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TAXING POTENTIAL COMMUNITY MEMBERS’ FOREIGN SOURCE INCOME

Daniel Shaviro*

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I. INTRODUCTION

--“We’re surrounded.”

--“What do you mean ‘we,’ kemosabe?”

The old Lone Ranger joke, predating modern sensibilities about both racism and white America’s centuries of horrendous mistreatment of native Americans, still expresses two truths that may help to keep it in memory. One is that “we” don’t always know, or agree about, who “we” are. A second is that being grouped among “us,” while on its face expressing solidarity and affiliation, can sometimes be a dubious blessing.

Both of these points are pertinent to the debate, currently unfolding on both sides of the Atlantic, about how to define the category of individuals whom a given country classifies as domestic taxpayers. The classification matters because domestic taxpayers are potentially taxable on all of their worldwide income, thus permitting the classifying jurisdiction to tax what it concedes is foreign source income (FSI).

There is little dispute that countries may (and generally will) classify as domestic taxpayers individuals who straightforwardly qualify as current year residents – in the simplest case, because they spend at least 183 days (i.e., more than half the year) in-

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country. Things become more contested, however, when countries assign, or consider assigning, domestic taxpayer status to individuals who mainly or wholly spend the year, and perhaps multiple years, living abroad.

In the United States, this issue is commonly described as concerning “citizenship taxation.”¹ This reflects the fact that the U.S. individual income tax system classifies all citizens (and permanent residents) as domestic taxpayers, and thus as subject to U.S. taxing jurisdiction on their FSI, even if they live abroad. The question commonly addressed in U.S. scholarship is whether this definition of domestic taxpayers is too broad² – although there is also some focus on the fact that much of our overseas citizens’ FSI does not actually trigger any net U.S. federal income tax liability.

Other countries, however, may rely on grounds other than citizenship to classify as domestic taxpayers individuals who are living abroad. For example, they may focus on past residence, or identify categories of evidence that suggests ongoing affiliation. Examples of factors that they may treat as pertinent include the location of property that one owns in-country, such as a home; the place where one’s primary business or other economic ties appear to be located; and the place of residence for close family members.

¹ Thus, consider the title of the conference for which I wrote this paper: the “Citizenship and Taxation Symposium,” to be held at the University of Michigan Law School on October 9, 2015. See “Call for Papers – Citizenship and Taxation Symposium – October 9, 2015,” available on-line at http://www.mcgill.ca/tax-law/events/call-papers-citizenship-taxation-symposium.

In some cases, despite such outreach, a given country may claim merely to be defining and taxing its “residents,” although Daniel Gutman views some such rules as “extend[ing] the concept of residence by resorting to fictions.” ³ In other cases, countries expressly rely on a distinct concept of domestic domicile. ⁴ Even if such rules are narrower overall than the U.S.’s citizenship-based approach, they may apply in particular cases where it would not.

Given the multiplicity and heterogeneity of grounds for classifying individuals who spend a lot of time abroad as domestic taxpayers, a general term is needed that stands apart from any particular country’s instantiation of the concept. For convenience, I will use the term “potential community members” or PCMs. This term has no precise outer limit, short of its including everyone in the world. In practice, however, the PCMs whom a given country might at least seriously consider classifying as domestic taxpayers are likely to have one or more of such potential markers of domestic affiliation as citizenship, former residence, expected future residence, and the above-noted domiciliary factors.

When focusing on a given country’s taxation of PCMs, it is important to keep in mind that deciding which of them are domestic taxpayers is merely the first step in deciding how to tax their FSI. Step 2 is deciding to what extent, and how, the resulting claim of tax jurisdiction over their FSI should actually be operationalized. In the United States, despite all the hubbub about citizenship-based taxation, Reuven Avi-Yonah notes

⁴ The United Kingdom uses a domicile concept to narrow, not just expand, the category of residents who are taxable on their worldwide income. It classifies certain full-time residents as non-domiciliaries, and thus as exempt from U.K taxation of their FSI. See HM Revenue & Customs, Guidance Note: Residence, Domicile, and the Remittance Basis (October 2013), available online at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/381569/hmrc6.pdf.
that, to a considerable extent, actual U.S. liability pertains just to “the relatively few cases of citizens living overseas in countries that have no or low income taxes.”\(^5\) Expatriates’ complaints often pertain more to compliance burdens imposed by the U.S. rules than to the actual imposition of U.S. tax liability.

Given all these considerations, I believe that the international tax policy debate over PCMs is best framed as involving the following two questions. First, which PCMs, if any, should one treat as subject to domestic tax jurisdiction with respect to their FSI? Second, to what extent, and how, should such individuals’ FSI actually be taxed?

This article does not attempt to resolve these questions definitively. Instead, it explores three main issues. \textit{First}, it critically examines the common assumption that the United States is an outlier on these issues. Is the perception of a gulf between citizenship-based taxation here, and residence-based taxation everywhere else, more helpful or more misleading?

\textit{Second}, at heart the debate concerning whose FSI to tax involves distinguishing between “us” and “them” – that is, between people whom we classify as members of the home community, and those whom we classify as outsiders. The distinction matters because it is widely agreed that domestic policymakers should “care only [or at least primarily] about the welfare of domestic individuals rather than everyone in the world.”\(^6\) As we will see, this distinction, though generally accepted for good practical reasons, not only stands on shaky normative grounds, but is hard to elucidate using conventional

\(^5\) Avi-Yonah, \textit{The Case Against Taxing Citizens}, supra, at 8-9. Avi-Yonah also dismisses the ability-to-pay argument, with respect to U.S. citizens, on the ground that the worldwide tax (insofar as it is levied) applies to nonresident green card holders, rather than just to citizens. \textit{See id.} at 8.

analytical tools, such as those derived from the tax policy and public economics literatures.

An apparent paradox, or at least conundrum, makes the “us” versus “them” question more perplexing still. If being among “us” means that we tax you on your FSI, then in effect we are telling you: If you win, you lose. That is, only if we decide that we care about you, will we impose tax burdens on you. I will argue that this paradox has a conceptual solution that, whether or not one actually wants to implement it, at least helps to clarify the tax issues associated with classifying particular PCMs as domestic taxpayers.

Third, I address the issue of how, if at all, one should tax nonresident PCMs’ FSI, once one has classified them as domestic taxpayers. In particular, how should one respond to their also facing source country taxation of their FSI? The usual analysis holds that home countries should honor source countries’ tax priority, by adopting rules that prevent “double taxation.” This may help to motivate exempting particular FSI, but in all other cases it ostensibly requires offering full foreign tax credits for the source country’s income tax liability. As I have discussed elsewhere, however,7 double taxation is a formalistic concept that lacks direct normative interest. Rather than focusing on how many times a given unit of income has been taxed, one should focus directly on the relevant margins involved. This not only permits a more informed analysis of the commonly accepted choice between exemption and full foreign tax credits, but may permit other alternatives to be considered as well.

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The rest of this article proceeds as follows. Section II addresses the U.S. rules’ degree of uniqueness. Section III discusses the “us versus them” issue. Section IV addresses how FSI might be taxed, in the case of nonresident PCMs. Section V offers a brief conclusion.

II. AMERICAN EXCEPTIONALISM?

“Look – everyone’s out of step but my Johny!” says the proud mother, watching the high school band as it marches down Main Street. The joke, of course, is that by definition it must be Johny who is out of step.

American policy analysts often find themselves in Johny’s mother’s shoes, whether or not they respond the same way. Relative to peer countries, the United States often is a distinctive outlier. Consider our military, institutions for healthcare delivery, continued use of the death penalty, separation-of-powers based presidential and legislative system, and prominent judiciary. Each is quite unusual by the standards of peer countries. In tax and fiscal policy, consider our comparatively small fiscal system, limited safety net institutions, higher-than-typical statutory income tax rates, and complete non-use at the national level of consumption tax instruments such as a value-added tax.

Whether all this is for good or ill in particular cases, it evidently is a source of national pride, as reflected in all the windy rhetoric that one regularly hears (especially in presidential election years) regarding “American exceptionalism.” Among tax academics, however, it has become common to decry, rather than celebrate, the distance between our rules and those of other countries. For example, it has prominently been
argued that we should be more generous to the poor,\textsuperscript{8} enact a national value-added tax that permits scaling back the individual income tax,\textsuperscript{9} lower our statutory corporate rates to be closer to those of peer countries,\textsuperscript{10} and/or more closely conform our rules for international business taxation to those of peer countries.\textsuperscript{11}

Sometimes, however, American exceptionalism is more apparent than real, reflecting greater commonality in actual practice than one might expect from the distinctive labels attached to particular U.S. legal or policy regimes. An example is our system for taxing resident multinational companies’ FSI. While, on the face of things, the United States is the “sole remaining notable country to have a worldwide system of taxation,”\textsuperscript{12} this observation is misleading since “the labels ‘territorial’ and ‘worldwide’ are outdated and unhelpful.”\textsuperscript{13} To be sure, the U.S. rules have some distinctive features, such as their generally applying deferral to FSI that is earned through controlled foreign subsidiaries, leading to a distinctive “trapped earnings” problem that accounting rules exacerbate.\textsuperscript{14} Nonetheless, the overly sharp distinction that observers sometimes draw, by reason of relying upon tax systems’ formal labels, “greatly oversimplifies a reality in which countries’ international tax systems overlap substantially.”\textsuperscript{15}

\textsuperscript{8} See, e.g., Edward D. Kleinbard, \textit{WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY} (2015).
\textsuperscript{9} See, e.g., Michael J. Graetz, \textit{100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES} (2007).
\textsuperscript{10} See, e.g., White House and Department of the Treasury, \textit{The President’s Framework for Business Tax Reform} (2012).
\textsuperscript{12} Kimberly A. Clausing, \textit{Beyond Territorial and Worldwide Systems of International Taxation} 1 (2015).
\textsuperscript{13} Id.
\textsuperscript{14} See Shaviro, \textit{The Crossroads Versus the Seesaw}, supra, at __.
\textsuperscript{15} Id. at 1, relying on Clausing, supra, along with Rosanne Altshuler, Stephen Shay, and Eric Toder, \textit{Lessons the United States Can Learn from Other Countries’ Systems for Taxing Income of Multinational Corporations}, Tax Policy Center Working Draft (2015). See also Brian J. Arnold, \textit{Comparative Perspective on the U.S. Controlled Foreign Corporation Rules}, 65 Tax L. Rev. 473, 479 (2012), concluding that the U.S. system’s controlled foreign corporation rules for taxing resident companies’
A similar point applies to how the United States taxes PCMs who are living abroad. In general and at least in principle, U.S. worldwide taxation applies to all American citizens, no matter how long and continuously they stay abroad and how scant their domestic ties may actually be. In this regard, we are apparently “an outlier in the international community,”16 joined by no other country in the world except arguably Eritrea.17 The uniqueness of the U.S. rules in this respect has been sufficiently widely noted to spawn an entire literature concerning our practice of citizenship-based taxation.18 It thus is worth briefly assessing, even though the ultimate question of interest, regarding the U.S. rules, is whether (and in what ways) they are good as opposed to bad – not how unique they are or are not.

Using a distinctive standard for identifying PCMs whose FSI will be domestically taxable does not, by itself, make the United States a true outlier. After all, by definition, any country with a distinctive legal standard will be the only one applying that particular standard. And even if that legal standard does indeed result in taxing some FSI of some individuals who would not have been reached by any other country’s standard, one still would need to know more before concluding that anything truly unusual, relative to global norms, is going on. In particular, one would need to ask the following two questions:

unrepatriated FSI are “not exceptional” either in the types of FSI that they address or in their breadth and rigor.


17 See id. at 445-446 n. 5. Ruth Mason, however, notes that “Eritrea applies [only] a flat two-percent tax on nonresident Eritreans, whereas the United States taxes nonresident Americans at regular progressive rates.” Ruth Mason, Citizenship Taxation 2-3, n. 13 (2015).

18 See n. 2, supra, for an extensive (though no doubt incomplete) list of such articles.
(1) How much broader is this legal standard than other standards, within the group of individuals whom it treats as domestic taxpayers? And to what extent do other standards reach individuals whom this one does not reach?

(2) To what extent does classification as a domestic taxpayer actually result in taxing covered individuals’ FSI? After all, if exemption and foreign tax credits have sufficient reach and effect, it might turn out not to matter much that a wide swathe of nonresident individuals’ FSI is being treated as domestically taxable in a jurisdictional sense.

These questions can be viewed as involving continua. For the first question, suppose we could identify all PCMs – that is, all of the people whom it is at all plausible that a given country could treat as domestic taxpayers. Then there is a continuum that runs from taxing just the FSI of current-year physical residents (or at least those among them whom one classifies as domiciliaries) to taxing all current-year residents plus all nonresident PCMs.

For purposes of the second question, once one has identified the PCMs who are being classified as domestic taxpayers, there is a continuum regarding the extent to which their FSI is actually being taxed. At one pole, none of it is taxed, whether due to exemption or to foreign tax credits that end up eliminating all domestic tax liability. At the other pole, all of their FSI faces full domestic taxation, under the same rates as those

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19 Presumably, some sort of at least minimally plausible domestic connection is necessary, in order for a country’s claim of global tax jurisdiction to avoid combining unenforceability with risibility. However, the analytical framework that I am suggesting can be used even if one defines everyone in the world as a PCM.

20 For purposes of defining this pole of the continuum, I assume that foreign tax credits cannot give rise to a negative tax burden on one’s FSI, given that they are generally nonrefundable and limited to offsetting the domestic tax liability that would otherwise arise with respect to FSI.
that apply to domestic source income,\textsuperscript{21} and with foreign income taxes being (at best) just deductible as a cost of earning income.\textsuperscript{22}

\textit{Who is taxable on a worldwide basis as a domestic individual?} – Again, only the United States automatically classifies all citizens as domestic taxpayers. We combine this with a residence rule that applies to non-citizens who have been granted permanent residence status, plus all those who meet a “substantial presence” test, based mainly on current-year physical presence, combined with a modest degree of look-back to the prior two years.\textsuperscript{23}

Peer countries, while not similarly relying on citizenship, resemble us in not looking just at current-year physical presence. For example:

--In the United Kingdom, while the only individuals subject to worldwide taxation are those classified as residents, current-year physical presence for the standard 183 days is not necessary (or indeed always sufficient)\textsuperscript{24} for one to so qualify. One who spends most of the year abroad may nonetheless qualify as a U.K. domiciliary, and thus as

\textsuperscript{21} In principle, a country might decide to tax all FSI at a higher rate than domestic source income, pushing this pole to the point where the tax rate on FSI was 100 percent (or, for that matter, infinite).

\textsuperscript{22} In the absence of foreign tax credits, foreign income taxes would presumably be deductible if they were viewed as a cost of earning income abroad. As it happens, despite any such argument, U.S. federal income tax law does not treat state and local income taxes paid by individuals as deductible business expenses. However, pushing the far right pole of my second continuum even further out, by defining it in terms of pre-foreign tax FSI, would not change the structure of my analysis.

\textsuperscript{23} See Internal Revenue Code section 7701(b)(1). The substantial presence test requires at least 31 days of current-year physical presence, plus at least 183 days over a three-year period that also includes the prior two years. For purposes of the latter computation, however, one multiplies the number of physical presence days in the immediately preceding year by one-third, and those from the year before that by one-sixth. See Internal Revenue Code section 7701(b)(3)(A). In addition, one who meets the substantial presence test despite being physically present for less than 183 days during the current year may escape being classified as a resident alien if she has a foreign tax home in a country to which she has closer ties than to the United States. See Internal Revenue Code section 7701(b)(3)(B).

\textsuperscript{24} As noted above, foreigners who reside in the U.K. may avoid being taxed on their FSI if they qualify as non-domiciliaries. See HM Revenue & Customs, supra. This rule has recently been criticized for, in practice, permitting “non-doms” who employ aggressive tax planning to “use the status to avoid tax on money made in the United Kingdom.” Tom Bergin, \textit{Special Report – Britain’s home-grown tax haven}, Reuters, May 22, 2015, available on-line at http://uk.reuters.com/article/2015/05/22/uk-britain-tax-nondoms-specialreport-idUKKBN0O711320150522.
subject to U.K. tax jurisdiction with respect to FSI, “depend[ing] on how often and how long you are here, the purpose and pattern of your presence and your connections to the UK …. includ[ing] the location of your family, your property, your work life, and your social connections.”

--France defines as residents, not just those individuals who spent more time during the year in France than in any other country, but also those whose home, principal professional activity, or center of economic interests is in France. This, too, uses evidence of long-term domestic domicile to overcome the significance of living abroad.

--Israel applies a “center-of-life” test, based on examining one’s domestic social, economic, and family ties, in addition to creating a rebuttable presumption that one is a domestic via a 183-days physical presence test.

Other countries may even impose tax on the worldwide income of individuals who lack *any* current-year domestic ties – for example, by taxing nonresident citizens who may have expatriated, but only recently. This is the ground on which Daniel Gutman discerns willingness to “extend the concept of residence by resorting to fictions,” such as that of continued residence, motivated by concern about tax-motivated expatriation.

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25 See HM Revenue & Customs, supra. I am grateful to Amir Cooper, a student in my spring 2015 Tax Policy Colloquium at NYU Law School, for bringing this and the next two examples to my attention.

26 See French Code général des impôts, section 4B., available online at [link](http://www.legifrance.gouv.fr/affichCode.do;jsessionid=81605B0C64A17F783AF7310980C6CB2C.tpdila13v_1?idSectionTA=LEGISCTA000006179569&cidTexte=LEGITEXT000006069577&dateTexte=20090228). These rules are described in English at [link](http://www.thegoodlifefrance.com/tax-residence-in-france).


28 Gutman, supra (again, using my translation of an article written in French).
citizenship-based taxation, at the same time that “an opposite doctrinal movement is emerging in the United States.”  

A key common thread between these countries’ rules and those followed in the United States is the use of evidence other than just physical presence in order to detect domestic affiliation. Arguably, there is a common underlying notion of “true” domestic domicile (or permanent home) that countries merely implement in different ways. Once such a notion exists in multiple countries, one should not be surprised by evidence of widespread reluctance to rely solely on a physical presence test, which in some cases could easily be manipulated by members of the home community who simply wanted to lower their domestic tax burdens through temporary relocation, without truly changing their long-term affiliations. Otherwise, and especially under a realization-based income tax, some individuals would surely find it all too easy to exit for a while, especially when they anticipated earning or realizing a large lump of income within a short period.

Based on this evident commonality of purpose, Edward Zelinsky questions the “scholarly consensus hold[ing] that U.S. citizenship-based taxation is an aberration.”  

In his view, citizenship is merely “an administrable, if sometimes overly-broad, proxy” for the concept of domicile or permanent home.  And even if the U.S. rules cast a broader net overall than those of most peer countries, in some instances our rules may be narrower. Perhaps reflecting the weight that they attach to citizenship, the U.S. rules do not separately use a domicile concept to classify people as U.S. taxpayers. Factors other than physical presence that arguably might suggest a U.S. domicile – for example, the

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29 Id.
30 Zelinsky, supra, at 1289.
31 Id.
location of one’s family, property, work life, social connections, or economic interests—will not cause one to be classified by the U.S. rules as a domestic taxpayer.\(^{32}\)

Suppose a non-citizen spends 120 days a year in a country that might treat her as a domestic taxpayer. While she would avoid substantial presence under the U.S. test,\(^ {33}\) countries such as the United Kingdom, France, or Israel might nonetheless classify her as a domestic taxpayer if her family, property, work life, other economic connections, and/or social connections were deemed sufficiently domestically based.

**How does the United States actually tax nonresident citizens on their foreign source income?** – When we turn to the second continuum, it becomes even clearer that the United States is not a dramatic outlier—even if our citizenship net applies, in the aggregate, to a much larger percentage of plausible PCMs than peer countries’ domiciliary rules. After all, we come nowhere close to levying the tax on nonresident citizens’ FSI that would arise if all of it were includable and foreign taxes were, at best, deductible.

The main tax benefits that we provide, relative to this benchmark, are twofold. First, Internal Revenue Code section 911 exempts from U.S. tax the “foreign earned income” of nonresident citizens (and green card holders), up to a ceiling of about $100,000 that is indexed to annual inflation.\(^ {34}\) The provision also allows certain high

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\(^{32}\) As noted above, under Internal Revenue Code section 7701(b)(3)(B), a domiciliary type of analysis can lead to a non-citizen’s avoiding substantial presence (and thus treatment as a domestic taxpayer) if she spends less than 183 days in the United States during the current year. The U.S. rules do not, however, similarly use a domiciliary analysis to establish substantial presence where its terms would not otherwise be met.

\(^{33}\) Again, the U.S. rules test for physical presence by adding together all current year physical presence days plus one-third of the previous year’s days plus one-sixth of the days from two years ago. U.S. Internal Revenue Code section 7701(b)(3)(A). One avoids substantial presence if the sum total is less than 183 days. Someone who was present in the United States for 90 days each year would continually have a “count” of 180 days (i.e., \(120 + 40 + 20\)).

\(^{34}\) Internal Revenue Code section 911(b)(2)(D). For 2015, the inflation-adjusted amount stood at $100,800.
housing costs that are incurred abroad to be deductible. Secondly, U.S. taxpayers generally can claim foreign tax credits with respect to the foreign income taxes that they pay on FSI. Thus, even for includable FSI, U.S. tax liability generally is limited to that resulting from the spread, if any, between the U.S. rate and the applicable foreign rate.

These limitations on the actual imposition of U.S. tax liability for nonresident citizens’ FSI are great enough that Reuven Avi-Yonah views them as effectively a game-changer. Despite believing that worldwide U.S. taxation of nonresident citizens, based on their ability to pay, “could be appealing” in theory, he dismisses it as irrelevant to the current debate, given that U.S. liability only pertains to “the relatively few cases of citizens living overseas in countries that have no or low income taxes.”

Avi-Yonah’s point is not that there is no significant revenue involved, but rather that there is nothing approaching a comprehensive effort to measure nonresident citizens’ ability to pay. Available data regarding nonresident citizens, while limited, tends to bear this out. For example, for 2011, published IRS data reveal that “nonresident Americans claiming the foreign-earned-income exclusion earned $54.1 billion abroad, of which more than $28.3 billion was not taxable due to the exclusion. After application of the exclusion and foreign tax credits, this group’s remaining U.S. income tax liability in 2011 was just over $5 billion.”

This combines being nontrivial in revenue terms with showing a fairly low U.S. effective tax rate for the reported income. Other published information for 2011 reveals

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35 Section 911(c).
36 Avi-Yonah, The Case Against Taxing Citizens, supra, at 8-9. Avi-Yonah also dismisses the ability-to-pay argument, with respect to U.S. citizens, on the ground that the worldwide tax (insofar as it is levied) applies to nonresident green card holders, rather than just to citizens. See id. at 8.
37 Mason, supra, at 14 (citations omitted).
38 The overall U.S. effective tax rate for foreign earned income may well be lower than that from the reported figures, even if one counts taxes that are legally owed but not paid. Some taxpayers who are
that, for nonresident Americans overall, less than 20 percent had any U.S. tax liability.\footnote{Id. at 15, citing NAT’L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS (2012) at 262.} At the high end, however, people who not only earn wages well above section 911’s roughly $100,000 floor but work in countries with comparatively low personal income tax rates, the residual U.S. tax liability may be significant.

Despite limited data availability, one can perhaps infer something about the U.S. system’s effect on nonresident high-earners from past political debate concerning section 911. In 2006, Congress amended it by causing the excluded income to affect the marginal tax rate that would apply to income above the ceiling, thus raising affected high-earners’ tax burdens.\footnote{Cite.} This apparently displeased U.S. companies that, when they send such individuals abroad, generally make them whole for the after-tax cost-of-living aspects of moving. The change therefore prompted a Wall Street Journal op-ed by Newt Gingrich and leading corporate tax lobbyist Ken Kies, urging Congress to reverse course and wholly exempt foreign earnings. Sounding a familiar theme, Gingrich and Kies argued that the changes would “make American business less competitive in the global economy.” Perhaps equally unsurprisingly, they claimed that the changes to section 911 would harm, not just big U.S. multinationals, but also those perennial favorites in American political rhetoric, “small- and medium-sized businesses.”\footnote{Newt Gingrich and Ken Kies, \textit{Our Taxed Expats}, Wall Street Journal, June 28, 2006, at A-14, available online at \url{http://www.wsj.com/articles/SB115146137545192705}.}

Whether one finds this persuasive or not, it does help to demonstrate the actual significance of the tax on high-wage-earning nonresident citizens, despite section 911 and

entitled to the exclusion may not claim it if foreign tax credits would eliminate the residual liability anyway. Id. at 14 n. 82. In addition, while section 911 does not eliminate the legal requirement to file a U.S. income tax return even if it would cause one to owe no U.S. tax, it is plausible that technical noncompliance is especially high among people with foreign earnings below the cap, whether because they generally have less access to good tax advice or because they regard filing in such circumstances as a pointless waste of time.\footnote{Id. at 15, citing NAT’L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS (2012) at 262.}
foreign tax credits. In addition, the Gingrich-Kies account offers a theory concerning the incidence of taxing the high-earners – asserting that it would fall at least initially on the company (raising standard questions about the incidence of the corporate tax), rather than on the high-earners themselves. Such individuals also may tend not to be burdened significantly by compliance and reporting costs, which large U.S. multinationals tend to help them with.42

By contrast, for many and perhaps most nonresident American citizens – given the evidence that most of them owe no U.S. tax – concern about filing and compliance burdens surely is primary. For example, section 911 requires complex computations even from people who, by reason of its application, end up owing little or no U.S. federal income tax.43 This reflects not only currency conversion issues, along with questions of the applicable marginal rate and allowable foreign tax credits for income above the ceiling, but also the fact that section 911 does not apply unless one expressly elects it.44 Thus, nonresident American citizens who earn much less than the ceiling amount, and who do not otherwise have significant taxable income, nonetheless are supposed to file U.S. tax returns every year, not only as a compliance obligation but also as a prerequisite to avoiding U.S. liability on their earned income.

The requirement that one file a U.S. tax return while abroad even if one owes no U.S. tax, and in particular that one expressly elect section 911 or else it will not apply, contributes to creating burdens that nonresident Americans may view as pointless and even offensive. Ruth Mason notes the widespread view that “onerous tax and financial

42 See Kirsch, Taxing Citizens in a Global Economy, supra, at 496-497.
44 See section 911(a).
reporting requirements … [by i]mplicitly casting Americans abroad as tax dodgers and money launderers[.],] tends to alienate them.”

This may be especially counter-productive if we are eager to maintain good relations with these individuals, whether to encourage their return to the United States at some point in the future, or so they will be more dedicated and effective U.S. goodwill ambassadors while living abroad.

Summing up – The above discussion suggests drawing the following conclusions:

1) Despite our uniquely applying citizenship-based taxation to nonresident PCMs who are not current U.S. residents, the United States could reasonably be viewed as not in substance a dramatic outlier. Indeed, even if our overall reach as to PCMs is unusually broad, keeping in mind both who is taxable on FSI and how much U.S. tax they owe (or what compliance burdens they occur), the gap may be narrowing as other countries, concerned about tax-motivated temporary or permanent expatriation, move in our general direction.

2) The fact that the U.S. rules do not fundamentally diverge from common global norms does not, of course, mean that they are just fine as they stand. Even absent a fuller analysis, a belief in the wisdom of crowds (in the sense of common practice elsewhere) might suggest narrowing the rules’ purely citizenship-based reach. It also might lend support to adding a domiciliary analysis.

3) The current U.S. rules’ most clearly dubious feature is the apparent disproportion, for most nonresident citizens, between the tax stakes at issue and the compliance burdens imposed. One response might be converting section 911 from an opt-in to an opt-out provision. Nonresident citizens who owed no U.S. tax because they

45 Mason, supra, at 43 (citations omitted).
46 On nonresident U.S. citizens’ potential role as goodwill ambassadors abroad, see, e.g., Kirsch, Taxing Citizens in a Global Economy, supra, at 521; Mason, supra, at 42-43.
only had earned income that was below the floor amount might be excused from filing. This might be accompanied by a rule providing that people who were eligible for the section 911 exclusion, by reason of being nonresidents, could also automatically exclude a modest amount of other income. To be sure, unless the exclusion amounts were designed as “cliffs” (ceasing to apply at all, once one exceeded them), there would still be people who legally had to file despite owing only trivial amounts of tax. At least, however, these would generally be people with greater resources than those subject to trivial tax burdens today, rendering them better equipped to handle the compliance burdens.

4) The fact that nonresident Americans paid $5 billion of tax in 2011 (presumably, mostly on FSI), despite the section 911 exclusion and foreign tax credits, suggests that the U.S. rules should not be scrapped simply on the ground that the game is not worth the candle. This is not trivial revenue, and it presumably comes mainly from high-earners, who have significant ability to pay. 47

One may always, of course, decide that particular income tax provisions represent bad policy, and thus should be scrapped even if they raise significant revenue from high-earners. The point here is simply that revenue inconsequentiality alone would not support greatly narrowing our rules identifying PCMs who are taxable on their FSI. One needs a fuller assessment. The rest of this paper explores two aspects of that assessment:

47 Greatly narrowing or eliminating citizenship-based taxation of nonresidents would potentially cost a lot more than the direct revenue cost indicated by present law, given the tax planning schemes that it could newly empower. Opponents of citizenship-based taxation commonly recognize this, and respond by calling for broader exit taxes and/or an expanded residence concept that might incorporate notions of domicile. See, e.g., Blum and Singer, supra, at 720 and 731-32; Schneider, supra, at 138; Reuven Avi-Yonah and Patrick W. Martin, Tax Simplification: The Need for Consistent Treatment of All Individuals (Citizens, Lawful Permanent Residents and Non-Citizens Regardless of Immigration Status) Residing Overseas, Including the Repeal of U.S. Citizenship-Based Taxation 9 (2013), available on-line at http://www.procopio.com/userfiles/file/assets/files1/tax-simplification-the-need-for-consistent-tax-treatment-of-all-individuals-residing-overseas-including-the-repeal-of-u-s-2658.pdf.
“us versus them” issues pertaining to how one defines taxable PCMs, and design issues for the taxation of FSI earned by such individuals.

III. “US” VERSUS “THEM”

In a one-country tax policy analysis, everyone’s wellbeing matters. With multiple countries, however, each sovereign in its own territory, one can expect that countries generally will look primarily, or even exclusively, to the welfare of their own people.

To the perfect altruist, this narrowing of the relevant framework of concern may seem ethically questionable. After all, people in other countries surely feel pleasure and pain as strongly, and are moral agents as fully, as those in one’s own country. Of course, by the same token, it might also be questionable for individuals to prioritize their own welfare and that of family members, rather than that of all humanity, when deciding how to spend their household incomes. The two cases raise parallel justificatory issues.

In practice, we commonly accept, on one ground or another, not just that people generally will take a narrower and more selfish view than perfect altruism would entail, but also that our everyday ethics must tolerate this. Otherwise, we would be demanding, both from ourselves and others, more than we or they are willing to give. Given this point, it is widely accepted that the ethical notions driving personal behavior may retreat from demanding perfect altruism towards relying on formulations that emphasize reciprocity, like the Golden Rule (“do unto others …”). Under such a view, a degree of self-centeredness is permissible from ourselves, given that we expect no more from others.
Returning from the personal realm to the national one, this may help to explain why largely checking one’s concern for human welfare at the notional national border is commonly viewed as entirely acceptable. In international tax policy debate, as I have noted elsewhere, even when people write about “worldwide welfare” as a policy guidepost that they prefer to “national welfare,” they appear to be urging the adoption of cooperative strategies that have the potential to improve everyone’s welfare – not self-sacrifice for others’ benefit. Thus, even proponents of unilateral foreign tax creditability – a position that effectively treats it as a matter of indifference whether one’s own country or another gets particular tax revenues – generally do not take the next step and urge, say, that the United States build no more schools until poorer and needier countries have been brought up to our level.

Once one accepts the priority of domestic individuals’ welfare, one has divided the world into “us” and “them.” However, there are no clear guideposts delineating where and how this distinction should be drawn. The best-known standards historically, emphasizing such considerations as race, common ancestry, and common culture, are rightly discredited today by their association, in many infamous cases over the centuries, with a country’s engaging in genocidal ethnic cleansing at home and/or aggressive imperialism abroad. Even without such a history, however, to live in a country like the United States is to see firsthand how greatly one’s society can be enriched – and not just economically – by the influx of immigrants from all over the world. So the category of

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48 See Daniel Shaviro, FIXING, supra, at 108-109, for a fuller discussion of the grounds for a given country’s pursuing national rather than global welfare, even though all people everywhere presumably matter equally from an ethical standpoint. [Added page cites for WW as a proxy for cooperation?]
49 See id. at _. 
“us” must be defined based on observations other than just who particular individuals
“are” in any predetermined sense.

For most international tax policy issues, one can simply take the “us versus them”
distinction for granted, and keep it in the background while asking how best to advance
national welfare. With respect to taxing PCMs, however, the definition of “us” and
“them” becomes the very question being asked. Thus, the lack of clear guidance
regarding how to draw a line, standing on somewhat shaky moral ground to begin with,
becomes a real problem.

Conventional tools from the tax policy and public economics literatures do not
offer much direct illumination. Consider optimal tax theory, which generally uses a
utility-based social welfare function as a tool for evaluating the merits of alternative
policies.50 Such a framework cannot help us to decide whose welfare should count for
purposes of the analysis. And, while there are literatures that discuss and seek to define
the notion of community – for example, in relation to immigration or voting rights
questions51 – those of us who proceed from a standard social welfare framework may find
it hard to motivate choosing one such normative approach over others.

Still, two factors that would appear clearly to have strong intuitive appeal, when
one thinks about the “us” category, are (a) people’s physical location and (b) something
about their mental states, be this focused on their connections, senses of personal identity,
or intentions regarding the future. Each of these two elements merits distinct attention.

Physical location – Even in a world with Skype, FaceTime, and rising “virtual
reality” technologies, it still clearly matters where people are physically located. On the

51 See Mason, supra n. 5, at 4 n. 24-25 (offering examples of scholarship exploring the notion of
community for immigration or voting rights purposes).
inbound side, consider the conflicting intuitions that may be evoked by illegal immigration. Even if one is comfortable with deporting illegal immigrants, it is hard to resist the intuition that one should care more about their wellbeing than one would if they were still overseas. Indeed, in the 2012 U.S. presidential election, Mitt Romney faced widespread criticism on these grounds, apparently to his political detriment, by reason of his advocating “self-deportation,” or making things so miserable for the illegal population that they would conclude they had no choice but to leave.52

The relevance of being here may reflect, not just its impact on people’s visibility, but also a sense of the moral relevance of the social interactions between people who are inhabiting the same space. If illegal immigrants have no rights and their welfare is ignored, one may worry about living in a two-class society, quite distinctly from how one would worry about global inequality in general.

Presumably for related reasons, it seems to matter intuitively when resident individuals go abroad for sufficiently long periods. Few would say that I am only 11/12 of an American this year if I spend a month in Europe. However, if I am abroad for long enough, a question arises as to whether I am as clearly and fully a member of the home country community as I would have been in the case where I stayed home.

In this regard, it is noteworthy that countries generally decline to extend their social safety net institutions to people who are living abroad. The United States, for example, is certainly no outlier when it limits Food Stamps and Medicaid coverage to

people who are physically in the U.S. Admittedly, this practice is a bit over-determined, in that attempting to offer such benefits to Americans abroad would raise a host of administrative and design problems. How would their circumstances be monitored? What if citizens abroad were in need simply because they had chosen to live in places where they lacked economic connections and marketable skills? And of course, for in-kind programs such as Medicaid, how would the benefits be delivered? Even beyond all these problems, however, it seems clear that we are inclined to care somewhat less about our own people when they are abroad for extended periods, rather than living among us.53

Mental states – While physical presence clearly matters intuitively, something about citizens’ mental states, when they go abroad for extended periods, evidently matters as well. Here, however, it may be useful to distinguish between self-identification and future intention. As an example of relying on self-identification, Michael Kirsch, arguing in favor of worldwide citizenship-based taxation of U.S. individuals, says that one who “retain[s] his U.S. citizenship is expressing a voluntary identification with the United States,”54 thus making it reasonable to apply ability-to-pay analysis and demand a tax contribution based on worldwide income.

To illustrate the relevance of intention, suppose that a given American expatriate is planning to return to the United States at some point, but is willing to let the timing be affected by tax considerations. For example, absent worldwide citizenship-based taxation, suppose that she would plan to sell her appreciated assets just before returning, rather than just afterwards. Since she will be a full-fledged American again once she has returned, and since we may view people as having (at least to a degree) continuous selves

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53 Social Security benefits are payable to Americans who go abroad, but this presumably reflects the benefits’ rhetorical status as an “earned benefit.”

54 Kirsch, supra, n. 4, at 481.
across their lifetimes, this consideration would surely weigh in favor of designing rules to combat such tax planning. However, such an argument, unlike one based on self-identification, may not apply to an expatriate who still retains some degree of psychic self-identification with her prior country, but who will not be coming back.

The paradox: If you’re among “us” and we care about you, you lose – The above discussion relates to how common intuitions might influence decisions regarding who is “us” and who is “them.” Returning to why this matters, recall the starting point, which is that only “our” welfare, not “their” welfare, matters for purposes of domestic policymaking.

One might think, therefore, that being counted as among “us” is a good thing – as indeed it may be, in practice, for some limited purposes, such as whether one can expect to be rescued if one is trapped in the middle of a foreign emergency.\(^{55}\) Instead, however, in the tax setting being one of “us” is evidently a bad thing, since it means that one may have to pay tax on one’s FSI. And again, this is not even offset by the prospect of receiving social safety net benefits, given that they are restricted to domestic residents.

In short, we burden those whom we care about, in the sense of having classified them as among “us.” By contrast, so far as FSI is concerned, we excuse from bearing any domestic tax burden those whom we do not care about, because, as members of the “them” group, they fall outside any analysis that is based on ability to pay. Yet ability to pay presumably matters due to beneficence, since it is thought to affect the marginal

\(^{55}\) Kirsch notes that American citizens have in the past been rescued from abroad by U.S. troops, as during disturbances in Lebanon in 2006. Id. at 472. Mason responds by noting that the U.S. government may demand reimbursement from U.S. citizens whom it evacuates from foreign hotspots. Kirsch more recently has noted that, even in a purely domestic setting, those who require rescue may be asked to reimburse the government for the costs of rescue if they took unreasonable risks. See Kirsch, supra n. 6, at 219.
dis utility of bearing tax burdens. This makes it seemingly odd if our not caring about you at all means that we charge you nothing, without regard to your circumstances.

How might one make sense of this apparent paradox? If one cares about the welfare only of domestic individuals, one should want to apply what I call the “Monty Python tax principle,” exemplified by the man wearing a bowler hat, in one of the famous TV show’s episodes, who says: “To boost the British economy I’d tax all foreigners living abroad.” To be sure, in general the Monty Python tax principle is not available as a policy tool, due both to its at best limited feasibility from both an information-gathering and an enforcement standpoint, and to the possibility that other countries would retaliate.

In the case of citizens and perhaps other plausible PCMs living abroad, however, seemingly the Monty Python principle is pertinent. Suppose one grants both that some of our citizens abroad are “us” and that we therefore want to tax them on ability-to-pay grounds, and that the rest are “them” but we can tax them on Python grounds – at least, without other countries complaining as heatedly of overreach as they would if we randomly targeted their residents. Then, giving the existence of grounds for taxing both categories of expatriates, expansive worldwide taxation of overseas citizens and other PCMs would seem clearly to make sense.

If we in fact taxed the FSI of all plausible PCMs living abroad, there would be no paradox. Failing to qualify as among “us” would fail to improve one’s tax treatment, as it would simply alter the motivation for imposing worldwide taxation.

On what grounds might one object to thus eliminating the paradox? Some readers may simply be uneasy with the Monty Python tax principle, even if they accept

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56 From Monty Python’s Flying Circus, episode 15 (the Spanish Inquisition episode), the script of which is available online at [http://www.ibras.dk/montypython/episode15.htm#2](http://www.ibras.dk/montypython/episode15.htm#2).
generally restricting the reach of national policymakers’ beneficence to “us.” This, however, could partly reflect the unconscious or intuitive weight of reciprocity concerns that arguably do not (at least fully) apply here, given the fig leaf that limiting the taxation of foreign residents to U.S. citizens may offer.

Another objection to implementing the Monty Python principle here strikes me as having greater intuitive force. Suppose that one cares somewhat about the welfare of citizens and other plausible PCMs who are living abroad. In short, suppose that, while these individuals are not entirely “us” for all purposes, they also are not entirely “them.” Then one may be reluctant to impose full domestic tax burdens on them – identifying emotionally with how one might feel about this, if in their shoes – even if one would be willing so to burden “pure” foreigners.

An associated question is how to think about the deadweight loss imposed on nonresident PCMs by taxing their FSI. If we think of these individuals entirely as “them,” rather than as “us,” and thus consider their welfare normatively irrelevant, imposing substantial compliance burdens on them, relative to any revenue that is raised, while pointless, at least is not affirmatively objectionable for its own sake. Objecting to it would seem to require concern about collateral consequences, such as on goodwill towards the United States among foreigners generally. However, insofar as we deem citizens living abroad still to be at least partially among “us” normatively, a bad ratio of deadweight loss imposed to revenue raised is directly objectionable.

_A link to the benefit tax debate?_ – One noteworthy feature of the U.S. debate concerning citizenship taxation has been its focus on benefit tax principles. For example, Michael Kirsch notes that expatriate citizens may receive personal protection from the
U.S. military and protection for their property abroad through the U.S. State Department, while also having the rights to vote in U.S. elections and to reenter the United States at any time. Reuven Avi-Yonah responds that these benefits are relatively trivial compared to those enjoyed by U.S. residents, who enjoy “first-class government protection, the rule of law, an outstanding educational system, and the many opportunities of a free market economy.” Hence, in his view, “the benefits argument for taxing nonresident citizens is wrong.” Other commentators have likewise addressed the benefits issue, with an overall lean towards Avi-Yonah’s dismissal of the relative significance of what nonresidents get.

What is surprising about this debate is its proceeding despite most participants’ agreeing that benefit tax principles generally should play a limited role at best in contemporary income tax policy debate. Kirsch and Avi-Yonah, for example, agree that taxpayer benefit from government spending is irrelevant insofar as one is focusing on the ability to pay principle. The frequency with which the issue of benefit has nonetheless surfaced in the U.S. citizenship taxation debate – seemingly in contrast to other tax policy areas, where it is mainly invoked by libertarians who reject the ability to pay standard – suggests that, for many people, it has special intuitive weight here.

58 Avi-Yonah, supra, at 7.
59 Id.
60 E.g., can cite Mason, Zelinsky, Schneider, others.
61 See Kirsch, Taxing Citizens in a Global Economy, supra, at 471.
62 Kirsch argues only that “benefits theory is sometimes used to justify taxing jurisdiction,” as distinct from the level of taxation. Id. at 478. Avi-Yonah views benefit tax and ability-to-pay arguments as offering alternative grounds for claims that particular individuals (such as nonresident citizens) should be taxed. Hence, in his view showing sufficient benefit would be sufficient but not necessary to support taxing nonresident citizens. [Note others.]
Why this might be is not immediately transparent. The classic problem with a benefits analysis, other than its being irrelevant if one relies on a distributionally-based standard such as ability to pay, relates to measurement problems. Public goods, such as national defense, the rule of law, and maintaining well-functioning markets, are non-rival and non-excludable. Hence, one cannot readily charge prices for them, or determine their value to particular individuals.  

An associated point, especially relevant to nonresident PCMs, is that there may be no ascertainable marginal cost associated with public goods provision to a particular individual. Suppose I am an American who chooses to live abroad for ten or twenty years. Even insofar as, while abroad, I derive no benefit from public goods that can only be enjoyed inside the United States, this may not affect the cost to other Americans of paying for their provision. Nor can their provision realistically be discontinued while I am away, and then restored when I return.

Given this point, suppose we were to ask how people – say, behind a veil of ignorance regarding how likely they individually are to live abroad – might be expected to resolve dividing up the cost of within-country public goods provision. The answer, at least initially, would have to be that we do not know. Perhaps the consensus would hold that people should only have to pay while here and actually using the public goods. Perhaps it instead would hold that people should pre-commit to bearing shares that cannot be avoided by temporarily relocating. Without more information, it is hard to say.

65 I ignore for now the possibility, which I discuss in section IV, infra, that my living abroad affects the possibility that foreigners will take my place working in the United States, and thereby generate replacement U.S. source income that can be used to help pay for public goods.
In light of these imponderables, perhaps benefit serves an entirely different function here than it does in domestic tax policy debate. Rather than relating to the libertarian quest for despised redistribution, it serves as an intuitive proxy for being entirely among “us.” A nonresident citizen who receives only scant benefits may be viewed, while this state of affairs continues, as partly outside the charmed circle – to his or her advantage, given that the issue is tax burdens.

Even if one agrees that the reason benefit seems to matter so much, in the U.S. citizenship debate, is that it relates closely to people’s intuitions regarding “us” versus “them,” it is hard to know, in the end, what to make of it. After all, one cannot readily deny either that nonresident U.S. citizens get some benefits that have value, such as the right to return, or that they are getting significantly less on a current-year basis than those who are presently in residence. So is the glass half-full or half-empty? (Or, for that matter, one-quarter full or three-quarters empty, since it is not clear that a preponderance standard would capture the underlying intuitions, even if one could define it.) This conundrum appears to be at the debate’s core, but standard economics approaches do not provide obvious mechanisms for resolving it.

A broader lesson of the debate over nonresidents’ benefits may be that “us versus them” intuitions do not have an entirely discontinuous, either/or character. For people who are considered among “us,” but only to a degree, one may be unsurprised to observe support for limiting both their burdens (such as taxes on FSI) and their benefits (such as income support), compared to those of full community members. And again, the difficulty of devising and evaluating clear standards for distinguishing between “us” and “them” impedes critiquing these intuitions, whether or not one entirely shares them.
IV. TAXING THE FOREIGN SOURCE INCOME OF PCMs WHO ARE CLASSIFIED AS DOMESTIC TAXPAYERS

A. Alleviating Double Taxation Via Exemption or Foreign Tax Credits

One subject on which there is near-universal consensus in international tax policy debate concerns the importance of avoiding, or at least minimizing, “double taxation,” which arises when the same dollar of income is taxed by two distinct countries. The usual way in which double taxation at least potentially arises is via the overlapping application of both residence-based and source-based taxation to a given taxpayer’s FSI. Given the widely accepted rule of source country priority, the conventional view holds that residence countries should either exempt FSI that is taxed elsewhere, or else allow foreign tax credits for the source country tax.

As I have argued elsewhere, the conventional view is in important respects mistaken, or at least misdirected. “What matters about taxes is the burdens they impose, not how many times they are separately (as a formal matter) levied. Thus, most of us would rather be taxed twice at a 15 percent rate than once at a 40 percent rate.”

Aversion to double taxation may work well as a coordinating device between countries that are sufficiently similar – helping to explain its omnipresence in bilateral tax treaties – but, in the end, policymakers should focus on issues of actual substance, and embrace anti-double tax norms only insofar as they have desirable net effects in practice.

Whatever the anti-double tax norm’s merits and demerits in practice, its effect on coherent analysis in the literature has been unfortunate. In particular, it seems to have

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66 See Shaviro, FIXING, supra, at 4-10.
67 Shaviro, The Crossroads Versus the Seesaw, supra, at 5.
impeded general comprehension of the distinction between two margins affected by the choice between approaches such as exemption and foreign tax creditability. The first margin involves the tax burden that a given country’s tax system imposes on FSI, whether one thinks of this in terms of the marginal tax rate (MTR) or the average tax rate. The second involves how paying foreign taxes affects one’s domestic tax liability. For example, if, by reason of paying a dollar of foreign income tax, one’s domestic tax liability declines in present value terms by a dollar, then the marginal reimbursement rate (MRR) for that tax is 100 percent.

Exemption, in the pure case, imposes an MTR and average tax rate of zero on FSI. Its MRR is also zero, but, as this equals the MTR, exemption is an implicit deductibility system for foreign taxes. Just like a system with a positive tax rate for FSI and express foreign tax deductibility, it induces taxpayers to seek to maximize after-foreign-tax income, and to treat a dollar of foreign taxes as equivalent to any other dollar of expense or forgone income.

Foreign tax creditability, absent complicating factors such as credit limits or (for corporate taxation) deferral of the credits along with the associated income, creates a 100 percent MRR for foreign income taxes paid. This gives the taxpayer an incentive to seek to maximize before-foreign-tax income, and indeed to be wholly indifferent to foreign tax liabilities. In practice, countries with foreign tax credit systems often apply the same MTR to FSI as to domestic source income, although the credits can greatly reduce the average tax rate for FSI.

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68 Foreign tax credit limits can reduce the MRR, however – indeed, to zero if the credits cannot be claimed in another year. In the case of U.S. corporate income taxation, deferral for FSI earned through foreign subsidiaries can have the effect, in practice, of reducing the MRR and thus making U.S. companies foreign tax cost-conscious. See Shaviro, FIXING, supra, at 82-85.
As applied to the FSI of U.S. corporations, I have argued that both systems have serious flaws. Pure exemption often imposes too low a tax burden on FSI – as many countries that are commonly described as having exemption systems appear to agree, given that they tax certain FSI of resident companies.\(^{69}\) As for exemption’s being an implicit deductibility system in which the MRR equals the MTR, this optimizes domestic taxpayers’ incentives from a unilateral national welfare standpoint. After all, foreign income taxes are purely a cost to “us,” since “we” don’t get the revenues.

However, either of two considerations might cause the MRR to be too low when, as under exemption, it equals, rather than exceeds, the MTR. The first is that more generous treatment of foreign income taxes, extending even to full creditability, may be beneficial if other countries reciprocate. The second is that, at least for corporate income taxation, avoiding foreign taxes appears to be a “tag” indicating profit-shifting at the expense of the domestic tax base. This consideration appears to have motivated even ostensibly territorial countries to treat tax haven income unfavorably, despite the resulting discouragement of foreign tax avoidance that might otherwise be domestically optimal.\(^{70}\)

**Applying the Analysis to Nonresident PCMs** – Much, but not all, of this analysis still applies when the issue is how to tax the FSI of nonresident citizens. In particular:

1. **How should we compare the two standard approaches, for nonresident PCMs whom we classify as among “us”?** Exemption, as an implicit deductibility system, induces the PCMs to focus on maximizing their after-foreign-tax income, rather than their before-foreign-tax income. This creates the right incentive from the standpoint of unilateral national welfare. Suppose, however, that we would like to impose a greater-


\(^{70}\) See id. at 17-21.
than-zero tax burden on nonresident PCMs whom we classify as among “us,” but that pure exemption and pure foreign tax creditability are the only permissible choices. Suppose further that the foreign tax credit system would come closer than exemption to setting average tax burdens at the “correct” level – although conceivably (depending on further analysis) it could set them too high. There would then be a tradeoff between (a) exemption’s imposing too-low average tax burdens but optimizing incentives that pertain to foreign taxes and (b) creditability’s being better with respect to average tax burdens but worse with respect to foreign tax cost-consciousness.

(2) How should reciprocity considerations affect the choice of MRR? – In the case of corporate income taxation, the argument for offering foreign tax credits in the hope that other countries will reciprocate may have been strong at one time, but then was greatly weakened by shifts towards territoriality. Thus, when the United States offers credits for German, British, or Japanese taxes paid by U.S. companies, it can no longer take comfort in the view that those countries are crediting U.S. taxes (and hence might cease to do so, if we stopped first).

For taxing nonresident PCMs, things are more complicated. In cases where other countries impose tax on their domestic taxpayers’ U.S. source income, the U.S. income taxes paid generally are creditable. However, implicit deductibility reigns in cases where other countries do not tax their citizens’ U.S. source income. This can happen either by reason of their not applying worldwide taxation to PCMs who live abroad, or as a result of their having rules that, like Internal Revenue Code section 911, treat certain foreign
earned income as tax-exempt. In sum, therefore, if the U.S. ceased fully crediting foreign taxes paid by nonresident PCMs, but also did not fully shift to exemption, there might be some, but not across-the-board, scope for retaliation. This may tend to make the case for creditability (or at least for an MRR above the MTR) stronger for individuals’ earned income than for business profits that face corporate income taxation.

(3) How should tagging considerations affect the choice of MRR? – Tagging considerations seem unlikely to apply as strongly to individuals’ earned income as to multinationals’ business income. It is easier to observe where individuals are living and working, than where companies with complex global operations and multiple entities are generating their profits. Thus, the fact that a U.S. individual claims to have generated earned income in a low-tax rather than a high-tax foreign country probably does not indicate, to anything like the same extent as it might for a U.S. multinational, the use of income-shifting techniques.

To be sure, Michael Kirsch has noted that “some consultants and other service providers might have flexibility with regard to the location where they perform services.” Short-term and off-site work in particular might be subject to tax-motivated location-shifting that there is no particular reason to encourage. Still, if the problem is generally smaller for earned income than for business profits, this might tend to weaken the case, based on tagging, for providing a foreign tax MRR that exceeds the MTR.

Must We Choose Between Full Exemption and Full Creditability? – Both bilateral tax treaties and the prevailing anti-double tax norm would appear to push towards the

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71 For discussion of exemptions for foreign earned income that apply in such countries as Canada, France, Sweden, Australia, and Holland, see Hugh J. Ault and Brian J. Arnold, 468-470 COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS, 3rd edition (2010).
72 Kirsch, supra n. 4, at 519.
conclusion that, even if neither exemption nor foreign tax creditability is entirely optimal, we must accept as a constraint the need to choose one or the other. Intermediate options, such as taxing FSI at an MTR between zero and the full domestic rate while providing an MRR for foreign taxes that lies between the MTR and 100 percent, risk violating applicable treaties and the norm, potentially inviting adverse consequences.

There may, however, be an alternative. In September 2013, the U.S. Senate Finance Committee Staff (under then-Chairman Baucus) released a discussion draft of international tax reform options, which included an “Option Z” showing how one could implement intermediate options in a manner that at least arguably avoided formal double taxation. The basic mechanism was to divide each dollar of relevant FSI between a percentage that was exempt, and a percentage that was taxable but subject to foreign tax credits.

In illustration, suppose that a rule resembling Option Z treated specified earned income of nonresident U.S. citizens as one-third exempt, and two-thirds taxable but subject to foreign tax credits. For a nonresident citizen otherwise subject to a 39.6 percent U.S. MTR, this would result in such income’s facing a 26.4 percent MTR. Meanwhile, foreign taxes that the individual paid on the earned income would be two-thirds creditable. Accordingly, there would both be some residual U.S. tax liability (unlike under pure exemption) and some incentive to reduce foreign tax liabilities (unlike under a pure foreign tax credit system). The point for now, however, is neither to

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74 In illustration, suppose that, under the above approach, $30 of foreign taxes were paid on $100 of foreign earned income. The U.S. tax liability would be $6.40 (i.e., $26.40 minus two-thirds of the foreign tax
advocate such an approach nor to urge that it use particular parameters, but simply to
suggest that it be kept in mind as among the range of possibilities.

B. Should Foreign Earned Income Get Favorable Domestic Tax Treatment?

As noted earlier, the United States does not stand alone in providing favorable tax
treatment for individuals, otherwise taxable domestically, who generate earned income
abroad. However, similar rules in other countries are sometimes more targeted. For
example, they may require that one’s foreign earned income face significant source
country taxation.\footnote{Both France and Sweden condition exemptions for certain foreign earned income on its being sufficiently taxable abroad. See Ault and Arnold, supra, at 468.} There also are rules that limit exemption to bonuses and special
payments for working abroad,\footnote{See id. at 468-469, describing grounds for earned income exemption in Canada, France, and Australia. The Netherlands conditions certain tax benefits for foreign earned income on working abroad for a Dutch company, in effect, taking a page from the Gingrich-Kies “competitiveness” playbook. See id. at 469.} or to particular industries or jobs.\footnote{See id., describing an additional ground for earned income exemption in France.}

What might be the grounds for exempting or otherwise tax-favoring the foreign
earned income of an individual whom one otherwise classifies as a domestic taxpayer?
The issue here evidently is not “us versus them,” given that only members of the “us”
group would need a special exemption in order to prevent their earned FSI, like their
other FSI, from being domestically taxable. As we will see, the usual rationale relies on a
claim of national self-interest, with a tincture of argumentation based on ability to pay.
However, before getting to the grounds that might support favorable domestic tax
treatment of foreign earned income (against the background of otherwise taxing FSI), it is
useful to start with the basic case against, made crisply by Robert Peroni in the course of
advocating that section 911 be repealed.
Peroni makes three main arguments in favor of repeal. First, section 911 creates economically inefficient incentives to work abroad for tax reasons, and for companies to place American workers in low-tax jurisdictions abroad if they are the ones bearing the incidence of the tax change. Second, the exemption violates ability-to-pay principles, and thus distorts horizontal and vertical comparisons between Americans who work abroad and other Americans. Third – and here many proponents of expanding section 911 would agree – it creates significant compliance burdens. Again, under present law, section 911 is elective, requiring U.S. tax filing even by people who, including by reason of its application, owe little or no U.S. tax. Even in an Internet era, U.S. tax filing help and resources are generally scarcer abroad than inside the United States – for example, due to the scarcity of tax forms, which may require high bandwidth to download, and in light of the need to convert foreign currency to dollars. A provision in section 911 that allows deductions for high housing costs further adds to the current regime’s complexity. Simply making all foreign earned income taxable would ease some of these filing burdens, although not others.

The traditional counter-argument in favor of section 911 is that it aids “an army of hardworking salesmen moving abroad, often at great personal discomfort and sacrifice, in order to expand their U.S. employers’ (and accordingly America’s) interests throughout the world.” Hence, it ostensibly is a goad to American exports, and/or is needed for U.S. businesses to compete abroad, as argued by Gingrich and Kies. More soft-edged arguments in support of favorable treatment for Americans’ overseas earnings cite the

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78 Peroni, supra, at 1008.
79 Id. at 1008-1009.
80 See Mason, supra, at 39.
81 See section 911(c); Peroni, supra, at 1009.
82 Kirsch, supra n. 4, at 458 (citations omitted).
benefits of having “goodwill ambassadors … spreading American values and culture”83 abroad, or of “increasing exposure to foreign culture and foreign languages [that] might benefit the country once the citizen returns to the United States.”84

These arguments, even if one does not reject them altogether, do not appear to be especially powerful. As Michael Kirsch notes, in a globalized world the links between U.S. resident companies, U.S.-produced goods, and the advancement of U.S. national welfare abroad are not so tight as they arguably might have been decades ago.85 For example, both U.S. and foreign multinationals exploit global production synergies, rather than simply making goods at home and shipping them abroad.

What is more, even if, at one time, U.S. firms could rightly have been viewed as national champions battling abroad for national economic success (perhaps a naïve view of how international trade operates), those days arguably have passed. Mihir Desai notes that the “archetypal multinational firm with a particular national identity and a corporate headquarters fixed in one country is becoming obsolete as firms continue to maximize the opportunities created by global markets. National identities can mutate with remarkable ease and firms are unbundling critical headquarters functions and reallocating them worldwide. The defining characteristics of what made a firm belong to a country – where it was incorporated, where it was listed, the nationality of its investor base, the location of its headquarters functions — are no longer unified nor are they bound to one country.”86

83 Id. at 521.
84 Id. at 521-522.
85 See id. at 521-523.
The more soft-edged arguments, regarding goodwill ambassadors abroad (as distinct, one hopes, from “ugly Americans”87) and the enrichment of U.S. culture at home, identify positive externalities that surely do matter to U.S. national welfare. Once again, however, as Kirsch rightly notes, at best “a broad, across-the-board foreign earned income exclusion … [offers] a very inexact way to achieve the desired results.”88

There are, however, alternative arguments for treating foreign earned income more favorably than might seem to follow from viewing section 911 as merely a poorly rationalized tax preference. For example, suppose one agrees that foreign tax credits create incentive problems, as judged from a unilateral national welfare standpoint, but regards anti-double tax norms as imposing a binding constraint. Then exempting foreign source income, instead of granting credits, can have the virtue of inducing foreign tax cost-consciousness among U.S. individuals who work abroad.

What is more, even if we could tax FSI however we liked, without any concern about treaty compliance, retaliation by other countries, or broader adverse reputational effects on the United States, it is plausible that taxing foreign earned income in full, with foreign taxes merely being deductible, would be suboptimal. By analogy, consider the application of the corporate income tax to business income that has been earned abroad. For many decades, it was widely accepted in the literature that taxing resident companies’ FSI at the full domestic rate, with foreign taxes merely being deductible – an approach

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88 Kirsch, supra n. 4, at 523.
known as “national neutrality” (NN) would be unilaterally nationally optimal. The fact that this generally was not done seemed to suggest that countries must, however inexplicably unless based on concern about retaliation, be seeking to maximize global, rather than national, efficiency and welfare. This, however, raised the conundrum of why one did not commonly observe countries trying to “cheat,” by following NN, in circumstances where they might have thought they could get away with it.

A large part of the answer, it now appears clear, was that NN not only offends powerful interest groups (i.e., resident multinational companies), but is unlikely promote national efficiency and welfare, even without regard to how other countries respond. Suppose the U.S. were applying an NN-style regime to the worldwide income of U.S. companies. Both U.S. individuals and foreign individuals who would otherwise have invested abroad through U.S. companies could respond by using non-U.S. companies instead.

One mechanism for doing this would be incorporating new companies abroad, rather than here. A second would involve portfolio shifts. Under NN, assets that were in tax havens, rather than in the United States, would be comparatively less attractive to U.S. companies than to foreign companies that did not face so stringent a residence-based regime. Thus, one would expect the U.S. companies to hold more U.S. assets and less foreign assets (and foreign firms the other way around) than if their residence-based tax regimes were more similar. Due to the availability of such mechanisms, one might expect outbound investment through U.S. companies to be considerably more tax-elastic than investment in the United States (which is taxable on a source basis without regard to

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corporate residence). This suggests that it may be efficient to tax U.S. companies’ FSI at a lower effective rate than U.S. source income.⁹⁰

Such reasoning still partly applies when we shift the focus to individuals and earned income. To be sure, U.S. individuals who remain citizens cannot do the equivalent of incorporating abroad when they want to work abroad, since they are being taxed directly, rather than at the entity level. They can, however, work abroad less, and in the United States more, with foreigners shifting in the opposite direction, if U.S. individuals face NN on earned income and foreigners do not. In other words, there may be job shifts, analogous to portfolio shifts at the entity level.⁹¹

Job-shifting occurs when a foreign individual earns income in the United States by reason of a slot’s becoming available because a U.S. individual is working abroad, rather than at home. Consider, for example, a university that hires a foreign professor to teach certain classes because a member of its own faculty is teaching abroad.⁹²

Job-shifting reduces the U.S. revenue loss from not fully taxing U.S. citizens’ earned income when they work abroad, relative to the case where inbound and outbound job flows are wholly unrelated. Thus, even leaving aside the more complicated case of replacement workers who already were U.S. residents, it may support applying a lower U.S. effective tax rate to foreign earned income than would be suggested by an NN-style

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⁹⁰ See Shaviro, FIXING, supra, at 145-150.
⁹¹ Job-shifting is an instance of labor mobility, which is discussed, for example, in Ruth Mason, Tax Expenditures and Global Labor Mobility, 84 NYU L. Rev. 1540 (2009), and Ruth Mason and Michael S. Knoll, What is Tax Discrimination?, 121 Yale L.J. 1014 (2012). These two articles, however, address multi-jurisdictional optimization, whereas I am concerned here with a single country’s unilateral incentives.
⁹² Where the replacement worker is a U.S. individual, one may need to ask the extent to which he or she wanted to work, and would otherwise have been “involuntarily unemployed” due to labor market imperfections.
analysis, in which aggregate domestic and foreign earned income are assumed to be purely substitutes for each other.\textsuperscript{93}

V. CONCLUSION

When countries decide which PCMs they will classify as domestic taxpayers, they have good reason to go beyond relying exclusively on a current-year, physical presence-based residence standard. Testing just for whether one had spent at least 183 days in-country during the current year would make tax avoidance too easy, especially with realization-based income taxation of appreciated assets, and for work that one can do anywhere. However, once a country thus expands its taxing reach, even if initially aimed just at addressing tax avoidance by people who unambiguously are members of the home community, it faces the question of how far to go, and using what criteria. This raises issues that lack clear conceptual guideposts.

A central problem relates to deciding whose welfare should matter to domestic policymakers. An “us versus them” distinction is inevitable in a world with separate national governments, but conventional tax policy and public economics tools shed little direct light on how one might operationalize it. After all, from a sufficiently broad perspective, everyone’s welfare should matter equally.

\textsuperscript{93} With complete or one-to-one job-shifting, such that every dollar a U.S. individual earned abroad, rather than at home, was replaced by an extra dollar earned in the United States by a foreign individual, the net revenue cost to the United States of not taxing foreign earned income would be zero. In the case of corporate business investment, Mihir Desai and James R. Hines have argued that such a scenario would support exempting FSI under an efficiency benchmark that they call “national ownership neutrality.” See Mihir A. Desai and James R. Hines, \textit{Evaluating International Tax Reform}, 56 Nat’l Tax J. 487, 496 (2003). I have explained elsewhere why I do not agree with their reasoning. See Shaviro, \textit{FIXING}, supra, at 150-154. What I dispute there, however, is the claim that FSI should be taxed at a zero rate under the full replacement hypothesis, not their regarding replacement as relevant to the optimal tax rate on U.S. companies’ FSI.
The lack of a clear framework may leave intuition playing an important role, although this can undermine achieving consensus between people whose intuitions differ. However, there may be enough commonality of perspective to permit some measure of agreement, at least regarding the broad outlines of potential inclusion. Among potential community members or PCMs, those most plausibly treated as among “us” come from among those who have such ties to a given country as citizenship, past residence, likely future residence, and/or arguable domiciliary ties (such as those pertaining to the location of family members, property such as homes, and economic or business connections).

Within common intuition regarding “us versus them,” it appears clear that physical location counts for something. Even illegal immigrants whom one might want to expel evidently count for something while they are here. And even if people can leave for long periods without entirely ceasing to be among “us,” prolonged physical absence may reduce (even if it does not eliminate) one’s sense both of beneficence for the expatriate, and of the expatriate’s obligations towards the rest of “us.” Their presumed mental states also appear to matter intuitively in the calculus.

This brings us to the potential paradox that arises if one limits unpleasant tax burdens and reporting obligations exclusively to those whom one cares about sufficiently to classify as among “us.” It’s one thing for pop songs to refer to “hurting the ones you love,” and another thing to observe it as a matter of common national policy.

The paradox would disappear if one followed the Monty Python tax principle, which calls for taxing all foreigners living abroad – precisely because they are not “us,” so we don’t care about them – subject to the proviso that one can only really get away

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94 For example, “You Always Hurt the One You Love” is an old pop standard that Ringo Starr included on his first post-Beatles album, Sentimental Journey.
with it in the case of plausible PCMs. Then one might want to define taxable nonresident PCMs broadly, on the view that we either care about them enough to apply an ability-to-pay standard, or else are happy to burden them gratuitously to our fiscal benefit. However, even if one sees some logic in this way out of the paradox, it may lack broad intuitive appeal.

Conventional tax policy and public economics tools can offer more aid on the question of how, once we have decided which nonresident PCMs to classify as among “us,” we actually should tax their FSI. To understand the issues, one must go beyond the conventional focus on avoiding “double taxation” via foreign tax credits or exemption, and distinguish between the issues of domestic tax burden on FSI, and domestic MRR for foreign taxes paid.

For foreign earned income, offsetting labor flows (such that, when Americans work abroad, foreigners take their place earning income here) could support levying a reduced rate. In addition, if one must offer either exemption or foreign tax credits, then the former, even if it sets the domestic rate too low, at least induces foreign tax cost-consciousness.

Treating foreign taxes paid as better than deductible, whether or not as fully creditable, has two main rationales. The first is that foreign countries may reciprocate in their tax treatment of their own nonresident PCMs who pay taxes to the home country that is making this choice. This consideration appears to be more pertinent to the taxation of PCMs than of resident companies, since foreign tax credits remain a larger part of the individual than of the corporate international tax landscape. It thus might tend to make high MRRs more appealing here than under the corporate income tax.
On the other hand, income-shifting through tax planning maneuvers may be more of a concern with respect to corporate business profits than for individuals’ earned income. This may reduce the extent to which, for such individuals, paying low foreign taxes is a tag suggesting that such maneuvers are likely to be involved. This could tend to make high MRRs less appealing with respect to individuals’ earned income than under the corporate income tax.

 Might it be possible, and if so desirable, to “split the baby” between exemption and foreign tax creditability in the manner of the Baucus Staff’s Option Z? I am inclined to think that this approach, at the least, merits further consideration. More fully assessing it, however, is a task for another day.