⁸ Assume the foreign subsidiary, the recipient of the interest income, is a hybrid entity formed in a low-tax jurisdiction and owned by a foreign member of the U.S. parent's group structure. The interest income may be subject to low or no tax locally, and if its owner earns sufficient active income, the interest income may not be currently taxable to the U.S. parent under the subpart F rules.⁸⁹

F. *Potential Harm and Economic Considerations of E-commerce Businesses' Use of Low-Tax Jurisdictions*

U.S. multinationals' pre-tax worldwide income earned abroad increased from "37.1 percent in 1996 to 51.1 percent in 2004."⁹⁰ This increased percentage appears to be due mostly to a shift in profits rather than a change in sales location.⁹¹ With the unique mobility of e-commerce companies, the shift of income to low-tax jurisdictions accomplishes a lower worldwide effective tax rate for these companies.⁹² As multinational corporations save approximately \$30 to \$60 billion annually through low-tax jurisdictions,⁹³ and with the substantial growth in revenues attributable to e-commerce⁹⁴ ("global e-commerce turnover is expected to grow to up to \$963 billion USD in

⁸⁸ See I.R.C. § 267 (West 2013). With the introduction of the "anti-hopscotch rule" to prevent abuse, these loan structures are less likely to allow companies to avoid taxation. See I.R.C. § 960(c) (West 2013).

⁸⁹ When income earned by the CFC is solely due to a loan to the U.S. parent corporation, the income would be considered subpart F income and included in the U.S. parent's income. See I.R.C. § 956 (West 2012). However, certain hybrid entity structures allow a U.S. parent to shift income to low-tax jurisdictions through loan arrangements. DEFERRAL OF INCOME, *supra* note 15, at xv, 51.

⁹⁰ Grubert, *supra* note 28, at 1 (citing data from a sample of 754 U.S. multinationals' income tax filings).

⁹¹ *Id.* at 2.

⁹² See *id.* at 9.

⁹³ See *Hearing on International Tax Reform*, *supra* note 4, at 5.

⁹⁴ For example, in 2008, "online retail sales in the United States alone reached \$133.6 billion, up from overall sales of \$22 billion in 1998." Oleksandr Pastukhov, *Going Where No Taxman Has Gone Before: Preliminary Conclusions and Recommendations Drawn from A Decade of Debate on the International Taxation of E-Commerce*, 36 RUTGERS COMPUTER & TECH. L.J. 1 (2009) [hereinafter Pastukhov *Preliminary Conclusions*].

2013,")⁹⁵ the importance in examining e-commerce companies' use of low-tax jurisdictions is heightened.⁹⁶

1. Potential Harm and Economic Issues

The use of low-tax jurisdictions by e-commerce businesses has various negative impacts⁹⁷ including the government's "reduced tax base with which to draw expenditures."⁹⁸ The shift of income to such jurisdictions leads to U.S. companies holding more assets abroad and employing more personnel in such jurisdictions than would otherwise be expected based on the relative sizes of their economies.⁹⁹ The shift of revenue loss from the United States may impair efficiency and decrease public funds available for public goods and services for U.S. residents.¹⁰⁰ With mobile profits and sales,¹⁰¹ especially in e-commerce businesses and businesses with intangible assets,¹⁰² companies may provide goods and services to U.S. customers while using public U.S. resources, and potentially pay little or no corresponding U.S. income tax.

⁹⁵ Azam *Cross-Border*, *supra* note 58, at 639 (referencing BlueMind, E-Commerce Market (slide presentation), available at <http://www.bluemind.nl/wp-content/uploads/2011/02/Report-e-commerce-market.pdf> (last visited Mar. 3, 2012)).

⁹⁶ It is difficult to quantify the amount of revenue lost to tax avoidance and e-commerce companies' use of low-tax jurisdictions. However, United States tax avoidance was estimated to cost the Federal Government billions of dollars in lost tax revenue each year during the 1990s. Zoe Prebble & John Prebble, *The Morality of Tax Avoidance*, 43 CREIGHTON L. REV. 693, 725 (2010); Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77 (2006).

⁹⁷ See Miguel González Marcos, *Seclusion in (Fiscal) Paradise Is Not an Option: The OECD Harmful Tax Practices Initiative and Offshore Financial Centers*, 24 N.Y. INT'L L. REV. 1, 30–31 (2011) (listing impacts such as "increasing the risk premium in international financial markets; undermining the operation of the tax system and public finances in non-tax-haven jurisdictions; increasing the inequitable distribution of tax revenues; reducing the efficiency of resource allocation in developing countries, making economic crimes more profitable, encouraging rent-seeking and reducing private incomes in developing countries; and damaging institutional quality and growth in developing countries.").

⁹⁸ Blair Downey, *E-Commerce: The Taxman's Nemesis*, 2 ASPER REV. INT'L BUS. & TRADE L. 53, 57 (2002).

⁹⁹ See Hines, *supra* note 18, at 2.

¹⁰⁰ See Oleksandr Pastukhov, *International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions*, 12 B.U. J. SCI. & TECH. L. 310, 316 (2006) [hereinafter Pastukhov *Current Problems*].

¹⁰¹ Grubert, *supra* note 28, at 11.

¹⁰² *Id.* at 21.

U.S. taxation of U.S. multinationals engaged in e-commerce challenges economic tax principles such as “equity (or fairness), certainty, convenience, economy in operation (efficiency), and neutrality.”¹⁰³ For example, tax neutrality involves “setting tax policy that neither favors nor disfavors a particular form of business activity or method for concluding a transaction.”¹⁰⁴ The goal of tax neutrality is undermined when e-commerce companies shift operations and income to low-tax jurisdictions solely for tax reasons.¹⁰⁵

An ideal international income tax system would allocate “income fairly among the jurisdictions in which the people who possess that income, whether businesses or individuals, enjoy the services provided by those jurisdictions.”¹⁰⁶ To implement that system, “everyone has to agree on what constitutes income, when to tax it, and how to coordinate those issues on an international basis.”¹⁰⁷ The ideal international tax system is not achievable when e-commerce companies enjoy services provided by the U.S. Government, especially when transacting with U.S. customers, but use low-tax jurisdictions to legally avoid U.S. tax on that income. “What constitutes income, when to tax and it, and how to coordinate”¹⁰⁸ taxation of e-commerce companies requires a further in-depth examination than that presented here, and should be considered in evaluating proposed tax reforms.

2. Possible Benefits of Low-Tax Jurisdictions

Although low-tax jurisdictions have detrimental effects by encouraging e-commerce companies to shift operations and earnings offshore, they have enabled U.S. multinationals to better compete internationally,¹⁰⁹ so the national economic benefits that may flow from their use also should be considered in any tax reform discussions. Low-tax jurisdictions may increase capital formation and employment in high-tax jurisdictions, such as the United

¹⁰³ See Sawyer, *supra* note 9, at 83.

¹⁰⁴ *Id.* at 84.

¹⁰⁵ See *id.*

¹⁰⁶ Peter Cobb, *Taxing E-Commerce: The Landscape of Internet Taxation*, 21 U. PA. J. INT'L ECON. L. 659, 664 (2000).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ See Michael Littlewood, *Tax Competition: Harmful to Whom?*, 26 MICH. J. INT'L L. 411, 455 (2004) (explaining that U.S. companies would be at a competitive disadvantage if other countries' companies could use tax havens but U.S. companies could not).

States, which could offset some of the revenue losses.¹¹⁰ Economic benefits of low-tax jurisdictions are not confined to helping U.S. multinationals' competitiveness because from a global perspective because low-tax jurisdictions also encourage investment within such jurisdictions and may encourage investment in nearby countries.¹¹¹

Despite the possible benefits of low-tax jurisdictions, any benefits from their use by e-commerce companies are outweighed by the economic costs. Low-tax jurisdictions can distort business decisions by attracting business for tax reasons; they also create inefficiency.¹¹² The "inefficient allocation of worldwide resources"¹¹³ results when a business chooses its location based solely on tax reasons. For example, assume under economic principles that it would be more efficient to allocate resources to Country A rather than Country B.¹¹⁴ Country A has a 20% tax rate but Country B reduces its tax rate to 5%, so a company decides to locate in Country B, allocating resources to Country B that would not otherwise be allocated without the low tax rate in Country B.¹¹⁵ To compete with the low tax incentives, other taxing jurisdictions may react by reducing tax rates and in effect contribute to a "race to the bottom" in tax rates.¹¹⁶ Although this paper suggests that the United States should lower its corporate tax rate, continual lowering of tax rates by competing taxing jurisdictions will not provide a lasting global solution.¹¹⁷

¹¹⁰ Marcos, *supra* note 97, at 30–31 (listing two sources that examine low-tax jurisdictions' benefits: "Mihir A. Desari et al., *The Demand for Tax Haven Operations*, 90 J. PUB. ECON. 219, 224 (2006) (concluding that "[t]he evidence indicates that American multinational firms establish operations in tax haven countries as part of their international tax avoidance strategies"); *see also* Esther C. Suss et al., *Caribbean Offshore Financial Centers: Past, Present, and Possibilities for the Future*, 7 (Int'l Monetary Fund Research, Working Paper WP/02/88, 2002) (describing the economic benefits gained from the creation of employment in offshore financial centers).

¹¹¹ *See* Hines, *supra* note 18, at 4.

¹¹² Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 940 (2010).

¹¹³ *Id.* at 939.

¹¹⁴ Adapted from an example provided in *id.* at 951–52.

¹¹⁵ *Id.*

¹¹⁶ *Cf.* Mitchell B. Weiss, *International Tax Competition: An Efficient or Inefficient Phenomenon?*, 16 AKRON TAX J. 99, 128 (2001) (finding that tax competition allows taxing jurisdictions to reach the appropriate level of tax that matches the value of "public goods and services that are received" by the tax-paying entity).

¹¹⁷ *See* Timothy V. Addison, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOBAL LEGAL STUD. 703, 709 (2009) (stating that when a jurisdiction reacts by lowering its tax rate, this will unlikely benefit industrialized jurisdictions despite some who believe that this signals an increase in public demand to eliminate wasteful government spending).

G. *Attempts to Resolve the Problems and Proposed Solutions*

Recent attempts to curb tax abuses that contribute to economic inefficiency do not adequately address the legal use of low-tax jurisdictions by e-commerce companies. Although FATCA and the proposed Stop Tax Haven Abuse Act address the potential abuse from using low-tax jurisdictions, these initiatives do not adequately address the detriment to the U.S. tax base in the e-commerce context because the Acts are mostly aimed at addressing illegal tax evasion, using information requirements, and not the legal use of such jurisdictions.¹¹⁸ Focusing on information reporting will not be effective. Rather, the U.S. Government should lower the U.S. corporate income tax rate and consider charging an electronic transaction tax to alleviate issues presented by e-commerce businesses' legal use of low-tax jurisdictions.

1. Recent Attempts to Address the Issue: FATCA, the Proposed Stop Tax Haven Abuse Act, and Proposed CUT Loopholes Act

The United States “seeks to improve detection and further discourage tax evasion by implementing a new reporting and withholding system” through FATCA.¹¹⁹ FATCA’s reporting requirements are aimed at collecting information to ensure that Americans, including U.S. corporations, properly report income.¹²⁰ Because FATCA focuses on exposing hidden offshore bank accounts through disclosure rules, it does not affect U.S. multinational companies engaged in e-commerce that have shifted operations or profits offshore and are not engaged in tax evasion. FATCA applies to more passive investments¹²¹ but it does not address the situation where e-commerce companies choose to relocate operations or legally shift profits overseas because of the relatively high corporate tax rate in the United States. For example, FATCA applies to “withholdable payments” such as U.S.-source

¹¹⁸ For example, these Acts are aimed more at tax evasion such as the “scandal [that] led the United States to act against the United Bank of Switzerland (UBS), the second largest bank in Europe, for conspiring to defraud the United States by helping U.S. customers conceal their ownership of, or beneficial interest in, income and assets held through offshore accounts in Switzerland and other jurisdictions.” Itai Grinberg, *supra* note 48, at 7.

¹¹⁹ Melissa A. Dizdarevic, *The FATCA Provisions of the Hire Act: Boldly Going Where No Withholding Has Gone Before*, 79 *FORDHAM L. REV.* 2967, 2969 (2011).

¹²⁰ *See generally* I.R.C. § 1471 (West 2013).

¹²¹ *See generally* I.R.C. §§ 1471–1473 (West 2013).

dividends and interest but does not apply to business income earned by foreign corporations held by U.S. multinationals.¹²² Consequently, FATCA does not address the situation where e-commerce companies locate servers and operations overseas to avoid U.S. federal corporate income tax.

The proposed Stop Tax Haven Abuse Act, “which invokes the use of a presumption strategy to remedy the lack of information problem, will most likely fall short of successful regulation.”¹²³ The proposed Act would not necessarily capture preferential tax regimes that do not fall under the Act’s definition of “tax haven” and even if a jurisdiction does fall within the definition of “tax haven,” the proposed Act would not discourage e-commerce companies from shifting operations to low-tax jurisdictions.¹²⁴ It is likely the proposed Act would not adequately address this truly international issue because of the lack of effectiveness the proposed Act would have over e-commerce companies.¹²⁵ For example, the proposed Act’s presumption strategy will not affect U.S. multinationals engaged in e-commerce where it is already clear that a U.S. corporation controls a foreign corporation in a low-tax jurisdiction and the group of corporations meets tax reporting obligations. The presumption would not incentivize e-commerce companies to retain operations in the United States, but could in fact encourage these companies to shift even more operations offshore to avoid any burdensome compliance requirements the Act may impose, such as new rules on information reporting.¹²⁶

Even if the proposed Act assisted in closing “current loopholes for trusts and shell corporations,”¹²⁷ the proposed Act would not prevent e-commerce companies from shifting operations offshore. The Senate’s Permanent Subcommittee on Investigations 2006 report, which was cited by senators introducing the proposed Act, examines case studies involving low-tax jurisdictions, but none of the six case histories considers how an e-commerce corporation shifts profits and operations overseas.¹²⁸ Similarly, the proposed

¹²² See I.R.C. § 1473 (West 2013).

¹²³ Leikvang, *supra* note 54, at 293.

¹²⁴ See Anthony D. Toder, *The Stop Tax Haven Abuse Act: A Unilateral Solution to a Multinational Problem*, 19 MINN. J. INT’L L. 241, 266 (2010).

¹²⁵ See Leikvang, *supra* note 54, at 325.

¹²⁶ See Rosenzweig, *supra* note 112, at 983–84. Increasing tax competition would mean that taxing jurisdictions would have a greater incentive to become low-tax jurisdictions to attract investment.

¹²⁷ Leikvang, *supra* note 54, at 341.

¹²⁸ See STAFF OF S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 109TH CONG., REP. ON TAX HAVEN ABUSES: THE ENABLERS,

CUT Loopholes Act, which is primarily based on the Stop Tax Haven Abuse Act and employs the same general strategies,¹²⁹ would not effectively address e-commerce companies' legal use of such jurisdictions. The two proposed Acts' ineffectiveness in addressing e-commerce companies that use such jurisdictions to substantially reduce their U.S. taxes suggests that other approaches are needed to address the e-commerce taxation issue.

2. Potential Solutions: Federal Corporate Income Tax Rate Reduction; Electronic Transaction Tax

Although this paper primarily focuses on steps the U.S. Government could take, a global solution will best address the international problem of e-commerce taxation.¹³⁰ An integrated global solution could address e-commerce across all taxing jurisdictions to accomplish economic goals of tax efficiency and neutrality. Because a global solution will take time to design and implement and will require significant coordination efforts, the U.S. Government should take steps to encourage e-commerce companies to keep operations and earnings in the United States and change its e-commerce taxation approach.

There are several possible suggested reforms for the taxation of e-commerce companies¹³¹ beyond the potential solutions addressed here. For example, one suggestion is that "governments should abandon the treaty concept of permanent establishment and adopt international tax reforms that restore the primacy of 'market country' taxation of multinational business profits promoted by domestic tax laws."¹³² This reform could address e-commerce issues "that demonstrate the tension of introducing traditional tax norms to a digital environment."¹³³ However, this reform continues to focus on income tax rules that may be ineffective in taxing income earned by e-

THE TOOLS AND SECRECY 2-3 (Comm. Print 2006). The report presents six case studies which demonstrate the use of "phony loans, billing schemes, [and] offshore credit cards," and mostly examines how individuals hide wealth in tax havens.

¹²⁹ CUT Loopholes Act Press Release, *supra* note 56.

¹³⁰ "Since decisions to tax e-commerce have international tax law implications, effective solutions must be internationally coordinated." Pastukhov *Preliminary Conclusions*, *supra* note 94, at 7.

¹³¹ See Forgione, *supra* note 60, at 721-22; JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 24-29 (2013).

¹³² Forgione, *supra* note 60, at 721-22.

¹³³ *Id.*

commerce companies in low-tax jurisdictions. Another suggested reform would repeal deferral of foreign source income,¹³⁴ but there are concerns “that firms could avoid the effects of repeal by having their parent incorporate in other countries that continue to allow deferral.”¹³⁵ Alternatively, this paper focuses on a combined solution for the taxation of e-commerce companies: a lowered tax rate and an electronic transaction tax.

a. Lower the Federal Corporate Income Tax Rate

Tax neutrality, more specifically capital export neutrality, means taxes do not factor into investment decisions.¹³⁶ Tax neutrality is hampered when low-tax jurisdictions attract investment with low tax rates and enable e-commerce companies to operate with nearly the same degree of efficiency as if they were located in the United States.¹³⁷ The U.S. Government should lower the U.S. corporate income tax rate to lessen that incentive.¹³⁸ Lowering the U.S. corporate income tax rate could assist in maintaining the competitiveness of U.S. multinationals engaged in e-commerce and keep both e-commerce and other companies within the United States.¹³⁹ Reducing the corporate income tax rate will also make the system more efficient because U.S. multinationals will spend fewer resources on shifting operations and income to legally avoid

¹³⁴ See GRAVELLE, *supra* note 131, at 24.

¹³⁵ *See id.*

¹³⁶ See DEFERRAL OF INCOME, *supra* note 15, at 23.

¹³⁷ *See id.* at 22.

¹³⁸ See Eric Toder, *International Competitiveness: Who Competes Against Whom and for What?*, 65 TAX L. REV. 505, 515, 520, 527 (2012) (acknowledging that “profits of multinational corporations represent a potential source of tax revenues that countries may compete for” and “lowering the marginal effective tax rate on corporate income would by itself help the United States in the competition for scarce capital resources.”).

¹³⁹ See Duanjie Chen & Jack Mintz, *Corporate Tax Competitiveness Rankings for 2012*, CATO Institute Tax & Budget Bulletin No. 65 (Sept. 20, 2012), available at http://www.cato.org/pubs/tbb/tbb_65.pdf; Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771, 788 (2010) (stating the “United States can unilaterally improve its competitiveness by reducing its corporate income tax rate.”); THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 200 (2005), available at http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf [hereinafter *President’s Advisory Panel*].

tax due to the reduced tax disparity between low-tax jurisdictions and the United States.¹⁴⁰

Although the exact tax rate that the U.S. Government should impose is not examined here, the successful Canadian corporate tax rate decrease to 15% from 29.12% provides an example.¹⁴¹ Canada's tax rate reduction spurred investment and economic growth in Canada without reducing tax revenues collected by the Canadian Government.¹⁴² Similarly, reducing the U.S. corporate income tax rate will put U.S. corporations at an advantage relative to foreign competitors.¹⁴³ Although Canada's tax rate reduction may serve as a model, the U.S. Government will need to evaluate the appropriate tax rate, which may be higher or lower than 15%, to align the tax rate with the services and resources provided to corporate taxpayers.

Reducing the corporate income tax rate in the United States can "boost domestic investment and spur inflows of foreign investment."¹⁴⁴ A lower corporate tax rate may actually generate tax revenue with this increase in investment.¹⁴⁵ The current noncompetitive U.S. corporate income tax rate harms economic growth because it results in "relatively low government revenues because...businesses...shift their investments and profits abroad."¹⁴⁶ Instead, "aligning a nation's corporate tax base with the international average rate or less helps protect the tax base" because businesses are less likely to shift investments and profits abroad.¹⁴⁷

¹⁴⁰ There will still be tax disparity between low-tax jurisdictions even if the tax rate is lowered to 20%, leaving incentives for companies to "migrate" intangible property to low-tax jurisdictions. See Michael F. Patton, *Transfer Pricing and Other Key Issues in Today's Tax Litigation Cases*, 2011 WL 2941007. However, with proposed legislation, a new category of subpart F income of "low-taxed income" would include intangible property income to address the erosion of the U.S. tax base with respect to intellectual property companies. See S. 2091, 112th Cong. § 201 (2012).

¹⁴¹ See Stephanie Soong Johnston, *Corporate Tax Cut Required for Global Competitiveness*, *CATO says*, TAX NOTES TODAY 184-9 (Sept. 21, 2012); Chen & Mintz, *supra* note 139 (finding that Canadian tax reforms, including reducing the tax rate to 15%, created a more competitive and neutral tax system, spurred growth, and encouraged multinationals to shift more profits into Canada).

¹⁴² Chen & Mintz, *supra* note 139.

¹⁴³ See Knoll, *supra* note 139, at 788 (finding that there is "good reason to believe that the U.S. corporate income tax discourages production" in the United States).

¹⁴⁴ Chen & Mintz, *supra* note 139.

¹⁴⁵ See Toder, *supra* note 138, at 530 (stating that "the lower corporate rate, with no corporate base-broadening, would encourage both U.S. and foreign resident multinationals to invest more in the United States and report a larger share of their profits to the U.S. Treasury.").

¹⁴⁶ Chen & Mintz, *supra* note 139.

¹⁴⁷ *Id.*

Although lowering the corporate tax rate could put the United States as a competitor in the “race to the bottom in the world on corporate tax rates,”¹⁴⁸ the United States is currently lagging in attracting and retaining U.S. multinationals in large part due to its high corporate income tax rates.¹⁴⁹ Therefore, as a first step, the U.S. Government should lower the corporate income tax rate to incentivize e-commerce companies to remain in the United States, but a long term solution requires a holistic global approach for ensuring the collection of tax on e-commerce.¹⁵⁰ As a step towards the global solution, tax reform discussions should include consideration of an electronic transaction tax to address the loss of tax revenue from e-commerce companies that shift operations and profits offshore for tax reasons.

b. Electronic Transaction Tax

A global electronic transaction tax could be, economically, the most efficient approach to taxing electronic transactions. Prior to global application, the United States could implement the tax only to the extent the e-commerce customer is a U.S. person. Although on an economic basis the tax may be fair and effective in meeting the principles of tax neutrality, implementing an electronic transaction tax requires addressing a large number of issues.¹⁵¹ To begin with, the tax’s similarity to a value added tax (VAT) will face political challenges given that the United States has consistently rejected implementing a VAT.¹⁵² That initial political hurdle would be exacerbated by the challenges in determining the tax implementation and collection details.

Initially, this tax would apply only to electronic transactions giving rise to e-commerce income; other types of income would continue to be taxed

¹⁴⁸ Elliot & Sapire, *supra* note 86. See Pastukhov *Current Problems*, *supra* note 100, at 323–24. Cf. Weiss, *supra* note 116, at 128.

¹⁴⁹ See Elliot & Sapire, *supra* note 86.

¹⁵⁰ See Azam *Cross-Border*, *supra* note 58, at 663 (stating that “[t]o overcome the challenges posed by global e-commerce taxation and in order to levy “good tax” on global e-commerce income, supranational taxation is needed.”).

¹⁵¹ Currently, the Internet Tax Freedom Act places a moratorium on “Internet access taxes and multiple and discriminatory taxes on electronic commerce.” Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1024 (2007). Therefore, the proposal for an electronic transaction tax would have to be considered within the framework of this Act or after the moratorium expires.

¹⁵² Cobb, *supra* note 106, at 663.

under existing rules.¹⁵³ To prevent penalizing e-commerce revenue as compared with other types of business income, there are two options. First, a tax credit system could allow e-commerce companies to credit the electronic transaction tax against any other U.S. income taxes that the company would otherwise pay based on the existing income tax rules. The e-commerce company could receive a credit to offset income tax payable and could carry the credit forward similar to the foreign tax credit regime.¹⁵⁴ However, the history of the foreign tax credit system and taxpayer dissatisfaction with complex tax credit rules shows the difficulties of implementing a new crediting system.¹⁵⁵ Alternatively, the electronic transaction tax could ultimately be designed as a VAT that also applies to non e-commerce goods and services.

Most countries impose VAT on e-commerce transactions.¹⁵⁶ The European Union imposes VAT on sales of digital products to EU customers, so “an American company selling digital products to EU customers must now register and collect EU VAT.”¹⁵⁷ The United States should consider the effectiveness and fairness, and the strengths and weakness of the European model for taxing digital sales to customers when designing the details of the electronic transaction tax.

Other countries, such as Australia and Canada, have coordinated federal and sub-federal (state or provincial) level taxes by either apportioning federal VAT among states or by implementing a “uniform provincial surcharge.”¹⁵⁸ If the U.S. Government attempted to set tax rates for individual states, this would undermine state autonomy and would not be a politically viable system in the United States.¹⁵⁹ Given this political reality, the U.S. Government should not implement these models in their entirety but should carefully consider the merits of certain aspects of the Australian and Canadian systems.

An electronic transaction tax would allow the U.S. Government to collect tax on e-commerce transactions regardless of the location of the company's headquarters, operations, management, or bank account. Therefore, an

¹⁵³ See Azam *Cross-Border*, *supra* note 58, at 662–70 (describing a global e-commerce tax and distinguishing between e-commerce income and non-e-commerce income).

¹⁵⁴ See I.R.C. § 901 (West 2013).

¹⁵⁵ See Wells, *supra* note 47, at 34.

¹⁵⁶ HARDESTY, *supra* note 14, at ¶ 11A.01.

¹⁵⁷ *Id.* at ¶ 1.02.

¹⁵⁸ Charles E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax*, 63 TAX L. REV. 639, 645 (2010).

¹⁵⁹ This system removes “state autonomy over rates” and would be politically unacceptable. *Id.*

electronic transaction tax should meet the goal of tax neutrality because it should not cause an e-commerce company to discriminate between locating in the United States or elsewhere for transacting with U.S. customers. Although e-commerce companies that choose to locate in a foreign jurisdiction would use less U.S. public resources and still remit tax on electronic transactions, the U.S. Government will not prefer that an e-commerce company locates off shore. The U.S. Government would continue to encourage e-commerce companies to locate in the United States to receive other benefits flowing from e-commerce companies such as the collection of payroll taxes. When designing the details of the electronic transaction tax and encouraging e-commerce businesses to remain in the United States, the U.S. Government will need to consider all the potential taxes e-commerce companies may pay and the benefits the businesses receive by locating in the United States as compared to low-tax jurisdictions.

Difficulties that will arise in this new system include defining “U.S. customer” and “electronic commerce companies” and determining which types of transactions would be subject to the tax. Additional considerations would include the tax rate and the calculation of the tax base, how the tax would be collected, and how to ensure compliance. The U.S. Government should also consider whether coordination between the federal electronic transaction tax and existing state sales tax would be possible.¹⁶⁰

The imposition of an electronic transaction tax on all e-commerce companies may discourage certain companies from providing electronic goods and services to U.S. customers, so the compliance requirements and effective tax rate must be calibrated carefully so that U.S. customers can continue to access goods and services from competing e-commerce businesses. Even though some companies could be dissuaded from supplying goods and services to U.S. customers on account of an electronic transaction tax, it is unlikely that many would pursue this course given the highly attractive U.S. consumer market.¹⁶¹

¹⁶⁰ In Canada, the provincial retail sales tax has been able to “coexist with a federal VAT, even if there is no federal/provincial coordination.” *Id.* at 643.

¹⁶¹ See Adis Maria Vila, *The Role of States in Attracting Foreign Direct Investment: A Case Study of Florida, South Carolina, Indiana, and Pennsylvania*, 16 L. & BUS. REV. AM. 259, 261 (2010) (citing various sources to support the proposition that the United States offers infrastructure, political stability, and economic stability that attracts foreign direct investment, and explaining that the U.S. consumer market consists of more than 300 million people, accounting for 42% of the global consumer goods market).

An electronic transaction tax on transactions between e-commerce companies and U.S. customers would allow the U.S. Government to collect a percent of the sales price just as businesses in U.S. states collect sales tax.¹⁶² The U.S. Government could structure the electronic transaction tax similar to a sales tax or VAT.¹⁶³ The key distinction between a sales tax and VAT is that unlike a sales tax that only applies on the sale to the final consumer, VAT is imposed on each sale in the process of selling the final product or service to a customer.¹⁶⁴ The electronic transaction tax could act as a sales tax in that it would only apply on the sale to the final customer. The electronic transaction tax could be based on the destination and recipient of goods or services, in a manner similar to that in which VAT is imposed, so that providers of goods and services are indifferent to their locations for the purposes of the electronic transaction tax.¹⁶⁵ Therefore, the electronic transaction tax could incorporate aspects of both state sales tax and VAT.

i. Rate of the Electronic Transaction Tax

Because the electronic transaction tax would be a tax on gross sales, rather than net income, the rate should be closer to a sales tax rate than an income tax rate. For example, the electronic transaction tax might be set at ten percent if the corporate income tax rate were lowered to 20%. Although the exact rate to charge is not proposed here, for simplicity the electronic transaction tax rate should be set at a single uniform rate.¹⁶⁶

ii. Defining “Electronic Transaction” and “U.S. Customer”

E-commerce may generally be defined as “a sequence of one or more related electronic transmissions that facilitate the purchase of and payment for

¹⁶² There have been proposals to “add a sales tax to the fiscal arena of the federal government” in either the form of a federal retail sales tax or a VAT. McLure, *supra* note 158, at 639.

¹⁶³ The VAT may be preferable to a federal sales tax because a VAT has “administrative advantages” and “political economy advantages.” *Id.* at 647–56 (2010). The President’s Advisory Panel on Federal Tax Reform has considered both a federal VAT and a National Retail Sales Tax to replace a portion of individual and corporate income taxes. *President’s Advisory Panel, supra* note 139, at 191–222.

¹⁶⁴ HARDESTY, *supra* note 14, at ¶ 11A.01.

¹⁶⁵ See Toder, *supra* note 138, at 530.

¹⁶⁶ *President’s Advisory Panel, supra* note 139, at 197.

goods and services between an originator and a recipient.”¹⁶⁷ For the purpose of the electronic transaction tax, an “electronic transaction” should be defined as any electronic purchase of goods and services by a U.S. customer.¹⁶⁸ The recipient should be defined specifically as a “U.S. customer” for the application of a domestic based electronic transaction tax. The recipient U.S. customer should be any person physically present¹⁶⁹ within the United States at the time the transaction occurs, and U.S. customer should only mean the final purchaser.¹⁷⁰ Although there will be instances where a U.S. person travels abroad and enters into an electronic transaction, thereby escaping the electronic transaction tax by not being physically present in the United States at the time of the transaction, a bright line rule of physical presence in the United States should be adopted for clarity.¹⁷¹ Physical presence of a customer in the United States may be determined by the Internet Protocol address of the purchaser, a United States billing address provided by the customer, or through other technological indications of location such as GPS technology.¹⁷²

¹⁶⁷ *Starpay.com, L.L.C. v. Visa Int’l Serv. Ass’n*, 514 F. Supp. 2d 883, 900 (N.D. Tex. 2007) (accepting this definition for payment card services purposes).

¹⁶⁸ Because the use of a credit card in a physical store would appear on the surface to be an “electronic transaction,” such transactions must be carved out.

¹⁶⁹ The physical presence of a customer is similar to the physical presence requirements that have been used to assess sales and use tax liability for sellers. For example, the Supreme Court upheld a physical-presence requirement for determining state nexus for sales and use tax liability of a marketing company. *Quill Corp. v. N. Dakota By & Through Heitkamp*, 504 U.S. 298, 317 (1992).

¹⁷⁰ For example, sales tax in the United States applies to the “consumer” who is the “ultimate user or purchaser.” Treas. Reg. § 1.164-3 (West 2013).

¹⁷¹ See *Quill Corp.*, 504 U.S. at 315 (acknowledging the “benefits of a clear rule” in establishing the “boundaries of legitimate state authority to impose a duty to collect sales and use taxes” and in reducing litigation over taxes).

¹⁷² For example, under the California sales sourcing regulations, customer location may be determined by the billing address of the taxpayer’s customer but the customer’s location may also be shown to be within or outside of the state based on customer contracts. CAL. CODE REGS. tit. 18, § 25136-2 (2012). Customer location technology may intrude on privacy rights, so a careful balance will need to be struck between customer location and privacy if GPS technology is used to locate customers. See Elise M. Simbro, *Disclosing Stored Communication Data to Fight Crime: The U.S. and EU Approaches to Balancing Competing Privacy and Security Interests*, 43 CORNELL INT’L L.J. 585, 590–91 (2010) (describing the privacy concerns with the technology in GPS enabled phones).

iii. Collecting the Electronic Transaction Tax

If an electronic transaction tax were imposed by the United States, then the e-commerce companies supplying electronic goods or services to U.S. customers would remit the tax to the U.S. Government. Foreign companies could use an agent in the United States to collect and remit the electronic transaction tax, similar to how a non-EU company may use a “tax compliance agent” to assist with VAT collection and remittance.¹⁷³ Alternatively, the U.S. Government could collect tax through an electronic system which would automatically collect a percent of the purchase price and transmit the tax to the U.S. Government if such technology and coordination were available.

If the electronic transaction tax is structured as a VAT, the compliance costs should not be as significant as compliance costs for income tax.¹⁷⁴ However, the potential burden placed on small e-commerce businesses in tax collection should be minimized so that these businesses can quickly and easily implement the new tax. For example, setting a threshold for gross receipts before the electronic transaction tax applies will reduce the burden on small, start-up businesses.¹⁷⁵ These small businesses should be defined so that larger companies could not circumvent the rules by breaking up into multiple smaller entities simply to fall under the small business threshold.¹⁷⁶

iv. Enforcement of the Electronic Transaction Tax

For physical goods sold via the Internet, taxing authorities often have the ability to audit companies’ compliance with tax payments through the trail of shipping records and customer invoices with addresses.¹⁷⁷ However, taxing

¹⁷³ HARDESTY, *supra* note 14, at ¶ 11A.03.

¹⁷⁴ See *President’s Advisory Panel*, *supra* note 139, at 201 (finding that “taxpayers’ compliance costs for the current income tax amount to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranges from 3 to 5 cents per dollar of tax receipts.”).

¹⁷⁵ A gross receipts threshold requirement for VAT registration is common and ranges from around \$10 thousand to \$115 thousand. McLure, *supra* note 158, at 681–82.

¹⁷⁶ Although a small company may avoid the electronic tax when gross receipts are below the registration threshold, this small advantage will be insignificant in comparison to the competitive advantages large corporations have over small corporations. For example, large corporations have a competitive advantage in “dealing with regulation.” The Honorable Laurence H. Silberman, *Will Lawyering Strangle Democratic Capitalism?: A Retrospective*, 21 HARV. J.L. & PUB. POL’Y 607, 610 (1998).

¹⁷⁷ See HARDESTY, *supra* note 14, at ¶ 6.06.

authorities find it more difficult to audit digital products and services that may not have the same trail of records.¹⁷⁸ Therefore, to enforce the electronic transaction tax, the U.S. Government would have to develop an electronic transaction tax monitoring system that securely traces payments made over the Internet in electronic transactions. This monitoring system would require design features that provide security for consumers' information and must contain strict privacy safeguards. Although an attempt to track every dollar spent in e-commerce may not seem practical,¹⁷⁹ advances in technology and improvements in sophistication of online monitoring systems may increase the practicability of tracking e-commerce purchases. The design features of such a system are beyond the scope of this article, and the U.S. Government should assess the feasibility of implementing such a system.

v. Comparison to State Taxes

In creating the electronic transaction tax, the U.S. Government should examine models adopted by states that face a similar challenge to maintain the state tax base with the proliferation of e-commerce.¹⁸⁰ One of the difficulties in state income tax collection is a company's requirement to assess whether it has nexus in the state and then determine the taxability of goods and services provided in that state.¹⁸¹ With the electronic transaction tax imposed at the federal level, the nexus test would be based on the customer's physical presence in the United States. The U.S. Government should consider how states have sourced digital sales to customers and examine the strengths and weaknesses in state systems when designing the details of the electronic transaction tax.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ See Quinn T. Ryan, *Beyond BATSA: Getting Serious About State Corporate Tax Reform*, 67 WASH. & LEE L. REV. 275, 302 (2010). States' loss of revenue due to sales over the Internet is estimated to be around \$12 billion in 2012. Donald Bruce et al., *State and Local Government Sales Tax Revenue Losses from Electronic Commerce* 7 (Apr. 13, 2009) (available at <http://cber.utk.edu/ecomm/ecom0409.pdf>).

¹⁸¹ HARDESTY, *supra* note 14, at ¶ 14.03.

vi. Global Tax

To build upon a domestic electronic transaction tax, a “global e-commerce tax on cross-border e-commerce income” could be used to fund global public goods and services, such as global communications infrastructure.¹⁸² Although a global e-commerce tax would encroach on the sovereignty of taxing jurisdictions, the use of low-tax jurisdictions by e-commerce companies also reduces other jurisdictions’ ability to collect tax on certain e-commerce income. By removing the income tax savings incentive offered by such jurisdictions, e-commerce businesses could decide where to locate operations and keep profits based on business, not solely on tax, considerations.

The details of a global e-commerce tax are not fully examined here, but some primary considerations in designing the tax would include defining the electronic products and services to which the tax would apply, the rate and base of the tax, who collects and pays the tax, and who would manage the tax fund.¹⁸³ Another consideration includes how income tax currently imposed by sovereign taxing jurisdictions would interact with the global e-commerce tax. For example, a company may receive a credit for the global e-commerce tax paid that can be used to reduce local income tax liability. If no credit is allowed, then the disparities in income tax rates between taxing jurisdictions will remain and e-commerce companies will continue to use low-tax jurisdictions to reduce income tax liability.

A global e-commerce tax could persuade U.S. multinationals engaged in e-commerce to keep operations and profits within the United States because relocating to a low-tax jurisdiction would not be as attractive if the same global e-commerce tax would apply regardless. Coupled with lowering the corporate income tax rate in the United States, corporations would have less tax-based motivation to relocate operations or shift income offshore. Although some type of electronic transaction tax, imposed at the U.S. or international level, coupled with a reduction in the U.S. corporate income tax, would substantially reduce the incentive for e-commerce companies to relocate operations and income in low-tax jurisdictions, the difficulties in implementing such a tax requires further consideration.

¹⁸² *Azam Cross-Border*, *supra* note 58, at 639, 643–44.

¹⁸³ *See Azam Cross-Border*, *supra* note 58, at 643–66 (distinguishing between three types of e-commerce, tangible products, intangible products, and services, and explaining that a flat rate tax would be paid by e-commerce corporations on net income, and collected by a global institution).

CONCLUSION

Many of the challenges for taxing e-commerce income stem from unintended consequences of the tax code. The subpart F rules do not operate effectively to address the “systemic problem in the U.S. tax system that created inequity and caused tax base erosion” with regard to e-commerce companies.¹⁸⁴

Recent measures to combat tax havens, such as FATCA and the proposed Stop Tax Haven Abuse Act and CUT Loopholes Act, which focus on information sharing and tax evasion, will not solve the problems presented by the use of low-tax jurisdictions in e-commerce business because these measures will not adequately address their legal use to shift income and operations offshore. Therefore, the U.S. Government should explore short term measures to incentivize e-commerce companies to stay in the United States. In the long term, a global solution is required to allow U.S. multinationals engaged in e-commerce to remain competitive internationally and to prevent the complete erosion of the U.S. tax base with respect to e-commerce companies.

The electronic transaction tax coupled with a reduction in the corporate tax rate should begin to address the U.S. Government’s inability to effectively tax e-commerce transactions under the current federal income tax rules. These solutions should promote the economic goal of tax equity by taxing e-commerce income from domestic and foreign entities at the same rate, without regard to the entity type or particular type of corporate group structure.¹⁸⁵ These solutions should also promote economic efficiency and neutrality by lessening the importance of tax in deciding where a company chooses to locate or how a corporate group decides to structure.¹⁸⁶ The electronic transaction tax should also promote “simplicity and administrability”¹⁸⁷ so that the rules are clear and simple and do not place an undue burden on companies providing electronic goods and services to U.S. customers. Whether these goals are achievable requires serious consideration. Further research into existing foreign and state models for collecting tax on electronic transactions should be conducted, and the strengths of those models should be adopted in

¹⁸⁴ See DEFERRAL OF INCOME, *supra* note 15, at 81.

¹⁸⁵ See *id.* at 83.

¹⁸⁶ See *id.* at 84.

¹⁸⁷ *Id.*

designing the electronic transaction tax. While a domestic solution is being introduced, countries should coordinate efforts to implement a global solution to the e-commerce taxation problem, recognizing that political and technological hurdles will certainly be a challenge to overcome.