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Should the United States Abandon Citizenship-Based Taxation?

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President Trump proposed during the election campaign to end the "double taxation" of American citizens living overseas.[1] To which the answer is, what double taxation?

Americans living overseas already benefit from three significant provisions that in most cases prevent any double taxation, and because of these most of them do not have any U.S. tax liability.[2] Those who do are typically wealthier, derive income from investments or from high wages, and are not subject to foreign tax because they live in tax havens or in countries that do not tax rich immigrants on foreign source income, and they do not have any income from their country of residence.

First, they do not have to pay tax on about $120,000 in earned income regardless of whether that income is taxed by any other jurisdiction.[3] This unique provision means that if they live in any of the many countries that either do not have an income tax (like the Gulf states or other tax havens) or who do not tax foreign source income (like the many countries that have "non-dom" regimes) they do not pay any taxes on a large amount of income.

Second, if they do pay taxes to a foreign country, they are eligible for the foreign tax credit on any income that is not U.S. source.[4] This result does not depend on whether there is a treaty with the foreign country. The foreign tax credit does not apply to U.S. source income,

but foreign countries would typically grant a credit for U.S. taxes on U.S. source income (if they do not exempt foreign source income altogether).[5]

Third, if there is a tax treaty in place, the treaty provides for tie breakers that ensure there will be no double residence-based taxation, and in some cases foreign tax credits for cases where there is no credit based on the code because the foreign tax may not qualify as an income tax or because the U.S. tax cannot be offset by foreign tax credits (like the net investment income tax, which arguably can be offset by foreign taxes if there is a treaty).[6]

Thus, the double taxation argument is spurious. There are many more cases where Americans living overseas enjoy double non-taxation because of Code Sec. 911 or 933 than cases of double taxation.

But this debate raises a more fundamental question, which is whether the U.S. should continue to tax citizens living overseas, as it has done since the Civil War. No other country does that.

The historical reason the U.S.-taxed citizens living overseas was anger that they avoided the draft during the most serious crisis in the history of the country.[7] That reason no longer exists. And the reason given by the Supreme Court when it upheld citizenship-based taxation a century ago, namely, the benefits provided by the U.S. government to citizens living overseas, seems weak because these benefits (diplomatic protection and the ability to enter the United States) also apply to citizens of any other rich country living outside it, and yet none of these countries tax them.[8] That is also true for countries whose passports are more widely accepted than U.S. passports, like Switzerland or Canada.

In addition, historically citizenship-based taxation was very difficult to enforce. It was enforceable for U.S. citizens seeking to renew U.S. passports, but U.S. citizens living overseas frequently had another passport, so they did not need a U.S. one. In some cases of

birthright citizenship, such "accidental Americans" may not even know they are citizens. And the U.S. government did not have a good idea of how many U.S. citizens live overseas.[9]

For these reasons, I wrote in 2010 that the United States should abandon citizenship-based taxation.[10] But I have since then changed my mind due to changed circumstances, and this issue is worth revisiting because of the possibility of legislation to end citizenship taxation being introduced in 2025.[11]

There have been three significant changes since 2010 that make citizenship-based taxation more appealing.

First, the enactment of Foreign Account Tax Compliance Act (FATCA) in 2010 followed by the negotiation of over 100 intergovernmental agreements by the Obama administration and the adoption of the Common Reporting Standard (CRS) by the rest of the world means that for the first time it is likely that the United States in fact effectively enforces citizenship-based taxation. Several recent cases like *Bittner*, *Farhy*, and *Ver* suggest that the government has the ability to find accounts or assets held by U.S. citizens living overseas even when they take elaborate steps to conceal their existence.[12]

Second, the proliferation of non-dom regimes in many attractive locations means that in the absence of citizenship taxation U.S. citizens living overseas in places like Lisbon would be able to avoid paying any taxes, including on income from U.S. sources. Like non-citizens do currently, they would be able to escape any tax on fixed, determinable, annual, and periodic (FDAP) from U.S. sources,[13] and if they work remotely for a U.S. employer, they will not be taxed by the United States because the source will typically be foreign if the services are provided from abroad. The foreign country will not tax them because of the non-dom regime.

Third, U.S. citizenship has become more important due to widespread political instability, economic disparities, and climate change.[14] In a world in which millions of people are trying to come to the United States legally or illegally and getting U.S. citizenship is a devoutly wished-for goal, it seems strange to say that this citizenship and the right to legally enter the United States at any time and live there permanently do not have great value.

Finally, the most fundamental question is, what is the basis of a country's right to impose worldwide taxation? Most countries impose worldwide taxation based on residence, but this is hard to justify because residence taxation is based on benefits provided by the country of residence, and those benefits typically do not extend to foreign source income. In addition, residents do not vote, and that means taxation without representation, which is also hard to justify given the importance of taxation in defining the level of public services. Residents may be subject to a higher level of taxation and receive more extensive public services than they would support if given the right to vote. They could move to another country with lower taxes, but there are often good reasons not to move (*e.g.*, family, a job, or immigration restrictions in other countries). The Tiebout hypothesis that taxpayers can always move to a tax regime that suits their preferences is hard to defend even in the domestic context and is fatally flawed in the international one.[15]

In my opinion, worldwide taxation based on the ability to pay should be based on membership in a political community that votes on the desired level of taxation it would like to be subject to and the level of government services it would like to receive. And if that is the basis for worldwide taxation, it should apply to citizens living overseas, who are part of the U.S. political community by virtue of their citizenship and have the right to vote to determine their level of taxation.[16]

The natural corollary for that would be for the United States to abandon taxing resident non-citizens on foreign source income because resident taxation is based on benefits, and the United States does not provide significant benefits to foreign source income.[17] Most resident non-citizens do not have foreign source income, so this rule would not change their taxes. Such a rule might discourage some residents from seeing U.S. citizenship, but the advantages of citizenship are sufficiently great that this is unlikely to make a huge impact. Citizenship provides both rights and responsibilities, and worldwide taxation is an important responsibility to go with the right to vote and the right to leave and enter at any time.

However, such a rule would turn the United States into the world's largest non-dom regime and would offend both U.S. resident citizens who pay tax on foreign source income and U.S. resident aliens with no foreign source income, both of whom will have no exempt income. The rule would also encourage residents to move their income offshore, so it would be both unfair and inefficient. While such a regime may sometimes be useful to attract talented people with useful skills, merely having foreign source income is insufficient as a basis for immigration; the focus should be on the skills, not the income.

Nevertheless, it makes sense to not tax residents on worldwide income because they cannot vote, but only if three conditions are met:

First, their country of citizenship must subject them to tax on global income, including U.S. source income. This would alleviate the unfairness and inefficiency mentioned above.

Second, to prevent such residents from obtaining a passport from a tax haven, there must be a "genuine link" between them and their country of citizenship.[18] It should not be enough to purchase a passport from a tax haven.[19]

Third, the country of citizenship must be a genuine democracy and allow its citizens living abroad to vote on the desired level of taxation.

At present, no country in the world would fulfill those conditions, and therefore the United States should continue to tax U.S. residents on worldwide income. But if other democracies adopt worldwide taxation of their citizens, then to be consistent with its own rationale for taxing citizens on global income (*i.e.*, membership in a political community and taxation with representation), the United States should refrain from taxing such resident aliens on foreign source income.

But even though citizenship-based taxation is justified and should be retained, there are several steps that Congress should take to ameliorate the hardship that citizenship-based taxation imposes on Americans living permanently outside the United States.

First, while current Code Sec. 911 is too broad because it applies regardless of whether the income is subject to tax in the country of residence, it should be retained in situations where the income is in fact subject to tax. For this purpose, it is not enough to rely on the existence of a tax treaty between the United States and the country of residence, because many countries with which the United States has tax treaties have adopted non-dom regimes that exempt residents from taxation on foreign source earned income that is eligible for Code Sec. 911. Instead, Congress could delegate to the Internal Revenue Service (IRS) the authority to designate countries that do in fact tax resident U.S. citizens on worldwide income, and in those cases Code Sec. 911 would apply.

Such a provision would be consistent with the single tax principle (STP), which has been the foundation of the international tax regime from its beginnings.[20] The STP underlies the base erosion and profit shifting (BEPS) project, and it is reflected in the current U.S. model treaty as well as in the Tax Cuts and Jobs Act (TCJA). For example, under the U.S.

model, treaty benefits are denied to corporations that are subject to special tax regimes in their country of residence.[21] Under the TCJA, deductions are denied for payments that are exempt from tax in the country of residence.[22] Both of these rules can be traced back to treaties negotiated in the 1960s, as well as to the first U.S. model treaty of 1981.

Second, FATCA imposes significant hardship on U.S. citizens and green card holders living permanently overseas, because foreign banks are reluctant to open accounts for Americans because of the reporting obligations imposed by FATCA. To ameliorate this problem, an exception from FATCA could apply to bank accounts in the country of residence, as long as such accounts are either exempt from Foreign Bank and Financial Accounts (FBAR) reporting because the amount in them is below $10,000 or is reported under FBAR.

This rule would be consistent with the original purpose of enacting FATCA, which was to prevent tax evasion by U.S. citizens and residents living in the United States, not abroad. FATCA was enacted in the wake of the UBS scandal, in which an investigation by the U.S. Senate Permanent Subcommittee on Investigations found that UBS would send bankers into the United States to recruit rich Americans to engage in tax evasion. UBS would set up shell corporations in a tax haven and these corporations would open accounts in UBS in Switzerland. The rich U.S. residents would then transfer funds to UBS *via* the shells, and UBS would invest them in the United States. In the Senate hearing, UBS claimed that under the Qualified Intermediary rules as they then stood, it was entitled to rely on Forms W8BEN provided by the shells and indicating foreign ownership of the funds even though it had set up the shells and knew the actual identity of the owners. This history shows that FATCA was intended for Americans living in the United States, and as long as FBAR reports are properly filed, there is no reason to apply it to Americans living abroad and having bank accounts in the country they live in.

Finally, many Americans living overseas own shares in foreign corporations, and if over 75% of the income of those corporations is passive or over 50% of their assets generate passive income, the corporations are passive foreign investment companies (PFICs). The PFIC regime is quite onerous because it requires a choice between current taxation, mark-to-market taxation, and taxation with an interest charge. Current taxation only applies if the PFIC elects, which rarely happens unless Americans are in control. Mark-to-market taxation only applies if the PFIC is publicly traded, which is rare. Therefore, the usual result is taxation with an interest charge, which involves complex calculations that are quite onerous for small investors. Moreover, it is unclear how the IRS can audit ownership in a PFIC if the amount invested is less than $10,000 and therefore no FBAR is filed, but there is no *de minimis* exception to taxation of U.S. shareholders in PFICs. Therefore, Congress could add a $10,000 *de minimis* exception to the PFIC regime for U.S. citizens living overseas.

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[*] I would like to thank Tsilly Dagan, Yvette Lind, Ruth Mason, Fadi Shaheen, and Ed Zelinsky for helpful comments. This article is based in part on Reuven S. Avi-Yonah, TAXING NOMADS: REVIVING CITIZENSHIP-BASED TAXATION FOR THE 21ST CENTURY, IN TAXING PEOPLE: THE NEXT 100 YEARS (Dagan & Mason, eds., Cambridge UP 2025, forthcoming).

[1] Alexander Rifaat, Trump Vows to End 'Double Taxation' of Overseas Citizens; *see also* Alexander Rifaat, Harris Acknowledges Tax Issues for Americans Living Overseas.

[2] Taxpayer Advocate Lists Recommendations to Congress (2022).

[3] Code Sec. 911. In addition, U.S. citizens who are residents of Puerto Rico are exempt from tax on Puerto Rico source income under Code Sec. 933. These sections

produce double non-taxation and are not needed in a world in which U.S. taxation of non-resident citizens is administratively feasible. *See*, *e.g.*, Walter A. Slowinski & B. John Williams, Jr., *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355 (1973); Philip F. Postlewaite & Gregory E. Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 VA. L. REV. 1093 (1979); Renee Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101 (1985). *See also* Joint Comm. on Taxation, "Review of the Present-law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency", JCS-2-03, p. 79 (Feb. 2003).

[4] Code Sec. 901.

[5] On the reality that treaties are not needed to prevent double taxation because most countries provide a credit or exemption unilaterally, *see* Tsilly Dagan, The Tax Treaties Myth, in Dagan, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (Cambridge UP 2017).

[6] *See* Michael Smith, Professors Push for Foreign Tax Credit on NII Tax Liability; David Rosenbloom and Fadi Shaheen, Toulouse: No Treaty-Based Credit? But *see* Avi-Yonah, Credit Where It's Due? Reflections on Christensen and Avi-Yonah, Is the Net Investment Income Tax a Treaty Override? Reflections on Toulouse.

[7] "We do not desire that our citizens who have incomes in this country ... should go out of the country, reside in Paris or elsewhere, avoiding the risk of being drafted or contributing anything personally to the requirements of the country at this time, and get off with as low a tax as everybody else ... If a man draws his income from our

public debt, or from property here, and resides in Paris, skulking away from contributing his personal support to the Government in this day of its extremity, he ought to pay a higher income tax." CONG. GLOBE, 38th Cong., 1st Sess. 2661 (1864) (statement of Sen. Collamer). The rule originally extended only to U.S. source income but in 1864 was applied to worldwide income, even though it was not enforceable for non-U.S. income.

[8] *See Cook v. Tait*, SCt, 1 USTC ¶92, 265 US 47, 44 SCt 444 (1924).

[9] *See* U.S. Government Accountability Office, Report to the Subcommittee on Technology, Information Policy, Intergovernmental Relations and the Census, Committee on Government Reform, House of Representatives, "2010 Census—Counting Americans Overseas as Part of the Decennial Census Would Not Be Cost-Effective," GAO-04-898 (Aug. 2004).

[10] Avi-Yonah, *The Case Against Taxing Citizens,* 58 TAX NOTES INT'L 389 (May 3, 2010).

[11] For a longer discussion, *see* Avi-Yonah, Taxing Nomads, *supra*. For other perspectives on the citizenship taxation issue, *see*, *e.g.*, Dagan, Tsilly and Mason, Ruth, Reconsidering Citizenship Taxation (Jan. 01, 2024). Virginia Public Law and Legal Theory Research Paper No. 2024-69, Virginia Law and Economics Research Paper No. 2024-34, Working Paper of the Max Planck Institute for Tax Law and Public Finance No. Forthcoming, Forthcoming in Taxing People: The Next One Hundred Years (Tsilly Dagan & Ruth Mason, eds.), Cambridge University Press, Available at SSRN: *ssrn.com/abstract=5029551* or *dx.doi.org/10.2139/ssrn.5029551*; Zelinsky, Edward A., Defending U.S. Citizenship-Based Taxation in Theory and in

Practice: An Essay on Fiscal Citizenship in a FATCA World (Nov. 01, 2024). Cardozo Legal Studies Research Paper No. 2024-45, Cardozo L. Rev. (forthcoming), Available at SSRN: *ssrn.com/abstract=5033405* or *dx.doi.org/10.2139/ssrn.5033405*; Yvette Lind and Reuven Avi-Yonah (eds.), Taxation, Citizenship and Democracy in the 21st Century (Elgar 2024); Tamir Shanan and Doron Narotzki, *Citizenship and Denizenship in the International Tax Context in an Era of Global Economy*, 35 FL. J. INT'L LAW (2023); Ruth Mason, *Citizenship Taxation*, 89 S. CAL. L. REV. 169 (2016); Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443 (2007); Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289 (2011); Cynthia Blum & Paula N. Singer, *A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals*, 41 VAND. J. TRANSNAT'L L. 705 (2008).

[12] *See A. Bittner*, No. 21-1195, SCt, 2023-1 USTC ¶50,127, 598 US 85, and *A. Farhy*, No. 23-1179, CA-DC, 2024-1 USTC ¶50,150 (2024). On these cases, *see* Avi-Yonah, *Taxing Fat Cats Abroad,* 113 TAX NOTES INT'L 1123 (Feb. 26, 2024) and Avi-Yonah, *Crypto and the Exit Tax,* 115 Tax NOTES INT`L 1683 (September 9, 2024). For other examples, *see* Robert Goulder, *FBAR and the Eighth Amendment: Did Schwarzbaum Get It Right?*, TNI; Goulder, *FBAR and the Eighth Amendment: The Mistakes of Toth*, TNI.

[13] *See* Avi-Yonah, *Does the US Have to Be a Tax Haven?*, TNI.

[14] This is also true for citizenship of other democratic countries like the UK. *See* Michael Avi-Yonah, *The Nation-State that Never Sets*, 46 YALE J. INT'L L. 325 (2021).

[15] *See* Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POLIT. ECON. 416 (1956); on the problems with this hypothesis in the domestic context, *see* Avi-Yonah, Orli Avi-Yonah, Nir Fishbien, and Haiyan Xu, *Federalizing Tax Justice*, 53 INDIANA L. REV. 461 (2020).

[16] For other perspectives, *see*, *e.g.*, Wolfgang Schoen, Taxation and Democracy, 72 TAX L. REV. 235 (2018); Tsilly Dagan and Talia Fischer, State, Inc., 27 CORNELL J. LAW AND PUB. POL'Y 661 (2018); Tsilly Dagan, Klaus Vogel Lecture 2021: Unbundled Tax Sovereignty—Refining the Challenges, 76 Bulletin for International Taxation No. 7 (2022).

[17] *See* Yvette Lind, *Voting Rights Compared to Income Taxation and Welfare Benefits through the Swedish Lens*, 23 FL. TAX REV. 713 (2020); Lind, A Critical Analysis of How Formal and Informal Citizenships Influence Justice between Mobile Taxpayers, in Lind and Avi-Yonah, *supra*.

[18] *See Guatemala vs. Lichtenstein*, ICJ 1 (1955). The ICJ defined the parameters of effective citizenship as "becoming wedded to [the country of citizenship`s] traditions, its interests, its way of life or of assuming the obligations- other than fiscal obligations-and exercising the rights pertaining to the status thus acquired." Note that this does not require residency in the country of citizenship, and that in fact fiscal obligations are (other than in the U.S. case) not required of non-resident citizens. For a discussion of the meaning of citizenship in a democratic political community, *see* Dagan and Fischer, *supra*.

[19] On the proliferation of citizenship by investment regimes *see* Kristin Surak, THE GOLDEN PASSPORT: GLOBAL MOBILITY FOR MILLIONAIRES (Harvard UP 2024). The

Court of Justice of the European Union is currently considering whether the EU should recognize Malta`s citizenship by investment scheme or accept the EU Commission`s argument that citizenship requires a genuine link. *See* Case C-181/23: Action brought on 21 March 2023—EUR-Lex.

The Advocate General has recommended a decision in favor of Malta. *See* Advocate General's Opinion in Case C-181/23. *Commission v Malta* (Citizenship by investment) (Oct. 8, 2024).

[20] On the origins and development of the STP *see* Avi-Yonah, *The 1923 Report and the International Tax Revolution*, 51 INTERTAX 427 (2023); Avi-Yonah, *International Taxation of Electronic Commerce,* 52 TAX L. REV. 507 (1997)*; Avi-Yonah, Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy,* 59 NYLS L. REV. 305 (2015); Avi-Yonah and Mazzoni, *Stanley Surrey, the 1981 US Model, and the Single Tax Principle,* 49 INTERTAX 729 (2021); Avi-Yonah and Fishbien, *Once More, With Feeling: TRA17 and the Original Intent of Subpart F,* 157 TAX NOTES 959 (Nov. 13, 2017).

[21] *See* Avi-Yonah, *Full Circle: The Single Tax Principle, BEPS, and the New US Model*, 1 GLOBAL TAX'N 12 (2016); Avi-Yonah, *Constructive Dialogue: BEPS and the TCJA,* 46 INT'L TAX J. 29 (2020). On the STP and pillar 2 *see* Ruth Mason, *The Transformation of International Tax*, 114 AM. J. INT'L L. 353 (2020).

[22] Code Sec. 267A.