Chapter 2
Taxation of U.S. Citizens

§ 2.01. Citizenship: In the Courts

Cook v. Tait

265 U.S. 47 (1924)

Opinion of the Court (McKenna, Justice)

Action by plaintiff [Cook] . . . to recover the sum of $298.34 as the first installment of an income tax paid, it is charged, under the threats and demands of Tait [Collector of Internal Revenue for District of Maryland].

The tax was imposed under the Revenue Act of 1921, which provides by § 210 (42 Stat. 227, 233): "That, in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum."[1]

Plaintiff is a native citizen of the United States and was such when he took up his residence and became domiciled in the City of Mexico. A demand was made upon him by defendant [Tait] . . . to make a return of his income for the purpose of taxation under the Revenue Laws of the United States. Plaintiff complied with the demand, but under protest, the income having been derived from property situated in the City of Mexico. A tax was assessed against him in the sum of $1,193.38, the first installment of which he paid, and for it, as we have said, this action was brought.

The question in the case . . . is . . . whether Congress has power to impose a tax upon income received by a native citizen of the United States who, at the time the income was received, was permanently resident and domiciled in the City of Mexico, the income being from real and personal property located in Mexico.

Plaintiff assigns against the power not only his rights under the Constitution of the United States but under international law, and in support of the assignments cites many cases. It will be observed that the foundation of the assignments is the fact that the citizen receiving the income, and the property of which it is the product, are outside of the territorial limits of the United States. These two facts, the contention is, exclude the existence of the power to tax. Or to put the contention another way, as to the existence of the power and its exercise, the person receiving the income, and the property from which he receives it, must both be within the territorial limits of the United States to be within the taxing power of the United States. The contention is not justified, and that it is not justified is the necessary deduction of recent cases. In *United*

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[1] The following regulation, No. 62, promulgated by the Commissioner of Internal Revenue under the Revenue Act of 1921, provides in Article 3: "Citizens of the United States except those entitled to the benefits of section 262 . . . wherever resident, are liable to the tax. It makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. Every nonresident alien individual is liable to the tax on his income from sources within the United States."

States v. Bennett, 232 U.S. 299, the power of the United States to tax a foreign built yacht owned and used during the taxing period outside of the United States by a citizen domiciled in the United States was sustained. The tax passed on was imposed by a tariff act,[2] but necessarily the power does not depend upon the form by which it is exerted.

> "The sovereign power of the United States as a nation, in its scope and extent . . . is based on the presumption that government by its very nature benefits the citizen and his property wherever found."

It will be observed that the case contained only one of the conditions of the present case, the *property* taxed was outside of the United States. In *United States v. Goelet*, 232 U.S. 293, the yacht taxed was outside of the United States but owned by a citizen of the United States who was "permanently resident and domiciled in a foreign country." It was decided that the yacht was not subject to the tax — but this as a matter of construction. Pains were taken to say that the question of power was determined "wholly irrespective" of the owner's "permanent domicile in a foreign country." And the Court put out of view the situs of the yacht. That the Court had no doubt of the power to tax was illustrated by reference to the income tax laws of prior years and their express extension to those domiciled abroad. The illustration has pertinence to the case at bar, for the case at bar is concerned with an income tax, and the power to impose it.

We may make further exposition of the national power as the case depends upon it. It was illustrated at once in *United States v. Bennett* by a contrast with the power of a State. It was pointed out that there were limitations upon the latter that were not on the national power. The taxing power of a State, it was decided, encountered at its borders the taxing power of other States and was limited by them. There was no such limitation, it was pointed out, upon the national power; and the limitation upon the States affords, it was said, no ground for constructing a barrier around the United States "shutting that government off from the exertion of powers which inherently belong to it by virtue of its sovereignty."

The contention was rejected that a citizen's property without the limits of the United States derives no benefit from the United States. The contention, it was said, came from the confusion of thought in "mistaking the scope and extent of the sovereign power of the United States as a nation and its relations to its citizens and their relations to it." And that power in its scope and extent, it was decided, is based on the presumption that government by its very nature benefits the citizen and his property wherever found, and that opposition to it holds on to citizenship while it "belittles and destroys its advantages and blessings by denying the possession by government of an essential power required to make citizenship completely beneficial." In other words, the principle was declared that the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation

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[2] Section 37, Tariff Act of August 5, 1909, c. 6, 36 Stat. 11, 112, provided in part as follows: "There shall be levied and collected annually on the first day of September by the collector of customs of the district nearest the residence of the managing owner, upon the use of every foreign-built yacht, pleasure-boat or vessel, not used or intended to be used for trade, now or hereafter owned or chartered for more than six months by any citizen or citizens of the United States, a sum equivalent to a tonnage tax of seven dollars per gross ton."

as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal — the government having power to impose the tax. c

Case Notes

Norman F. Dacey v. Comm'r, T.C. Memo 1992-187 (1992). Dacey "is an author. His book, *How to Avoid Probate!*, originally published in 1966 with updated versions published in 1980 and 1983, was a best seller and has sold over 2½ million copies." During tax years 1981 to 1985, he earned royalties totaling over $370,000. Appearing *pro se* before the Tax Court, Dacey sought to avoid U.S. tax on his royalty income primarily under Article VIII(1) of the U.S./Ireland income tax treaty. To claim benefits under the treaty, Dacey needed to establish that he was a citizen of Ireland and was not a citizen of the United States. Although he was a natural-born U.S. citizen, Dacey claimed that he had given up his U.S. citizenship in 1980 and had become a citizen of Ireland. He alleged that he had mailed a letter to the U.S. State Department renouncing citizenship on January 1, 1981, from Galway, Ireland, but no copy of the letter could be located. He applied for and received a U.S. passport in 1980 and 1985 — in both instances claiming to be a U.S. citizen. Throughout the 1980s, Dacey resided in Portacarron, Oughterard, in County Galway, Ireland. He formally renounced his United States citizenship on April 27, 1988, by appearing personally before the Vice Consul of the United States at the United States Embassy in Dublin, Ireland, and "signing both an Oath of Renunciation of the Nationality of the United States and a Statement of Understanding." The court held that Dacey was liable for U.S. income taxes and self-employment taxes on his royalty income. The negligence penalty imposed by the IRS was also upheld by the court.

Estate of Efthimios D. Vriniotis v. Comm'r, 79 T.C. 298 (1982). Vriniotis was a naturalized citizen of the United States who had returned to Greece (his country of birth) towards the end of his life. After he died, representatives of his estate argued that he was exempt from the U.S. estate tax under the U.S. tax treaty with Greece. The court held to the contrary. In discussing whether Vriniotis should be characterized as a U.S. citizen, the court observed that "[a]lthough the term 'citizen' is not defined in the estate tax statutes or regulations, it is defined in section 1.1-1(c), Income Tax Regs., as follows:

> (c) *Who is a citizen?* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For other rules governing the acquisition of citizenship, see chapters 1 and 2 of title III of the Immigration and Nationality Act (8 U.S.C. 1401-1459). For rules governing loss of citizenship, see sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489), *Schneider v. Rusk*, (1964) 377 U.S. 163, and Rev. Rul. 70-506, C.B. 1970-2, 1. . . .

The court went on to state that "[t]he courts have consistently held that United States citizenship implies not only rights but also duties, one of which duties is the payment of taxes. *United States v. Rexach*, 558 F. 2d 37, 42 (1st Cir. 1977); *United States v. Matheson*, 532 F. 2d 809, 819 (2d Cir. 1976), cert. denied 429 U.S. 823 (1976); *Rexach v. United States*, 390 F. 2d 631, 632 (1st Cir. 1968), cert. denied 393 U.S. 833 (1968). In *Cook v. Tait*, 265 U.S. 47 (1924), the Supreme Court held that a United States citizen domiciled in Mexico with no assets or income from sources within the United States nevertheless was liable for United States income tax. The Court reasoned that since the United States government benefits its citizens and their property wherever found, its power to tax them is based on their relation to it as citizens and not on their domicile or on the situs of their property. 265 U.S. at 56."

Felix Benitez Rexach v. United States

390 F.2d 631 (1968)

Opinion of the Court (Aldrich, Chief Judge)

Felix Benitez Rexach, hereafter taxpayer, a native-born Puerto Rican, became an American citizen by virtue of the Jones Act of March 2, 1917, 48 U.S.C. § 731 et seq. In 1944 he left Puerto Rico and became a resident of the Dominican Republic, where he remained until 1961. In July 1958 he executed a written renunciation of his American citizenship before a United States consulate official in the Dominican Republic pursuant to the Immigration and Nationality Act of 1952, 8 U.S.C. § 1481 (a)(6). A certificate of loss of nationality was duly approved by the Department of State. On July 26 taxpayer was decreed to be a citizen of the Dominican Republic. Thereafter, he naturally suffered certain losses of status and benefits as a consequence of being declared a non-resident alien of the United States.

Taxpayer was engaged in large scale contracting activities in the Dominican Republic in connection with the then dictator, Trujillo. In 1961 Trujillo was assassinated. The following year taxpayer applied for an American passport, claiming that his 1958 renunciation was not voluntary but had been compelled, against his will, by economic pressure and physical threats that he feared to resist. The United States Consul denied his application, and taxpayer appealed to the Department of State. The Board of Review on the Loss of Nationality took taxpayer's testimony and accepted it, as a result of which his certificate of loss of nationality was cancelled, and his passport application granted. There followed the present chapter. The Commissioner of Internal Revenue assessed taxpayer with an income tax on account of income earned in the Dominican Republic during the years following his renunciation of citizenship, alleged to be due because of his continued American citizenship. *Cook v. Tait*, 265 U.S. 47 (1924), 44 S. Ct. 444, 68 L. Ed. 895. Taxpayer not responding, the present suit was brought to foreclose liens in payment of such taxes. Taxpayer moved, unsuccessfully, for summary judgment on the claim that no taxes could be due.

> "Taxpayer applied for an American passport, claiming that his 1958 renunciation . . . had been compelled . . . by economic pressure and physical threats that he feared to resist."

Taxpayer concedes that as a matter of law he is precluded by the record from claiming that he ever ceased to be a United States citizen, and concedes that during the period in question he was a de jure citizen. However, he says that he was not a "de facto" citizen.

> "Appellant does not claim that his citizenship was lost as a result of the renunciation, but that as a result of the determination of the Secretary of State and consequent issue of the Certificate of Loss of Nationality, the United States was freed of its obligations to him as a citizen and he in fact lived and existed as an alien to the United States during the period in question."

He concludes that since the United States "owed" him, or apparently owed him, no citizen's protection, he, in turn, owed no tax.

While there is language in *Cook v. Tait*, supra, indicative that these are reciprocal obligations, the Court also observed that "government by its very nature benefits the citizen * * *." 265 U.S. at 56, 44 S. Ct. at 445. We cannot agree that the reciprocal obligations are mutual, at least in the sense that taxpayer contends. It is sufficient that the government's stem from its de jure relationship without regard to the subjective quid pro quo in any particular case. We will not hold that assessment of benefits is a prerequisite to assessment of taxes.

§ 2.02. Taxation of U.S. Citizens

The United States imposes an income tax on the worldwide income of those individuals owing it allegiance as citizens or residents.[3] In general, a citizen is a person who was born or naturalized in the United States.[4] An alien individual is someone who is not a U.S. citizen.

Most countries do not follow the U.S. rule of imposing worldwide taxation on native-born and naturalized citizens. For many years, the Philippines employed a citizenship rule, having adopted it while a colony of the United States. So also did Mexico. Albania, Bulgaria, and some of the other states of Central Europe adopted a citizenship rule during the socialist era. The current trend in Central Europe, however, is to abandon a citizenship test so as to conform with the practices of the European Union.

Many countries use citizenship as a positive factor in determining whether an individual is a resident. Bilateral tax treaties typically use citizenship as one of the tie-breaker tests in determining the residence for treaty purposes of an individual who otherwise would be a resident in both treaty countries.[5]

In general, a U.S. citizen may avoid U.S. citizenship jurisdiction by renouncing citizenship in accordance with the formal procedures established by the State Department (in a foreign country) or by the Justice Department (in the United States) or by performing "an expatriating act" within the meaning of the Immigration and Nationality Act.[6] Informal renunciation is not enough.[7] Individuals who lost their citizenship and had it retroactively restored prior to 1993 may obtain tax relief for the period they appeared not to be citizens under rules and procedures established by the Internal Revenue Service.[8]

To reduce the tax benefits otherwise obtainable from renouncing U.S. citizenship, Code section 877A provides that U.S. citizens holding significant amounts of assets who give up their citizenship are taxed when they exit from the United States on the difference between the fair market value of their assets and their basis in those assets. This mark-to-market rule was adopted in 2008 because of difficulties in applying the prior rules under section 877.[9] A similar rule applies to certain individuals who forfeit their U.S. permanent residency status. Under the rule, an individual entitled to a large pension from activities performed while a U.S. citizen or long-term permanent resident would not be able to avoid tax on the pension income by renouncing U.S. citizenship or residence status. Although the tax would be assessed at th time of exit from the United States, the payment of the tax might be deferred. Section 877 had sought to achieve a similar result by altering the source rules for a 10-year period for taxpayers who renounced their citizenship or

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[3] Reg. § 1.1-1(b) (2008).

[4] See Reg. § 1.1-1(c) (2008).

[5] See, e.g., U.S./Spain treaty, Art. 4(c).

[6] Section 8, 8 U.S.C. § 1481 (Matthew Bender, 2009).

[7] See, e.g., *Darcy v. Comm'r,* TC Memo 1992-187, 63 TC.M 2584 (1992).

[8] See Rev. Rul. 92-109, 1992-2 C.B.3.

[9] For a criticism of the rule of IRC § 877for taxing individuals as citizens who are not citizens under federal law, see Michael S. Kirsch, "The Tax Code as Nationality Law," 43 HARVARD JOURNAL ON LEGISLATION 375 (2006) (objecting on the ground that the rule violates customary international law).

long-term residence status for tax avoidance reasons. Section 877 continues to apply to individuals who renounced U.S. citizenship or long-term residence status prior to the adoption of section 877A.

The United States unilaterally surrenders much of its jurisdiction to tax nonresident citizens working abroad under Code section 911. For 2002 and thereafter, that section allows U.S. citizens having a substantial foreign presence to exclude up to $80,000 of earned income from U.S. taxable income.[10] Certain foreign housing expenses are also made nontaxable under section 911.[11] For 2006, approximately 50 percent ($18 billion out of $37 billion) of foreign source earned income reported by American citizens was exempt from tax under Code section 911.[12]

U.S. income tax treaties include a so-called Saving Clause that allows the United States, with some exceptions, to tax its citizens and residents as if the tax convention had not gone into effect.[13] For example, a U.S. citizen residing in Canada is not entitled to a reduced withholding rate under the U.S./Canada tax treaty on dividends he receives from the United States. A few treaty benefits, such as exemption for government pensions, are available notwithstanding the Saving Clause. Many treaties extend the Saving Clause, for a ten-year period, to cover former citizens who gave up citizenship to avoid tax.[14]

Compared to a residence test, a citizenship test is remarkably easy to administer. Most taxpayers rarely change their citizenship status, and then only with some ceremony. The only significant administrative problem with the test is that it commits the tax authorities to collect tax from nonresident citizens who have long absented themselves from their home country. Few countries have the administrative resources to pursue such taxpayers effectively, and most do not have the inclination to do so. The United States is the exception on both counts.

A country could obtain many of the administrative benefits of a citizenship rule by establishing the presumption that a citizen is a resident taxpayer under certain circumstances. The presumption might apply, for example, unless the citizen showed that he was absent from the country for an extended period and had established residency in a foreign country.

Questions

1. Should it matter, in deciding whether a taxpayer ought to be taxable by the United States, whether that taxpayer has received a benefit from the United States? Can the "presumption" of benefit mentioned in *Cook v. Tait* be rebutted? Or is the actual or potential benefit irrelevant? If benefits matter, must the tax be proportional in some way to the benefit? How might that goal be achieved? Does the U.S. Constitution require *any* benefit link? What provision, if any? Is it enough for constitutional purposes if the government shows that some taxpayers in comparable circumstances might receive a benefit? What is the gloss put on *Cook v. Tait* by *Rexach*?

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[10] IRC § 911(b)(2)(D). For taxable years beginning after 2007, the $80,000 is adjusted for inflation. Id.

[11] [21]IRC § 911(c). The housing exemption is also indexed for inflation.

[12] See Scott Hollenbeck and Maureen Keenan Kahr, "Individual Foreign-earned Income and Foreign Tax Credit, 2006," 29 *SOI Bulletin* 54-84 (Spring 2009), at 54.

[13] See, e.g., U.S. Model Treaty (2006), Art. 1(3).

[14] See, e.g., U.S./Spain treaty, Protocol to Art. 1(3).

2. *Cook v. Tait* simply affirms the constitutional power of the federal government to tax U.S. citizens living abroad. Should the federal government exercise that power? Always? Is it appropriate, for example, for the United States to tax the American spouse of a British citizen and resident living permanently in England? What about American citizens living for short periods abroad? What about American living in Canada or Mexico? What about American citizens working in the diplomatic service abroad? See Code sections 911 and 912.

3. There is nothing despotic about taxing citizens living abroad, in that the power to tax is grounded on the assent of the citizen through his allegiance to the U.S. government. Is it also appropriate to tax U.S. resident aliens who are living abroad for some period?

4. How should individuals who have repudiated their U.S. citizenship be taxed? Assume, for example, that a wealthy American writer gives up her U.S. citizenship and becomes a resident of Ireland, or some other tax haven? Should it matter what the source of the taxpayer's income is? See Code section 877.

5. The list of countries using citizenship as a basis for asserting tax jurisdiction is pretty short. The main country is the United States. The list once included Mexico, the Philippines, Bulgaria, and perhaps a few other former communist states of Eastern Europe. Why is the list so short, and why did countries that once used citizenship abandon it? Is residency a superior or a complimentary basis for taxation? Note that citizenship is sometimes used as a tie-breaker in determining residence under a tax treaty. See Article IV(2)(d) of the U.S./Canada income tax treaty.