TAX EXPENDITURES AND GLOBAL LABOR MOBILITY

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Governments often deliver social welfare benefits through "tax expenditures," which are provisions of the tax code (such as home mortgage deductions) designed to serve social policy objectives. This Article considers the criteria for granting tax expenditures to individuals who work outside the state where they reside. International tax norms currently assign the primary entitlement to tax labor income to the state where the taxpayer works, but they assign the obligation to confer personal tax expenditures exclusively to the state where the taxpayer resides. This Article argues that the disjunction between the entitlement to tax and the obligation to provide tax benefits affects cross-border labor mobility and has important distributive implications for taxpayers and states. In constructing these arguments, this Article introduces the concepts of "labor export neutrality" and "labor residence neutrality" as tools for analyzing government policies that affect global labor mobility. A policy is labor export neutral if it does not distort taxpayers' decisions about where to work. A policy is labor residence neutral if it does not distort taxpayers' decisions about where to reside.

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INTRODUCTION

Globalization has forgotten the worker. Scholarship on the tax consequences of globalization emphasizes the movement of capital and corporations, neglecting labor.[1] This oversight is not limited to taxation. Social scientists frequently protest the omission of labor issues from the study of globalization.[2] Emphasis on capital and corporations is not surprising, however, given their greater mobility compared to labor. But as international and regional trade agreements begin to relax restrictions on human migration, labor mobility will play an increasingly important role in globalization.[3]

This Article examines the provision of personal tax expenditures to taxpayers who work outside the state where they reside. Tax expenditures are tax benefits (such as exemptions, deductions, and credits) designed to serve social welfare purposes rather than income measurement purposes. Tax expenditure provisions are diverse; they include credits for buying hybrid fuel cars, deductions for childcare costs, and deductions for home mortgage interest.[4] As one of the most important mechanisms for delivering government benefits to

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[1] Exceptions include INCOME TAXATION AND INTERNATIONAL MOBILITY (Jagdish N. Bhagwati & John Douglas Wilson eds., 1989), which discusses income tax jurisdiction in response to increased movement across borders, and Mihir A. Desai et al., *Sharing the Spoils: Taxing International Human Capital Flows*, 11 INT'L TAX & PUB. FIN. 663 (2003), which examines potential tax policy responses from developing countries in reaction to migration of labor from those countries.

[2] *See, e.g.*, Jonathan W. Moses, *Exit, Vote and Sovereignty: Migration, States and Globalization*, 12 REV. INT'L POL. ECON. 53, 54 (2005) ("[T]he literature on globalization and human mobility is remarkably thin.").

[3] *See infra* Part I.A.

[4] Stanley Surrey, who introduced the tax expenditure concept to the United States, defined tax expenditures as tax provisions that "achieve a particular purpose, claimed to be desirable, *other than the measurement of net income*." Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 707 (1970) (emphasis added). Boris Bittker termed them simply "tax subsidies." Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244, 244 (1969). For criticism of the ambiguity of the tax expenditure concept, see *id.* at 260, which notes that "every man can create his own set of 'tax expenditures,' but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be."

It would be difficult to overstate the importance of the tax expenditure concept to tax scholarship. Some of the hundreds of law review articles dealing with tax expenditures and referenced *infra* include: Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006); Tsilly Dagan, *Commuting*, 26 VA. TAX REV. 185 (2006); Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187 (2004); Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407 (1999); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155 (1988). For more on tax expenditures in general, see *infra* Part I.B.

individuals and rewarding them for engaging in socially desirable behavior, tax expenditures represent a substantial fiscal commitment. For example, in the United States, tax expenditures nearly tripled in real terms over the last thirty years to $730 billion in 2004, of which approximately $650 billion represented expenditures for individual taxpayers.[5] Amounting to 7.5% of gross domestic product (GDP), U.S. tax expenditures exceeded discretionary spending in most years of the last decade.[6]

Despite the enormous body of scholarship dedicated to tax expenditures, the international aspects of personal tax expenditures remain unconsidered. Domestic income tax scholars have focused on domestic recipients of personal tax expenditures to the exclusion of cross-border recipients,[7] and international tax scholars have focused on business tax expenditures to the exclusion of personal tax expenditures.[8]

When individuals work outside the state where they reside, international law acknowledges the entitlement of both the work, or "source," state and the "residence" state to tax them.[9] An elaborately theorized network of at least three thousand bilateral tax treaties attempts to eliminate double taxation by providing priority rules for taxing income connected to more than one state.[10] Thus, the question of *entitlement to tax* international income has been examined closely since at least the 1920s, and detailed treaty rules govern which state may tax cross-border income, under what circumstances, and to what extent.[11] Curiously, however, the complementary question of which

[5] *See* U.S. Gov't Accountability Office, GAO-05-690, Tax Expenditures Represent a Substantial Federal Commitment and Need To Be Reexamined 3 (2005) [hereinafter GAO, Tax Expenditures], *available at* http://www.gao.gov/new.items/d05690.pdf.

[6] *Id.* at 4–5.

[7] *See, e.g.*, Stanley S. Surrey, Pathways to Tax Reform: The Concept of Tax Expenditures (1973); Stanley S. Surrey & Paul R. McDaniel, Tax Expenditures (1985); *see also, e.g.*, sources cited *supra* note 4.

[8] *See, e.g.*, International Tax Expenditures: A Comparative Study (Paul R. McDaniel & Stanley S. Surrey eds., 1983) [hereinafter International Tax Expenditures]; J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 Va. Tax Rev. 437 (2008).

[9] *See* Model Tax Convention on Income and on Capital (OECD Comm. on Fiscal Affairs 2008) [hereinafter OECD Model], *available at* http://www.oecd.org/dataoecd/14/32/41147804.pdf (providing a model treaty that allocates tax jurisdiction between the source and residence states).

[10] For more on how states tax cross-border labor income, see *infra* Part I.C.

[11] *See generally* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021 (1997) (providing history of the tax treaty process).

state bears the *obligation to confer tax benefits* has received almost no attention.

One might assume that the duty to grant personal tax expenditures to cross-border workers would be proportional to the entitlement to tax their income—that is, that the obligation to provide benefits would follow the entitlement to tax. The widespread tax treaty practice among states, however, has been to lodge the obligation to confer personal tax expenditures exclusively with the residence state, even though the source state usually has the primary entitlement to tax cross-border workers.[12] Tax treaty preparatory documents reveal that states' desire for an administratively simple method to prevent cross-border taxpayers from claiming duplicative benefits from more than one state motivated them to allocate the tax expenditure burden exclusively to the residence state.[13] At a time when policymakers have begun to question this allocation rule,[14] this Article examines its normative underpinnings and concludes that the current practice is efficient, fair, and simple.

Allocating personal tax expenditures exclusively to the residence state may not, however, be appropriate in all circumstances. By disassociating the entitlement to collect tax from the obligation to provide tax benefits, the current allocation may require a state to extend benefits to a taxpayer from whom it has collected little or no tax. As long as a state's inward and outward labor mobility flows are symmetrical—meaning that foreign workers earn income in its territory in roughly the same amounts as domestic workers earn income abroad—the state should not suffer net tax revenue losses, no matter what allocation rule it adopts in its tax treaties. Due to asymmetries in global labor mobility flows, however, the current tax treaty allocation rule paradoxically may shift net tax revenue from developing states, which tend to be net labor exporters, to developed states, which tend to be net labor importers. Although this effect has so far gone unnoticed, acknowledging it could improve the bargaining position of developing states in tax treaty negotiations with developed states.[15]

The allocation of personal tax expenditures must also account for other important factors, including whether the taxing states belong to

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12 *See infra* Part I.C.

13 *See infra* Part II.D.2.c.

14 *See* Ctr. for Tax Policy and Admin., Org. Econ. Co-operation & Dev. [OECD], Application and Interpretation of Article 24 (Non-discrimination), Public Discussion Draft (May 3, 2007) [hereinafter OECD Public Discussion Draft], *available at* http://www.oecd.org/dataoecd/59/30/38516170.pdf (identifying treatment of personal allowances under the OECD model tax treaty as an issue that "require[s] a more fundamental analysis").

15 *See infra* Part II.C.2.

an economic or political union, such as the European Union (EU). Similar cross-border allocation issues arise for interstate workers in other federal systems, such as the United States. Due to strict nondiscrimination provisions in both the European Community Treaty (EC Treaty) and the U.S. Constitution, both EU member states and U.S. states have had to defend their policies of denying workers from fellow states personal tax expenditures, even though such denials are consistent with international tax practices and, if the analysis in this Article is correct, consistent with principles of good tax policy. In turn, the European Court of Justice (ECJ) and the U.S. Supreme Court have had to determine how membership in an economic or political union affects a state's obligation to confer personal tax expenditures on taxpayers who reside in fellow states of the union. As this Article explains, both the states defending their policies and the courts imposing judgments have missed crucial issues. As a result, judicial precedents in this area provide little guidance to states attempting to resolve difficult tax issues raised by cross-border labor mobility.

To provide a framework for discussing international labor mobility issues, this Article builds on the influential work of economists Richard and Peggy Musgrave, who analyzed the impact of taxation on global capital mobility. I propose four benchmarks for analyzing government policies that affect global labor mobility. Under "labor export neutrality" (LEN), taxes would not distort taxpayers' choices about whether to work at home or abroad. To achieve LEN, states should tax their residents' foreign-source and domestic-source income the same way. Under "labor import neutrality" (LIN), cross-border tax differences would not distort taxpayers' choices about whether to engage in labor or leisure. To achieve LIN, states should exempt their residents' foreign-source income. Under "labor ownership neutrality" (LON), taxes would not distort whether particular jobs are filled by resident or nonresident taxpayers. To achieve LON, all states must either tax residents on a worldwide basis or all states must exempt foreign-source income. Finally, under "labor residence neutrality" (LRN), taxes would not distort taxpayers' choices about where to reside. To achieve LRN, states should exempt their residents' foreign-source income. Development of these labor mobility benchmarks is a major contribution of this Article, and, like the Musgraves' ubiquitous capital mobility benchmarks, the labor benchmarks I propose can be used to evaluate any tax or regulatory policy that affects cross-border work. This Article, however, uses the benchmarks to analyze which state should account for cross-border workers' personal tax expenditures. As Part II explains, the current exclusive allocation of the personal tax expenditure obligation to the residence state is consistent with labor export neutrality, whereas shifting the obligation to the source state would move toward labor residence neutrality.

My analysis of the personal tax expenditure allocation question proceeds in three parts. Part I provides background: It considers the effects of globalization on labor mobility, categorizes types of cross-border workers, defines personal tax expenditures, describes the taxation of cross-border workers, and discusses some alternatives to the current international tax norm of allocating personal tax expenditures exclusively to the residence state. Part II introduces the labor mobility benchmarks and employs them to analyze the current allocation rule under the classic tax policy criteria of efficiency, fairness, and simplicity. The Part concludes that, on balance, these criteria support the current allocation rule, which assigns the personal tax expenditure obligation exclusively to the residence state. Part III argues that although the current tax treaty allocation rule should not be amended to shift the full obligation for personal tax expenditures to the source state, states should consider taking steps to resolve what I call "double denial" situations. These situations arise when taxpayers earn almost all of their income abroad, such that they have too little taxable income in their residence state to be able to make effective use there of tax expenditures structured as exemptions, deductions, or nonrefundable credits. Part III also considers the implications of the normative analysis in Part II for states that are members of economic or political unions. It reviews conflicts that have arisen over how to allocate the personal tax expenditure obligation among the U.S. states and among the member states of the European Union.

I
Globalization, Labor Mobility, and Taxation

This Part discusses legal developments that make cross-border labor mobility an increasingly important issue. It then defines personal tax expenditures, describes international taxation of cross-border workers, and provides some alternatives to the current method of allocating personal tax expenditures among taxing states.

Throughout this Article, the terms "nonresident taxpayer" and "nonresident" refer to a person liable for tax in a jurisdiction even though she does not qualify as a resident under its tax law.[16] The terms "tax resident" and "resident" refer to a person qualifying as a

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[16] A person generally is subject to tax by a state if she derives income there, regardless of her state of residence. For more on residence-based taxation, see *infra* Part I.C.

resident under a state's tax law.[17] States' definitions differ, but a taxpayer's physical presence in a jurisdiction for more than half the days of the year is usually the most important factor for determining whether she is a tax resident.[18] For example, a tax professor who resides for the entire tax year in the United States but receives remuneration for delivering some lectures in Canada would be a tax resident of the United States and a nonresident taxpayer of Canada. As this Part explains, under international tax principles, both the United States and Canada would be entitled to tax the remuneration for the Canadian lectures.

A. Labor Mobility Trends

It is no mystery why people are less mobile than capital. Migrants face significant legal restraints and considerable costs in moving, including both monetary costs and costs caused by differences in language, culture, and professional standards. Moving also usually involves breaking work, social, and family ties. Yet despite the costs, people move. International economic migration is usually described in terms of the "push" and "pull" factors motivating it.[19] Lower wages, lower standards of living, poor public infrastructure, and high unemployment "push" workers to emigrate, especially from less developed countries.[20] At the same time, higher wages, higher standards of living, labor demands caused by aging populations, and the need for workers to fill positions deemed undesirable by native populations "pull" workers to more developed countries.[21] Rising income inequalities between nations increase migratory pressures,[22] while easily crossed borders, low travel costs, cheap long-distance communi-

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[17] For a comparison of immigration status and tax status under U.S. law, see generally Cynthia Blum, *Rethinking Tax Compliance of Unauthorized Workers After Immigration Reform*, 21 GEO. IMMIGR. L.J. 595 (2007).

[18] HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 347 (2d ed. 2004) (reviewing several states' definitions of tax residence). The tiebreaker rule proposed in the OECD model tax treaty resolves dual residence conflicts according to the following factors (in descending order of importance): where the taxpayer maintains a permanent home, where her personal and economic relations are closer, where she has her habitual abode, and her nationality. OECD MODEL, *supra* note 9, art. 4(2).

[19] NAT'L INTELLIGENCE COUNCIL, GROWING GLOBAL MIGRATION AND ITS IMPLICATIONS FOR THE UNITED STATES 3 (2001) [hereinafter NIC GLOBAL MIGRATION REPORT], *available at* http://www.dni.gov/nic/PDF_GIF_otherprod/migration.pdf.

[20] *Id.* at 13–16.

[21] *Id.* at 16–18.

[22] *See, e.g.*, Siow Yue Chia, *Labor Mobility and East Asian Integration*, 1 ASIAN ECON. POL. REV. 349 (2006) (analyzing migration of unskilled labor and professionals from developing world).

cations, and growing expatriate communities in receiving states aid migration.[23]

It is difficult to accurately gauge trends in international economic migration. Social scientists, national labor officials, and multinational organizations such as the World Bank and the Organisation for Economic Co-operation and Development (OECD) have lamented the paucity of salient statistics.[24] This gap can be explained in part by reliance on immigrant self-reporting,[25] the prevalence of undocumented immigration,[26] the lack of global standardization about how to categorize migrants,[27] and the relaxation of immigration controls within the European Union.[28]

Despite their deficiencies, the data reveal some general trends. First, international migration is growing in absolute numbers. A 1993 report for the World Bank concluded that the number of persons resi-

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23 NIC Global Migration Report, *supra* note 19, at 18; *see also* William J. Carrington et al., *Migration with Endogenous Moving Costs*, 86 Am. Econ. Rev. 909, 909 (1996) (reasoning that the presence of an expatriate community in the migrant-receiving state helps to lower costs for new migrants through information-sharing, housing assistance, and other cultural mechanisms).

24 *See, e.g.*, W.R. Böhning & Nana Oishi, *Is International Economic Migration Spreading?*, 29 Int'l Migration Rev. 794, 794 (1995) ("[M]any countries' statistics do not provide reliable data for legal migration; most countries do not have good estimates for illegal migration, [and] quite a few have no useable data at all, especially migrant-sending countries."); Sharon Stanton Russell & Michael S. Teitelbaum, International Migration and International Trade 13 (World Bank, Discussion Paper No. 160, 1992) ("Quantitative data on migrant flows . . . are virtually nonexistent."); John Salt, *A Comparative Overview of International Trends and Types, 1950-80*, 23 Int'l Migration Rev. 431, 431 (1989) (describing data as "grossly inadequate"); Jean-Christophe Dumont & Georges Lemaître, Counting Immigrants and Expatriates in OECD Countries: A New Perspective 2 (OECD Soc., Employment and Migration Working Papers), *available at* http://www.oecd.org/dataoecd/27/5/33868740.pdf ("Despite . . . increased movements and the heightened policy interest in this area, the quality and comparability of international data on migration have scarcely kept pace."). Data for developed countries are slowly improving. *See id.* (noting that almost all OECD countries have by now included questions regarding residents' state of origin in their censuses).

25 *See* Dumont & Lemaitre, *supra* note 24, at 9 (discussing problems self-reporting creates for data collection).

26 Michael Hoefer et al., Office of Immigration Statistics, Dep't of Homeland Sec., *Estimates of the Unauthorized Immigrant Population Residing in the United States: January 2008*, at 1 (2009), *available at* http://www.dhs.gov/xlibrary/assets/statistics/publications/ois_ill_pe_2008.pdf (reporting that 11.6 million unauthorized immigrants lived in the United States as of January 2008).

27 For example, some states only include permanent immigrants in their statistics on immigration while others also include temporary immigrants. Likewise, some states define immigrants as anyone foreign-born while others define immigrants as anyone possessing foreign nationality. *See* Dumont & Lemaitre, *supra* note 24, at 3. For a summary of the deficiencies of immigration data, see Russell & Teitelbaum, *supra* note 24, at 13.

28 *See generally* Heather Grabbe, *The Sharp Edges of Europe: Extending Schengen Eastwards*, 76 Int'l Affairs 519, 527 (2000) (describing relaxation of immigration controls within EU).

dent outside their nations of citizenship increased from 80 million in 1987 to over 100 million in the early 1990s, due in large part to the dissolution of the Soviet Union.[29] By 2001, the U.S. National Intelligence Council estimated that over 140 million people lived outside their birth countries.[30] Regional and international trade agreements facilitate such human mobility.[31] Second, the norm is now temporary migration, due to tighter restrictions on permanent immigration.[32] Third, migration to and among developed welfare states has increased,[33] reflecting growing migration by highly skilled labor.[34] As migration to developed countries increases, the question of how the tax expenditure burden should be allocated will become more acute, since developed countries deliver more social welfare benefits through their income tax systems than do developing countries.[35]

Cross-border workers are a highly diverse group, including both unskilled agricultural workers and executives of multinational enterprises. They walk, drive, or fly across borders. They may reside in the source state for long periods or commute there daily. Neither discrete nor exhaustive, the following categories of cross-border workers give a more nuanced picture of economic migration. For the purposes of this Article, the most important characteristic of a cross-border worker is that she earns labor income taxable by at least two different states.[36]

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[29] Russell & Teitelbaum, *supra* note 24, at 6.

[30] NIC Global Migration Report, *supra* note 19, at 3.

[31] For example, EU nationals have the "freedom of movement" to reside, work, or provide services in any other EU member state. *See* Consolidated Version of the Treaty Establishing the European Community, Dec. 29, 2006, 2006 O.J. (C 321E) art. 18 [hereinafter EC Treaty] (free movement of persons); *id.* art. 39 (free movement of workers); *id.* art. 49 (freedom to provide services); *see also* General Agreement on Tariffs and Trade: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Annex IB, pt. I, art. I.2(d), Apr. 15, 1994, 33 I.L.M. 1125, 1169 (extending application of agreement to services performed in one state by natural persons of another).

[32] Salt, *supra* note 24, at 448.

[33] *See* OECD, Policy Coherence for Development: Migration and Developing Countries 11, 41 (2007) (finding that developed countries' share of the migrant population has steadily risen and that the largest source for migrants to OECD countries was other OECD countries).

[34] *See* Böhning & Oishi, *supra* note 24, at 796–98 ("High-income countries are senders [of highly qualified economic migrants] to a much larger extent than previously.").

[35] *Cf*. Richard M. Bird & Eric M. Zolt, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. Rev. 1627, 1655 (2005) (finding that developing countries rely less than developed countries on income taxation).

[36] This Article does not cover workers who fail to report their income to their residence state or source state(s) because those workers are not subject to tax by more than one state.

Itinerant workers. Itinerant workers have a primary state of domicile where their family and social relationships are centered, but they earn income in several states. This group includes entertainers and athletes who earn income by performing in several states.

Seasonal workers. Seasonal workers have a primary state of work and domicile, but they take advantage of high wages temporarily available in other states due to seasonal changes. Examples include agricultural, hotel, and construction workers.

Cross-border commuters. Cross-border commuters live in the border region of two countries. Domiciled with their families in one state, they commute regularly across the border and typically earn most or all of their income in the other state. They include both unskilled and skilled workers, such as agricultural workers, domestic care-givers, doctors, and bankers. Cross-border commuting may occur at the border between a developed and developing country. For example, El Paso, Texas, and Juarez, Mexico, form a single border metropolis in which cross-border commuting in both directions is common.[37] Cross-border commuting also occurs between countries at similar stages of development. In 2005, for example, 35% of the workforce of Luxembourg commuted from neighboring developed countries.[38]

Company-aided migrants. Company-aided migrants move at the behest of a government, international civil service organization, or multinational business enterprise. They have the same employer before and after migration.

Long-term contract workers. Long-term contract workers are usually unskilled or semi-skilled workers permitted to work temporarily on a contract basis in the source state, often in dangerous and undesirable jobs.[39]

Permanent settlers. Permanent settlers who move in the middle of a tax year may be taxable by both their old and their new residence states.

B. What Are Personal Tax Expenditures?

The term "personal tax expenditures" generally refers to tax benefits—such as deductions, exemptions, credits, reduced tax rates, and so on—that serve primarily social welfare purposes, rather than

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[37] *See* Timothy C. Brown, *The Fourth Member of NAFTA: The U.S.-Mexico Border*, 550 ANNALS AM. ACAD. POL. & SOC. SCI. 105, 116 (1997) (noting that in 1997, 16,000 people commuted daily from Juarez to El Paso and 6000 made the reverse daily commute).

[38] OECD, REMOVING OBSTACLES TO GEOGRAPHIC LABOUR MOBILITY 157 (2007).

[39] *See* Chia, *supra* note 22, at 350 (describing the need for states to import foreign workers for "3D (dirty, dangerous, and demanding) jobs shunned by local workers").

income measurement purposes.[40] Many states, including the United States, publish annual tax expenditure budgets, which attempt to calculate how much tax revenue the state forgoes by virtue of tax expenditures.[41] But defining tax expenditures is a controversial affair, and little consensus exists as to how governments should measure their tax spending.[42] Critics of tax expenditure analysis argue that the concept is hopelessly vague because it requires a common normative definition of net income against which deviations (i.e., tax expenditures) can be measured.[43] For example, should we consider a deduction for commuting expenses to be part of the normative net income baseline, since commuting to work is a cost of earning income? Or should deductions for commuting expenses be labeled a tax expenditure, since a taxpayer's choice about where to live represents personal consumption, much like her decision about how much to spend on food or clothing?[44]

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[40] Whether a tax benefit serves a social welfare or income measurement purpose generally depends on whether the benefit directly relates to the production of taxable income. States must allow tax deductions for business expenses, including expenses incurred to perform personal services (such as a painter's costs for paint and brushes). But states also allow taxpayers to deduct many expenses unrelated to the production of taxable income. For example, the U.S. home mortgage interest deduction is not necessary for measuring net taxable income because the United States does not tax the imputed rental income associated with a personal residence. William G. Gale et al., *Encouraging Homeownership Through the Tax Code*, TAX NOTES, June 18, 2007, at 1171, 1173. Because the home mortgage deduction is not necessary for measuring income, it is deemed a tax expenditure; it is usually characterized as incentivizing home ownership. *See id.* at 1178 ("One of the popular misconceptions about the [mortgage interest deduction] is that Congress created [it] to encourage homeownership.").

[41] The Congressional Budget Act of 1974 requires estimations of tax expenditures as part of the President's annual budget, and it defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 2 U.S.C. § 622(3) (2006). For discussion of the difficulties of measuring forgone revenue, see STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Comm. Print 2008) [hereinafter JCT, TAX EXPENDITURES].

[42] The controversy in the United States regarding how to define tax expenditures is at least partially due to the politicization of the tax expenditure concept. Sugin, *supra* note 4, at 424–27; *see also* Shaviro, *supra* note 4, at 207–13 (proposing a more flexible approach that would characterize tax expenditures as primarily allocative provisions contained in an otherwise primarily distributional tax system).

[43] Bittker, *supra* note 4, at 247. For a discussion of the challenges inherent in the tax expenditure estimation process, see GAO, TAX EXPENDITURES, *supra* note 5, at 92–98. To eliminate reliance on a normative baseline, the Joint Committee on Taxation recently proposed measuring tax expenditures as deviations from an "identifiable general rule of the present tax law." JCT, TAX EXPENDITURES, *supra* note 41, at 39. For academic attempts to surmount the normative baseline problem, see McIntyre, *supra* note 4, at 83–92, Shaviro, *supra* note 4, at 207–14, and Thuronyi, *supra* note 4, at 1186–92.

[44] For a full discussion of this deceptively simple question, see Dagan, *supra* note 4, at 201–07.

Complicating matters, tax expenditure budgets do not include all tax benefits unrelated to measuring income. For example, states may not include in their tax expenditure budgets certain features of their tax systems that exist as a matter of administrative necessity, such as the failure of the tax system to account for inflation, the exclusion of imputed income,[45] or the realization rule.[46] Since these administrative features of the tax code generally apply equally to resident and nonresident taxpayers, they do not pose special problems for cross-border workers.

Commentators have already thoroughly discussed the difficulties in defining tax expenditures, and I do not revisit that debate because the precise definition of the term does not matter for this discussion. While I couch my analysis so far in terms of personal tax expenditures because that term is familiar, my analysis applies more broadly to any tax benefits conferred on resident, but not nonresident, taxpayers. This broader concept of tax benefits encompasses not only tax expenditures, but also so-called structural tax provisions that most commentators agree fall outside the definition of tax expenditures.[47] Structural provisions include progressive tax rates,[48] joint marital filing,[49] personal tax exemptions,[50] and the standard deduction.[51]

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45 Imputed income is the value of services one provides to oneself or the value of using one's own assets. For example, if a taxpayer lives in a house she owns, she has imputed rental income, which the United States excludes from taxation.

46 Under the realization rule, states defer inclusion of gains and deduction of losses until disposition of the related asset. An alternative would be a mark-to-market regime, which would account for annual appreciation and depreciation of assets. Marking to market is administratively infeasible because it requires accurate valuation of all assets on a yearly basis.

47 JCT, TAX EXPENDITURES, *supra* note 41, at 19, 22, 43.

48 *See, e.g.*, Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933 (holding that the German system of denying the benefit of progressive tax rates to EU taxpayers residing in other EU member states violated EC law).

49 *See, e.g.*, Case C-87/99, Zurstrassen v. Administration des Contributions Directes, 2000 E.C.R. I-3337 (holding that a residence member state could not deny marital joint filing to an EU national who earned nearly all his income in that residence state just because his wife and children resided in another EU member state). The United States denies nonresident aliens the opportunity to file joint returns unless they are married to citizens. I.R.C. § 6013(a)(1) (2006).

50 *See, e.g.*, *Gerritse*, 2003 E.C.R. I-5933 (holding that Germany's categorical denial of personal exemptions to EU taxpayers who earned income in Germany but resided in fellow EU member states violated EC law); *cf.* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79–80 (1920) (holding that a U.S. state violated the Privileges and Immunities Clause when it categorically denied personal exemptions to U.S. taxpayers who resided in fellow U.S. states).

51 *See, e.g.*, I.R.C. §§ 63(c)(6)(B), 873 (denying nonresident alien taxpayers the standard deduction and most itemized deductions, even when such nonresidents are subject to net basis taxation at progressive rates).

Thus, this Article concerns what I will call "personal tax benefits," a category broader than personal tax expenditures.

States use personal tax benefits to pursue a wide variety of goals. For example, states may create tax incentives for charity, home ownership, education, and even procreation.[52] Other tax benefits, such as progressive tax rates, serve distributional purposes.[53] Of course, some tax provisions serve more than one end. For example, the U.S. earned income tax credit, which is available to low-income taxpayers with earned income, provides an incentive for its recipients to work and also serves distributive goals.[54] Likewise, in addition to encouraging socially useful behavior, deductions for charity, education, and childcare costs may be seen as necessary to properly calculate net income.[55] It is important to keep in mind states' goals for offering particular tax benefits, since those goals—to influence behavior, redistribute income, or calculate income—may influence the decision about which state should provide the benefit. Additionally, the content and scale of tax benefits vary from state to state, reflecting voters' cultural, moral, and political values. Thus, the question about which state should grant personal tax benefits affects not only *whether* a taxpayer will be able to claim personal tax benefits but also *what kinds* of tax benefits will be available for the taxpayer to claim.

C. Taxing Cross-border Workers

This Article concerns states' discrimination in conferring personal tax benefits: States grant more tax benefits to resident taxpayers than to nonresident taxpayers. Understanding the international treatment of personal tax benefits requires us to understand how countries tax cross-border income. Two jurisdictional predicates for taxation exist: source and residence.[56] No matter where the owner of an item of income resides, the state where the income is produced or "sourced" may tax it.[57] The source state's entitlement to tax derives from bene-

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52 *See, e.g.*, *id*. § 21 (childcare); *id.* §§ 25A, 117, 221 (education); *id.* § 163(h)(2)(D) (home mortgage interest); *id.* § 170 (charity); *see also* Russell Shorto, *No Babies?*, N.Y. Times Magazine, June 29, 2008, at 34, 41, 68 (comparing child-related tax benefits in United States and several European states).

53 *See* Shaviro, *supra* note 4, at 207–13 (defining tax expenditures relative to a tax system that "does much of the work of the distribution branch" of the public sector).

54 JCT, Tax Expenditures, *supra* note 41, at 12; *see also* I.R.C. § 32 (2006) (providing earned income tax credit).

55 *Cf.* JCT, Tax Expenditures, *supra* note 41, at 12–14 (considering this issue but concluding that these deductions constitute social spending); *see also* Dagan, *supra* note 4, at 201–07 (exploring the blurry line between business and personal expenses).

56 Restatement (Third) of Foreign Relations Law of the United States § 411 (1986) [hereinafter Restatement (Third)].

57 *Id.* § 412(1)(b). For more on sourcing income, see *infra* Part II.B.4.

fits it provides that facilitate the earnings, including natural and human resources, markets, and infrastructure.[58]

Additionally, no matter where in the world income is sourced, the state where its owner resides may tax it on a residence basis.[59] As noted, states have different domestic law definitions of tax residence, but the most important residence factor is generally length of physical presence in the jurisdiction.[60] Whereas the source state may tax only income sourced within its territory, the residence state may tax the worldwide income of its residents.[61] This broad entitlement derives from the residence state's provision of benefits to its residents, such as education and personal and property protection.[62]

States are thus entitled to tax in two capacities: They may tax nonresidents on income sourced in their jurisdiction ("source" taxation), and they may tax residents on their worldwide income ("residence" taxation). For example, when the American professor receives remuneration for delivering lectures in Canada, Canada may tax the remuneration on a source basis and the United States may tax the same income on a residence basis.

Because these jurisdictional predicates overlap, if both the source state and the residence state exercise the right to tax someone on the same item of income, the taxpayer suffers double taxation. States avoid double taxation through bilateral tax treaties, which allocate tax jurisdiction between source and residence states.[63] Most of the

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[58] *See* Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *"What's Source Got To Do with It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 91–93 (2002) (arguing that source taxation is the price paid for access to a state's market). *But see* Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* TAXATION IN THE GLOBAL ECONOMY 11, 32 (Assaf Razin & Joel Slemrod eds., 1990) (arguing that the source state's tax entitlement is grounded more in "force majeure" than "any ethical conception of sovereignty"); Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 183–87 (1998) (challenging the notion that source-based tax rules reflect provision of benefits by the source state to taxpayer).

[59] RESTATEMENT (THIRD), *supra* note 56, § 412(1)(a), (3)(b).

[60] *See generally* AULT & ARNOLD, *supra* note 18, at 347–49 (comparing various states' definitions of tax residence).

[61] *See* OECD MODEL, *supra* note 9, art. 4(1) (defining tax residence by reference to domestic law); *see also* RESTATEMENT (THIRD), *supra* note 56, §§ 411(1)(c), 412(1)(a), (3)(b).

[62] *Cf.* Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 470–79 (2007) (arguing that benefits provided by the United States to nonresident U.S. citizens justify taxing nonresident citizens on their worldwide income).

[63] Even in the absence of tax treaties, states generally relieve their residents of double tax burdens, either by crediting the source state's tax or exempting residents' foreign-source income.

Other kinds of overlaps also occur, such as when two countries consider the same item of income to be sourced within their jurisdiction (source-source conflicts). But double tax thousands of bilateral tax treaties in force are based on the model tax treaty prepared by the OECD, which OECD member states developed over decades.[64]

For the sake of simplicity, this Article considers examples of cross-border workers with only active labor income, although the analysis presented here also may apply to taxpayers with passive investment income.[65] The OECD model tax treaty ("OECD Model") allocates the entitlement to tax labor income between the source state (where the taxpayer works)[66] and the taxpayer's residence state.[67] The precise details of the tax rules do not matter for our inquiry, except it is important to note that in many circumstances, both the source state and the residence state retain an entitlement to tax the same income.[68] The failure of tax treaties to lodge exclusive tax juris-

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treaties primarily address source-residence overlaps. OECD MODEL, *supra* note 9, cmt. on art. 4, ¶¶ 1–5.

64 The OECD is an international organization composed of thirty member states, most of which are highly developed. *See* OECD MODEL, *supra* note 9, at 2 (listing member states). The OECD tracks economic statistics and trends in its member states, and, most importantly for our purposes, it prepares the influential OECD model tax treaty ("OECD Model"). *See id.* at 2–3. The OECD Model is used by both OECD member states and non-member states. *See* Press Release, OECD, OECD Model Tax Convention: 50 years of promoting a business-friendly tax environment (Apr. 9, 2008) [hereinafter OECD Press Release], *available at* http://www.oecd.org/document/36/0,3343,en_2649_201185_41255460_1_1_1_1,00.html (noting the existence of three thousand tax treaties based on the OECD Model).

Other important model tax treaties closely adhere to the OECD Model. *See* United States Model Income Tax Convention of November 15, 2006, *available at* http://ustreas.gov/press/releases/reports/hp16801.pdf, *reprinted in* 1 Tax Treaties (CCH) ¶ 209; U.N. Dep't of Econ. & Soc. Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, ¶ 45, U.N. Doc. ST/ESA/PAD/SER.E/21 (2001) [hereinafter *UN Model*], *available at* http://www.un.org/Docs/journal/asp/ws.asp?m=ST/ESA/PAD/SER.E/21.

65 Passive income includes investment income, such as interest and dividends, and income from other assets, such as rent and royalties. Active income includes compensation for personal services and income from the conduct of a trade or business.

66 Generally, compensation for personal services is "sourced" in a state if the work was performed in its territory. *See, e.g.*, I.R.C. § 861(a)(3) (2006) (sourcing personal services performed in the United States to the United States). However, tax treaties may place limits on a source state's entitlement to tax income from services performed within its jurisdiction. *See infra* note 68.

67 *See* OECD MODEL, *supra* note 9, art. 7 (allocating to the source state the primary right to tax certain business profits, including income from independent personal services); *id.* art. 15 (providing conditions under which source state may tax income from employment).

68 The source state may tax income from employment unless all of the following are true: (a) the worker spends fewer than 184 days of the year in the source state, (b) her employer does not reside there, and (c) the expense of her wages is not borne by her employer's "permanent establishment" there. *Id.* art. 15. The source state may not tax independent personal services unless the service-provider has a "permanent establishment" in the source state. *Id.* art. 7 (apportioning tax on business profits between states);

diction with one state differentiates them from more traditional mechanisms for resolving conflict-of-laws disputes. However, because tax treaties oblige the residence state to relieve its residents of any double taxation that results from the combination of its own tax with that of the source state,[69] the source state has *primary* entitlement to tax labor income.

States generally deny nonresidents personal tax benefits or grant nonresidents a limited version of the benefits allowed to residents.[70] Concomitantly, states usually provide their own residents full personal tax benefits, even when those residents have significant income sourced (and taxed) abroad. The OECD Model approves of this approach. Under the OECD Model, a state is not obliged "to grant to

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see also id. art. 5(1) (defining "permanent establishment" as "a fixed place of business through which the business of an enterprise is wholly or partly carried on"). The residence state may also tax both employment income and business profits, which include income from the performance of personal services. *Id.* arts. 7, 15.

[69] *See, e.g.*, *id.* arts. 23A–23B (providing that the residence state shall relieve double taxation either by crediting the source state's tax or by exempting foreign income). States also limit double taxation unilaterally, so the analysis in this Section would not change significantly if the source and residence states did not have a tax treaty. *See, e.g.*, I.R.C. § 901 (providing foreign tax credit).

[70] The United States provides only limited personal tax benefits to nonresidents. Internal Revenue Code § 873 disallows nonresident aliens deductions for expenses unrelated to income effectively connected to the United States, and it denies nonresidents all itemized deductions except state and local taxes, tax preparation fees, unreimbursed employee expenses, casualty losses, charitable contributions, and one personal exemption. *See* I.R.C. § 873(a)–(b). Other than the personal exemption, these deductions arguably represent income-defining provisions. The full set of deductions allowed to nonresident aliens with income effectively connected to the United States includes educator expenses; health savings-account deductions; moving expenses; self-employed SEP, SIMPLE, and qualified plans; self-employed health insurance deduction; penalty on early withdrawal of savings; scholarship and fellowship grants excluded; deductions for IRA contributions; student loan interest, and domestic production activities. *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N NO. 519, U.S. TAX GUIDE FOR ALIENS 25–26 (2009). Nonresident aliens may not take the standard deduction or any itemized deductions that are not enumerated in § 873. *See* I.R.C. § 63(c)(6)(B) (denying the standard deduction to nonresident aliens); *id.* § 873 (denying itemized deductions to nonresident taxpayers).

Some states are more generous to nonresidents. *See, e.g.*, Case C-169/03, Wallentin v. Riksskatteverket, 2004 E.C.R. I-6443, ¶ 6 (describing Swedish system of granting a proportional standard deduction to partial-year Swedish residents subject to unlimited tax liability in Sweden); Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 9 (describing now-defunct Dutch system granting personal tax benefits to nonresidents in proportion to their Dutch-source income divided by their worldwide income). Other states are less generous. *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 6 (describing German system of denying nonresident taxpayers certain personal deductions). Occasionally, double tax treaties oblige source states to provide personal tax benefits. *See* Luc Hinnekens & Philippe Hinnekens, *General Report: Non-discrimination at the Crossroads of International Taxation*, *in* 93A CAHIERS DE DROIT FISCAL INTERNATIONAL 15, 31 (2008) (providing examples).

residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."[71] By confirming that the source state has no obligation to offer nonresidents personal tax benefits even when it taxes their income, the OECD Model endorses a disjunction between the entitlement to tax and the obligation to provide personal tax benefits.

D. Alternative Methods of Allocation

Endless options exist for reallocating some (or all) of the burden to provide personal tax benefits from the worker's residence state to her source state or states. For example, the states could share the obligation according to a formula that attempts to measure the taxpayer's relative connections to each jurisdiction. The formula could include factors such as the number of days spent in each jurisdiction, the amount of income earned in each, the value of the taxpayer's assets in each, and so on. States entering into tax treaties also could negotiate the precise method for allocation on a case-by-case basis.

The entitlement to tax and the obligation to confer personal tax benefits would be perfectly aligned under what the Dutch have called the "proportionality method."[72] Under this method, each state grants both residents *and nonresidents* personal tax benefits in proportion to the ratio of their income sourced (and taxable) in that state to their overall taxable income.[73] Thus, if the Netherlands were entitled to tax 40% of a taxpayer's overall income, the Netherlands would grant the taxpayer 40% of its personal tax benefits, however defined under Dutch law. As I discuss later, the European Court of Justice (ECJ) recently held that the Dutch proportionality method violated the EC Treaty's prohibition on state tax discrimination, so proportionality may not be a viable option for providing personal tax benefits to EU

[71] OECD Model, *supra* note 9, art. 24(3). This provision makes clear that when an independent service provider is taxable by the source state because the service provider has a permanent establishment there, the source state is not obliged to grant her personal tax benefits, although it must allow her to deduct business expenses under article 7 of the OECD Model. The source state may nevertheless choose to extend personal tax benefits to nonresidents. *Id.*, cmt. on art. 24, ¶ 22 (explaining that article 24(3) "leaves it open to the [source state] whether or not to give personal allowances and reliefs to the persons concerned"). The OECD Model contains no express provision for personal or business expenses of employees.

[72] *De Groot*, 2002 E.C.R. I-11819, ¶ 32.

[73] *Id.* ¶ 9. States that tax their residents' worldwide income, which includes their foreign-source income, would either have to grant their residents 100% of their own personal tax benefits or grant "tax sparing credits" in order to preserve the tax benefits granted by the source state. *See infra* notes 225–26 and accompanying text.

nationals working within the EU.[74] However, states outside of the European Union could implement proportionality.

The proportionality method would ensure that all cross-border taxpayers received a full set of personal tax benefits, although that set would be composed of an aggregation of fractional benefits from each state in which that taxpayer earned income. To reduce the administrative complexity engendered by the need for taxpayers to file returns in every state in which they earn income, states could adopt a modified proportionality rule under which the obligation would be apportioned only to states in which the taxpayer earned more than a de minimis portion of her income. Depending on how the states defined de minimis, they could narrow the sharing obligation to just a few states.[75] The U.S. states presently implement proportionality for conferring personal tax benefits on U.S. taxpayers with income from more than one U.S. state.[76] Additionally, precedent for proportional arrangements exists in a few tax treaties[77] and in social security treaties.[78]

Any deviation from the current allocation rule would necessarily impose greater responsibility for providing personal tax benefits on the source state, since current practice places sole responsibility on the residence state. Thus, an important consideration in evaluating the current allocation rule is that any change would generally shift respon-

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74 *De Groot*, 2002 E.C.R. I-11819, ¶¶ 110–11 (holding that the unilateral proportionality rule in Dutch domestic law violated the EC Treaty, but not ruling on whether proportionality could be included in a reciprocal tax treaty). For more discussion of European Court of Justice (ECJ) tax cases, see *infra* Part III.C.1.

75 For example, if the de minimis rule required all states in which the taxpayer earned at least 20% of her worldwide income to share the obligation in proportion to all the income sourced in those states, then at most five states would provide benefits. Any threshold above 25% would limit the sharing obligation to three states.

76 *See infra* notes 266–68 and accompanying text (discussing proportionality in the U.S. states).

77 *See* Hinnekens & Hinnekens, *supra* note 70, at 31 (noting that Belgium's tax treaties with France, Luxembourg, and the Netherlands all contain provisions requiring the contracting states to grant residents of their treaty partner pro rata personal and family allowances). Such provisions represent derogations from Article 24(3) of the OECD Model, which expressly discharges states from the obligation to provide residents of their treaty partners personal and family allowances. *Id.* *See generally* text accompanying note 71 (quoting OECD MODEL, *supra* note 9, art. 24(3)).

78 Under social security totalization agreements, states aggregate periods worked by cross-border taxpayers within their jurisdictions for purposes of determining whether the taxpayer has worked enough to qualify for benefits. Once eligibility is established, each state grants the cross-border worker a portion of its social security benefit depending on the proportion of work performed within its territory. *See* Allison D. Christians, *Taxing the Global Worker: Three Spheres of International Social Security Coordination*, 26 VA. TAX REV. 81, 103–04 (2006) (describing the international social security framework for cross-border workers).

sibility for providing tax benefits from the state with which the taxpayer has the preponderance of her *personal* contacts to a state with which the taxpayer's contacts are predominantly *economic*.[79] The next Part considers the advisability of such a shift.

II
Allocating Personal Tax Benefits

Since Adam Smith, scholars have judged tax rules according to efficiency, fairness, and simplicity.[80] This Part uses these criteria to analyze the question of how to allocate among taxing states the obligation to provide personal tax benefits to cross-border workers.

A. Efficiency

This Section considers efficiency arguments for allocating the personal tax benefit obligation to either the source state or the residence state. First, it argues that allocation to the residence state is efficient for personal tax benefits designed to induce taxpayer behavior. Second, extrapolating from economist Charles Tiebout's work,[81] this Section argues that provision of personal tax benefits by the residence state is more likely than other allocation rules to reveal and satisfy cross-border workers' preferences regarding the content of those benefits. Finally, this Section takes a broad view of efficiency that assumes states will choose the allocation rule that distorts cross-border labor mobility least. Building on the capital mobility benchmarks introduced by Peggy and Richard Musgrave, this Section constructs labor mobility benchmarks and describes the international tax rules that states could adopt to achieve tax neutrality with respect to each of the following four dimensions: where taxpayers work, how much they work, who works which job, and where workers reside. It concludes that more empirical evidence is needed to guide states' choice between the competing labor mobility benchmarks.

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79 This is because the definition of tax residence incorporates personal nexus elements as well as economic nexus elements, whereas source rules measure only economic nexus elements. For more on nexus elements, see generally *infra* Part II.B.2.

80 *See* Adam Smith, An Inquiry Into the Nature and Causes of the Wealth of Nations 945–47 (Regnery Publishing, Inc. 1998) (1776) (setting forth the criteria for evaluating tax policy), *cited in* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261, 294 (2001).

81 *See generally* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. Pol. Econ. 416 (1956).

1. Efficiency of Tax Incentives

a. Which State is the More Efficient Subsidizer?

States design many personal tax expenditures to improve economic efficiency by correcting for positive externalities—cases where a taxpayer's behavior produces benefits that she cannot fully capture. From an efficiency perspective, the state where the positive externality resulting from a tax incentive accrues should be the one to grant the incentive, since that state is best motivated to properly tailor the subsidy.

Under this view, the case for requiring the residence state to provide tax incentives is strongest when the positive externality always accrues to the taxpayer's residence state, no matter where the taxpayer incurs the expense. For example, suppose a state's goal in offering a mortgage interest deduction is to encourage residents to save in the form of real estate in order to reduce their dependence on public aid in retirement. The state could simply grant mortgage interest deductions to all resident taxpayers, irrespective of the geographic location of the home.[82] Similarly, a state interested in promoting its residents' health might allow them to deduct medical expenses, regardless of where the taxpayer incurred the expenses. But positive externalities associated with a taxpayer's behavior do not always accrue to her residence state. For example, if instead of encouraging savings, a state's purpose in offering a home mortgage interest deduction is to promote the stability of its neighborhoods[83] or to subsidize domestic housing construction, the location of the home will matter.

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[82] To qualify for the mortgage interest deduction in the United States, the taxpayer's house need not be in U.S. territory, but it must be a "qualified residence," a term broad enough to include two homes. *See* I.R.C. § 163(h)(4)(A)(i) (2006) (defining "qualified residence" to include taxpayer's principal residence and one other residence). Nonresidents cannot claim the home mortgage interest deduction in the United States. *See id.* § 873(a) (allowing deductions only for a nonresident's business taxes).

Providing tax incentives to cross-border workers could result in unexpected efficiencies in cases in which the tax incentive is already reflected in higher residence state asset prices. For example, partial capitalization of the mortgage interest deduction into the price of U.S. homes dampens the incentive effect of the deduction. *See* Gale et al., *supra* note 40, at 1179–82 (discussing factors affecting the extent of capitalization of the U.S. mortgage interest deduction). The tax incentive would be stronger for U.S. residents who purchase homes located in states that do not have such a deduction, since housing prices in those states would not reflect the deduction.

[83] *See* Nordlinger v. Hahn, 505 U.S. 1, 12 (1992) (upholding against equal protection challenge California's Proposition 13A, which based property taxes on 1975–76 assessments in order to encourage "neighborhood preservation, continuity, and stability"). *See generally* Gale et al., *supra* note 40, at 1177 (critically reviewing arguments for subsidizing home ownership).

Separation in time between the conferral of the tax incentive and the accrual of the positive externality may increase the likelihood that the externality will accrue outside the residence state. For example, a state may allow its residents to deduct or credit the costs of higher education with the expectation that the state will recover some of the subsidy by taxing residents' earnings after graduation.[84] If, however, taxpayers use their education to earn income abroad, the residence state loses primary jurisdiction to tax the income.[85] Likewise, many states subsidize their residents' contributions to savings and pension plans with the expectation of taxing the distributions from those plans.[86] If the resident moves abroad before receiving distributions from the savings plan, however, tax treaties generally grant the new residence state exclusive entitlement to tax the distributions.[87]

A state could reduce such spillovers by minimizing time lags between the conferral of the tax benefit and the accrual of the associated positive externality. For example, states could structure their educational tax incentives as deductions for student loan interest rather than upfront deductions or credits for the costs of education. States could similarly modify other tax incentives to ensure that the benefits of subsidized taxpayer behavior do not spill over to other

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[84] *See* Desai et al., *supra* note 1, at 682–85 (suggesting ways states could use taxes to recoup expenses related to development of the human capital of residents who later emigrate); *see also* I.R.C. §§ 25A, 117, 221 (providing for education-related tax benefits).

[85] *See* OECD Model, *supra* note 9, art. 7 (permitting the source state to tax income from certain business profits, including those from independent personal services); *id.* art. 15 (permitting the source state to tax income from employment); *id.* arts. 23A–23B (requiring the residence state to relieve any resulting double taxation).

[86] *See id.* cmt. on art. 18, ¶¶ 12–14 (listing this as a reason for some states' objection to the model treaty rule that allocates tax on pensions exclusively to the (new) residence state). The United States allows nonresidents to deduct contributions to certain U.S. retirement savings vehicles. *See, e.g.*, I.R.C. § 219 (allowing deduction for contributions to pension plans); *id.* § 408 (allowing deduction for contributions to individual retirement accounts); *id.* § 873 (restricting nonresidents' deductions). The United States would consider income from such plans to be U.S. source income, and it would be taxable by the United States to nonresidents unless a tax treaty specifying other treatment applied. *See id.* § 1441 (assessing withholding tax on nonresident aliens' income, including income annuities and other annual or periodic gains). In many cases, cross-border workers contribute to pension plans in their residence states, particularly if they expect their work abroad to be only temporary. *See* OECD Model, *supra* note 9, cmt. on art. 18, ¶ 32 (explaining that individuals working abroad often continue contributing to pensions in their home countries to retain benefits and avoid the practical difficulties of having multiple pensions in different countries). Many states allow residents engaged in cross-border work to deduct such contributions. *Id.* cmt. on art. 18, ¶ 33.

[87] OECD Model, *supra* note 9, art. 18. A different rule applies for pensions related to government service: The government paying the pension retains the exclusive right to tax its former employee on her pension. *Id.* art. 19(2)(a). Governments also retain taxing rights over their social security insurance payments. *See* Christians, *supra* note 78, at 106–12 (discussing taxation of cross-border social security benefits).

states. For example, a state might allow both resident and nonresident taxpayers to take deductions for charity, but only if the charity directs its services to residents of the state.[88]

When designing tax incentives, states could also consider—to a greater extent than they do presently—whether extending tax incentives to nonresidents would enhance their incentive effects. For example, suppose a state offers deductions for mass transit expenses in order to reduce local pollution and congestion. If both resident and nonresident users of mass transit equally reduce pollution and congestion, it would be efficient to grant them the same tax incentives. If nonresidents' use of mass transit produces larger externalities (for example, because their commuting distances are longer), it might even be efficient for the source state to grant nonresidents larger tax incentives for mass transit.

In many cases, however, it would be difficult or impossible to trace the benefits created by tax expenditures to particular geographic territories.[89] As the example with the mortgage deduction showed, not only may a single state's goals with respect to a tax benefit be plural or otherwise unclear, but two states' goals for enacting similar tax incentives might vary significantly.[90] Such variation would raise questions about which state should provide particular subsidies.

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[88] The United States allows nonresident taxpayers to take deductions only for contributions to U.S. charitable organizations. *See* I.R.C. § 170(c) (defining charitable contribution under § 170 to be a contribution to a U.S. organization); *id.* § 873(b)(3) (allowing nonresidents charitable contribution deductions under § 170). U.S. charities may, however, be organized for the purpose of helping those abroad. *See id.* § 170(c) (allowing charitable orginizations to operate abroad by negative implication); *see also* David E. Pozen, *Tax Expenditures as Foreign Aid*, 116 YALE L.J. 869, 870–76 (2007) (arguing that tax exemptions for charities and tax deductions for charitable contributions can be seen as foreign aid to the extent that domestic charities spend money abroad). Not all states allow deductions for charitable contributions to institutions that direct their charitable works outside the state. *Cf.* Case C-386/04, Centro di Musicologia Walter Stauffer v. FA München für Körperschaften, 2006 E.C.R. I-8203 (holding that Germany violated EC law by conditioning deductions for contributions to non-German charities on whether those charities benefit German society, since deductions for contributions to German charities were not similarly conditioned).

[89] U.S. Supreme Court jurisprudence provides anecdotal confirmation of the difficulties of the accrual approach. In *Plyler v. Doe*, the Court considered whether the Equal Protection Clause prevented a school district in Texas from excluding undocumented aliens from public elementary schools. 457 U.S. 202, 205 (1982). The school district argued that because undocumented aliens were less likely to remain in the state than were citizens or legally resident aliens, the benefits of educating undocumented aliens might not accrue to Texas, and therefore Texas should not have to undertake the expense of educating them. *Id.* at 229–30. The Supreme Court rejected this argument, reasoning that a state has "no assurance that any child, citizen or not, will employ the education provided by the State within the confines of the State's borders." *Id.* at 230.

[90] *See supra* notes 82–83 and accompanying text (discussing various possible purposes motivating a state's offer of a mortgage interest deduction).

Notice also that even where states are concerned that the positive externalities associated with subsidized behavior may accrue outside the residence state, it would not be efficient to shift the obligation to subsidize the activity to the source state unless states could be reasonably sure that the externality would accrue in the source state. For example, while cross-border workers may be more likely to retire abroad than domestic workers, unless cross-border workers are more likely to retire in their source state than in their residence state (or a third state), it would not be efficient to shift the responsibility for subsidizing pensions to the source state.

The difficulty of predicting where externalities will accrue could explain why states currently allocate personal tax expenditures exclusively to the residence state. Despite potential mismatches between the state bearing the cost of the tax subsidy and the state accruing the associated positive externality, as long as it is generally true that the taxpayer's residence state receives more of the positive externalities from her subsidized behavior than do her source state or states, allocating the obligation to confer tax incentives to the residence state should be more efficient than allocating it to the source state. This conclusion depends on the assumption that the state that benefits most from the positive externality will most efficiently subsidize it.

b. Predictability

The need for certainty also supports exclusive allocation of tax incentives to the residence state. For tax incentives to influence taxpayer behavior, taxpayers need to know their eligibility for tax incentives in advance.[91] Splitting the tax incentive obligation among states according to where positive externalities accrue would introduce uncertainty into taxpayers' estimations of their eligibility, since no two states offer precisely the same tax incentives. Likewise, it might be difficult for taxpayers to determine the content of tax incentives available in each state in which they earn income. The added administrative burdens associated with discerning, qualifying for, and claiming tax incentives in several states could reduce taxpayer uptake of tax subsidies, thereby reducing their effectiveness. Because taxpayers generally can predict their residence state better than they can predict the proportion of income that they will earn in each of their source states, the need for predictability favors retaining the onus to confer tax incentives on the residence state.

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[91] *See* JCT, TAX EXPENDITURES, *supra* note 41, at 62–67 (highlighting the importance of transparency, targeting, and certainty in the design of tax expenditures).

2. *Tieboutian Sorting and Voter Preferences*

Another argument supports the provision of personal tax benefits by the residence state: A cross-border worker's preferences regarding the size and scope of government activity may be more likely to match those of fellow residents of her home state than those of fellow workers in her source state or states. Therefore, allocating the personal tax benefit obligation to the residence state may be more likely than other allocation methods to satisfy workers' preferences for the content of those benefits. Moreover, because voters define government benefits through the political process, and because cross-border workers are more likely to be entitled to vote in their home state than in their source state or states, allocation of the personal tax expenditure obligation to the residence state enables cross-border taxpayers to collect benefits where they participate in the political process that decides the content of those benefits.

Economist Charles Tiebout showed that, under certain narrow constraints, when jurisdictions offer different levels of taxes and public benefits, taxpayers efficiently sort themselves by jurisdiction according to their preferences.[92] If this theory were applicable internationally, then taxpayers would choose to reside in the jurisdiction that offered their preferred mix of taxes and public benefits, and granting personal tax benefits on the basis of residence would satisfy taxpayer preferences.

There are several reasons, however, to question whether Tieboutian sorting works on an international scale. First, Tiebout posited a situation in which people could move freely, for example between local communities within the United States.[93] But significant legal and economic barriers prevent free human migration. Second, Tiebout contemplated that people would "vote with their feet" by moving to the local jurisdiction that gave them the best *combination* of tax and public benefits. He did not analyze a situation in which the payment of taxes and the collection of benefits could be disassociated in the ways possible under international taxation.[94] By allocating the primary entitlement to tax to the source state but allocating the costs of providing public goods and personal tax benefits mostly to the residence state, international tax norms presently disassociate the obligation to pay taxes from the entitlement to collect tax benefits. As a

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92 *See* Tiebout, *supra* note 81, at 420–22.

93 *See id.* at 419 (assuming, in addition to perfect human mobility and other assumptions, no externalities from government activities (i.e., no spillovers), that people have perfect information about public services and taxes in each community, and that there is a sufficient variety of communities to satisfy everyone's preferences).

94 *See id.*

result, allocating the personal tax benefit obligation exclusively to the residence state may heighten a free-rider effect, at least in exemption countries: Cross-border workers may vote for expensive tax and public benefits in their residence state for which they do not have to pay because they pay most of their taxes to their work state. States could avoid this free-rider problem by taxing their residents' worldwide income and granting them the same personal tax benefits as residents with only domestic income.

3. *Labor Mobility Benchmarks*

Rather than viewing the allocation question from the perspective of the efficiency of particular tax incentives[95] or the efficiency of the political process that determines the content of personal tax benefits, it may be appropriate to adopt a broader perspective that takes into account the effect of the allocation rule on the efficiency of the global labor market.

Many factors influence a state's labor migration policy. Factors favoring outward migration include high domestic unemployment rates and low wage rates.[96] Additionally, states benefit when their expatriates send home remittances, and when workers return home, they bring not only capital but also new skills learned abroad.[97] But outward migration has disadvantages. Although many workers return to their home states, the most highly skilled tend to stay abroad, resulting in "brain drain."[98] The emigration of highly skilled workers also erodes the sending state's tax base.[99]

Inward migration is similarly fraught. States with low unemployment or aging populations may want to encourage immigration to fill job vacancies and expand the number of workers paying into their tax

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95 In any case, allocation of personal tax benefits according to accrual of positive externalities will be insufficient since many tax benefits are not designed to compensate taxpayers for producing positive externalities. *See, e.g.*, I.R.C. § 63(c)(3), (f) (2006) (providing additional personal deductions for the blind and aged).

96 *See generally* Michael J. Trebilcock & Matthew Sudak, *The Political Economy of Emigration and Immigration*, 81 N.Y.U. L. Rev. 234 (2006) (reviewing economics literature on benefits and burdens of human migration primarily from the perspective of the sending state, with special emphasis on "brain drain," tax, and remittances).

97 *See id.* at 253, 255–56 (citing $100 billion as the IMF's estimate of remittances in 2000).

98 *See id.* at 250–51 (citing studies showing that migrants to OECD countries are on average better educated than their compatriots who remain at home and noting that major receiving states including Canada, New Zealand, and Australia give immigration preference to highly educated people).

99 Desai et al., *supra* note 1, at 682–85 (arguing that migrant-sending states could compensate themselves for tax base erosion due to emigration by (1) taxing nonresident citizens on a worldwide basis, (2) splitting tax revenues with the emigrant's new state, or (3) taxing exit).

and social security systems, but integrating newcomers into resident populations can be challenging.[100] Additionally, immigration of low-skilled workers may depress wages of unskilled workers already residing in the receiving state, and it may place new burdens on the state's social welfare system.[101] Thus, if free movement of other factors of production facilitated by trade agreements—including goods and capital—is an adequate substitute for labor mobility but disrupts families and communities less, states may prefer capital movement and trade in goods to labor migration.[102] On the other hand, restrictions on personal movement clash with the respect for individual autonomy prized by liberalism, and such restrictions may reduce global economic efficiency.[103]

This Article does not assess whether labor mobility is a net benefit or detriment to a particular state. Rather, it assumes that absent a specific policy objective to encourage or discourage international labor mobility, tax laws should not distort decisions regarding cross-border migration or cross-border work. The efficiency arguments against distorting labor migration are analogous to arguments against distorting cross-border trade in goods or cross-border capital investment. By distorting the flow of workers (or goods or capital) across borders, states trap productive assets in less productive locations, resulting in welfare losses. In contrast, a hands-off policy toward labor migration would allow workers to move to where their labor could be used most productively, thereby increasing global produc-

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100 *See* Howard F. Chang, *Cultural Communities in a Global Labor Market: Immigration Restrictions as Residential Segregation*, 2007 U. CHI. LEGAL F. 93, 104–06 (2007) (noting that, in addition to benefits, multiculturalism may impose efficiency costs, particularly when immigrants do not speak the dominant language of the receiving state); *cf.* F.H. Buckley, *Liberal Nationalism*, 48 UCLA L. REV. 227, 240 (2000) (arguing that a "homogenous culture economizes on scarce mental resources").

101 *See* Alan O. Sykes, *Welfare Economics of Immigration: A Theoretical Survey with an Analysis of U.S. Policy*, *in* JUSTICE IN IMMIGRATION 158, 169 (Warren F. Schwartz ed., 1995) (describing potential negative externalities of influxes of new workers); *see also* Trebilcock & Sudak, *supra* note 96, at 269–73 (reviewing conflicting studies about the effects of immigration on source state wages and unemployment but noting consensus that immigration harms low-skilled workers in receiving states). Studies estimate that the net tax gain or loss to the United States per immigrant ranges from a gain of $198,000 to a loss of $13,000, depending on the skills of the immigrant. *Id.* at 272–73.

102 *Cf.* Chia, *supra* note 22, at 351 (noting complex economic, institutional, and policy variables that affect investment and labor flows across states). *See generally* Robert A. Mundell, *International Trade and Factor Mobility*, 47 AM. ECON. REV. 321 (1957) (explaining substitutability of factor mobility).

103 *See* Moses, *supra* note 2, at 57 (noting estimates that $150 billion is lost annually because of restrictions on global labor mobility).

tivity.[104] Additionally, such migration would equalize wage rates across jurisdictions and thus help to equalize incomes and standards of living across states.[105]

Even when a state's specific goal is to influence labor mobility, tax policy may not be the best tool for doing so because a state's international tax policy consists not only of domestic tax law but also of international tax treaties. Tax treaties are plentiful, long-lived instruments[106] amended infrequently and with difficulty.[107] The United States has over sixty treaties in force;[108] worldwide, tax treaties number several thousand.[109] Changes to tax treaty policy require renegotiation on a treaty-by-treaty basis, and, as a result, treaties cannot adapt quickly to economic changes that affect labor migration, such as short-term labor shortages or periods of high unemployment. In contrast, other regulatory tools, such as immigration law, may more readily accommodate dynamic national labor market conditions.

Taxes influence where people live and work.[110] For example, high taxes may drive high-income taxpayers to relocate to, or to work

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104 *See* Howard F. Chang, *Liberalized Immigration as Free Trade: Economic Welfare and the Optimal Immigration Policy*, 145 U. Pa. L. Rev. 1147, 1149 (1997) (arguing that economic welfare increases when workers cross borders to provide needed services).

105 *Cf.* Moses, *supra* note 2, at 65–66, 70 (arguing that states compete for citizens in a world of free mobility).

106 The oldest U.S. tax treaty currently in force was ratified in the 1950s. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Greece, Feb. 20, 1950, 5 U.S.T. 47 (entered into force pursuant to ratifications exchanged on December 30, 1953).

107 *See* Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formula and Arm's Length Allocation Method*, 28 Va. Tax Rev. 619, 654 n.55 (2009) ("[Treaties] are incredibly slow-moving creatures. They are time-consuming to negotiate and impossible to update on a regular basis." (quoting David R. Tillinghast, *Tax Treaty Issues*, 50 U. Miami L. Rev. 455, 455 (1996))).

108 Shay et al., *supra* note 58, at 112.

109 *Cf.* OECD Press Release, *supra* note 64 (citing three thousand tax treaties in force based on the OECD Model).

110 *See* Jon Bakija & Joel Slemrod, *Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns* 36 (Nat'l Bureau of Econ. Research, Working Paper No. 10645, 2004) (finding evidence suggesting that taxpayers change residence in response to estate taxes); Gebhard Kirchgässner & Werner W. Pommerehne, *Tax Harmonization and Tax Competition in the European Union: Lessons from Switzerland*, 60 J. Pub. Econ. 351, 353–59 (1996) (finding that cantonal tax rates influence cantonal residence decisions of high-income Swiss taxpayers); Ira S. Saltz, *State Income Tax Policy and Geographic Labour Force Mobility in the United States*, 5 Applied Econ. Letters 599, 599–600 (1998) (developing theoretical model showing that high tax rates discourage inbound labor migration in U.S. states); *cf.* James R. Hines, Jr., *Altered States: Taxes and the Location of Foreign Direct Investment in America*, 86 Am. Econ. Rev. 1076, 1080–92 (1996) (finding that corporations from exemption countries are more likely to invest in low-tax U.S. states than high-tax U.S. states, suggesting that higher taxes discourage inbound investment).

in, lower-tax jurisdictions.[111] Because they affect taxpayers' effective tax rates, national variations in personal tax benefits likewise may affect states' relative attractiveness to taxpayers. Although such tax distortions may be significant, states cannot completely eliminate them without harmonizing their tax rates and tax bases. Recognizing the impossibility of achieving perfect labor mobility neutrality in the taxation of cross-border workers, this Article offers several labor neutrality benchmarks by which to judge states' international tax policies.

Of course, taxes are not the only factor that workers take into consideration when deciding whether to work in or migrate to another state. A whole variety of other factors—including wage rates, working conditions, family and community support, cultural differences, standards and costs of living, labor and immigration regulations, geography, and even climate—may weigh more heavily than taxation in workers' decisions about where to live and work. The labor mobility benchmarks presented here can be used to analyze any regulatory policy that affects cross-border labor mobility along any of these dimensions. In this Article, however, I limit the inquiry to the question of how states should tax cross-border workers, and in particular, how they should allocate the obligation to confer personal tax benefits.

a. Capital Mobility Benchmarks

The labor mobility benchmarks presented here derive from the capital mobility benchmarks developed by economists Richard and Peggy Musgrave.[112] The Musgraves presented two competing benchmarks for maximizing worldwide welfare: capital export neutrality and capital import neutrality.[113] These benchmarks have

111 *See* sources cited *supra* note 110 (providing empirical and theoretical evidence for claim); *see also* Kirsch, *supra* note 62, at 490 & n.202 (noting French government estimates that "at least one millionaire per day abandons French residence in order to avoid French taxes" (citing Molly Moore, *Old Money, New Money Flee France and Its Wealth Tax*, WASH. POST, July 16, 2006, at A12)).

112 *See* PEGGY BREWER RICHMAN [Musgrave], TAXATION OF FOREIGN INVESTMENT INCOME 8 & n.4 (1963) [hereinafter PEGGY MUSGRAVE, TAXATION] (crediting Richard Musgrave for coining the term "capital-export neutrality"). For concise explanations of capital export neutrality and capital import neutrality, see generally Richard A. Musgrave & Peggy B. Musgrave, *Inter-nation Equity*, *in* MODERN FISCAL ISSUES 63 (Richard M. Bird & John G. Head eds., 1972); Richard A. Musgrave, *Criteria for Foreign Tax Credit*, *in* TAXATION AND OPERATIONS ABROAD 83 (1960) [hereinafter Richard Musgrave, *Criteria*]. For more thorough explorations, see generally PEGGY MUSGRAVE, TAXATION, *supra*, and Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203 (2007), the latter of which evaluates tax neutrality benchmarks and compares source-based to residence-based taxation.

113 Peggy Musgrave also set forth a benchmark under which the state's goal was to maximize national, rather than global, welfare. *See* PEGGY MUSGRAVE, TAXATION, *supra* note

become the principal tools used by policymakers and scholars to analyze the impact of international tax policies on capital mobility.[114] It is rare to find a law or economics article or a government policy document that discusses international taxation without explicitly referencing these benchmarks.[115]

The first capital neutrality benchmark, and the one that has traditionally enjoyed the most support from economists,[116] is capital export neutrality (CEN). CEN describes locational neutrality; it obtains when shifting capital across borders would not increase welfare.[117] If there were no taxes, or if tax rates were the same in every jurisdiction, CEN would obtain because capital would be allocated across jurisdictions efficiently as taxpayers invested wherever they could earn the

112, at 32 (developing the counter-intuitively named "national neutrality" (NN) benchmark). Under NN, states would tax their residents' worldwide income, but allow only a deduction for foreign taxes, rather than a credit, in order to encourage capital investment at home rather than abroad.

I discuss capital and labor benchmarks that promote global, rather than national, welfare because I am interested in determining what tax policy a state should adopt if there is no clear domestic policy reason for encouraging or discouraging labor migration. *See supra* Part II.A.3 (discussing labor mobility). Although the traditional capital benchmarks promote global welfare, they also indirectly advance national welfare. *See* Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 155–56 (2007) (noting that proponents of both capital export neutrality (CEN) and capital import neutrality (CIN) "can (and do) argue on both the worldwide and the national fronts"). Although this Article assumes that states pursue migration neutrality, it also suggests some reasons why a state might want to influence labor migration—including unemployment and problems with "brain drain." *See supra* notes 96–105 and accompanying text (discussing factors that influence labor migration policy).

114 *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 102ND CONG., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 5 (Comm. Print 1991) (discussing neutrality benchmarks); *see also* Mihir A. Desai & James R. Hines, *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003) (discussing the CEN and CIN benchmarks and suggesting new benchmarks to evaluate international taxation systems); Graetz, *supra* note 80 (discussing CEN and CIN and arguing that U.S. international tax policy should focus more on promoting national welfare); Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q. J. ECON. 793 (1980) (discussing optimal taxation of international investment income in terms of neutrality benchmarks); Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53 (2006) (arguing that we lack empirical evidence that current methods of double tax relief cause ownership distortions that are distinct from locational distortions); Michael S. Knoll, *Reconsidering International Tax Neutrality* (Univ. of Penn., Inst. for Law & Econ., Research Paper No. 09-16, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1407198 (discussing neutrality benchmarks and arguing that economic and legal literature should use the term "CIN" more precisely).

115 *See* sources cited *supra* note 114 (providing examples of articles using neutrality benchmarks).

116 *See* Graetz, *supra* note 80, at 272 ("CEN enjoys the greatest normative support both in government analyses and in the academy.").

117 Knoll, *supra* note 114, at 9 (defining CEN).

highest pre-tax return. Diversity in national tax rates distorts capital allocations, however, because a lower-yield investment subject to low tax rates may produce a higher after-tax return than a higher-yield investment subject to high tax rates.[118] Tax rate diversity thus may result in too much capital investment in low-tax jurisdictions. A world characterized by CEN does not exhibit this cross-border misallocation of capital.[119]

CEN obtains when all taxpayers resident in a particular jurisdiction face the same tax burden on their investments, regardless of where they invest.[120] As noted, a world without taxes would be capital export neutral, as would a world in which all states had exactly the same tax rates, because in either case taxes would not factor into taxpayers' choice of where to invest.[121] In the absence of tax rate harmonization, states can achieve CEN by implementing the "worldwide" or "credit method" of taxing international income. Under the ideal form of worldwide taxation, states currently tax their residents' foreign-source income as if they had earned it domestically, while fully crediting any foreign taxes paid on that income.[122] By using credits to effectively eliminate foreign taxes, the residence state neutralizes any differences between its own tax system and that of the source state, thereby also neutralizing any tax incentives or disincentives for investing abroad. If all states enacted worldwide taxation, CEN

118 For example, suppose that a German investor wants to buy a bond for $100. She can buy a German corporate bond that pays $6 or an Irish corporate bond that pays $5. In the absence of taxes, the investor would choose the asset with the higher return, so she would buy the German bond. Suppose, however, that the German bond bears a 35% German tax, whereas the Irish bond bears only a 20% tax in Ireland and no tax in Germany. The after-tax return from the German bond would be $3.90, and the after-tax return on the Irish bond would be $4. After taking taxes into consideration, the investor would now choose the Irish bond, resulting in an inefficient allocation of capital.

119 *See* PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 108–10 (comparing non-neutral and neutral tax systems to demonstrate distortions created by taxation); Shaheen, *supra* note 112, at 207 (describing CEN as a system that "does not distort the locational allocation of investment capital").

120 *See* Desai & Hines, *supra* note 114, at 492 (explaining how CEN would be implemented).

121 For example, CEN would obtain if all states (1) assessed tax at the same rate (2) upon the same base and (3) exempted foreign income from tax.

122 Graetz, *supra* note 80, at 271–72 (explaining the role CEN plays in the current policy debate). States could achieve CEN in a more straightforward manner if they relinquished source tax jurisdiction and only taxed on a residence basis, so that the only tax burden an investor faced was that of her home state. Since states generally do not relinquish source taxation, however, in order to effectuate CEN, states must offer their residents foreign tax credits.

would obtain because taxpayers would always face the same tax burden no matter where they invested.[123]

The second capital mobility benchmark introduced by the Musgraves is capital import neutrality (CIN). CIN pursues savings neutrality; it obtains when shifting savings among taxpayers would not increase welfare. In the absence of taxes, people would decide how much to save and consume based purely on their preferences regarding those activities. However, because the return to savings is taxed under an income tax, but consumption is not taxed, income tax systems favor current consumption over savings. This distortion between savings and consumption arises under any system that taxes income, and it would exist even if the world consisted of a single taxing jurisdiction. But the existence of multiple jurisdictions that tax savings at different rates may create additional distortions. For example, if Germany is a high-tax jurisdiction, and Ireland is a low-tax jurisdiction, Irish tax residents will receive higher after-tax returns from their savings than will German tax residents. As a result, Irish tax residents may save too much compared to Germans, who save too little.[124] Economists note that one way this distortion manifests itself is that within a particular jurisdiction, investment may be skewed inefficiently toward Irish investors compared to German investors.[125] Thus, shifting savings from Irish investors to German investors could

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123 The bond example from note 118, *supra*, also illustrates how worldwide taxation ensures investment wherever the pre-tax return is highest notwithstanding diversity of national tax rates. Recall that if only Irish tax were due on the Irish bond, and only German tax were due on the German bond, then a German investor faced with a choice between a higher yield German bond and a lower yield Irish bond might nevertheless purchase the Irish bond if Irish taxes were only 20% while German taxes were 35%. Now suppose that Germany enacted worldwide taxation. As the investor's residence state, Germany would include the Irish interest in the investor's income as if it had been earned domestically. Thus, the $5 of Irish interest would be subject to German tax at 35%. Against this $1.75 tax, Germany would credit the $1 of tax collected by Ireland at its 20% rate, resulting in net tax due to Germany of $0.75. Under worldwide taxation, the after-tax return on the Irish bond ($\$5 \times (1 - 0.35) = \$3.25$) would be less than the after-tax return on the German bond ($\$6 \times (1 - 0.35) = \$3.90$), so the investor would buy the German bond. By subjecting both foreign and domestic investment to the home state's tax burden, worldwide taxation removes tax incentives and disincentives for investing abroad, thereby ensuring capital investment wherever the pre-tax return is highest.

124 Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 20 TAX NOTES INT'L 1579, 1581 (2000).

125 *Id.*

improve welfare.[126] To resolve this cross-border misallocation of savings, economists advocate CIN.[127]

CIN obtains when all taxpayers investing in a particular jurisdiction face the same effective tax rate on their investments, regardless of where they reside.[128] States can achieve CIN by various methods, all of which require international coordination. For example, if no states taxed savings, or if all states taxed savings at the same rate, then investors from different jurisdictions would face the same tax rate on savings everywhere. In the absence of tax rate harmonization, states can achieve CIN by (1) exempting their own residents' foreign investments from tax while (2) taxing residents and nonresidents investing in their territory identically (i.e., the source state should not discriminate against nonresident taxpayers). By implementing this ideal form of the "exemption method" of taxation, states would ensure that all investors within a jurisdiction would be subject to the exact same taxes: those of the source state. Thus, under the exemption method, both Irish and German investors would face identical tax rates on their investments within a particular jurisdiction.

Although CEN and CIN represent the dominant capital neutrality benchmarks, Professors Mihir Desai and James Hines recently have suggested another benchmark: capital ownership neutrality (CON).[129] Desai and Hines argue that the global allocation of capital is efficient when taxes do not affect who owns an asset.[130] Thus, CON

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126 *See id.* (showing that under pure residence-based taxation (i.e., CEN) "savings decisions are distorted; residents in country A save too little, while those in country B save too much").

127 *See id.* (noting that under a pure source-based tax system (i.e., CIN), "investors from country A receive the same after-tax returns to investment in country B as investors resident in country B").

128 *See id.* (defining CIN).

129 Desai & Hines, *supra* note 114, at 494–95 (introducing "CON" benchmark). Other capital mobility benchmarks exist, but this Article does not discuss them. For example, under the rubric of "national neutrality," Peggy Musgrave argued that states should promote national welfare by creating a bias against foreign investment by taxing foreign-source income while providing only a deduction, rather than a credit, for foreign taxes. *See* PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 32–33 (explaining deduction approach). Like Peggy Musgrave, Desai and Hines advocate national welfare, but under their "national ownership neutrality" (NON), states would exempt foreign-source income from tax in order to encourage foreign investment by domestic residents. NON would enhance national welfare if (1) the amount of inbound foreign capital at least equals the amount of outbound domestic capital, so that outbound investment does not reduce domestic investment; and (2) foreign-owned domestic capital is not less productive than domestically-owned domestic capital. If these two conditions hold, states can enhance national welfare by exempting residents' foreign investment because exemption will make domestic residents more competitive abroad at no cost to domestic production. Desai & Hines, *supra* note 114, at 496–97 (developing concept of NON).

130 Desai & Hines, *supra* note 114, at 494.

obtains when shifting particular assets among owners does not increase productivity.[131] There are two ways to achieve CON, but each requires all states to adopt the same method for taxing international income. Either all states must implement worldwide taxation or all states must implement exemption.[132]

Under the first alternative, CON would be achieved if all states enacted worldwide taxation. All states would currently tax their residents' worldwide income while fully crediting their foreign taxes. If all states adopted worldwide taxation, then taxpayers who resided in different jurisdictions but invested in the same source state would not face identical tax burdens. Nevertheless, taxpayers would always face their home state's tax burden, no matter where they invested. As a result, variations in tax rates among source states would not affect competition for ownership of assets, and CON would be maintained.[133] If all states enacted worldwide taxation, they would simultaneously achieve CEN and CON.[134]

Alternatively, CON could be achieved if all states enacted exemption systems.[135] Recall that under exemption, states do not discriminate between residents and nonresidents; they tax all investors the same way on income sourced within their jurisdiction.[136] Additionally, under exemption, a state fully exempts its own residents' foreign-source income, regardless of whether and at what rate the source state taxed it. As a result, foreign investment bears only the tax assessed by the source state. If all states enacted exemption, all investors within a jurisdiction would face the same tax burden (i.e.,

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131 *Id.* at 495. Professor Mitchell Kane provides the following definition of CON, which does not assume that each investor owns a fixed supply of capital: "Ownership neutrality will hold where the potential acquirer with the greatest productivity advantage will be able to offer the highest bid for the target." Kane, *supra* note 114, at 59. *See generally* Knoll, *supra* note 114 (arguing that commentators conflate savings neutrality and CON by referring to both concepts as CIN). An example of the phenomenon Knoll describes can be found in Ault & Bradford, *supra* note 58, at 39 (characterizing CIN as promoting neutrality with respect to "nationality of ownership of firms").

132 Desai & Hines, *supra* note 114, at 494.

133 *Id.*; *see* Knoll, *supra* note 114, at 22–24 (providing an example illustrating that CON and CIN can be achieved simultaneously via global adoption of exemption); *cf.* Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857, 866–72 (2007) (making a similar point in the context of investments by tax exempt organizations).

134 *See* Knoll, *supra* note 114, at 33–34 (showing that CIN as ownership neutrality (i.e., CON) and CEN can be achieved simultaneously via global adoption of worldwide taxation).

135 Desai & Hines, *supra* note 114, at 494.

136 *See supra* text accompanying notes 128–29 (describing exemption). As a logical consequence of the requirement that the source state treat nonresidents the same as residents, source states must also treat nonresidents who come from different foreign jurisdictions the same way under ideal exemption.

the source state's taxes), which would allow level competition between residents and nonresidents, even if tax rates in the nonresidents' home states differed from the tax rate in the source state. If all investors face the same tax burden with respect to a particular investment, taxes should not affect who owns it, and ownership neutrality will be maintained. Note that if all states implemented exemption, states could simultaneously achieve CIN and CON.[137] Simultaneous CIN and CEN, however, would require harmonized tax rates and tax bases,[138] so international tax proposals are usually framed as a choice between CEN and CIN.[139]

b. Labor Mobility Benchmarks

This Article proposes a labor analog for each capital efficiency benchmark. Without endorsing any of them, this subsection presents the labor analogs as a framework for thinking about cross-border labor mobility issues. Subsection 3.c presents factors for choosing among the benchmarks.

The labor analog to CEN is "labor export neutrality" (LEN). Like CEN, LEN promotes locational neutrality. While CEN focuses on the efficient allocation of capital across jurisdictions, LEN focuses on the allocation of labor across jurisdictions, which is efficient when taxpayers work wherever they earn the highest pre-tax wages.[140] States violate LEN when they tax cross-border work differently than domestic work, because such differences create tax incentives and disincentives for cross-border work. To achieve LEN, states should tax residents who work abroad the same way (and grant them the same personal tax benefits) as residents with only domestic income. In other words, states pursuing LEN should tax labor income analogously to how states pursuing CEN tax capital income: They should tax their residents' worldwide labor income while granting residents unlimited credits for foreign taxes. Moreover, states should continue to allocate personal tax benefits exclusively to the residence state, because that allocation ensures that taxpayers always receive the same personal tax benefits, regardless of whether they work at home or

137 Knoll, *supra* note 114, at 33–34.

138 Graetz, *supra* note 80, at 272 & n.36.

139 *See, e.g.*, *id.* at 277–97 (arguing that instead of focusing on CEN and CIN, U.S. international tax policy should focus more on advancing national interests).

140 Discussions of the capital mobility benchmarks generally assume that capital is perfectly mobile. *See, e.g.*, Shaheen, *supra* note 112, at 207 ("The basic assumption of all international tax neutrality theories is that capital is perfectly mobile and that labor and land are perfectly immobile."). Although this analysis likewise assumes that labor is perfectly mobile, that assumption is far less realistic for labor than for capital for the reasons given in Part I.A, *supra*.

abroad. If taxpayers always receive their home state's personal tax benefits, then national differences in the content or value of personal tax benefits should not distort taxpayers' choices about whether to work at home or abroad.

Suppose a German resident earns all her income in Ireland. Under LEN, Germany would tax her worldwide income, including the Irish income, and it would provide her unlimited credits for any Irish taxes she paid. It also would grant her full German personal tax benefits. By assessing the same taxes and conferring the same personal tax benefits on its residents regardless of where they earn their income, Germany would ensure that tax considerations would not influence its residents' decisions about whether to work in Germany or abroad. Thus, LEN promotes locational efficiency in taxing labor. While differences in such factors as wage rates and working conditions would still influence workers' choices about whether to work at home or abroad, tax considerations would not.

The second labor neutrality benchmark is "labor import neutrality" (LIN). Just as states pursuing CIN want taxpayers investing within the same territory to face the same tradeoff between savings and consumption, states pursuing LIN want taxpayers working within the same territory to face the same tradeoff between labor and leisure. As with the savings-consumption distortion, the labor-leisure distortion exists under any income tax because labor generates taxable income whereas leisure does not. Thus, leisure is a tax-preferred activity compared to labor. As a result, even in a world with only one taxing jurisdiction, taxpayers' decisions about whether to work an additional hour or spend that time at leisure would be distorted.

As with the taxation of savings, the existence of multiple taxing jurisdictions applying diverse tax rates may exacerbate the labor-leisure distortion. Economists claim that violations of CIN lead to misallocation of savings across jurisdictions, resulting in over-savings by taxpayers from lower-tax jurisdictions compared to taxpayers from higher-tax jurisdictions.[141] In effect, the "wrong person" ends up saving and therefore ends up making the investment.[142] Likewise, the existence of multiple tax jurisdictions with different tax rates may exacerbate the labor-leisure distortion, resulting in too much work being done by residents of low-tax states and too little work being done by residents of high-tax states. One way this distortion could manifest itself is that within a source jurisdiction, workers resident in

[141] *See* Altshuler, *supra* note 124, at 1581 (illustrating how differential taxes result in distorted savings decisions).

[142] Daniel N. Shaviro, Decoding the U.S. Corporate Tax 124 (2009).

low-tax states might be willing to work more hours than residents of a higher-tax jurisdiction. Thus, within Ireland, Irish residents who face low Irish taxes might be willing to work more hours at a particular wage than German residents, who face high German taxes on their Irish income. The tax distortion could also result in German tax residents working *more* hours than they would prefer in a no-tax world because they desire to make a certain dollar amount of after-tax income. Thus, taxes may induce differences in Irish and German work effort even if Irish workers' preferences regarding labor and leisure would be identical to those of German workers in a no-tax world. In effect, the "wrong" taxpayers end up working extra hours in Ireland.

The tax policy prescription of LIN is analogous to that of CIN: All workers within a particular jurisdiction should face the same effective tax rate on their work, regardless of the features of their residence state's tax system. To achieve this, states must not discriminate against nonresident workers; they must tax residents and nonresidents identically on labor income earned within their territory,[143] including by granting nonresidents proportional personal tax benefits. Additionally, states must exempt their own residents' foreign-source income to ensure that it bears only the tax of the source state. Under this tax method, a person's tax burden, including her personal tax benefits, would be determined by where she worked, not where she resided.

Under this implementation of LIN, if a German resident earned all her income in Ireland, only Ireland would tax her, and Ireland would do so on the same base it used for, and at the same rates it applied to, domestic workers. In this scenario, Ireland would grant the German resident 100% of Irish personal tax benefits, since it would tax 100% of her worldwide income. Under LIN, all workers earning income in Ireland would be taxed the same way on that income, regardless of where they reside. Thus, LIN promotes efficiency by minimizing cross-border distortions of the choice between labor and leisure.

A labor analog to Professors Desai and Hines's CON benchmark can also be introduced. A state supporting "labor ownership neutrality" (LON) would want to eliminate tax as a factor in competition among workers for jobs. For example, suppose a German resident competed with an equally qualified Irish worker for a job in Ireland. The fact that, under current international tax practices, the German

[143] In other words, the source state must not discriminate between resident and nonresident taxpayers.

worker might face additional taxes in Germany on her Irish-source income (or be eligible in Germany for less generous personal tax benefits than those available to Irish residents in Ireland) might enable the Irish resident to out-compete the German resident for the job. If, accounting for personal tax benefits, the effective tax rate on Irish residents working in Ireland were lower than the effective tax rate on German residents working in Ireland (taking into consideration both Irish source-based taxes and German residence-based taxes), the difference in effective tax rates might allow the Irish resident to underbid the German resident for a job in Ireland, even if the German resident were the better candidate for the job.[144] As with CON, there are two ways to achieve LON: (1) all states must adopt exemption and grant both residents and nonresidents proportional personal tax benefits, or (2) all states must adopt worldwide taxation and grant their residents full personal tax benefits.

Thus, each of the traditional capital neutrality benchmarks has a labor analog. First, CEN and LEN both concern locational distortions. CEN obtains when taxes do not distort where taxpayers invest their capital; LEN obtains when taxes do not distort where taxpayers work. Second, CIN concerns distortions of taxpayers' decisions about how much to save; CIN obtains when all taxpayers investing within a particular jurisdiction face the same tax tradeoff between savings and consumption. Similarly, LIN concerns distortions of taxpayers' decisions about how much to work; LIN obtains when all taxpayers working within a particular jurisdiction face the same tax tradeoff between labor and leisure. Finally, CON concerns ownership distortions; it obtains when taxes do not affect who owns an asset. Analogously, LON concerns whether a particular job is held by a resident or nonresident taxpayer; it obtains when taxes do not affect who works a particular job.

In the labor context, however, we must also consider another potential distortion. In addition to affecting where taxpayers work, how many hours they work, and which job they work, taxes also may affect where individuals live. Rather than simply working in a lower tax jurisdiction, taxpayers might change their state of residence in order to escape high taxes.[145] To prevent tax-motivated residence

[144] While some states might regard this employment preference for residents over foreigners as an advantage of limiting personal tax benefits to residents, such distortions may hamper the ability of domestic businesses to hire the most qualified worker at the best price. Additionally, domestic workers would suffer a competitive disadvantage vis-à-vis foreign workers from states with more generous tax expenditure programs.

[145] *See* sources cited *supra* note 110; *see also* Lionel Laurent, *Federer's Tax Break Not So Great*, FORBES.COM, Jul. 18, 2008, http://www.forbes.com/2008/07/18/

changes, states would adopt "labor residence neutrality" (LRN), the tax policy prescriptions of which are the same as for CIN.[146] To achieve global residence neutrality, all states should (1) tax resident and nonresident taxpayers earning income within their jurisdiction the same way, including by granting them proportional personal tax benefits, and (2) exempt their residents' foreign-source income from taxation. If all states adopted these rules, then all taxpayers would be taxed based on where they earned their income, not where they resided. As a result, they would have no tax motivation for changing their state of residence.

c. Factors for Selecting a Benchmark

Since the 1960s, policymakers, economists, and tax academics have vigorously debated the comparative virtues of the capital efficiency benchmarks.[147] Choosing whether to implement a worldwide or exemption tax system depends in part on answers to empirical questions, such as the relative responsiveness of locational, savings, and ownership decisions to taxation and the relative welfare losses caused by locational, savings, and ownership distortions.[148] Because capital location decisions are thought to be more responsive to taxation than savings decisions, economists generally favor CEN over CIN.[149] Commentators disagree about whether capital location or

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federer-tax-switzerland-markets-face-cx_ll_0718autofacescan02.html (describing tennis champion Roger Federer's move to the "lax-on-tax village of Wollerau from his relatively pricier native region of Basel"). Residence neutrality is more important for taxpayers with significant passive income, because residence states—even those that have enacted primarily exemption systems—often tax passive foreign income. *See* AULT & ARNOLD, *supra* note 18, at 372–73; *cf.* Timothy Noah, *Bono, Tax Avoider: The Hypocrisy of U2*, SLATE, Oct. 31, 2006, http://slate.com/id/2152580 (criticizing the rock band U2's decision to move its publishing business from Ireland to the Netherlands to avoid Irish taxes on royalties).

146 *But cf.* Kirsch, *supra* note 62, at 488–93 (defending U.S. method of taxing citizens on their worldwide income, no matter where they reside, because such citizenship-taxation discourages tax-motivated migration). Unlike exemption, however, citizenship-based taxation is not fully residence-neutral, since taxpayers can change their state of citizenship. *But see id.* at 493 (finding that few Americans have renounced citizenship for tax reasons).

147 *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT-LAW RULES AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION § IV.D (Comm. Print 1999) ("At present, there is considerable conflict at both the theoretical and empirical levels regarding whether a system of worldwide taxation is, or is not, more economically efficient than an exemption system."), *quoted in* J. Clifton Fleming, Jr. et al., *Fairness in International Taxation: The Ability-To-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 308 n.14 (2001).

148 *See, e.g.*, Graetz, *supra* note 80, at 272 ("Many economists regard the choice . . . as essentially empirical, turning on the relative elasticities of savings and investment.").

149 *See, e.g.*, Altshuler, *supra* note 124, at 1581–82 (discussing the relative responsiveness of savings and locational decisions); Graetz, *supra* note 80, at 272 (noting that economists generally favor CEN); Klaus Vogel, *Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part II)*, 16 INTERTAX 310, 312–13 (1988) (discussing

capital ownership decisions are more responsive to taxation, which makes the choice between CEN and CON difficult.[150] Perhaps because they believe it would lower their overall tax burden, businesses often favor the exemption method.[151]

As with capital neutrality, states' selection of LEN, LIN, LON, or LRN as their labor neutrality benchmark will depend on several factors. Economists likely would favor LEN over LIN if taxation distorts decisions concerning where to work more than it distorts the labor-leisure decision.[152] Whether LEN is preferable to LON depends on whether the efficient allocation of labor across jurisdictions is more important than distortions of competition for jobs within particular jurisdictions. Because taxpayers' ability to change their state of tax residence is so limited under immigration law, their decisions about where to reside are unlikely to be more responsive to taxation than their decisions about where to work, how many hours to work, or which job to take. As a result, making residence decisions tax-neutral (LRN) is probably not as important as making location, leisure, and ownership decisions tax-neutral.

The degree of international coordination required to achieve each benchmark also impacts the desirability of each benchmark. Analysis of the capital neutrality benchmarks provides insight into the degree of international cooperation needed for the labor mobility benchmarks. Neither CIN nor CON can be achieved unilaterally.[153] This is because CIN requires all savers within a jurisdiction to face the same effective tax rate on their investment, no matter where they reside.[154] To achieve this, all states must either tax investment income at the same rate or all states must exempt foreign-source income.[155] Either option would require international coordination. If some states exempt foreign-source income, but others tax it, then taxpayers

assumptions made by economists favoring each theory). *See generally* Kane, *supra* note 114, at 60–66 (comparing locational and ownership distortions).

150 Kane, *supra* note 114, at 73–79 (arguing against ownership neutrality as welfare benchmark due to lack of empirical evidence that methods of double tax relief cause ownership distortions distinct from locational distortions).

151 *See, e.g.*, Ault & Bradford, *supra* note 58, at 41 (noting business community's preference for exemption method of taxing U.S.-controlled foreign subsidiaries).

152 Recall that under an income tax, the labor-leisure decision will already be distorted in the domestic tax context, so the question for LIN is whether there will be differences in the degree of the distortion across different taxing jurisdictions. *See supra* Part II.A.3.b (discussing labor mobility benchmarks).

153 *See* Desai & Hines, *supra* note 114, at 493 (observing that "CIN is a feature of all tax systems analyzed jointly"); *id.* at 495 ("If some countries tax foreign income while others do not, then it is impossible to restore CON without bringing them all into alignment.").

154 Altshuler, *supra* note 124, at 1581.

155 *See supra* notes 124–28 and accompanying text (discussing conditions for CIN).

investing in a particular jurisdiction will face different tax rates depending on where they reside. Such differences would violate CIN. CON likewise requires international coordination. For CON to obtain, either all states must exempt foreign-source income, or all must tax it while offering unlimited foreign tax credits.[156] Again, each option would require international coordination. Because the policy prescriptions of LIN are identical to those of CIN, and the policy prescriptions of LON are identical to those of CON, LIN and LON also cannot be achieved unilaterally.

In contrast, a state may be able to achieve a limited form of CEN or LEN via unilateral adoption of worldwide taxation.[157] If a particular state adopts worldwide taxation—meaning that it subjects its own residents' capital and labor income to tax as if that income had been earned domestically, grants them unlimited credits for foreign taxes, and grants them full personal tax benefits—then differences in tax rates and personal tax benefits between jurisdictions should not distort its residents' decisions about where to invest and where to work. Thus, even if some states implement exemption, the locational decisions of residents of states implementing worldwide taxation should not be distorted. Such unilateral adoption of CEN or LEN would be limited in the sense that although the state would achieve locational neutrality for its own residents, residents of any states not implementing the same system would still face locational distortions created by differences in national tax systems.

As with LIN and LON, global LRN would require international coordination because it demands that all states adopt exemption.[158] As with locational neutrality, however, states may be able to achieve a limited form of residence neutrality by acting unilaterally. If a particular state exempts its own residents' foreign-source income,[159] then differences in taxes should not factor into its residents' decisions about where to reside. If a taxpayer's residence state completely exempted her foreign-source income, she could receive the benefit of

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[156] Desai & Hines, *supra* note 114, at 494; *see also* Knoll, *supra* note 114, at 22–24 (providing illustration of circumstances under which CON obtains).

[157] Desai & Hines, *supra* note 114, at 493 (arguing that "individual country policies can embody CEN"). *But see* NAT'L FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY (1999) (advocating exemption because states cannot achieve CEN unilaterally), *cited in* Altshuler, *supra* note 124, at 1583 n.9; *cf.* PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 6 (noting that the General Theory of Second Best calls into question whether unilateral action by any one state moves the world closer to any of the neutrality benchmarks (citing R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956))).

[158] *See supra* note 146 and accompanying text (discussing conditions for LRN).

[159] This would include exemption of residents' passive foreign income.

another state's lower tax rate simply by earning income sourced there. Under unilateral exemption, a taxpayer need not move to another state in order to secure the benefit of its lower tax rates; it would be sufficient for her to earn income there. As a result, by implementing exemption unilaterally, states can achieve residence neutrality for their own residents. I describe such unilateral LRN as limited for two reasons. First, the residence decisions of taxpayers residing in states failing to adopt exemption systems would still be distorted. Second, if fewer than all the states granted proportional personal tax benefits, taxpayers would still have incentives to move to jurisdictions with more generous personal tax benefits. If personal tax benefits constitute only a small component of the overall effective tax rate, then the residence distortions they create will be small, so that unilateral exemption would be a reasonably good way to avoid residence distortions. But if personal tax benefits significantly alter effective tax rates, then taxpayers' decisions about where to reside could still be significantly distorted under unilateral exemption. It is difficult to devise an administrable unilateral solution to the residence distortion created by the availability of different personal tax benefits abroad.[160]

In conclusion, states cannot unilaterally pursue LIN or LON, which require significant international coordination.[161] Because states set their policies for taxing international income largely unilaterally, neither LIN nor LON represents a practical policy goal at this time. In analyzing the question of how to allocate personal tax benefits for cross-border workers, this Article therefore primarily focuses on locational neutrality and residence neutrality, even though international

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[160] Some solutions may seem theoretically attractive but would be difficult to administer. For example, states could grant residents a tax credit for the dollar value of the personal tax benefits they would have received from their source state had the source state adopted proportionality. There is precedent in the United States for one state determining a resident's benefits by reference to the law of another state. In the 1990s, in order to prevent migration of welfare-recipients from other U.S. states, California limited new California residents' welfare benefits. New residents were entitled to either California's benefits or their former residence state's welfare benefits, whichever was less. To administer this system, California had to determine what benefits the resident would have received had she not moved. In *Saenz v. Roe*, the Supreme Court held that California's taxing scheme discriminated against new residents in violation of the Privileges and Immunities Clause. 526 U.S. 489 (1999).

To eliminate residence distortions stemming from national variations in personal tax benefits, the residence state could also adopt a method for granting personal tax benefits that did not depend on residence. For example, states could always grant taxpayers the personal tax benefits available in their state of birth. In addition to being complicated, the methods suggested in this note are impractical because they would result in the new residence state granting another state's tax benefits.

[161] *See supra* notes 153–56 and accompanying text.

diversity in the content of personal tax benefits hinders states' ability to achieve residence neutrality unilaterally.

d. International Tax in the Real World

Notwithstanding the lingering empirical and theoretical uncertainty surrounding the selection of the most appropriate neutrality benchmark, states must decide how they will tax cross-border capital and labor income. Although not employing the term, some states seem to favor unilateral LEN. For example, some states tax their residents' worldwide labor income while granting them credits for foreign taxes, a practice that promotes LEN. Like all states, states enacting such worldwide tax systems generally grant full personal tax benefits to residents with foreign-source income, another practice consistent with LEN.

For other states, unilateral LRN seems to be the favored benchmark; many states exempt their residents' foreign-source labor income. As noted earlier, however, although exemption reduces tax-based incentives for moving, states cannot unilaterally achieve full residence neutrality because the content of personal tax benefits differs from state to state. Like all states, exemption states typically deny nonresidents personal tax benefits and grant residents with foreign-source income full personal tax benefits. This practice is inconsistent with LRN and may motivate taxpayers to change their state of tax residence in order to take advantage of more generous personal tax benefits available elsewhere.

While states thus seem to favor unilateral LEN or unilateral LRN, it is important to note that states do not implement the ideal forms of worldwide or exemption taxation described earlier.[162] As already discussed, to achieve LEN for its own residents, a state must currently tax its residents' worldwide income and fully credit any taxes assessed by the source state on foreign income. But states that implement worldwide taxation deviate from this ideal in several ways. First, rather than currently taxing all of their residents' foreign income, states that enact primarily worldwide taxing systems nevertheless allow residents to defer tax on some types of foreign income.[163]

[162] Worldwide taxation is ideal if the state currently taxes all of its residents' foreign-source income (i.e., no deferral) and credits foreign taxes without limitation. Exemption is ideal if, when taxing in a source capacity, the state does not discriminate between resident and nonresident taxpayers and, when taxing in a residence capacity, the state exempts *all* of its residents' foreign-source income. *See supra* notes 132–37 and accompanying text.

[163] For example, states allow deferral of tax on unrepatriated active foreign-source income earned by foreign subsidiaries of resident companies. *See* AULT & ARNOLD, *supra* note 18, at 377–78 (noting argument that in such contexts, "[c]ompetitive considerations . . . require . . . at least deferral of[ ] the potentially higher domestic tax").

Second, states do not grant their residents unlimited credits for taxes imposed by the source state because unlimited credits could result in the residence state issuing refunds for foreign taxes.[164] To avoid issuing refunds, states usually limit credits to the amount of tax that would have been due had the taxpayer earned the income domestically. The United States adopts this approach.[165] Such foreign tax credit limitations violate locational neutrality because they maintain tax disincentives for investing and working in higher tax states, even when investment or work there earns superior pre-tax returns.

Just as states do not implement pure worldwide taxation, states do not implement pure exemption systems.[166] For example, states usually exempt only some of their residents' foreign-source income; typically, they exempt active, but not passive, foreign income.[167] Labor income is active income, and therefore is generally exempt from tax in states applying only partial exemption systems.[168]

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164 To see how unlimited credits could result in a refund of foreign taxes, suppose an Irish investor buys a $100 German bond with a 5% pre-tax return. Further, suppose that the German tax rate is 35% but the Irish tax rate is only 20%. Under a worldwide tax system, if the Irish investor bought the German bond, she would pay $1.75 in tax to Germany on the interest (35% of $5). But the same investment if made in Ireland would have yielded tax of only $1 (20% of $5). To eliminate the tax-induced locational distortion caused by Germany's higher tax rate, under its worldwide tax system, Ireland would have to fully credit the German tax of $1.75 before assessing its own tax of $1. This would result in a net refund to the taxpayer of $0.75, which represents the difference between the Irish and German taxes (15% of $5, or $1.75 – $1.00). Generally, however, states limit the foreign tax credit to the amount of the domestic tax liability on the income (here, $1). Although a credit for $1 would wipe out the investor's Irish tax liability, she already would have paid $1.75 in tax to Germany. The higher tax to which her investment is subject in Germany would discourage her from investing there.

In addition to preserving revenue, states may impose credit limitations to discourage the source state from increasing its own tax rate up to the amount of the residence state's rate in order to "soak up" the tax credit in the residence state. *See* Ault & Bradford, *supra* note 58, at 38 ("[T]he Canadian corporate tax [is] an instrument for absorbing the U.S. tax credit.").

165 I.R.C. § 904 (2006).

166 States cannot achieve CIN or CON via unilateral adoption of exemption. *See supra* notes 153–56 and accompanying text. Nevertheless, many states exempt significant portions of their residents' foreign-source income. This could be because states are unaware that they cannot achieve savings or ownership neutrality unilaterally, or it could be because they seek to enhance national welfare by creating a bias for foreign investment. *See* Desai & Hines, *supra* note 114, at 496–97 (advocating exemption to promote national welfare).

167 Recall that passive income includes dividends, interest, rent, royalties, and similar income, while active income includes profits from active business and remuneration for personal services.

168 Ault & Arnold, *supra* note 18, at 406–10.

4. *Conclusion*

This Section first considered the narrow question of how states should allocate the obligation to provide a subset of personal tax benefits: those that take the form of tax incentives for socially useful behavior. It argued that since the positive externalities associated with taxpayer behavior accrue more often to the taxpayer's residence state, rather than her source state or states, the residence state generally will be better motivated than the source state to subsidize those activities efficiently. Thus, on balance, allocating the obligation to account for tax incentives to the residence state is more efficient than allocating it to the source state or states. Although there may be some cases in which it would be more efficient for the source state to provide particular tax incentives because the associated positive externalities accrue in the source state, the complexity and uncertainty engendered by requiring taxpayers to claim tax incentives from more than one state make exclusive allocation to the residence state a more attractive policy option.

Turning to the efficiency of the political process for determining the content of personal tax benefits, this Section argued that allocation of the personal tax benefit obligation to the residence state would be more likely to reveal and satisfy preferences regarding the content of those benefits, since cross-border taxpayers are more likely to participate in the political process of their residence state than their source state.

As a broader framework for assessing the impact of the allocation question on the efficiency of global labor markets, this Section introduced labor analogs to the preexisting capital neutrality benchmarks. States may seek to prevent taxes from distorting several decisions made by workers, including where to work (LEN), how much to work (LIN), which job to work (LON), and where to reside (LRN). The principal purpose of this Section was not to select the most appropriate welfare benchmark for taxing international labor income but rather to point out that, like the efficient allocation among states of entitlements to tax income from capital, the efficient allocation among states of the obligation to confer personal tax benefits requires consideration of what *kind* of efficiency states want to achieve.

Notwithstanding that selecting a benchmark was not the goal of this Part, I argued that because states pursue their international tax policies largely unilaterally, it is impractical to expect that states will undertake the level of international coordination necessary to implement LIN or LON, each of which requires global harmonization of either tax rates or methods of taxing international income. Due to the impracticality of LIN and LON, the rest of this Article focuses on LEN and LRN.

B. Taxpayer Equity

Selection of a method for taxing cross-border income depends not only on efficiency but also on equity and administrability.[169] This Section considers the equity arguments for allocating the personal tax benefit obligation to the residence state or the source state and concludes that, on balance, allocation to the residence state is more equitable.

1. Benefits Theory of Taxation

If, in accordance with the "benefits theory of taxation," we conceive of taxes as payments in exchange for government benefits, perhaps states should be obliged to confer personal tax benefits on nonresidents who contribute to their tax coffers.[170] The benefits theory would imply that a nonresident should be able to collect personal tax benefits to the extent that her tax payments to the source state exceed the dollar value of any source state government benefits she already receives, including infrastructure, regulated labor and capital markets, and so on.

Although intuitively attractive, the benefits theory of taxation suffers from two major drawbacks.[171] First, it would be impossible to implement precisely due to the difficulty of determining the amount of government benefits—including diffuse benefits such as military protection—received by each resident and nonresident taxpayer. Second, the benefits theory does not accord with modern understandings of income taxation.[172] In a purely domestic context, states generally do not condition government benefits upon recipients' payment of taxes. Indeed, taxpayers receiving the largest government benefits may be those who, due to their needy circumstances, pay the least taxes. For example, the very absence of tax-paying capacity entitles a person to the earned income tax credit, and the credit itself may com-

169 *See, e.g.*, Fleming et al., *supra* note 147, at 311–18 (arguing for worldwide taxation on equity grounds).

170 James M. Buchanan, *The Pure Theory of Government Finance: A Suggested Approach*, *in* FISCAL THEORY AND POLITICAL ECONOMY: SELECTED ESSAYS 8, 13 (1960).

171 *Id.*

172 Buchanan argues that rejection of the benefits theory has a logistical basis, which concerns the difficulty of pricing government services for tax purposes, and an ethical basis, which rejects the very notion that government benefits should be exchanged for taxes, even if it were possible to make such calculations. *See id.*

pletely eliminate her tax liability and result in a refund.[173] Rather than being conditioned upon the payment of a certain amount of tax, entitlement to government-provided social welfare benefits usually depends on factors such as citizenship or domicile.[174] Allocating the obligation to confer public benefits according to source—that is, according to tax collections—would conflate the question of who should receive benefits with the question of who should pay for benefits. Therefore, the benefits theory does not provide a convincing argument for allocating to the source state the obligation to confer personal tax benefits on cross-border workers.

2. *Ability-To-Pay Principle*

Rather than the benefits principle, the "ability-to-pay principle" generally dominates modern equity discussions.[175] Under the ability-to-pay principle, people with higher incomes should pay more taxes than people with lower incomes.[176] Applying this equity criterion to our question leads to the conclusion that cross-border taxpayers should be taxed the same as similar taxpayers with similar abilities to pay. Since different states measure ability to pay differently, however, a question that arises for cross-border taxpayers that does not arise for purely domestic taxpayers is: Which state's conception of ability to pay should apply?

Return to the example of the German tax resident who earns all her income in Ireland. Since taxpayer equity involves comparisons, determining the proper basis for taxing the cross-border German worker requires a judgment about *with whom* she is most appropriately compared. Two possible comparisons immediately present themselves. We could compare her with (1) fellow residents of

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173 Some personal tax benefits phase out with higher incomes, but this should be viewed as a judgment about ability to pay rather than an attempt to correlate (here inversely) government-provided benefits with the payment of taxes.

174 Nonresident aliens cannot claim the benefit of the earned income tax credit (EITC) unless married to a U.S. citizen or resident. I.R.C. §§ 32(c)(1)(D), 6013(g)–(h) (2006). Although the EITC is refundable, most personal tax benefits are nonrefundable, so a taxpayer must have a positive tax liability in order to collect the benefit. This feature of tax expenditures has been heavily criticized as inequitable and inefficient. *See, e.g.*, Surrey, *supra* note 4, at 720–27 (criticizing tax expenditures as inequitable because they benefit high marginal rate taxpayers more than low marginal rate taxpayers); Batchelder et al., *supra* note 4, at 42–72 (criticizing tax expenditures as inefficient because they subsidize higher marginal rate taxpayers more than lower marginal rate taxpayers without evidence that higher marginal rate taxpayers are more responsive to tax subsidies).

175 James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1133–40 (2008) (discussing the benefits theory and the ability-to-pay principle).

176 *Id.* at 1139.

Germany who earn all their income in Germany or (2) fellow workers earning all their income in Ireland but who reside in Ireland. The choice between these two equity conceptions is not obvious. However, if, as most political theorists argue, the purpose of the state is to advance the welfare of its own members,[177] then a state may be obliged to confer both direct benefits and tax benefits on its own members even when they work abroad, and, concomitantly, a state may be justified in excluding nonmembers from such benefits. Perhaps motivated by such philosophical arguments, most economists and legal scholars considering the issue have concluded that cross-border taxpayers should be taxed like fellow residents of their home state.[178] This would result in the application of Germany's conception of ability to pay to the German earning all her income in Ireland.

When states extend benefits to their own members but exclude nonmembers from benefits, the definition of national community

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[177] Diverse political theorists seem to agree that the purpose of the state is to advance the welfare of its own members. *See, e.g.*, JOHN LOCKE, THE SECOND TREATISE OF GOVERNMENT 71 (Thomas P. Peardon ed., 1952) ("The great and chief end, therefore, of men's . . . putting themselves under government is the preservation of their [lives, liberties, and estates]."); John Stuart Mill, *Considerations on Representative Government*, *in* ON LIBERTY AND OTHER ESSAYS 203, 227 (John Gray ed., 1991) ("[W]ell-being [of the governed] is the "sole object of government."); ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 321 (1974) ("A nation or protective agency may not compel redistribution between one community and another, yet a community such as a kibbutz may redistribute within itself (or give to another community or to outside individuals)."); JEAN-JACQUES ROUSSEAU, ON THE SOCIAL CONTRACT 67 (Donald A. Cress trans., 1983) ("What is the goal of the political association? It is the preservation and prosperity of its members.").

Governments also advance these views. See, for example, *Graham v. Richardson*, in which Pennsylvania and Arizona defended their policies of denying public assistance to resident aliens because a state has a "special public interest in favoring its own citizens over aliens in the distribution of limited resources such as welfare benefits." 403 U.S. 365, 372 (1971) (internal quotation marks omitted).

Other philosophers advance theories under which outsiders cannot be justly excluded from benefits. *E.g.*, JOHN RAWLS, A THEORY OF JUSTICE 4–5 (1971) ("[A] society is well-ordered when it is not only designed to advance the good of its members but when it is also effectively regulated by a public conception of justice."); NOZICK, *supra*, at 185 (arguing that Rawls's theory of distributive justice cannot be limited to cases of social cooperation). Cosmopolitan theorists have developed this notion and advocated global distributive justice. *See infra* Part II.B.3 (discussing cosmopolitanism).

[178] PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 11–12 (concluding without further reasoning that "all *residents and citizens* of a certain country who enjoy the protection and other privileges provided by the government . . . should be taxed by that country at rates equal for all those receiving equal income from whatever source, be it domestic or foreign" (emphasis added)); *see also* DAVID F. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 89–91 (1984) (favoring residence-based taxation); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1328–36 (1996) (supporting residence-only taxation of individuals on the basis of ability to pay); Musgrave & Musgrave, *supra* note 112, at 68 (concluding without further reasoning that fairness requires the taxpayer's liability at home to be calculated in the same way no matter where she earns her income).

membership becomes important. Different political theorists define national community membership differently.[179] Most consider citizens to be national community members, and citizens are usually the greatest beneficiaries of a government's spending.[180] People obtain citizenship by birth, inheritance, marriage, and long domicile.[181] These criteria generally, although not always, assure meaningful contacts between the citizen and the state.

Defining national community membership by reference to citizenship, however, may be both over- and under-inclusive. For example, few would consider a person to be a member of the U.S. national community who, although a U.S. citizen by birth, lived her entire life elsewhere. Likewise, many would consider permanent immigrants to be members of the national community, even if they never naturalize.[182] To resolve the tax benefit allocation question, however, it is not necessary to define national community membership with a high degree of precision. Rather, it is sufficient to observe that under most conceptions, because membership in the national community is a matter of a person's connections to the state—including citizenship, family, and community connections—national community membership will generally coincide better with tax residence than it does with source.

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179 *Cf.* Paul S. Berman, *The Globalization of Jurisdiction*, 151 U. PA. L. REV. 311, 459 (2002) ("The concept of 'community' is one of the most widely used in the social sciences. However, a precise definition has been predictably elusive."); *see also id.* at 459–72 (reviewing definitions of community from sociology).

180 The term "citizenship" is equally difficult to define. *See* Linda Bosniak, *Citizenship Denationalized*, 7 IND. J. GLOBAL LEGAL STUD. 447, 450 (2000) ("[T]he meaning of citizenship has been, and remains, highly contested among scholars."). The International Court of Justice has defined nationality as "a legal bond having as its basis a social fact of attachment, a genuine connection of existence, interests and sentiments, together with the existence of reciprocal rights and duties." Nottebohm Case (Liech. v. Guat.), 1955 I.C.J. 4, 23 (Apr. 6), *cited in* Kim Rubenstein & Daniel Adler, *International Citizenship: The Future of Nationality in a Globalized World*, 7 IND. J. GLOBAL LEGAL STUD. 519, 534 (2000) (reviewing conceptions of citizenship from human rights jurisprudence).

181 Some countries, including the United States, confer citizenship on all persons born within their territorial jurisdiction, regardless of the citizenship of the person's parents. Other countries require a person to be a descendant of one or more citizens in order to qualify as a citizen herself. Requirements for naturalization vary widely, but most states consider domicile within the state and family relationships with other citizens to be important factors. *See generally* John D. Snethen, *The Evolution of Sovereignty and Citizenship in Western Europe: Implications for Migration and Globalization*, 8 IND. J. GLOBAL LEGAL STUD. 223 (2000) (tracing the evolution of the legal conception of citizenship in Western Europe).

182 *See Joint Hearing before the Subcomm. on Immigration, Refugees, and International Law of the H. Comm. on the Judiciary and the Subcomm. on Immigration and Refugee Policy of the S. Comm. on the Judiciary*, 97th Cong. 9 (1981) (testimony of William F. Smith, Att'y Gen. of the United States) (referring to undocumented immigrants as "members of the community"), *quoted in* Plyler v. Doe, 457 U.S. 202, 218 n.17 (1982).

Tax residence is the better proxy for national community membership because tax residence encompasses personal contacts between the taxpayer and the state whereas source reflects only economic contacts. Different states define tax residence differently, but they usually employ factors such as physical presence in the jurisdiction, maintenance of an abode there, intention to make a long-term commitment to remain in the jurisdiction, and nationality.[183] Thus, while a taxpayer may have several source states, she generally has only one residence state. In cases where a taxpayer is a resident of more than one state under each state's domestic law, the OECD Model tiebreaker rule resolves dual residence conflicts according to the following factors (in descending order of importance): where the taxpayer maintains a permanent home, where her personal and economic relations are closer, where she has her habitual abode, and her nationality.[184] Tax residence therefore usually reflects significant personal connections between the taxpayer and the state.

In contrast, the entitlement of a source state to tax a nonresident derives from the state's connection to her income, not its connection to the taxpayer herself. For many kinds of income, the degree of connection between the source state and the taxpayer can be slight. For example, interest income is sourced in the state of the debtor. A taxpayer's maintenance of a bank account in a foreign state or her purchase of a foreign bond need not reflect personal connections between the taxpayer and the foreign state. As a result, compared to residence, source serves as an inferior basis upon which to distribute government benefits, including tax benefits.

The desire to confine welfare-enhancing benefits to members of their own national communities helps explain why states extend income-defining, but not welfare-enhancing, tax benefits to nonresident taxpayers. For example, although the United States denies nonresidents the standard deduction and most itemized deductions, it allows them to deduct business expenses as well as certain personal expenses that resemble income-defining provisions, such as casualty losses.[185] Likewise, tax treaties require source states to allow nonresi-

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183 Ault & Arnold, *supra* note 18, at 347–49. The United States asserts unlimited tax jurisdiction over its citizens and permanent residents (green card holders) wherever they reside, as well as over resident aliens, defined for tax purposes as those meeting a physical presence test. *Id.* at 347.

184 OECD Model, *supra* note 9, art. 4(2).

185 I.R.C. § 63(c)(6)(B) (2006) (denying nonresidents the standard deduction); *id.* § 873 (disallowing deductions unrelated to earning taxable income in the United States, except for certain enumerated itemized deductions, including the casualty deduction).

dents to deduct certain business expenses,[186] but tax treaties do not require source states to confer personal tax benefits on nonresidents.[187]

3. *Global Welfare*

Not all theorists agree that maximization of national welfare promotes equity. Cosmopolitans argue that the inherent equality of all human beings imposes on states moral obligations to "help other nations and their peoples."[188] Although cosmopolitanism tells us that all people are equal and therefore deserving of equal treatment, it does not tell us whether the source state or the residence state should confer personal tax benefits. Animating much cosmopolitan writing is the view that the inherent equality of humans requires international redistribution of wealth.[189] Cosmopolitans might therefore support a personal tax benefit allocation rule that would redistribute wealth. States could accomplish this by, for example, imposing the obligation to confer personal tax benefits on the taxing state with the higher per capita GDP.[190]

Despite its humanitarian appeal, states are not likely to adopt a cosmopolitan method for allocating tax benefits internationally. Preferences for national, rather than global, welfare maximization could change, however, as we face problems—such as pollution—that states cannot solve by acting alone. Increasing multilateralism in trade and human rights protection may reflect rising cosmopolitan sentiments. These changes, however, are unlikely to affect tax policy dramatically

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186 The OECD Model requires states to allow nonresident taxpayers to deduct business expenses, at least when the taxpayer carries on a business through a permanent establishment, defined as a fixed place of business in the source state. OECD MODEL, *supra* note 9, arts. 5(1), 7(3), 24(3). Many states allow nonresidents to deduct expenses related to active income, even if the nonresident does not have a permanent establishment. *See, e.g.*, I.R.C. §§ 871–873 (taxing nonresidents).

187 *See supra* notes 174, 185–86 and accompanying text (discussing differences in treatment between resident and nonresident taxpayers).

188 Jack Goldsmith, *Liberal Democracy and Cosmopolitan Duty*, 55 STAN. L. REV. 1667, 1668 (2003); *see also* Bosniak, *supra* note 180, at 448 ("[The cosmopolitan outlook] expresses loyalty and moral commitment to humanity at large, rather than any particular community of persons."). *But see* Goldsmith, *supra*, at 1668–70 (providing arguments for limiting liberal democracies' obligation to engage in cosmopolitan action).

189 Martha Nussbaum has called for an international tax institution that would redistribute wealth on a global scale, and Thomas Pogge has argued for a global tax on natural resources that would fund global redistribution. Goldsmith, *supra* note 188, at 1670–73.

190 *Cf*. Musgrave & Musgrave, *supra* note 112, at 74 (concluding that states could achieve international redistribution via tax treaties by implementing nonreciprocal withholding rates designed to allocate more tax to the developing country than to the developed country).

in the near term.[191] As a result, we should expect states to continue to limit both direct and tax spending benefits to their own residents.

4. *Arbitrariness of Source*

A final argument favors allocating the personal tax benefit obligation to the residence state. The rules that determine the geographic source of income have long been subject to criticism for their arbitrariness.[192] Source rules classify income according to its type (compensation for personal services, dividends, royalties, and so on) and then assign or "source" it to a state based upon that classification. Sourcing personal services income to the performance state is relatively uncontroversial,[193] although prominent commentators have argued that it may be inappropriate to do so when the human capital needed to provide the services was developed in another state.[194] Other source rules, however, engender significant controversy. For example, views on the proper rules for sourcing interest and sales vary widely.[195] In addition to disputes about how types of income should be sourced, disputes also arise over how to classify income. For example, does an artist who sells his own paintings have income from personal services or income from the sale of personal property?[196] Does a musical conductor whose payment depends on the sales of recordings of his performances have services income or royalty income?[197] The answers to

[191] *See* Graetz, *supra* note 80, at 279 (globalization does not signal "the demise of national identity or national politics").

[192] *See, e.g.*, Ault & Bradford, *supra* note 58, at 30 ("[T]he source of income is not a well-defined economic idea."); Shay et al., *supra* note 58, at 154 ("[A]lthough taxation at source has a robust normative foundation, the source rules that implement this form of taxation lack a strong theoretical or prescriptive content.").

[193] *See* PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 26 (noting that most countries consider it their right to tax income arising within their borders, that taxation by source is widely imposed, and that, for individual wage or salary earners, taxation by source is easy to implement).

[194] Shay et al., *supra* note 58, at 140 (arguing that state in which a taxpayer's "extensive human capital" was developed may have a tax claim on part of her income).

[195] *See, e.g.*, Carlo Garbarino, *A Study of the International Tax Policy Process: Defining the Rules for Sourcing Income from Isolated Sales of Goods*, 29 HARV. INT'L L.J. 393, 398–413 (1988) (noting theories for sourcing sales of goods according to where title passes, place of sale, or place of consumption); Klaus Vogel, *Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part I)*, 16 INTERTAX 216, 227 (1988) (noting that interest may be sourced to "the residence of the debtor, the place at which the principal is made available, the place at which it is used, the place interest payments are made[, or] the residence of the bank through which interest is paid").

[196] *See* Tobey v. Comm'r, 60 T.C. 227, 235 (1973) (holding that because the sale by an artist of his own paintings was personal services income, a certain dollar amount could be excluded under the statutory foreign earned income exclusion).

[197] *See* Boulez v. Comm'r, 83 T.C. 584, 596 (1984) (holding that the payments were compensation for personal services, not royalties).

these questions determine where income is sourced, which in turn determines which state may tax it.[198] Thus, as a basis for conducting equity analysis and as a basis for conferring personal tax benefits, residence is more stable and less arbitrary than source.[199]

5. *Conclusion*

The defining characteristic of personal tax expenditures is their implementation for social or political reasons rather than for income measurement.[200] If maximization of national welfare is a legitimate goal of government, then it is appropriate for voters and their governments to limit tax expenditures to members of the national community and to deny them to outsiders. And because residence is generally a better proxy than source for national community membership, distributing personal tax benefits according to residence rather than according to source does a better job of confining personal tax benefits to national community members.

Tax residence is not, however, a perfect proxy for national community membership. For example, a person may have significant contacts with both the United States and Mexico, including having family, abodes, and other ties in both states. We might regard such a person as a member of both national communities. But under the Mexico-U.S. tax treaty, she would be a tax resident of only one state. Likewise, cases may arise in which a taxpayer is a member of the national community of her source state but not her residence state.[201] Notwithstanding these possibilities, on average, residence coincides better than does source with national community membership, and therefore residence serves as a more appropriate basis than source for conferring government benefits—including personal tax benefits—designed to enhance the welfare of national community members.

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198 *See, e.g.*, *id.* at 584 (noting that if the payments to Boulez were properly classified as royalties, then under the U.S.-Germany tax treaty, only Germany would be able to tax them, whereas if the payments were compensation for personal services, both the United States and Germany could tax them).

199 *Cf.* Avi-Yonah, *supra* note 178, at 1311–13 (favoring residence-based taxation for individuals in part because determining an individual's residence state is usually easier than determining the source of her income).

200 *See supra* Part I.B (discussing personal tax expenditures).

201 Use of outlier jurisdictional predicates may increase the likelihood of a mismatch between the taxpayer's state of tax residence and her national community membership. For example, the United States is almost alone in the world in taxing its citizens as residents even if they actually reside elsewhere. For ten years after exit, the United States even taxes as residents those who renounce their U.S. citizenship, if the renunciation was motivated by tax avoidance reasons. I.R.C. § 877 (2006). It is therefore easy to imagine scenarios in which a U.S. citizen would be a tax resident of the United States, but not a member of its national community.

Note, however, that it follows from this line of analysis that when a cross-border worker earns all her income in the source state, the equity argument that the source state should grant her personal tax benefits (including those designed to promote social welfare) is stronger than when she earns only a small portion there. This is so because a taxpayer who earns all her income in a source state is more likely to be a member of the source state's national community, even if she is not a resident for tax purposes. This Article will discuss cases in which the taxpayer earns all or almost all of her income in the source state at greater length later.[202]

But if it is generally more equitable to tax cross-border workers like fellow residents of their home state rather than fellow workers in their source state or states, then states should tax their residents' worldwide income, fully credit their foreign taxes, and grant them full personal tax benefits. Thus, both criteria analyzed so far—efficiency and taxpayer equity—generally favor maintenance of the current allocation of personal tax benefits to the residence state, although in neither case is that conclusion unequivocal. By adopting worldwide taxation and conferring the same personal tax benefits on their residents no matter where they earn their income, states would promote LEN.[203] In other words, they would prevent taxes from influencing their residents' decisions about where to work. Such worldwide taxation would, however, increase taxpayers' motivation to change their state of residence in order to take advantage of lower taxes or more generous personal tax benefits available elsewhere. Thus, it would violate LRN.

C. *Inter-nation Equity*

Peggy Musgrave coined the term "inter-nation equity" to refer to concerns about how states divide the tax revenue from cross-border activities.[204] Unlike the taxpayer equity question discussed in the last Section concerning how to divide the costs of government across taxpayers within a jurisdiction, inter-nation equity concerns how to divide the costs of government across taxing states. This Section argues that inter-nation equity concerns should not motivate the selec-

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[202] *See infra* Part III.B–C.

[203] If every state adopted worldwide taxation and granted personal tax benefits to residents, regardless of the source of their income, states would achieve both LEN and LON, although they would violate LIN and LRN.

[204] Peggy Musgrave, Taxation, *supra* note 112, at 15–24; *see also* Musgrave & Musgrave, *supra* note 112, at 68 ("Inter-nation equity deals with the allocation of national gain and loss.").

tion of a rule for allocating among states the obligation to provide personal tax benefits to cross-border workers.

1. Linking Taxes and Benefits

In 2002, the European Court of Justice (ECJ) decided the *De Groot* case, which challenged the Dutch proportionality method.[205] De Groot was a Dutch resident taxpayer who argued that by varying from the international practice of granting resident taxpayers full personal tax benefits, the Netherlands penalized his economic activities in other EU member states. Denying him tax benefits in proportion to his foreign-source income, De Groot argued, constituted a violation of his freedom to work in other EU member states, a right guaranteed by the EC Treaty.[206] Supported by Belgium, the Netherlands argued that it was unduly burdensome for the Netherlands to provide De Groot with a full complement of personal tax benefits since it did not collect taxes on his foreign income.[207] Furthermore, Belgium argued that allocating the obligation to provide personal tax benefits solely to the residence state was unfair because that state already supplied "the greatest part of the public services performed for the taxpayer."[208] In *De Groot*, Belgium and the Netherlands seemed to argue that a state's obligation to provide government benefits to a person should correspond to the state's opportunity to collect taxes from that person.

Rather than a precise exchange of tax for government benefits, in *De Groot* the Netherlands advocated a rough cost-sharing arrangement under which a state would confer personal tax benefits on a taxpayer in proportion to its relative entitlement to tax her income. By linking a state's obligation to provide costly tax and public benefits to its collection of tax revenue, the proportionality method appeals to inter-nation equity.

Although in *De Groot* the Netherlands did not expressly couch its argument in terms of the labor mobility benchmarks, we can observe that the Dutch proportionality method is consistent with uni-

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[205] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819.

[206] *Id.* ¶¶ 27–33; *see also* EC Treaty, *supra* note 31, art. 39 (abolishing employment discrimination on the basis of nationality).

[207] *De Groot*, 2002 E.C.R. I-11819, ¶¶ 53–63. Belgium and the Netherlands both exempt foreign-source personal services income. *Id.*

[208] *Id.* ¶ 64. Justice Ginsburg raised similar arguments in her 1998 dissent in *Lunding v. New York Tax Appeals Tribunal*, in which the majority held that a U.S. state could not, consistently with the Privileges and Immunities Clause, categorically deny nonresident taxpayers alimony deductions when it granted alimony deductions to residents. *See* 522 U.S. 287, 324–25 (1998) (Ginsburg, J., dissenting) (arguing that although the source state may provide deductions that advance the welfare of its own residents, it need not extend similar aid to nonresidents). For more on the Privileges and Immunities Clause and its implications for personal tax benefits, see *infra* Part III.C.

lateral LRN: The Netherlands exempted its residents' foreign-source income, and it treated resident and nonresident taxpayers earning labor income in the Netherlands the same way for tax purposes, including by granting them personal tax benefits proportional to the fraction of their income earned within its territory. If every state adopted the Dutch proportionality method, states would achieve LRN, because taxpayers would be subject to tax on their income only where they earned it, and taxpayers would secure personal tax benefits only where they worked.[209] As a result, taxes would not distort workers' choices about where to reside.

The Dutch proportionality method, however, violates LEN because it distorts taxpayers' decisions about where to work. Under proportionality, national differences in both tax rates and the content of personal tax benefits distort taxpayers' choices about where to work. For example, taxpayers from high-tax states might be motivated to work in low-tax states, since their wages would be exempt at home under the proportionality method. In contrast, taxpayers from low-tax states would be discouraged from working in high-tax states, since no credits for those high taxes would be available from their residence state. Likewise, under proportionality, taxpayers residing in states with parsimonious personal tax benefits might have a tax incentive to work in states with more generous benefits. And taxpayers from states with generous tax benefits might be discouraged from working abroad because cross-border work would decrease their benefit entitlements at home. Of course, these two effects might work in opposite directions if high-tax states generally provide larger personal tax benefits than do low-tax states.[210]

2. *Reciprocity and Choosing the Appropriate Instrument*

Before concluding that proportionality would advance internation equity, we must examine the personal tax benefit allocation

[209] Indeed, if every state adopted the Dutch proportionality method they would achieve not only LRN, but also LIN and LON, because every taxpayer working in a particular jurisdiction would be subject to the same effective tax rate (i.e., the source state's tax rate), no matter where the taxpayer resided. This conclusion assumes that source states would allow nonresident taxpayers proportional personal tax benefits *and* treat resident and nonresident taxpayers the same—i.e., that source states would not discriminate against nonresidents, or among nonresidents from different states.

[210] In the context of capital taxation, Richard Musgrave criticized the tendency of debates about tax competition to focus on effective tax rates while ignoring the public benefits that taxes fund. Richard Musgrave, *Criteria*, *supra* note 112, at 91 ("I wonder whether the expenditure side of the public budgets can be disregarded entirely. If taxes are used to provide public services which reduce business costs, . . . a combined increase in taxes and public expenditures may raise rather than reduce the net rate of return on investment . . . .").

rule in light of the other provisions of the tax treaty. Because bilateral tax treaties impose reciprocal entitlements and obligations on the contracting states, if cross-border labor mobility between the two states is symmetrical, then any method they choose for allocating tax entitlements and personal tax benefit obligations should be revenue neutral. The easiest way to explain this is with an example. Assume that, consistently with international tax norms, France confers full personal tax benefits on French residents, even when they earn a majority of their income (and pay a majority of their taxes) in Germany. France loses revenue because it extends tax benefits to French residents from whom it collects little or no tax. But consider the reverse situation, in which German residents earn income in France. France collects taxes from the German workers without incurring any obligation to grant them personal tax benefits. The outbound and inbound scenarios balance: What France loses in a residence capacity, it gains in a source capacity. As long as the income earned by French residents in Germany is roughly equal to the income earned by German residents in France, any method they choose for allocating tax revenue and personal tax benefits should be close to revenue neutral. If all reciprocal methods for allocating personal tax benefits are revenue neutral under conditions of symmetrical labor migration, then there is no inter-nation equity argument for choosing among them, and other criteria should guide the allocation decision.

In contrast, asymmetrical bilateral labor migration produces net revenue gains and losses from the provision of personal tax benefits. Specifically, under the current rule that allocates personal tax benefits to the residence state, net labor exporters—states that send more workers abroad than they receive from other states—lose revenue because they cede to the source state primary taxing authority over their residents' foreign labor income, but they retain full personal tax benefit obligations with respect to those residents. Likewise, net labor importers gain revenue because they tax foreign workers' income but do not need to provide them personal tax benefits. Developing states tend to be net labor exporters because they tend to have lower wages and labor surpluses, while developed states tend to be net labor importers due to their higher wages and labor shortages.[211] Ironically, the personal tax benefit allocation rule in the current OECD Model therefore may shift tax revenue from poor states to rich states.

This developed state bias does not by itself establish a violation of inter-nation equity. Because tax treaties are negotiated instruments that allocate the entitlement to tax all types of cross-border income

[211] *See supra* Part I.A (discussing labor mobility trends).

among the two contracting states, we should not view any single provision of a tax treaty in isolation. For example, while the personal tax benefit allocation rule in the OECD Model may be more costly for developed than developing states, other Model provisions may compensate by providing a net tax advantage to developing states.[212] Unfortunately, however, it has long been recognized that some of the other provisions of the OECD Model—in particular the business and capital tax provisions—also tend to shift tax revenue from poor to rich states.[213]

If states decide that tax treaties between developed and developing states result in an inequitable division of tax revenue, they must then decide on the best way to address the issue. Since the bias favoring developed states permeates the OECD Model, rather than isolating and amending a single provision in the OECD Model (such as the personal tax benefit allocation rule), states should consider more comprehensive solutions. The United Nations model tax treaty ("UN Model") was introduced to address the systematic bias against developing states in the OECD Model; it does so by allocating to developing states greater entitlements to tax certain kinds of cross-border income.[214]

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212 Non-treaty factors might also compensate developing states for the loss of tax revenue from cross-border labor. For example, cross-border workers from developing states may remit significant portions of their income to relatives back home. When the relatives spend these remittances in the developing state, the developing state collects consumption taxes, which may help compensate for the loss of the entitlement to income taxes on the cross-border workers' labor. Since developing states rely more heavily on consumption than income taxes, the taxation of these remittances may be important. Likewise, since developing states do not rely as heavily as developed states on income taxation, it is reasonable to assume that they do not administer as many social welfare benefits through their income tax codes. As a result, the burden of retaining the personal tax benefits obligation may not be as significant for developing as developed states. For more on the tax systems of developing countries, see Bird & Zolt, *supra* note 35.

213 *See* Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. Int'l L. & Pol. 939, 977–90 (2000) (discussing why the net effect of tax treaties between developed and developing states is to reduce tax revenue in developing states without attracting additional investment there).

214 With business and capital income, unlike labor income, developing states are more often source states because investment flows from developed states to developing states. But in the context of business and capital income, the effect of the OECD Model is to shift tax entitlements from the source state to the residence state. *See id.* at 983 (describing benefits to residence states of treaties which "limit the jurisdiction of host countries to tax certain kinds of income, such as business income"). As a result, in the context of labor, business, and capital income alike, the OECD Model tends to shift revenue from developing to developed states, sometimes by shifting revenue to source and sometimes to residence. In the context of business and capital income, the introduction to the UN Model states:

> [T]he Fiscal Committee of the [OECD acknowledged in 1965 that] "the traditional tax conventions have not commended themselves to developing coun-

Although the UN Model grants developing states greater entitlements to tax cross-border business and capital income than the OECD Model does, the UN Model closely resembles the OECD Model when it comes to allocating the entitlement to tax labor income[215] and the obligation to provide personal tax benefits.[216] The UN could address this developed state bias by adding proportionality to its model. Because money is fungible, however, to resolve an overall imbalance in the division of tax revenue between two states, the states could amend *any* provision of their tax treaty. Thus, states could leave the personal tax benefit allocation rule exactly as it is, but grant developing states the entitlement to tax more cross-border labor income. They could also rectify revenue imbalances by altering tax treaty provisions unrelated to labor taxation. For example, they could grant developing states even greater entitlements to tax cross-border business or capital income than the OECD Model does. States should not resolve inter-nation equity issues by altering the personal tax benefit allocation rule unless they determine that altering that rule is the best way to achieve the desired revenue split. In determining whether it is the best way, states should consider whether amending the rule will lead to greater distortions of taxpayers' work decisions or pose significant administrative hurdles. As already discussed, shifting the personal tax benefit obligation to the source state would lead to

> tries." . . . [I]t is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one-sided.

UN Model, *supra* note 64, intro., ¶ 3. Although the UN Model closely follows the text of the OECD Model, there are some important differences. For example, rather than recommending reduction in source state withholding on direct and portfolio dividends to 5% and 15% respectively, the UN Model leaves the figures blank. *Id.* art. 10. The blanks allow for the negotiation of non-reciprocal withholding rates and higher source withholding rates than those available under the OECD Model. *See id.* cmt. on art. 10(2), ¶¶ 6, 8, 12. Since developing countries tend to be net capital importers relative to their developed treaty partners, allocation of greater source tax entitlements over business and capital income favors developing countries.

215 *Compare UN Model*, *supra* note 64, art. 14 (concerning dependent personal services) *and id.* art. 15 (concerning independent personal services) *with* OECD MODEL, *supra* note 9, art. 15 (concerning income from employment) *and id.* art. 7 (concerning income from business profits, which covers income from independent personal services where service provider has a permanent establishment in source state).

216 The UN Model contains the exact same language as the OECD Model regarding personal tax benefits. *Compare UN Model*, *supra* note 64, art. 24(3) ("This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.") *with* OECD MODEL, *supra* note 9, art. 24(3) (same).

inefficient locational distortions,[217] and, for reasons explained in the next Section, doing so would also pose administrative hurdles.

3. Conclusion

A theory of the proper division of global tax revenues falls outside the scope of this Article. But states should understand how tax treaties affect the global distribution of tax revenue. Although amending the personal tax benefit allocation rule of the OECD Model may not be the best way to resolve the inter-nation equity concerns identified here, it is important to recognize that the current allocation rule tends to shift revenue from poorer, labor-exporting states to richer, labor-importing states. Highlighting the revenue losses suffered by developing countries when they relinquish the entitlement to tax their residents' foreign-source income (but retain the obligation to grant them personal tax benefits) may help developing states negotiate more favorable terms in their tax treaties with developed states.

D. Administrability

States do not deny nonresident taxpayers all personal tax benefits. For example, tax benefits that exist primarily for the administrative convenience of the taxing state—such as the exclusion of imputed income or deferral of tax until realization—apply equally to residents and nonresidents. But just as administrative convenience provides a reason for extending certain tax benefits to nonresidents, it also provides a justification for excluding nonresidents from other benefits. For example, to eliminate the need for nonresidents to file complete tax returns, source states may tax nonresidents on a gross basis, denying them deductions for both business and personal expenses.[218] Even in cases where states allow nonresidents to deduct business expenses, states may deny nonresidents personal tax benefits rather than undertake the administrative burden of verifying nonresidents' eligibility for those benefits. So far, this Article has argued that although the case is not unequivocal, on balance, efficiency and equity

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[217] Locational distortions would arise because because shifting the personal tax benefit obligation to the source state may cause taxpayers to work in low wage states that offer generous personal tax benefits. *See supra* Part II.C.1 (discussing Dutch proportionality method).

[218] The United States does this for passive income. It subjects nonresidents who are not engaged in a trade or business in the United States to a 30% gross basis withholding tax on their "fixed," "determinable," "annual," or "periodical" income—i.e., their passive income. I.R.C. § 1441 (2006). Some states subject nonresidents' active income to gross income taxation. *See, e.g.*, Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933, ¶¶ 3–22 (describing Germany's tax treatment of certain nonresident taxpayers).

considerations favor provision of personal tax benefits exclusively by the residence state. This Section concludes that the current allocation rule is also simpler and more administrable than splitting the personal tax benefit obligation among the cross-border taxpayer's source state or states.

1. *Taxpayer Information*

One advantage of assigning the personal tax expenditure obligation to the residence state is that the residence state usually has the best access to information about the taxpayer. States' personal jurisdiction over their residents facilitates collection of tax information about their worldwide income.[219] In contrast, because source states often tax nonresidents' gross income at flat rates,[220] they have less motivation to collect detailed taxpayer information.

Taxpayer information is crucial for determining eligibility for personal tax benefits. First, many tax benefits are subject to an income cap.[221] Likewise, states may condition tax benefits on aspects of the taxpayer's personal or family situation. For example, the child tax credit is only available to taxpayers with children, and taxpayers must be married to file joint returns.[222] By assigning the obligation to account for personal tax benefits to the state with superior access to information about the taxpayer, states make it easier to verify taxpayers' eligibility for such benefits, which may reduce fraud. International taxpayer information-sharing agreements may mitigate the information asymmetry between source and residence states in the future,[223] but at present, the residence state generally has the best access to personal taxpayer information.

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[219] States collect information about their residents' net worldwide income in order to apply progressive tax rates. Even countries that exempt their residents' foreign income may require it to be reported so that it can be taken into account for purposes of applying progressive tax rates at home, a technique called "exemption with progression." AULT & ARNOLD, *supra* note 18, at 372.

[220] *See, e.g.*, I.R.C. § 1441 (applying gross withholding taxes to passive income earned by certain nonresident taxpayers in the United States). The OECD Model also provides for gross withholding on passive income. *See* OECD MODEL, *supra* note 9, arts. 10–12 (concerning taxation of dividends, interest, and royalties, respectively).

[221] *See, e.g.*, I.R.C. § 32(a)(2) (phasing out earned income tax credit); *see also* CCH, 2008 U.S. MASTER TAX GUIDE ¶ 88A (91st ed. 2007) (listing the adjusted gross income phaseout thresholds for major personal deductions).

[222] Taxpayer identification numbers (TINs) may assist the residence state in verifying taxpayers' personal tax benefit claims. For example, any U.S. taxpayer claiming certain child-related tax benefits must provide each child's TIN. *E.g.*, I.R.C. § 32(c)(3)(D)(i).

[223] *See, e.g.*, OECD Convention on Mutual Assistance in Tax Matters, arts. 1, 4–10, Jan. 25, 1988, 1 TAX TREATIES (CCH) ¶ 220 (providing for states' exchange of taxpayer information).

2. *Other Problems with Splitting Methods*

Any method the states choose for dividing the personal tax benefit obligation that does not put the full onus on either a single source state or the residence state may result in other serious administrative drawbacks.

a. Multiple Tax Filings

Although taxpayers generally have only one residence state, they may have many source states.[224] Under the current allocation rule, since taxpayers claim benefits only in their residence state, they file complete returns only at home, where they are likely to speak the national language or languages and have at least some familiarity with available tax benefits. In contrast, if the states shifted the personal tax benefit obligation to source, taxpayers would be entitled to claim personal tax benefits in every state in which they earned income, necessitating multiple tax filings.

b. Need for Tax Sparing

Allocating to the source state the obligation to confer personal tax benefits also would require coordination between the source and residence states, at least in cases where the residence state operates a worldwide tax system with foreign tax credits. For taxpayers from worldwide tax states, any reduction of source taxes due to the conferral of personal tax benefits by the source state would simply increase their residual tax liability at home, thereby eliminating the benefit conferred at source.[225] If states desired to overcome this difficulty, some mechanism (such as a "tax sparing"[226] credit) would be

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[224] Tax treaties resolve cases of dual residence. *See supra* note 184 and accompanying text (discussing OECD Model tiebreaker rule).

[225] To see why, suppose Elle resides in Residence, which has a tax rate of 35% and uses the credit method to eliminate double taxation. Elle earns $100 in Source, which also has a tax rate of 35%. Suppose further that Source grants Elle a personal tax benefit that saves her $5 in Source taxes. She would pay $30 in tax to Source (($100 × 0.35) – $5). But because Elle is subject to tax on her $100 worldwide income in Residence, she will also owe $35 in taxes there, against which Residence would credit the $30 of tax paid to Source, leaving an additional $5 to be paid to Residence by Elle. Elle would be no better off from an after-tax perspective than if Source had not granted her the tax expenditure. The states have merely shifted $5 of tax revenue from Source to Residence. *Cf.* Michael J. McIntyre & Richard D. Pomp, *State Income Tax Treatment of Residents and Nonresidents Under the Privileges and Immunities Clause*, 13 State Tax Notes 245, 245 (1997) (considering tax credits at the U.S. state level).

[226] Under such a mechanism, the residence state would consider the taxpayer to have paid higher taxes to the source state than she actually paid, which would increase the taxpayer's foreign tax credits. For example, in the fact pattern discussed in note 225, *supra*, Residence would consider Elle to have paid $35 in tax to Source, and Residence would therefore grant her a $35 tax credit, even though, after accounting for her personal tax

required to ensure that residence taxation did not nullify the benefit granted by the source state. This would further complicate an already overly complex international tax regime.

c. Duplication of Benefits

Disparities among states in how they define tax benefits and whether they use tax expenditures or direct expenditures to deliver government benefits pose serious obstacles to any method of splitting the personal tax benefit obligation among the taxing states. An example will illustrate the point. Suppose that both France and Germany provide incentives for parents to work outside the home. France decides that the best way to incentivize parental workforce participation is to establish public daycare centers. Parents must pay for their children's daycare, but the cost is low due to the government subsidy. In contrast, Germany simply provides a deduction for a certain dollar amount of childcare costs to working parents.

Now imagine that the parents of a French-resident family with children enrolled in French public daycare earn all of their income from work in Germany. Under the French-German tax treaty, Germany would be entitled to tax all of the couple's income, and France would exempt it.[227] If Germany and France split the personal tax benefit obligation according to the proportionality method, Germany would be required to grant the French couple 100% of German personal tax benefits, since it would tax 100% of their income. But if Germany grants the French parents its deduction for childcare costs, the parents would secure a double benefit. They would collect an in-kind daycare subsidy in their residence state and a tax subsidy in their source state.

In addition to violating taxpayer equity principles, collection of duplicative personal tax benefits also violates LEN by, in this instance, creating a tax incentive for the French couple to work in Germany in order to be eligible for the double benefit. Nor would proportionality achieve LRN, since Germans would have an incentive to move to France to take advantage of the daycare double dip; they could enroll their children in French public daycare[228] while continuing to earn

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benefits in Source, Elle only actually paid $30 to Source. For an economic analysis of tax sparing, see PEGGY MUSGRAVE, TAXATION, *supra* note 112, at 80–88.

[227] The example assumes that France and Germany have a tax treaty identical to the OECD Model except that it implements proportionality. *See* OECD MODEL, *supra* note 9, arts. 15, 23A (regarding employment income and double-taxation relief via exemption, respectively).

[228] This example assumes that France would allow the new residents from Germany to enroll their children in French subsidized daycare.

their income, pay taxes, and take the childcare deduction in Germany. Thus, any method of splitting the obligation to confer personal tax benefits increases the likelihood, already present under current law, that a taxpayer will collect duplicative benefits from two states. In contrast, allocation of the obligation exclusively to one state minimizes the risk of conferring double benefits, and allocation exclusively to the residence state reduces that risk further if taxpayers are more likely to collect in-kind benefits in their residence state than abroad.

d. Double Denial of Benefits

Proportionality could also increase the risk, already present under current law, of what might be called "double denials": cases in which the taxpayer cannot claim personal tax benefits in either the source state or the residence state. Another example will illustrate. This time, suppose that a German-resident couple earns all of their income in France. Now France would tax the income and Germany would exempt it. If Germany and France implemented proportionality in their tax treaty, Germany would have no obligation to grant the German couple a deduction for childcare costs, since they earned no income in Germany. But since France provides its childcare subsidy through provision of an in-kind benefit, rather than a tax expenditure, the tax treaty would not oblige France to grant the subsidy to German tax residents. Thus, France would not violate the tax treaty by denying the German-resident workers the opportunity to enroll their children in a French subsidized daycare program. As a result, the German couple would be able to claim childcare benefits neither at home nor in their work state. These examples highlight that diversity in how states deliver benefits—whether through direct benefits or tax deductions—poses an obstacle to proportionality. Interestingly, to avoid such conflicts and to reduce their obligation to confer costly tax benefits on nonresident taxpayers, states adopting proportionality might elect to deliver more benefits though direct, rather than tax, spending. Proportionality might therefore find support from commentators who argue that states should minimize or eliminate tax expenditures.[229]

e. Tax Base Diversity

Other practical difficulties plague attempts to split the personal tax benefit obligation. For example, under the proportionality method, each state would confer personal tax benefits in proportion to

[229] *See generally, e.g.*, Surrey, *supra* note 4 (arguing for strong presumption against use of tax incentives and advocating use of direct subsidies).

the income it taxed divided by the taxpayer's overall, worldwide income. Since each state defines income differently, however, each state might use a different denominator to calculate its proportional obligation. As a result of such denominator differences, taxpayers might collect more or less than one full share of personal tax benefits, which would violate equity and efficiency principles. Similarly, since conceptions of what constitutes a tax expenditure differ widely, disputes may arise about whether a state is obliged to provide nonresidents particular benefits.[230]

3. Conclusion

The Commentaries to the OECD Model reveal that a desire to prevent inequities that would result if cross-border taxpayers received duplicative personal tax benefits from more than one jurisdiction motivated the adoption of the current allocation rule.[231] By clearly relieving the source state of personal tax benefit obligations, the OECD Model prevents duplication of benefits while avoiding the confusion, uncertainty, and forum shopping that might result from allocating some (or all) of the personal tax benefit obligation to the taxpayer's source state or states. Additionally, the current allocation rule assigns the obligation to provide personal tax benefits to the state likely to have the best information about the taxpayer, and it avoids the need for multiple tax filings and tax sparing. It also may help avoid both double denials and duplication of personal tax benefits for cross-border taxpayers. Thus, the need for simple and administrable tax rules supports the residence state retaining the onus to confer personal tax benefits.

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[230] *See supra* Part I.B (discussing controversy over how to define tax expenditures); *see also* OECD, REVENUE STATISTICS 31 (2003) ("[I]t has not proved possible to produce internationally comparable data on tax expenditures because of the difficulty in defining a common benchmark against which the reduced tax obligations can be measured.").

[231] The Commentaries to the OECD Model state:

> [The personal tax benefit allocation rule] is designed mainly to ensure that such persons do not obtain greater advantages than residents through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment.

OECD MODEL, *supra* note 9, cmt. on art. 24, ¶ 36. The OECD Commentaries are widely accepted by courts and administrative bodies as a guide to the interpretation of the OECD Model. Due to the significant influence of the OECD Model, both OECD member states and non-member states participate in writing the Commentaries. OECD MODEL, *supra* note 9, intro., ¶ 10.

III
Implications for Treaties and Constitutional Law

The preceding Part established the normative criteria for determining which state ought to grant personal tax benefits to cross-border workers, and it argued that, on balance, these factors favor maintaining the current international tax norm of allocating the obligation exclusively to the residence state. This Part considers the implications of the foregoing analysis for tax treaties and for constitutional law in the European Union and the United States.

A. Tax Treaties

If efficiency, equity, and administrability principles support exclusive allocation to the residence state of the obligation to grant personal tax benefits to cross-border workers, then the rule in the OECD Model that discharges the source state of any responsibility to confer personal tax benefits on nonresidents should not be altered. Confirmation of the status quo usually is not heralded as a major discovery, but it is important in this case because the OECD has begun considering whether to amend the allocation rule in the OECD Model to shift more responsibility for personal expenses to the source state.[232] Recognition that allocation to the residence state promotes not only administrability but also equity and efficiency should make the OECD member states more reluctant to alter the Model.

B. Resolving Double Denials

Retention of the status quo in tax treaties raises the question of what, if anything, should be done to resolve double denials, which arise when a cross-border taxpayer has insufficient taxable income in her residence state to allow her to claim personal tax benefits there. Because personal tax benefits usually take the form of offsets against taxable income (such as deductions), if the taxpayer has little or no taxable income in her residence state, there may be no way for her to claim benefits there.[233] In addition to being unfair, double denials also raise efficiency concerns. When cross-border work results in double denials, taxpayers may be discouraged from engaging in it. Additionally, in double denial cases, both states miss the opportunity

[232] *See* OECD Public Discussion Draft, *supra* note 14, at 28 (identifying the current allocation rule as an issue requiring more fundamental analysis).

[233] If such benefits were offered in the form of cash payments (or refundable tax credits), this problem would not arise. *See infra* notes 236–40 and accompanying text (discussing different approaches to resolving double denials).

to use their tax systems to encourage cross-border workers to engage in socially desirable behavior.[234]

Double denials may arise under worldwide or exemption taxation, but they represent a more serious problem under exemption systems. Since worldwide taxation with unlimited credits places residents with foreign income in the exact same tax position as residents with the same amount of domestic income (thereby achieving LEN), cross-border workers are at no *greater* risk than domestic workers of being unable to secure personal tax benefits. To the extent that domestic and cross-border workers—who are taxed identically under LEN—have legal entitlements to tax benefits that exceed their tax liability, they are denied personal tax benefits to the same extent. Such denials may be vertically inequitable (because high income taxpayers are less likely to exhaust their tax liability than low income taxpayers) and inefficient (because the government fails to incentivize desirable behavior by taxpayers who have little or no income tax liability). But they are not horizontally inequitable, since all taxpayers with the same amount of income—whether earned domestically or abroad—are denied tax benefits to the same extent. In contrast, exemption reduces cross-border workers' tax base at home, thereby reducing the amount against which they can apply tax benefits. This increases the risk that cross-border workers will not have enough taxable income at home to allow them to claim personal tax benefits there.[235] Likewise, foreign tax credit limitations increase the risk of double denials for residents of worldwide taxing states.

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[234] *See supra* Part II.A.1 (examining reasoning behind requiring residence state to provide tax incentives).

[235] Suppose two taxpayers reside in Exemption, which fully exempts foreign-source income. Harrison earns all his income domestically, whereas Allison earns all her income abroad in Source. Source and Exemption both tax at 20%, and they have a double tax treaty based on the OECD Model. Harrison and Allison each earn $100, and each is entitled to a nonrefundable personal tax credit of $5. After the personal tax credit, Harrison will pay $15 of tax at home to Exemption (($100 × 20%) – $5). Consistently with the tax treaty, Source denies Allison personal tax credits, so Allison pays $20 in tax to Source ($100 × 20%). Although Allison qualifies for the nonrefundable personal tax credit in Exemption, the credit in Exemption is of no use to her because she has no tax liability there. Harrison and Allison reside in the same state and have the same amount of income, but Allison pays higher taxes, which violates horizontal equity and penalizes Allison for cross-border work—a violation of LEN.

Suppose that instead, Allison and Harrison reside in Credit, which taxes residents' worldwide income while allowing them unlimited foreign tax credits. Harrison's tax situation would not change; after claiming the personal tax credit, he would pay $15 in tax to Credit. Allison would still pay $20 to Source, but Credit would grant her a foreign tax credit of $20 *and* the personal tax credit of $5. Thus, Allison would also pay $15 in net taxes, just like Harrison. Notice that foreign tax credit limitations would reintroduce the inequity in some cases.

Without altering the current allocation rule, there are at least four ways that states could unilaterally eliminate double denials, although none is politically likely. First, as the immediately preceding discussion suggests, states could resolve the double denial problem by taxing their residents' worldwide income while granting them unlimited credits for foreign taxes. This solution is politically unlikely, however, because it would be expensive and involve residence states granting refunds for foreign taxes.[236]

Second, states could resolve double denials by structuring tax expenditures as refundable credits, rather than exemptions, deductions, and nonrefundable credits. Increased use of refundable credits by many states reflects growing awareness of the disadvantages of structuring tax expenditures as deductions.[237] Despite this increase in refundable tax expenditures, it is unlikely that states would convert all their tax expenditures to refundable credits. Nevertheless, the possibility of eliminating double denials for cross-border workers bolsters arguments made in the domestic context that the preferred structure of tax expenditures should be refundable credits.[238]

Third, states could resolve double denials by eliminating personal tax expenditures in favor of direct expenditures. But rather than decreasing over time, tax expenditures have increased dramatically in many countries, including the United States.[239] They are now an integral part of tax systems, so prospects for complete elimination of tax expenditures remain dim.

Finally, states taxing in a source capacity could also eliminate double denials by extending their tax benefits to nonresident taxpayers. Although the OECD Model does not require source states to provide personal tax benefits to nonresidents, its Commentaries expressly note that source states have the option to provide nonresidents personal tax benefits.[240]

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[236] *See supra* note 164 and accompanying text (illustrating this "refund" problem).

[237] *See* OECD, Tax Policy Studies no. 13, Fundamental Reform of Personal Income Tax 62 (2006) (noting that in many countries, conversion to refundable or "nonwastable" credits has been motivated by equity concerns for taxpayers unable to participate in tax expenditures when they have no taxable income).

[238] *See, e.g.*, Batchelder et al., *supra* note 4, at 42–65 (arguing that, in absence of specific knowledge that either elasticity or the size of a positive externality varies with income level, the most efficient structure for tax incentives is uniform refundable credits, and that structuring tax incentives as refundable credits could smooth household income and macroeconomic demand).

[239] *See* GAO, Tax Expenditures, *supra* note 5, at 19–42 (discussing growth of U.S. tax expenditures over time).

[240] OECD Model, *supra* note 9, cmt. on art. 24(3), ¶ 36 ("[Article 24(3)] leaves it open to [the source state] whether or not to give personal allowances and reliefs . . . .").

Rather than acting unilaterally, it may make more sense for states to take a bilateral or multilateral approach to resolving double denials. States could retain the primary obligation to confer personal tax benefits on the residence state but modify the OECD Model allocation rule by shifting responsibility to provide personal tax benefits to the source state in double denial situations. As the next Section explains, that is precisely how member states of the European Union have resolved the problem. In contrast, states in the United States have adopted the proportionality method.

C. Economic and Political Unions

The European Union and the United States are well-integrated economic unions, and as such, they present interesting case studies for the personal tax benefit allocation question. This Section discusses European Court of Justice (ECJ) and U.S. Supreme Court decisions involving allocation of personal tax benefit obligations among the EU member states and U.S. states.

1. European Court of Justice

Nineteen of the thirty OECD member states are also members of the European Union, and personal tax benefit allocation cases decided by the ECJ inspired the OECD's recent reexamination of the personal tax benefit allocation rule in the Model Treaty.[241] The European Union's foundational document, the EC Treaty, contains strong prohibitions on discrimination.[242] An EU member state may not discriminate against residents of another state who exercise their freedoms of movement of goods, workers, services, and capital.[243] More specifically, these freedoms prevent a member state from using its tax system to discriminate against (1) workers from other EU member states who earn income in its territory or (2) its own residents who work in other states.[244]

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241 *See* OECD Public Discussion Draft, *supra* note 14, at 29 (reviewing the "[p]ossible impact of European Community law on Article 24" of OECD Model and referencing Austria's *Schumacker* rule); *see also* OECD MODEL, *supra* note 9, art. 24(3) (containing the current personal tax benefit allocation rule).

242 *See, e.g.*, EC Treaty, *supra* note 31, art. 12 (prohibiting discrimination on grounds of nationality). The ECJ views the EC Treaty as "the constitutional charter of a Community based on the rule of law." Opinion 1/91, European Economic Area, 1991 E.C.R. I-6079, ¶ 1.

243 *See* EC Treaty, *supra* note 31, art. 18 (free movement of persons); *id.* pt. 3, tit. 1 (free movement of goods); *id.* art. 39 (free movement of workers); *id.* art. 48 (freedom of establishment); *id.* art. 49 (freedom to provide services); *id.* art. 56 (free movement of capital).

244 *See generally* RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 38–50 (2005) (discussing ECJ tax cases involving the freedom of movement of workers).

In 1995, the ECJ decided the landmark *Schumacker* case.[245] Schumacker was a Belgian national and resident who earned all his income in Germany, where he was denied deductions for personal and family expenses because he was a nonresident.[246] Because Belgium exempted his foreign-source income, Schumacker owed no tax there, so he was also unable to take advantage of personal tax benefits at home in Belgium.[247] Thus, Schumacker faced a double denial of personal tax benefits: Germany refused to grant him benefits because he was a nonresident, and the availability of personal tax benefits to Schumacker in Belgium did him no good because he had no tax liability there.[248] Schumacker sued Germany, the source state, arguing that Germany violated the EC freedom of movement of workers by denying him the personal tax benefits it granted German residents.[249]

The ECJ acknowledged that Germany was within its rights under its tax treaty with Belgium to deny personal tax benefits to Schumacker.[250] Furthermore, it affirmed—primarily for administrative reasons—that the residence state was ordinarily the proper state to account for personal and family expenses.[251] Nevertheless, the ECJ ruled that the stringent nondiscrimination principles of the EC Treaty required an EU member state to confer personal tax benefits on a nonresident EU national who earned "almost all"[252] of his family income within its territory, such that the nonresident's income at home was insufficient to allow him to claim benefits there.[253] *Schumacker* was a landmark case because the ECJ required member

245 Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225.

246 *Id.* ¶¶ 5, 11–15. This case involved both tax expenditure and structural tax elements. Germany denied nonresident taxpayers personal exemptions, marital income splitting, automatic refund of excessive wage withholding, and certain other personal tax deductions. *Id.* ¶¶ 11–14.

247 *See id.* ¶ 19(3). Like many states, Belgium exempts active foreign-source income, including remuneration for personal services. In contrast, the United States taxes its residents' worldwide income while granting credits for foreign taxes. *See generally* James R. Repetti, *The United States*, *in* AULT & ARNOLD, *supra* note 18, at 137, 137–55 (describing U.S. tax system).

248 *See Schumacker*, 1995 E.C.R. I-225, ¶ 36.

249 *Id.* ¶ 18.

250 *See id.* ¶ 32 (citing OECD Model).

251 The ECJ reasoned that since many personal tax benefits were tied to ability to pay, the residence state's privileged access to information about resident taxpayers' income positioned it well to calculate benefits. *See id.*

252 *Id.* ¶ 38.

253 *Id.* ¶ 41.

states to depart from international tax norms. The case led to major changes in EU member states' domestic tax laws.[254]

2. *U.S. Supreme Court*

U.S. states taxing interstate income face challenges similar to those of nation-states taxing international income. For example, when a taxpayer resides in one U.S. state but works in another, both states may tax him, which raises the risk of double taxation.[255] U.S. states do not enter double tax treaties with each other. Instead, the residence state unilaterally relieves double taxation by crediting the income taxes levied by the source state.[256] Like nation-states, U.S. states deliver social welfare benefits through their tax codes, and disputes have arisen concerning source states' obligations to confer such tax benefits on residents of other U.S. states. The Privileges and Immunities Clause of the U.S. Constitution prevents states from using their tax systems to discriminate against residents of other states,[257] and, like the ECJ, the U.S. Supreme Court has held that states may not categorically deny nonresident taxpayers personal tax benefits.[258] Unlike the ECJ, however, the Supreme Court has not asserted that the residence state is ordinarily the more appropriate state to provide personal tax benefits.

In *Lunding v. New York Tax Appeals Tribunal*, the Supreme Court set forth its views on personal tax benefits.[259] A 6-3 majority of the Court refused to hold that all personal expenses should automati-

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[254] Hinnekens & Hinnekens, *supra* note 70, at 31 (noting that typical domestic law formalizations of *Schumacker* require an EU taxpayer to earn 75% of her income in the source state before becoming eligible for personal tax benefits there).

[255] 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 20.10 (3d ed. 1999 & Supp. 2009).

[256] *Id.*

[257] The Privileges and Immunities Clause provides that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." U.S. CONST. art. IV, § 2. U.S. citizenship by birth or naturalization under federal immigration law confers citizenship in the state wherein the U.S. citizen resides. *Id.* amend. XIV, § 1. For a comprehensive analysis of state tax discrimination under the Privileges and Immunities Clause, see 2 HELLERSTEIN & HELLERSTEIN, *supra* note 255, ¶ 20.06.

[258] *See infra* notes 259–62 and accompanying text.

[259] 522 U.S. 287 (1998). *Lunding* involved alimony deductions, which ordinarily would be considered "structural" provisions rather than personal tax expenditures. *See supra* Part I.B (defining structural provisions). A majority of the Court, however, perceived the alimony deduction to be a personal expense. *See Lunding*, 522 U.S. at 310. In dicta, the majority also discussed items that qualify as personal tax expenditures according to more traditional classification criteria. *Id.* at 311 ("[W]e do not propose that States are required to allow nonresidents a deduction for all manner of personal expenses, such as . . . mortgage interest relating to an out-of-state residence."). For a discussion of the problem of defining tax expenditures, see *supra* Part I.B.

cally be allocated to the taxpayer's residence state.[260] Instead, the Court concluded that a source state could only categorically deny nonresidents personal expense deductions if the particular expense could be "geographically fixed" in another state.[261] The Court gave examples of personal expenses that could be geographically fixed, including mortgage interest and real estate taxes.[262]

The Supreme Court's "geographic" approach in *Lunding* is conceptually similar to the accrual-of-the-benefits approach explored in Part II,[263] and it suffers from similar drawbacks. Just as it would be difficult to determine where positive externalities associated with expenses accrue, it would be difficult, if not impossible, to "geographically fix" expenses. For example, in her dissent in *Lunding*, Justice Ginsburg argued that the quality of house that a taxpayer can afford (and therefore the size of her mortgage) relates to how much she earns overall.[264] This point calls into question the majority's assertion that mortgage interest deductions have a clear geographic nexus with the state wherein the property is located, as opposed to the state or states where the homeowner earns her income.[265]

Perhaps because they found the Supreme Court's geographic nexus approach too difficult to administer, most states have since adopted proportionality, which does not rely on geographically fixing expenses.[266] The proportionality method is consistent with dicta in *Lunding* indicating that the fairest result would be for New York to offer nonresidents personal expense deductions proportional to their

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[260] Until 1987, New York allowed nonresidents to deduct personal expenses in proportion to their New York–taxable income. The proportion was computed by dividing the nonresident's New York income by her federal income. *See* McIntyre & Pomp, *supra* note 225, at 250. Repeal of that proportional allowance precipitated the controversy in *Lunding*. In *Lunding*, the Court held that the Privileges and Immunities Clause did not imply that "a State may disallow nonresident taxpayers every manner of nonbusiness deduction on the assumption that such amounts are inevitably allocable to the State in which the taxpayer resides." 522 U.S. at 314.

[261] *Lunding*, 522 U.S. at 311.

[262] *Id.* The *Lunding* Court considered how to allocate a deduction for an expense actually incurred by the taxpayer. It is unclear how the Court's reasoning in *Lunding* would apply to other personal tax benefits, although previously the Court had held that a source state could not categorically deny nonresidents personal tax exemptions. Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79 (1920).

[263] *See supra* Part II.A.1.

[264] *Lunding*, 522 U.S. at 327 (Ginsburg, J., dissenting).

[265] *See id.* at 327–28 (arguing that the majority's "related-to-income approach" would mandate across the board personal deductions to nonresidents (internal quotation marks omitted)).

[266] *See* 2 HELLERSTEIN & HELLERSTEIN, *supra* note 255, ¶ 20.06[2][d] (noting that "the overwhelming majority of states permit nonresidents to deduct a proportionate share of their personal expenses," and that "any state's refusal to allow a proportionate deduction for personal expenses would have to be evaluated in light of [*Lunding*]").

New York–taxable income.[267] Interestingly, in order to comply with constitutional prohibitions of tax discrimination, the U.S. Supreme Court suggested (and the U.S. states adopted) the very proportionality method held by the ECJ in *De Groot* to violate the EC Treaty's prohibition on tax discrimination![268]

3. *Did the ECJ and Supreme Court Err?*

If, as Part II concluded, allocation of personal tax benefits to the residence state can be reconciled with sound tax policy principles, how should we evaluate decisions by the ECJ and Supreme Court that shift the obligation to provide benefits from the residence state to the source state? Did the failure of these courts to consider the criteria discussed in Part II lead them to err? And, if the special features of a common market make it appropriate to shift some responsibility for providing personal tax benefits to the source state, why should the alternative allocation rules be so different in the United States and the European Union? In the European Union, states allocate personal tax benefits exclusively to the residence state except in *Schumacker* situations,[269] when the source state has the exclusive obligation to confer such benefits. In contrast, the U.S. states share the obligation proportionately with their entitlement to tax the cross-border worker. This subsection applies the efficiency, equity, and administrability criteria developed in Part II to the question of how to allocate the personal tax benefit obligation among states in the European Union and United States.

a. Efficiency

In *Schumacker*, the ECJ concluded that the residence state was ordinarily the most appropriate state to confer personal tax benefits,[270] although a source state must confer personal tax benefits in limited circumstances.[271] By largely confirming the consistency of the OECD personal tax benefit allocation rule with the EC Treaty, the ruling in *Schumacker* seems to accord better with LEN than LRN.

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[267] The Supreme Court noted that "[i]t would seem more consistent with [New York's] taxing scheme and notions of fairness for the State to allow nonresidents a pro rata deduction for alimony paid." *Lunding*, 522 U.S. at 315.

[268] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 116(1).

[269] A taxpayer is in a *Schumacker* situation when she earns almost all her income from a single source state to which she is not resident.

[270] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 32.

[271] *Id.* ¶ 41 (holding that the source state must grant personal tax benefits when the nonresident earns almost all her income in the source state such that there is insufficient taxable income in the residence state to allow her to claim benefits there).

Specifically, in most cases, working abroad will not entitle cross-border EU workers to greater or lesser personal tax benefits than they could secure at home. As a result, national variations in personal tax benefits will not distort EU nationals' decisions about whether to work at home or abroad. Only in a minority of cases—*Schumacker* situations, in which taxpayers earn almost all their income in the source state—will EU taxpayers receive the personal tax benefits of their source state. Even this rule could be seen as an effort by the ECJ to reduce locational distortions, since the *Schumacker* rule only applies in double denial cases. Double denials arguably represent more significant distortions of cross-border work decisions than would limited entitlement to the source state's personal tax benefits under proportionality. The *Schumacker* rule may represent a second best solution: It reduces, but does not eliminate, locational distortions. In contrast, if the ECJ thought that the EC Treaty demanded complete elimination of locational distortions (i.e., LEN), it should have required Belgium to provide Schumacker personal tax benefits despite his lack of taxable income in Belgium.[272] Belgium could accomplish this via refundable credits.

The *Schumacker* rule makes no pretense at achieving LRN. The *Schumacker* rule might motivate an EU taxpayer to move her tax residence to another state in order to take advantage of more generous personal tax benefits available there. Far from condemning such residence competition between the EU member states, the ECJ has stated that the ability to move within the Community to take advantage of more favorable regulation available elsewhere is an important Community value.[273]

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[272] Under the EC nondiscrimination principle, member states cannot subject cross-border workers to heavier taxation than domestic workers on account of their cross-border work. Member states need not, however, ensure that cross-border workers face identical tax situations whether they work at home or abroad. Thus, the EC Treaty does not guarantee (as LEN would) that the decision to work abroad must be tax neutral. *See, e.g.*, Case C-365/02, *In re* Lindfors, 2004 E.C.R. I-7183, ¶ 34 ("[T]he EC Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation."). *But cf.* Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1212–23 (2006) (arguing that the ECJ's tax discrimination jurisprudence is fundamentally incoherent because it simultaneously requires member states with different national tax rates to achieve both CIN and CEN).

[273] The freedom of establishment entitles companies, like natural persons, to particular protections. *See, e.g.*, Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH, 2002 E.C.R. I-9919, ¶¶ 56–59 (holding that a host member state could not deny legal recognition to a company incorporated in another member state simply because it refused to reincorporate in the host state); Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459, ¶¶ 25–27 (holding that a host member state must allow a company validly incorporated in another member state to register a

In its own jurisprudence, the Supreme Court has also held that the nondiscrimination provisions of the Constitution limit source states' ability to deny personal tax benefits to taxpayers residing in other U.S. states. For example, in *Travis v. Yale & Towne Manufacturing Company*, the Supreme Court held that the Privileges and Immunities Clause prevented New York from categorically denying personal tax exemptions to residents of Connecticut and New Jersey who earned income from employment in New York City.[274]

In contrast to the ECJ, however, the Supreme Court deviated substantially from the OECD Model allocation and imposed considerably greater obligations on source states to provide nonresidents personal tax benefits. While the Supreme Court's personal tax benefit allocation rulings did not mention the OECD rule, New York's brief in *Lunding* referred to "well-settled norms of international taxation" that allocated personal deductions exclusively to the residence state.[275] Despite these norms, the Supreme Court refused to hold that providing personal expenses was primarily the duty of the residence state.[276] Instead, the Supreme Court took a more nuanced approach that looked to the nexus between the state and the particular expense.

Rather than adopting the inadministrable geographic nexus rule suggested by the Supreme Court in *Lunding*, the U.S. states have adopted the proportionality method for allocating personal tax benefits, under which each state grants nonresident workers personal tax benefits proportional to their income earned within its territory divided by their federal income.[277] Compared to allocation exclu-

secondary establishment in the host state from which it may develop its entire business). The freedom of establishments has limits. *See, e.g.*, Case C-81/87, Queen v. H.M. Treasury, *ex parte* Daily Mail, 1988 E.C.R. 5483, ¶¶ 15–16, 24–25 (holding that member states may not hinder their own nationals from establishing business in other member states, but the freedom of establishment does not grant a company already incorporated under the law of one member state the right to transfer to another member state while retaining its status as a company in the first state); Case C-210/06, Cartesio Oktató és Szolgáltató bt, [2009] 1 C.M.L.R. 1394, ¶¶ 112–14 (2008) (confirming the ruling in *Daily Mail*).

274 252 U.S. 60, 79–80 (1920). Under New York law, residents received a $1000 personal exemption, whereas nonresidents received no personal exemption. *Id.* at 79.

275 Brief of Respondent Commissioner of Taxation and Finance at 20, Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287 (1998) (No. 96-1462) (citing McIntyre & Pomp, *supra* note 225, at 247–49). *Travis* was decided in 1920, before the writing of the first model tax treaty. *See* Graetz & O'Hear, *supra* note 11, at 1066 (noting that the League of Nations predecessor to the OECD Model was developed in the mid-1920s).

276 *Lunding*, 522 U.S. at 304–11 (rejecting New York's argument that Supreme Court precedent should be interpreted to mean that U.S. host states are only required to grant nonresidents business, not personal, expenses).

277 2 HELLERSTEIN & HELLERSTEIN, *supra* note 255, ¶ 20.06[2][d]. Since all U.S. states use the credit method of taxation, in order to avoid taxing away personal tax benefits granted by the source state, logically the residence state must either grant tax sparing credits or grant residents 100% of its personal tax benefits.

sively to the residence state, the U.S. states' proportionality method reduces the incentive for U.S. workers to move to other U.S. states to take advantage of more generous personal tax benefits available there. Thus, the U.S. states' proportionality method seems to accord with LRN, although by providing tax incentives and disincentives for cross-border work, it violates LEN.

Interestingly, in both the European Union and the United States, the dominant method for conferring personal tax benefits is at odds with the dominant method for taxing intra-Community or interstate income. Although the *Schumacker* rule is more consistent with the credit method of taxing international income, most European states exempt their residents' foreign-source labor income.[278] Likewise, although the U.S. proportionality method is more consistent with the exemption method of taxing cross-border income, all of the U.S. states that tax personal income do so using the credit method.[279] The desire to encourage simultaneously the freedom of movement of workers and the freedom to choose a residence state could account for these mixed results,[280] but explicit consideration by the ECJ and U.S. Supreme Court of the labor neutrality benchmarks could help clarify states' EC Treaty and constitutional obligations when taxing interstate income.

b. Equity

Recall that the concept of taxpayer equity asks whether it is more appropriate to tax cross-border workers like residents of their home

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[278] *See* Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. Rev. 751, 754 (stating that exemption systems are "prevalent in continental Europe"). Exemption violates LEN whenever there is national diversity in tax rates or bases. *See supra* Part II.A.3.d (noting that taxpayers may change their tax residence to receive better tax rates or personal tax benefits).

[279] 2 Hellerstein & Hellerstein, *supra* note 255, at ¶ 20.04[2].

[280] In addition to guaranteeing the freedom of movement of workers, the EC Treaty and the U.S. Constitution also guarantee the freedom of movement of persons. *See* EC Treaty, *supra* note 31, art. 18(1) ("Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect."); *see also, e.g.*, Saenz v. Roe, 526 U.S. 489, 500 (1999) (holding that U.S. citizens enjoy right to travel to other U.S. states under Privileges and Immunities Clause, and that this right includes (1) free egress and ingress, (2) the right to be "treated as welcome visitor" while temporarily visiting, and (3) the right of new residents to the same privileges and immunities as preexisting residents).

U.S. states and EU member states are not the only taxing jurisdictions that mix elements of exemption and credit systems. All states have hybrid tax systems. Michael J. Graetz, Foundations of International Income Taxation 13 (2003).

state or like workers in their source state.[281] In *Schumacker*, the ECJ did not analyze the preliminary question of whether it would be more equitable to tax Schumacker like fellow Belgian residents or fellow German workers. Instead, the ECJ compared Schumacker only to competing German workers before concluding that Germany discriminated against him by denying him personal tax benefits.[282]

Had the ECJ considered the preliminary taxpayer equity question, it might have concluded that, as a resident, Schumacker was a member of the national community of Belgium, and therefore Belgium should have taxed him like other Belgians. This presumably would have led the ECJ to conclude that Schumacker should have had an effective means of claiming personal tax benefits at home in Belgium, and that by reducing his personal tax benefits because of his cross-border work, Belgium violated his freedom to work in other EU member states.[283] Thus, the ECJ might have held that Belgium, not Germany, violated Schumacker's EC Treaty rights. Belgium could then have cured this discrimination either by instituting worldwide taxation with unlimited credits, which would ensure equal tax treatment of resident taxpayers no matter where they earned their income, or by allowing Schumacker to collect his personal tax benefits via some other method, such as refundable credits.[284] But because the ECJ did not perform the preliminary taxpayer equity analysis suggested in Part II, it never considered whether the proper state to cure the disadvantage was Belgium, Schumacker's residence state, or Germany, his source state.

On the other hand, perhaps if the ECJ had considered the preliminary equity question, it would have concluded that although cross-border workers generally ought to be compared to fellow residents for equity purposes, cross-border workers in *Schumacker* situations, who earn almost all of their income in a single source state, ought to be

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[281] *See supra* Part II.B.

[282] *See* Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 24 (holding that the EC Treaty prohibits members from treating non-citizen workers differently under their direct tax laws).

[283] If cross-border workers should be treated like fellow residents of their home states, then Belgium, as Schumacker's residence state, should have taxed him on his worldwide income, fully credited his German taxes, and granted him full personal tax benefits. By subjecting Schumacker's German income to tax and crediting the German taxes he paid, Belgium would have avoided the double denial situation, and Schumacker would have been able to take advantage of Belgian tax benefits on the same basis as a fellow Belgian resident with a similar amount of income earned in Belgium. *See supra* Part III.B. (comparing likelihood of double denials under credit and exemption systems).

[284] The procedural posture of the case could explain the ECJ's imposition of the duty to remedy the double denial on Germany: Schumacker sued Germany, rather than Belgium, so only the source state was before the ECJ.

taxed like fellow workers in their source state. This would not be an unreasonable conclusion, since taxpayers who earn almost all of their income from a single source state likely have significant personal contacts with that state and may be members of its national community. This reasoning would imply that the ultimate result in *Schumacker*—shifting the personal tax benefit obligation to the source state only in cases where the taxpayer earns almost all his income there—was an appropriate outcome. But the ECJ's failure to explicitly consider whether Schumacker should be compared to Belgians or Germans raises doubts about what lessons the EU member states should draw from *Schumacker*.

For example, suppose Schumacker resided in Belgium and earned all of his income abroad—half of it from Germany and half of it from France. Because he would have no income taxable in his residence state of Belgium, Schumacker would have no effective way to claim personal tax benefits there. At the same time, however, he would not meet the *Schumacker* threshold in either of his source states, since he would not earn "almost all" of his income from France or from Germany. Should France and Germany split the personal tax benefit obligation, or does *De Groot* preclude such splitting? If France and Germany do not split the obligation, does it revert to Belgium, which would have to grant Schumacker refundable credits? Because the ECJ conducted no preliminary equity analysis in *Schumacker*, the case gives no insight into which state (or states) should grant personal tax benefits when the taxpayer does not earn a majority of his income in any one EU member state.

The U.S. Supreme Court's equity analysis in *Lunding* was also incomplete. Lunding was a Connecticut resident who earned income in New York, but he was unable to deduct a pro rata share of his personal expenses from his New York–taxable income because he was a nonresident.[285] The Supreme Court characterizes the Privileges and Immunities Clause as an equality principle,[286] but in *Lunding* it assumed that the only relevant comparison was that between Lunding and competing workers in New York who also resided in New York.[287] The majority never compared Lunding with fellow Connecticut

285 Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 293 (1998).

286 *See id.* at 297–98 (describing "a rule of substantial equality of treatment" (quoting Austin v. New Hampshire, 420 U.S. 656, 665 (1975))).

287 *See id.* at 297–98, 302, 310 (framing the issue solely as one of discrimination against residents); *see also id.* at 311 (considering a situation in which a nonresident taxpayer earns "nearly all of her income from New York, a scenario that may be 'typical'"). In *Schumacker*-type situations, it may be more appropriate to compare nonresident taxpayers with resident taxpayers for equity purposes. But Lunding earned only 48% of his overall income in New York. *Id.* at 293.

residents, and it considered irrelevant to its inquiry the fact that Connecticut imposed no income tax at that time (so that all of Lunding's Connecticut source income was exempt from tax).[288] But unlike *Schumacker*, Lunding earned less than half of his income from New York, which raises doubts about the fairness of taxing him identically to New Yorkers, especially when his Connecticut-source income was subject to no tax whatsoever.

Likewise, in *Travis*, the other case involving New York's treatment of commuters from neighboring states, the Supreme Court compared nonresidents who were denied personal tax exemptions in New York only to fellow workers who resided in New York.[289] The Court noted that New York's denial of personal exemptions to nonresident taxpayers was "not *conditioned* upon the existence of . . . untaxed [out-of-state] income."[290] Perhaps this means that had New York expressly conditioned the denial of the personal exemption upon the presence of untaxed income elsewhere, or upon the provision of a personal exemption to the taxpayer by another state, its tax scheme would have survived constitutional challenge. However, the Court's failure to make an explicit comparison between Connecticut residents who earned income in New York and Connecticut residents who earned all their income in Connecticut obscures the limits of the Court's ruling in *Travis*.

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288 *Id.* at 314 ("Nor . . . can the constitutionality of one State's statutes affecting nonresidents depend upon the present configuration of the statutes of another State." (quoting Austin, 420 U.S. at 668)).

Unlike the majority's opinion, Justice Ginsburg's dissent compared Lunding to both Connecticut and New York residents. Justice Ginsburg's approach is more consistent with traditional tax policy views. For her, the question of deductibility of alimony represents a choice regarding which former spouse should be taxable on alimony, rather than a question concerning the allocation to states of obligations to account for personal expenses. *Id.* at 316 (Ginsburg, J., dissenting). New York taxed alimony as income to the recipient. To ensure that alimony income was taxed at least once, but not more than once, between the former spouses, New York allowed the alimony payer to deduct it. But the same result—a single tax on the alimony—could be achieved by including the alimony in the payer's income (by denying the deduction) and excluding the alimony from the income of the recipient. The first method makes the recipient taxable on the alimony, while the second method makes the payer taxable. The choice between the two is a matter of state tax policy. Justice Ginsburg considered how the alimony *recipient* was taxed as part of her discrimination analysis; she posed cases in which the alimony recipient was a resident of New York (and therefore taxable on the alimony) or a nonresident of New York (and therefore exempt from New York tax on the alimony). *Id.* at 317–18 (defending New York's approach).

289 Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920).

290 *Id.* at 81 (emphasis added).

c. Administrability

Part II argued that, as a bright-line rule that imposes the personal tax benefit obligation solely on the residence state, the current international tax norm is simple and easy to administer.[291] The *Schumacker* rule is more complex than exclusive allocation to the residence state. However, it avoids most of the administrative problems raised by splitting methods, including the need to file multiple tax returns. When the *Schumacker* rule applies, the worker claims personal tax benefits from only one state—his source state rather than his residence state. Moreover, because the *Schumacker* rule applies only in cases in which the taxpayer earns "almost all"[292] of his family income in the source state, the source state may possess the best information about the taxpayer's overall income. Additionally, the Mutual Assistance Directive provides a legal basis for EU member states to obtain information about taxpayers residing in other EU states, making it easier to apply the *Schumacker* rule.[293]

The Supreme Court's ruling in *Lunding*, by contrast, does not fare as well under the administrability criterion. The Court held that states may deny nonresident taxpayers personal expenses only when those expenses can be "geographically fixed" in another U.S. state.[294] Assuming that it could be accomplished at all (and Justice Ginsburg justifiably doubted it), allocation according to geographic origin of expenses would require an item-by-item analysis of each expense to determine where it should be geographically fixed.

In lieu of the geographical fixing method, after *Lunding* the U.S. states opted for proportionality, a method that Part II argued was inadministrable due to differences in states' tax bases.[295] Recall that under proportionality, each state grants a taxpayer a portion of its tax benefits, determined by multiplying its full benefits by the taxpayer's income earned in its territory divided by the nonresident's overall, worldwide income. Proportionality would be problematic in the international context because each state would divide the nonresident's in-state income by her worldwide income calculated according to its own national tax rules. Each state's use of a different denominator when determining its share of a cross-border worker's personal tax benefits could result in gaps and overlaps in the provision of personal tax ben-

[291] *See supra* Part II.D.

[292] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 38.

[293] *See* Council Directive 77/799, 1977 O.J. (L 336) 15 (providing for mutual assistance in tax matters), *as amended by* Council Directive 79/1070, 1979 O.J. (L 331) 8, and Council Directive 92/12, 1992 O.J. (L 76) 1.

[294] Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 311 (1998).

[295] *See supra* Part II.D.2.e.

efits. The existence of a common federal tax base in the United States, however, removes many of these practical obstacles. Each U.S. state can divide a taxpayer's in-state income by a common denominator: the taxpayer's federal tax liability. Additionally, because states substantially harmonize their tax bases with the federal tax base,[296] the risk that cross-border taxpayers will receive double benefits or less than full benefits is lower than it would be for independent countries with completely unharmonized tax bases. Thus, while not as easy to administer as a rule that exclusively allocates personal tax benefits to the residence state, both the *Schumacker* rule and U.S. proportionality avoid the major administrative pitfalls of Dutch-style proportionality.

d. Conclusion

It should not surprise us that courts and states in political or economic unions may evaluate the criteria presented in Part II differently from unrelated states entering into a tax treaty. The goal of political union places more weight on taxpayer equity, and the goal of economic union emphasizes efficiency. Additionally, both the ECJ and the U.S. Supreme Court have long-standing policies of ignoring states' revenue concerns when evaluating state tax discrimination cases.[297] Thus, in EU and U.S. tax discrimination cases, inter-nation (or interstate) equity concerns appear to be subordinate to taxpayer equity and economic integration goals. In contrast, unrelated states may rank administrability or revenue concerns higher than other factors when negotiating tax treaties.

Compared to international tax norms, both the EC Treaty and the U.S. Constitution expand member states' obligations to confer personal tax benefits on residents of fellow states. But the ECJ and the U.S. Supreme Court have come to somewhat different conclusions about what the tax nondiscrimination principles of the EC Treaty and the U.S. Constitution mean for allocating the obligation to confer personal tax benefits on interstate workers. The differences accord with differences in the legal provisions each court interpreted. In *Schumacker*, the ECJ interpreted the EC Treaty's freedom of movement of workers, a provision that promotes *economic* integration among the EU member states. This economic integration goal

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[296] 2 Hellerstein & Hellerstein, *supra* note 255, ¶ 20.02.

[297] *See, e.g.*, Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 103 ("[A] loss of tax revenue can never be relied upon to justify a restriction on the exercise of a fundamental freedom." (citation omitted)); *cf.* McKesson v. Div. of Alcoholic Beverages & Tobacco, 496 U.S. 18, 50 (1990) ("[T]he State's interest in financial stability does not justify a refusal to provide relief.").

encourages elimination of barriers to cross-border work, such as double denials, but it does not necessarily require the states to ensure equal treatment of residents and nonresidents. In fact, the *Schumacker* court expressly noted that EC law imposes no general requirement that a member state treat nonresident taxpayers the same as resident taxpayers.[298] In deciding the case, the ECJ hewed closely to the established international tax norm of requiring only the residence state to supply personal tax benefits; the ECJ required the source state to provide such benefits only in *Schumacker* situations in which the worker earned almost all her income in the source state.

In contrast, the *Travis* and *Lunding* Courts interpreted the Privileges and Immunities Clause, which broadly promotes both economic and *political* integration within the United States. The Court explained that the purpose of the clause was to "place the citizens of each [s]tate upon the same footing with citizens of other [s]tates"[299] and to "strongly . . . constitute the citizens of the United States [as] one people."[300] Requiring similar treatment of resident and nonresident taxpayers promotes political unity among the residents of the various states by deemphasizing state borders and the importance of state residence. As a result, the U.S. Supreme Court held that differences in the scope of the unification undertaken in the European Union and United States could account for the differences in each Court's rulings in these very similar cases.

While thorough analysis of state taxation in the European Union and the United States is beyond the scope of this Article, this discussion suggests that rather than signifying judicial error, the deviations from residence-state allocation seen in *Schumacker*, *Travis*, and *Lunding* may accord with the principles articulated in Part II, once those principles are modified to account for the special goals of economic and political unions. However, states attempting to comply with their EC Treaty or constitutional obligations as well as taxpayers attempting to discern their legal entitlements would benefit from clearer analysis by the ECJ and U.S. Supreme Court of the personal tax benefit allocation issue using the criteria set forth in this Article. Since the *Schumacker* rule does not work in triangular situations in

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298 *Compare* Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 34 ("[T]he fact that a Member State does not grant to a nonresident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayer are not in a comparable situation.") *with Lunding*, 522 U.S. at 297 (noting the Privileges and Immunities Clause requires "substantial equality of treatment for resident and nonresident taxpayers" (internal citation and quotation marks omitted)).

299 Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 78 (1920) (quoting Paul v. Virginia, 75 U.S. 168, 180 (1868)).

300 *Lunding*, 522 U.S. at 296 (internal citation omitted).

which a taxpayer resides in one EU member state but derives her income equally from two or more other EU member states,[301] the ECJ may have the opportunity to consider these issues again.

Conclusion

Groundbreaking decisions by the ECJ requiring source states to confer personal tax benefits on nonresident taxpayers raise deep questions concerning the advisability of the international norm, memorialized in the OECD Model tax treaty, that allows taxpayers to claim personal tax benefits only from their residence states. Because the source state has the primary entitlement to tax labor income, this international norm creates a disjunction between the entitlement to tax and the obligation to confer benefits. Despite this counterintuitive result, this Article argued that sound efficiency, equity, and administrability principles support the current allocation rule.

This argument is particularly timely as EU member states revise their tax treaties in response to recent ECJ decisions and as OECD policymakers contemplate changes to the default allocation rule in the influential OECD Model, which serves as the basis for three thousand treaties in force.

In order to provide a framework for analyzing how taxes and regulations impact global labor mobility, this Article offered labor mobility analogs to the capital mobility benchmarks introduced by economists and widely used by tax policymakers to evaluate international tax policies. Each labor benchmark would eliminate tax distortions of decisions about where to work, how much to work, who works which job, or where to live. More empirical research is needed to determine which labor benchmark is most important. We do not yet know whether locational, leisure, occupational, or residence decisions are most responsive to the taxation of labor, but as labor mobility becomes more important in the global economy, the need for answers to these questions will become more pressing.

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301 *See supra* Part III.C.3.b.