

# Taxing Potential Community Members' Foreign Source Income

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# What's the issue?

While only the U.S. taxes wholly non-resident citizens with no time limit, in some ways there's more commonality than meets the eye.

E.g., other countries “extend the concept of residence by resorting to fictions” (Daniel Gutman).

And while the U.S. is super-aggressive in placing compliance burdens on expatriates, we often don't charge them much tax (§911, FTCs).

Some other countries are considering broadening their reach, while we are (perhaps) considering narrowing ours.

Calling the issue “citizenship taxation” risks confusing particular U.S. legal details with the more general question of whom one taxes on foreign source income (FSI) and why.

My paper (which I won't attempt to fully summarize here) offers observations on both the “whom” question & the “how” question re. taxing nonresidents' FSI.

# Potential community members

With apologies for the jargon, I find it useful to think in terms of which *potential community members* (PCMs) one includes for tax purposes.

These are the people whom we might plausibly choose to classify as among “us,” rather than “them,” within the world’s population.

An “us” versus “them” distinction is universal – albeit grounds for normative unease – among polities with geographically limited jurisdictions.

But note the irony or conundrum here: usually being among “us” is good – it means we care about you – but here it’s bad.

Being among “us” means we may treat your FSI as taxable (e.g., because we care about your ability to pay). So, if you win, you lose.

Only in the case where we *don’t* care about you will we decline thus to burden you.

# Explaining the conundrum

I find “benefit tax” debates about taxing nonresidents’ FSI a bit odd, given benefit’s usually limited role in modern tax policy debate.

We know the very rough answer:  $0 < \text{nonresident citizen's B} < \text{resident's B}$ .  
But why exactly is this driving the analysis?

The Monty Python tax principle – “tax foreigners living abroad” – might say: If we don’t care at all about particular PCMs, evidence of affiliation may provide an excuse for burdening them without outraging host countries. (But probably not being followed here.)

“Us vs. them” intuitions are hard to nail down, lacking in clear bright lines, and cause for genuine normative unease.

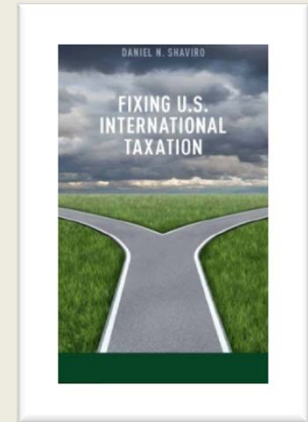
Physical presence surely matters – cf. immigration & those who live among us – but isn’t all that matters.

I don’t try to resolve this here. But note the importance of the social insurance / transfers side of the ledger, not just the taxing-FSI side.

# Once we've decided "who," how should we think about "how"?

I've previously thought a fair amount about whether / how to tax residents' FSI in the case of corporate income taxation.

The issues re. taxing individuals differ in some ways. But still, I'm inclined to think, it's worth considering cross-applicability.



A few of the main points: (1) Shouldn't focus so much on "double taxation" – what matters is burdens, not how many times one is taxed.

E.g., I'd rather be taxed ten times at 1% each time, than once at 35%.

(2) Important to distinguish 2 margins in taxing FSI: (a) net burden imposed, & (b) marginal reimbursement rate (MRR) for foreign taxes paid.

# Ways of taxing residents' FSI

Immediate and unlimited foreign tax credits offer a 100% MRR for foreign taxes paid – whereas exemption = implicit deductibility (MRR = MTR).

*Fixing* shows that, under some circumstances, one may want the effective tax rate on resident TPs' FSI to be  $> 0$  but  $<$  that for domestic source income.

It also suggests that the MRR for foreign taxes should generally be  $< 100\%$  (barring full reciprocity), but that in some circumstances it should be worse than deductible (as may result from having anti-tax haven rules).

Further work needed on how the analysis changes re. taxing individuals' FSI (although I offer preliminary observations).

Factors that may differ include TP residence elasticity, mobility of the taxable income at issue, and tax incidence / identity of corporate shareholders vs. individuals potentially treated as domestic TPs.

# Taxing foreign earned income

U.S. provides exemption up to a \$ ceiling (plus certain housing costs) under §911; FTC for taxable amounts; must file & elect exemption even if you'd owe no tax (!).

Peroni: exemption violates ability to pay & locational neutrality; doesn't mind FTCs since his standard is WW welfare; notes complexity of the current rules.

Kirsch: notes the weakness of certain standard arguments *for* §911 (e.g., export subsidy, maintain “competitiveness” of U.S. firms).

But here are 2 virtues of a lower (even if not zero) tax rate for foreign earned income of individuals who are treated as domestic TPs:

(1) A la the Desai-Hines analysis of “national ownership neutrality” (NON), to some extent “outbound” activity may be replaced by new “inbound.”

(2) May want domestic individuals working abroad to retain some foreign tax cost-consciousness (suggesting that the MRR be less than 100%).

# Worth thinking about?

2013 Senate Finance Committee discussion draft on international (business) tax reform: Option Z discussed how one might avoid formal double taxation without EITHER exemption or full foreign tax credits.

The basic idea: apportion each \$ of FSI between exempt and foreign tax-creditable components.

E.g., say the top individual rate is 39.6% & that earned income in that range is 1/3 exempt, 2/3 foreign tax-creditable.

Then, in effect, each dollar of earned income in that range faces a 26.4% MTR & is 2/3 creditable.

It's beyond today's scope to discuss in detail whether this is treaty-compliant, why it might be appealing in re. corporate income, & to what extent the same analysis carries over to individuals' foreign earned income –

But having more options on the table is generally a good thing.