Changing Places, Changing Taxes: Exploiting Tax Discontinuities

*Julie Roin**

President Trump's decision to move his official state of residence from high-tax New York to no (income)-tax Florida has brought public attention to an issue that has long troubled scholars, designers and administrators of income tax systems: how the interaction of tax rules deferring the taxation of income and tax rules based on residency allows taxpayers to reduce and even avoid taxation of their deferred income. These discontinuities in tax treatment may lead to excessive migration, as well as reductions in state income tax revenues and distortions in the design of state taxing mechanisms. This Article explains what states would have to do to eliminate these avoidance opportunities. However, it also points out that many of these policy changes would create other tax discontinuities. Ultimately, it leaves open the question whether making any of these changes would lead to fewer financial and behavioral distortions.

Introduction

Interjurisdictional mobility is a critical component of the salutary process of interjurisdictional competition, through which governments compete for residents.[1] It is the mechanism which allows individuals (and businesses) to

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* Seymour Logan Professor of Law, University of Chicago Law School. Thanks are due Saul Levmore, Walter Hellerstein, Charles Wolf, and participants in the Cegla Center's Conference on Legal Discontinuity and the University of Chicago Law School's Works in Progress Workshop for their comments on a previous draft of this article, and to the Samuel J. Kersten Faculty Fund for its financial support. Cite as: Julie Roin, *Changing Places, Changing Taxes: Exploiting Tax Discontinuities*, 22 Theoretical Inquiries L. 335 (2021).

1 *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. Pol. Econ. 416, 420 (1956) ("The act of moving or failing to move is crucial. Moving or failing to move replaces the usual market test of willingness to buy a good and reveals the consumer-voter's demand for public goods.")

choose the jurisdiction that best comports with their desired mix of tax burdens and governmental services.[2] Such competition helps police against governmental incompetence and corruption, while also catering to the heterogeneity of individual desires regarding the scope and content of governmental services.[3] Individuals can move to a jurisdiction in order to benefit from the services provided by that jurisdiction; however, residency brings with it the obligation to pay that jurisdiction's taxes. Those taxes may defray the costs of the benefits the individual seeks to enjoy. By contrast, an individual can decide that a jurisdiction's tax burdens outweigh the benefits it provides, and move to another jurisdiction offering lower benefits (or different benefits) at a different tax cost. In general, individuals who physically leave a jurisdiction to establish residency elsewhere are—and should be—relieved from further responsibility for paying the taxes levied by the original jurisdiction on the basis of residence,[4] just as they should lose access to services paid for by

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2 *See id.* at 419 ("the consumer-voter may be viewed as picking that community which best satisfies his preference pattern for public goods.") It is not of course the only mechanism people have for expressing their desires—residents can also utilize their political "voice" in an effort to mold the choices made by their political representatives. *See* Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States 16 (1970) ("Voice is political action par excellence.")

3 Few dispute that in the real world, such competition is far from perfect in achieving these desirable ends. For starters, the Tiebout model begins with a number of unrealistic assumptions, ranging from full knowledge by all taxpayers to costless mobility and incomes stemming from capital investment rather than labor. *See* Vicki Been, *"Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine*, 91 Colum. L. Rev. 473, 514-15 (1991). And many have decried the effects of tax competition on the overall levels of tax collection, and thus government spending. *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573, 1576 (2000) ("globalization and tax competition lead to fiscal crises for countries that wish to continue to provide social insurance."); Richard A. Musgrave, *Devolution, Grants, and Fiscal Competition*, 11 J. Econ. Persp. 65, 69-70 (1997) (arguing that tax competition may lead to a "'race to the bottom'" and "[p]ublic services, as seen by the nation as a whole, may be left at a deficient level.") *But see*, John R. Brooks, *Fiscal Federalism as Risk-Sharing: The Insurance Role of Redistributive Taxation*, 68 Tax L. Rev. 89, 116 (2014) ("State competition for high-value taxpayers is not the only possible behavior. Coordination and even collusion are possible.")

4 There are two widely accepted bases for asserting taxing jurisdiction: source of income and residence of the taxpayer. *See* Ferdinand P. Schoettle, State and Local Taxation: The Law and Policy of Multi-Jurisdictional Taxation

such taxes.[5] These new nonresidents, like all other nonresidents, should become taxable in the original state only with respect to income generated from sources within, and property located within, that state.

There is a well-known problem with the income tax, however. Because the tax is collected on a yearly basis, rules have been established to allocate income to particular tax years. Many current tax rules allow taxpayers to defer taxation by allocating income to years later than the year in which the income had been economically earned. Some but not all of these rules are conceptualized as applications of the "realization" principle, an administrative doctrine allowing taxpayers to defer payment of tax on economically accrued gain until the occurrence of a realization event. In the best case, realization events provide taxpayers with either independent verification of the amount of accrued income or with the cash necessary to pay the applicable tax.[6] For

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14 (2003) ("Taxing of income can be based on a relationship with the taxpayer, such as being the state of domicile or of residence. Alternatively, the right to tax can be based upon a relationship with the income, such as being the source of the income."); Michael J. McIntyre, The International Income Tax Rules of the United States 1-4 (1992) (discussing "competing claims for tax revenue based on residence and source.") Taxpayers moving away from a jurisdiction, like all nonresidents, remain taxable on income sourced within the jurisdiction. *See* Edward A. Zelinsky, *Apportioning State Personal Income Taxes to Eliminate the Double Taxation of Dual Residents: Thoughts Provoked by the Proposed Minnesota Snowbird Tax*, 15 Fla. Tax Rev. 533, 539 (2014) ("As a practical matter, the jurisdiction in which income is earned typically has the first and most enforceable claim to tax.")

5 In fact, nonresidents continue to enjoy the right to receive some governmental benefits, pursuant to local practice, local law, and the Commerce and Privileges and Immunity Clauses of the federal Constitution. The exact contours of those rights remain a matter of some dispute. *See* Martin H. Redish & Brandon Johnson, *The Underused and Overused Privileges and Immunities Clause,* 99 B.U. L. Rev. 1535, 1539-541 (2019) (criticizing judicial doctrines preventing jurisdictions from making some benefits available only to their own residents); Roderick M. Hills, Jr., *Poverty, Residency, and Federalism: States' Duty of Impartiality Toward Newcomers*, 1999 Sup. Ct. Rev. 277, 286 (1999) ("Article IV's Privileges and Immunities Clause specifies that discrimination against nonresidents is presumptively forbidden. But the Court allows such discrimination in contexts where no 'fundamental right' is at stake.")

6 An event may be treated as a "realization event" even if it fails to do either, however. Barter exchanges, for example, constitute "realization events" triggering taxation of accrued gains. *See* Cottage Savings Assoc. v. Cmmr, 499 U.S. 554, 556 (1991). Distinguishing between "realization events" and "non-events" can be quite difficult. *See* Marvin A. Chirelstein & Lawrence Zelenak, Federal

example, if a taxpayer buys a share of Amazon stock for $200 in 2019, and over the course of that year this share appreciates in value to $250, the $50 of gain often is not included in the taxpayer's 2019 income for tax purposes. Instead, it is taken into account for tax purposes in the year in which the taxpayer sells the stock,[7] which may be many years in the future. In tax terms, the accrued gain is not "realized" until the year of the sale. There are many situations like this one, in which taxpayers earn income from an economic standpoint in one year, but are not required to pay tax on the income until some later year. Not all of them implicate the realization doctrine, but many do.

Although tax deferrals impose a financial cost on the adopting jurisdictions,[8] jurisdictions often decide that the administrative and (in some cases) behavioral incentives of delay are worth the limited revenue loss. But the stakes change when taxpayers who have taken advantage of these favorable timing rules move another jurisdiction before the end of the deferral period. In such situations, taxpayers may avoid, rather than merely defer, the underlying tax obligations if the move is to a lower tax or no-income-tax jurisdiction. And even if they eventually do pay tax on this accrued income, they often end up paying the tax to jurisdictions other than that the one in which they lived when the income was earned. As a result, the first jurisdiction's tax revenue declines—or the jurisdiction is forced to increase its tax rate on the income

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Income Taxation 101 (14th ed., 2018). Some tax scholars have characterized the realization doctrine as "the original sin of the federal income tax" because of the problems and distortions it creates. *See* Joseph Bankman, Daniel N. Shaviro, Kirk J. Stark & Edward D. Kleinbard, Federal Income Taxation 230 (18th ed., 2019). States incorporate the federal realization rule along with most other base-defining tax rules for purposes of operating their own income tax systems. *See* Tax Policy Center: Urban Institution & Brookings Institution, *The State of State (and Local) Tax Policy*, *in* Briefing Book: A Citizens Guide to the fascinating (though often complex) elements of the federal tax system, https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-individual-income-taxes-work. As is discussed later in the Article, *infra* notes 88-91, the realization doctrine is merely one of several sources of deferral in the tax system.

7 *See* I.R.C. § 61(a)(3) (2019) (limiting gross income for tax purposes to "gains derived from *dealings* in property") (emphasis added). The mere possession of property does not constitute a "dealings." Section 61(a)(3) is a statutory instantiation of "the realization principle."

8 Allowing taxpayers to defer the payment of tax is the economic equivalent of granting such taxpayers an interest-free loan with a principal amount equal to the amount of tax deferred. *See* Daniel I. Halperin & Alvin C. Warren Jr., *Understanding Income Tax Deferral*, 67 Tax L. Rev. 317, 321 (2014) ("A second relationship that is often used to elucidate deferral is that the tax benefit…is equivalent to an interest-free loan from the government.")

that remains subject to its taxing jurisdiction or to otherwise reconfigure its taxing structure.[9] All of these responses reduce the original jurisdiction's attractiveness to new entrants, while increasing the economic incentive for existing residents, especially those residents who have taken advantage of such deferral privileges, to move to lower-tax jurisdictions. These tax discontinuities inefficiently distort decisions about mobility. They may distort the design of states' tax systems as well. For example, an individual who has spent her career in high-tax New York might, upon retirement, move to Florida where she can both liquidate her appreciated stock portfolio and collect her retirement benefits at a lower (or even nonexistent) tax cost. She may even move there temporarily for the express purpose of liquidating her stock portfolio, and then move again to another jurisdiction with a preferable tax and benefits package, or better weather. New York may rearrange its tax system to try to undercut opportunities for tax planning. If New York cannot prevent sophisticated taxpayers from avoiding its state tax on stock appreciation and retirement benefits, New York may decide to increase the rate of tax imposed on income more likely to remain in its tax base. It may, for example, raise the tax rate on its residents' cash salaries. Unless New York is able to target those tax rate increases on precisely those taxpayers who will engage in future tax avoidance maneuvers, some individuals will be left paying higher taxes on their salaries to make up for the nontaxation of income generated by other taxpayers from appreciated stock portfolios or generous retirement plans. This shift in the tax burden may well have a systemic skew, as a subset of wealthy taxpayers is more likely to benefit from the nontaxation of stock portfolios and retirement plans than other taxpayers. By contrast, the burden of an additional tax on cash salaries is likely to fall on a more diverse group of income earners.

In the international arena, tax authorities have long regarded taxpayer attempts to minimize taxes payable on already accrued but untaxed income through strategic residency changes as an abuse. Though a new jurisdiction might need (want) tax revenues to pay for the benefits it will provide its new resident, in the international arena, the consensus is that those revenues are supposed to come from taxes imposed on income economically connected to the new jurisdiction, rather than taxes imposed on income earned elsewhere. Countries have altered their tax rules to make sure that the original country of residence, rather than the new country of residence, collects taxes attributable to gains economically generated prior to an expatriation event. The United

9 For example, a jurisdiction might increase sales tax rates to make up for lost income tax revenues.

States, like many countries,[10] imposes an "exit tax" on expatriating taxpayers, treating them as having sold all of their property on the day prior to their expatriation, and forcing them to pay an immediate tax on all their accrued gains.[11] It is unclear why new states should be treated more favorably than new countries—or old states less favorably than old countries. The argument for allocating taxing jurisdiction to the state in which the gains were originally earned would seem identical.

However, at least in the United States, there are constitutional impediments to imposing such taxes inside the country, at the state level.[12] Absent the exit tax option, state tax authorities have dealt with this sort of tax avoidance by intensifying "residence audits" to ensure that individuals claiming to have moved to another state have actually done so.[13]

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10 *See, e.g.*, Council Directive (EU) 2016/1164, art. 10, 2016 O.J. (L 193) 1 (EC), laying down rules against tax avoidance practices that directly affect the functioning of the internal market (laying out parameters of permissible exit taxes), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.193.01.0001.01.ENG; Sebastian Dueñas & Daniel Bunn, *Tax Avoidance Rules Increase the Compliance Burden in EU Member Countries*, Tax Found. (Mar. 28, 2019), http://taxfoundation.org/eu-tax-avoidance-rules-increase-tax-compliance-burden/ (17 out of 28 EU members have exit taxes which tax "the excess of the market value of the transferred assets over their tax value.")

11 *See* I.R.C. §§ 367(a) (2019) (transfers by U.S. corporations to foreign corporations treated as taxable sales); 877A(a)(1) (2019) (deemed sale of "[a]ll property of a covered expatriate" prior to expatriation.)

12 At least there are in the absence of an explicit congressional authorization for such taxation. *See infra* notes 17-29.

13 *See* Sandy Weinberg, Jill Cantor & Alan S. Kufeld, *Voices: Moving from A High-Tax State? Be Prepared for A Residency Audit*, Accountingtoday (Nov. 20, 2019), http://accountingtoday.com/opinion/moving-from-a-high-tax-state-be-prepared-for-a-residency-audit (reporting that New York, Connecticut, New Jersey, Rhode Island, California and "other high tax states" audit taxpayers purporting to leave the jurisdiction; New York alone "[i]nitiated over 3,000 residency audits on high net worth and high income individuals each year" during the last five years); Darla Mercado, *Five Reasons Why Your High-Tax State Won't Let You Move Out*, CNBC.com (June 14, 2019), https://www.cnbc.com/2019/06/14/five-reasons-why-your-high-tax-state-wont-let-you-move-out.html ("If you're thinking of moving from your high-tax locale, chances are your state's income tax auditor won't let you leave without a fight."); Anupam Singhal, *Voices: 4 Red Flags that Can Trigger A Residency Audit*, Accountingtoday (June 4, 2019), https://www.accountingtoday.com/opinion/4-red-flags-that-can-trigger-a-residency-audit ("As states seek to fill revenue gaps and recover tax

This Article looks at whether states could do more. It examines the alternatives to exit taxes for two particular types of deferred income: gains generated from the sale of investment property, such as stocks and bonds, and retirement income. To some extent, it reevaluates and updates two articles written thirty years ago by Professors James Charles Smith and Walter Hellerstein. The first article dealt with state taxation of income that was "realized" but "unrecognized" under federal tax law,[14] whereas this Article looks at the slightly different issues raised by taxpayers exiting with unrealized income. The second article looked at the issues surrounding the state taxation of retirement income.[15] Much has happened in the intervening thirty years, including the enactment of federal legislation limiting state taxation of nonresidents' retirement benefits.[16] More changes may be on the horizon which may make it easier for states to tax gains as they accrue, rather than waiting for a realization event.

Part I of this Article explores the constitutional impediments to the imposition of exit taxes. Part II describes the tax avoidance opportunities made available by the realization requirement's treatment of investment gains, and the options, other than exit taxes, available to states seeking to reduce those opportunities. Part III looks at the separate tax avoidance possibilities made available through qualified pension arrangements, and the options states have for dealing with that problem. Part IV concludes.

I. Exit Taxes, the Constitution, and Tax Neutrality

Although different commentators have cited different constitutional grounds for arguing that state exit taxes are constitutionally impermissible,[17] there

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revenue losses, the risk of state residency and non-residency audits continues to grow.")

14 James C. Smith & Walter Hellerstein, *State Taxation of Federally Deferred Income: The Interstate Dimension*, 44 Tax L. Rev. 349 (1989). In particular, the article examined the problems posed by the nonrecognition of gain from the sale of a personal residence under the now-repealed I.R.C. § 1034, or from exchanges by like-kind property located in different states. *See id.* at 350. Such income met § 61(a)(3)'s test of "realization" because the houses had been sold, but Congress decided as a policy matter to further postpone taxation of the gain accrued with respect to the original residence. The gain realized from such sales was ignored, or "not recognized" for tax purposes.

15 Walter Hellerstein & James Charles Smith, *State Taxation of Nonresidents' Pension Income*, 56 Tax Notes 221, 224 (1992).

16 *See infra* notes 96-98.

17 *See* William Thomas Worster, *The Constitutionality of the Taxation Consequences for Renouncing U.S. Citizenship*, 9 Fla. Tax Rev. 921, 950 (2010) (arguing that

seems to be no dispute that such taxes are constitutionally problematic. Much of the doctrinal confusion can be traced to one of the original Supreme Court cases striking down such a tax. In *Crandall v. Nevada*,[18] the Court struck down a Nevada tax imposed on travelers leaving the state by railroad or state coach. Although several of the Justices would have struck down the tax as a violation of the Commerce Clause,[19] the majority expressed uncertainty over whether the tax at issue "institute[d] any regulation of commerce of a national character," and instead held the tax to be unconstitutional because it "may totally prevent or seriously burden all transportation of passengers from one part of the country to another"— a claim that sounds more in the nature of the "right to travel"[20] than the Commerce Clause.

The common factual predicate underlying all of these constitutional claims is that exit taxes in general, and an exit tax on unrealized income in particular, impose a tax cost on departing taxpayers that exceeds the tax burden imposed on taxpayers who remain residents of the taxing state. Individuals who stay in their original jurisdiction can continue to benefit from tax rules allowing them to defer the taxation of economically accrued income.[21] Such deferral is a clear economic benefit, equivalent to allowing the taxpayer to enjoy an interest-free loan financed by the government.[22] Moreover, such deferral often morphs into a permanent tax exemption. Much property gain can escape income taxation due to the rule allowing for the step-up in basis at death.[23]

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the right to travel extends to expatriation, so that I.R.C. § 877A violates that right); Smith & Hellerstein, *supra* note 14, at 369 (arguing that an exit tax would violate the Privileges and Immunities clause); *id.* at 396 (expressing "doubt" that an in-state investment limitation on nonrecognition against nonresidents would be countenanced under the Commerce Clause.)

18 Crandall v. Nevada, 73 U.S. 35 (1868).

19 *See id.* at 49 (Justice Clifford and Chief Justice Chase).

20 The "right to travel" is a non-textually based constitutional right, which at least sometimes is conceptualized as a component of the protections provided by the Privileges and Immunities clause. *See* Saenz v. Roe, 526 U.S. 489, 500-02 (1999) (explaining the constitutional derivation and reach of the "right to travel" doctrine).

21 States follow the federal rule, ignoring increases in the value of property for tax purposes prior to the year in which a "dealings in property" occurs. *See* 26 I.R.C. § 61(a)(3) (2019).

22 *See supra* note 8.

23 *See* I.R.C. § 1014 (2019) (providing step-up). States seem to follow this federal rule. *See* Elizabeth McNichol, *State Taxes on Capital Gains,* Ctr. on Budget & Pol'y Priorities (Dec. 11, 2018), https://www.cbpp.org/research/state-budget-and-tax/issue-brief-state-taxes-on-capital-gains ("Under current state and federal

The basis of inherited property is its fair market value on the date the previous owner died. Gain accrued during the lifetime of the decedent thus permanently escapes income taxation when such a basis step-up rule applies.[24] Although state tax rates are lower than federal tax rates, few states have special rates for capital gains,[25] and many states maintain progressive rate structures,[26] so both deferral and exemption can provide taxpayers with substantial economic benefits. The imposition of an exit tax on departing residents would bring this tax deferral to a premature end (relative to remaining residents), while causing the forfeiture of any possibility of obtaining a tax exemption through basis step-up for gains accrued during the taxpayers' period of residency. This would constitute a substantial economic disincentive to moving across state lines, at least arguably interfering with interstate commerce,[27] burdening an individual's right to travel,[28] and violating the Privileges and Immunities Clause.[29]

For purposes of this Article, however, the point is not so much that an exit tax levied by the states would be unconstitutional, but that if it were constitutional, it would merely substitute one discontinuity in tax treatment for another,

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law, people who inherit assets…pay no taxes on any appreciation of those assets that occurred before they inherited them.")

24 Such gains do become part of the tax base used when calculating a decedent's state and federal estate tax liability (if any).

25 *See* McNichol, *supra* note 23 (noting that nine states tax long-term capital gains less than ordinary income).

26 Katherine Loughead & Emma Wei, *State Individual Income Tax Rates and Brackets for 2019*, Tax Found. (March 20, 2019), https://taxfoundation.org/state-individual-income-tax-rates-brackets-2019/ ("32 states levy graduated-rate income taxes.")

27 Given that consumer spending is the "single most important driving force of the U.S. economy," see Kimberly Amadeo & Somer G. Anderson, *Consumer Spending and Its Impact on the Economy*, the balance (Sept. 27, 2020), https://www.thebalance.com/consumer-spending-definition-and-determinants-33059167, the imposition of a move-discouraging exit tax could certainly be regarded as a protectionist attempt by a state trying to keep such spending within its borders.

28 The Supreme Court established in *Roe*, 526 U.S., that the right to travel included the right to establish residency in another state. *Id.* at 502. The obstacle to the movement in that case was the receiving state, but there is no reason to think that the outcome would or should be different if the barrier to establishing a new residency was enacted by the state of origin.

29 *See* Ruth Mason, *Flunking the ECJ's Tax Discrimination Test*, 46 Colum. J. Transnat'l L. 72, 82 (2007) ("The Privileges and Immunities Clause also provides a basis for invalidating discriminatory taxation by the U.S. states against individual taxpayers."); Smith & Hellerstein, *supra* note 14, at 366 (asserting that an exit tax is a tax on non-residency).

and distort taxpayer behavior in another direction. Instead of encouraging taxpayers to move to low-tax states, an exit tax would discourage moves to both high-tax and low-tax states. All relocations would be accompanied by a tax penalty if a taxpayer owned appreciated property. This does not mean that taxpayers would never move between states. Taxpayers would still move to low-tax states if the reduction in taxes on future-earned income offsets the additional tax burden imposed by an exit tax. And taxpayers might still move to higher-tax states if the benefits offered to them were worth more than the additional tax costs, including the cost of the exit tax. But there would be fewer such moves, fewer than would occur in the absence of the new discontinuity.[30]

From a policy standpoint, some states may be made financially better off by levying an exit tax, while states as a whole would undoubtedly collect more tax because their combined tax bases would include more income,[31] and some taxes would be accelerated.[32] In this era of budget shortfalls, this seems like a perfect trifecta. If the goal is to reduce tax-induced distortions in behavior, however, it is unclear whether the enactment of exit taxes will achieve that goal. It may well lead to an inefficiently low number of taxpayer relocations rather than merely correct for an inefficiently high number of such relocations. The question is whether and what alternatives exist to make the tax system more neutral with respect to taxpayer moves and possibly the design of tax systems. Not only would such alternatives be less likely to face constitutional challenges, but ideally they could reduce the distortionary behavioral effects of the current tax rules. Those alternatives are the subject of the next Parts of this Article.

II. Eliminating or Reducing the Reach of the Realization Doctrine

It is often more convenient for both taxpayers and governments to defer the taxation of gains generated through investments in property until the year

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30 Such moves would be further discouraged, of course, if inconsistencies between state rules for taxing such gains led to their being taxed by both the old and new state. This point is discussed in greater detail *infra* notes 62-63.

31 Some income that would have been omitted from the tax base due to the step-up in basis due to death will now be included in the income tax base.

32 Governments are on the losing side of taxpayers' deferral gains. Their effective rate of taxation declines when taxpayers defer paying taxes in the absence of an offsetting interest charge. Anything that reduces deferral opportunities for taxpayers benefits state treasuries—unless, of course, those tax increases are accompanied by behavioral distortions which have the opposite effect.

in which a "realization event"[33] occurs. In the best case, a sale for cash, this realization transaction both precisely quantifies the amount of appreciation or economic gain enjoyed by the taxpayer and provides her with the cash necessary to defray the resulting tax obligation. However, this convenience comes with well-recognized governmental costs, costs that have led Congress, the courts, and the Internal Revenue Service to broaden the definition of "realization events" which trigger taxation of accrued gain to include events less definite than a sale for cash.[34] On occasion, Congress has even mandated that some gains of some taxpayers be taxed on a mark-to-market basis.[35] Taxpayers subject to mark-to-market rules pay tax on the difference in the value of their property between the first and last days of their taxable years even in the absence of any transaction involving the property.[36] For example, if a taxpayer has property worth $1,000 on January 1 of 2019, and the property's value increases to $1,500 by December 31, 2019, under mark-to-market rules she would be required to include the $500 increase in value in her 2019 income whether or not she sold or otherwise disposed of the property. If the property continued to increase in value, so that it was worth $2,500 on December 31, 2020, she would include the additional $1,000 of gain in her 2020 income.

As the discussion in Part I makes clear, realization-based tax systems create tax discontinuities by severing the temporal connection between the economic accrual of income and its taxation. Taxpayers who have earned gains in one year can take advantage of this disconnect by strategically moving between locations or otherwise changing their tax characteristics before engaging in a transaction that triggers taxation of those accrued gains. Doing so allows them more than time-value-of money/deferral benefits; they can reduce the absolute amount of taxes payable on such gains. These discontinuities and the distortions they create would be eliminated by moving the income tax system away from realization and towards "mark-to-market" taxation. But less systemic changes can also reduce the impact of the realization requirement. Both alternatives warrant further discussion.

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33 One of the problems with the "realization"-based tax regime is that it is often unclear whether an event rises to the level of a "realization event" triggering taxation. *See* Chirelstein & Zelenak, *supra* note 6, at 82 ("the application of [the realization requirement] in close cases is fairly arbitrary.")

34 For example, most barter exchanges count as "realization events" leading to immediate taxation of gains accrued with respect to the bartered property. *See Cottage Savings Assoc*, 499 U.S., at 556 (holding that an exchange of mortgage securities was a realization event).

35 *See* I.R.C. § 475 (2019) (mark-to-market accounting required for dealers of stocks and securities).

36 *See* Bankman, et al., *supra* note 6, at 241 (describing "mark-to-market" taxation).

A. Instituting Mark-to-Market Taxation

Imagine a taxpayer, Jane, a resident of the state of Illinois, who buys 100 shares of X Corporation's stock in 2019 at a price of $10 per share. Luckily for her, the stock zooms in price to $30 per share by the end of that year. Under current law, no portion of that $2,000 gain appears in her gross income for federal or state tax purposes in 2019 unless she sells her shares of stock in that year. This is because tax law awaits a "realization" event. Now suppose Jane moves to Florida, a state which has no income tax, on January 1, 2020, and promptly sells her X Corporation stock for $3,000. She will have to pay federal tax on that gain—but no state income tax because the sale took place while she was a resident of Florida, a state with no income tax. She will of course have to pay the non-income taxes levied by the state of Florida going forward, such as property taxes and sales taxes, which may, or may not, be higher than the taxes she would have paid in Illinois, but the amount of those other taxes would not be tied directly to the amount of her stock gain. Her ability to avoid paying tax on that stock gain may well underlie her decision to move to Florida.

Even if it does not—if it turns out that Jane's Floridian tax burden (calculated with or without reference to her stock gain) is similar to what her Illinois burden would have been had she stayed put—there would be a misallocation of tax revenues. At the time Jane's stock appreciated in value, at the time her gain accrued as an economic matter, Illinois could claim two jurisdictional bases for subjecting that gain to its income tax: residence and source. Jane was a resident of Illinois, and thus subject to tax in Illinois on all of her income earned during that period of residence. Illinois could also claim to tax this income based on source, because under the doctrine of *mobilia sequuntur personam*, the source of investment income generated from intangible property such as stocks and bonds is "attributed to and taxed by the state of residence of the owner of such stocks and bonds."[37] Under a mark-to-market taxing regime, Illinois and only Illinois would have had the right to tax that income.

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37 Zelinsky, *supra* note 4, at 541. It is unclear whether this allocation of taxing authority is being made on "source" grounds (the actual economic "source" of the gain often being indeterminate because the underlying business is active in many different jurisdictions) or is a pure expression of residence-based taxing jurisdiction because of the absence of a definitive "source." The distinction is important if some other jurisdiction asserts source tax jurisdiction over such income. Under applicable tax norms, a state asserting only residence jurisdiction would have to grant some form of tax relief to offset the taxes paid to the "source" state. *See id.* at 542 ("The domestic (and international) norm is for the jurisdiction of residence to extend to its resident an income tax credit for

Jane would have included the $2,000 gain in her 2019 Illinois income for tax purposes, and her later change in residence would have had no impact on its taxation. Florida would have been a complete stranger to this gain under both jurisdictional principles, and deservedly so. Florida played no role in creating the gain, and provided no benefits to Jane in the year in which the gain accrued economically.[38]

It is only under the current realization-based system, which ignores gains until there has been a "dealing" in property, as under section 61(a)(3) of the (U.S. Tax) Code, that Florida, rather than Illinois, becomes entitled to tax (or not) this $2,000 gain. If the time of the "dealing" is paramount, Jane's "dealing" occurred while she was a resident of Florida, not Illinois; this residence status would also make Florida the source of this income under the doctrine of *mobilia sequuntur personam*.

Both states have arguments for why they have the better "right" to tax this income. Florida would argue that it needs the tax revenues to defray the costs of providing future benefits to its new resident;[39] Illinois, however, would argue that it needs the tax revenues to defray the costs of providing past benefits enjoyed by the individual, benefits which were responsible, at least in part, for her ability to earn the income in the first instance.

As laid out above, at the international level, taxing rights follow the location of a taxpayer at the time of economic accrual rather than her location at the time of a realization event.[40] A new jurisdiction has the right to tax (or not) new income; previously accrued income is supposed to be taxed by the previous jurisdiction. After all, to the extent that any residence or source jurisdiction can claim credit for the creation of the income (by, say, providing the market

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income taxes the resident pays to the jurisdiction of source.") For a discussion of the implications of this point, *see infra* Section II.B.

38 Under a mark-to-market regime, Florida would have the right to tax (or not) only gain that accrued economically after Jane moved to the state.

39 And, in fact, this argument held some appeal for Congress in 1996 when it enacted Pub. L. No. 104-95, now codified at 4 U.S.C. §114, see *infra* notes 96-98, forbidding states from taxing the pension income of nonresidents. *See* Hellerstein & Smith, *supra* note 15, at 224 (describing this argument as "unpersuasive"). Congress certainly does not believe in that argument when the federal government's own tax revenues are at stake. Congress amended the Internal Revenue Code in 2008 to impose an exit tax on the accrued but as yet untaxed income of expatriating taxpayers. *See* I.R.C. § 877A(a)(1) (2019) (treating covered taxpayers as selling all of their property on the day prior to their expatriation). There is no principled reason to believe that a new state of residence should be more entitled to the tax due on preexisting gain than a new country of residence would be.

40 *See supra* notes10-11.

or other conditions that made the earning of the income possible), it would be the jurisdiction involved in the economic creation of the income and not one that appears on the scene after (and perhaps long after) the income arose as an economic matter. In addition, allowing taxpayers to recharacterize income earned in one jurisdiction as income earned in a lower-tax jurisdiction merely encourages additional, socially useless tax planning. Taxpayers operating under a realization-based system enjoy the interest-free loan benefits of deferring their tax obligations, Allowing them to also reduce the absolute number of tax dollars owed by postponing the realization event until they move to a low-tax country encourages yet more deferral.

If a state mandated that all taxpayers had to mark their assets to market value each year—rather than limiting this treatment to departing residents as an exit tax does—such departures would not create any tax discontinuities with respect to formerly accrued income. A change in residence would affect only the amount of taxes paid with respect to future income, as would be appropriate. There could be no constitutional objections, because the change in residence would not itself trigger any additional taxation. Illinois would collect its tax, but it would collect it in the normal course and without ever referring to, or having the tax liability in any way based on, changes in a taxpayer's residency status. All taxpayers would be treated exactly the same, whether or not they moved across state boundaries.[41]

Of course, the elimination of deferral under a mark-to-market system would effectively increase the tax burden imposed on capital. Owners of capital would no longer qualify for interest-free loans from the government, or the ability to reduce the absolute number of taxes paid with respect to some gains. This increase in tax burden may deter some taxpayers from saving (as opposed to consuming) their income. If a jurisdiction is truly worried about creating a disincentive for investment, however, it could simply reduce the rate of tax imposed on all capital income. This would spread the revenue loss (and create an investment incentive) for all owners of capital, and not just those disproportionately profiting from taking advantage of deferral and relocation opportunities. It is unclear why the latter group deserves special favoritism.

The desirability (or not) of moving the federal government's tax system away from realization and towards a mark-to-market approach has been widely debated for almost as long as the income tax has been in existence.[42]

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41 However, they might be subject to duplicative taxation if they moved to another state which operated a realization-based tax system. *See infra* note 63.

42 *See, e.g.*, Karen C. Burke & Grayson M.P. McCouch, *The Moving Target of Tax Reform*, 93 N.C. L. Rev. 649, 669 (2015) ("One approach that deserves further consideration is an accrual-based tax on unrealized appreciation in publicly

Its virtues—in terms of eliding valuation and liquidity problems—are as obvious as its evils. Neither of these virtues seems particularly relevant to investments in publicly traded stock. Public trading establishes visible, and generally reliable, values for the instruments being traded, and few investors own a high enough percentage of a publicly traded company to generate worries about the costs (if any) of forcing them to sell shares to raise the cash necessary to pay the tax liability generated under a mark-to-market regime. I would not be the first to suggest[43] moving to a mark-to-market system for publicly traded stock, while retaining a realization-based system for other, more difficult to value, assets.[44] Yet agreement on even such a partial move to mark-to-market taxation at the federal level is far from universal. Concerns have been expressed about the discontinuities created by a mixed system. The expressed fear is that the inequality in tax treatment between publicly traded stock and other investment assets would encourage taxpayers to shun the first and invest more in the second.[45] It is unclear how seriously to take such objections; the inability to easily value alternative investments may well

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traded stock."); Samuel D. Brunson, *Taxing Investors on a Mark-to-Market Basis*, 43 Loy. L.A. L. Rev. 507, 511 (2010) ("As a best-case solution, this Article proposes expanding the mark-to-market election to investors."); Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 Tax L. Rev. 503, 527 (2004) (listing articles debating mark-to-market taxation); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95, 96 (1999) (listing articles debating mark-to-market taxation).

43 I am not sure, however, that I am suggesting it.

44 *See, e.g.*, David Elkins, *The Myth of Realization: Mark-to-Market Taxation of Publicly-Traded Securities*, 10 Fla. Tax L. Rev. 375, 406 (2010) ("Mark-to-market taxation [of publicly traded stock], on the other hand, is both equitable and efficient"); Brunson, *supra* note 42, at 511 ("As a best-case solution, this Article proposes expanding the mark-to-market election to investors."); Schenk, *supra* note 42, at 528 ("almost everyone assumes that marking publicly traded securities to market is a good idea because there would be no valuation and liquidity issues.")

45 *See* Schenk, *supra* note 42, at 529 (arguing that marking publicly traded securities to market would be useless unless derivatives were also marked to market, which would "increase valuation costs"); Weisbach, *supra* note 42, at 97:

> It is not clear that a mixed system… would be an improvement over current law… Wherever the line is drawn, similar transactions on either side of the line will be taxed differently, causing taxpayers to distort their behavior and requiring the complexity and anti-avoidance rules of current law. The problem of the second-best may mean that a partial move toward the ideal may not be an improvement.

keep most investors (and certainly most unsophisticated investors) away from them. If there is some movement at the margin, it is likely to be fairly limited.

Moreover, some of the valuation issues surrounding non-publicly traded assets may be confronted and surmounted if some of the wealth tax proposals floated by (unsuccessful) Democratic candidates in the last Presidential election come to fruition.[46] If politicians desire and are able to come up with a workable mechanism for determining asset values for a federal wealth tax, it might be possible to include a broader range of investment assets in a mark-to-market system for income tax purposes, reducing the opportunities for (and the distortions created by) strategic behavior. Although in theory, states would not have to wait for the federal government to adopt a wealth tax or move to mark-to-market taxation, and could independently decide to use such valuation mechanisms to impose a state mark-to-market regime, in actuality, few if any states maintain tax bureaucracies large or sophisticated enough to effectively operate such valuation schemes. Most state tax authorities are relatively small operations and rely on the federal government's tax bureaucracy for the performance of many auditing and valuation functions. It is unclear whether it would be financially worthwhile for states to develop such capabilities.[47]

Even states contemplating a move towards limited mark-to-market taxation, such as a regime encompassing only publicly traded stock, would encounter logistical challenges if they have to operate outside of the federal administrative umbrella. And, at least for the moment, they would probably have to do so.

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46 *See* Elizabeth Warren, *Ultra-Millionaire (2 Cent) Tax*, Warren Democrats, https://elizabethwarren.com/plans/ultra-millionaire-tax (last visited Apr. 9, 2020) (describing her wealth tax proposal); Elizabeth Warren, *Elizabeth Warren's Proposal for Medicare for All: Ending the Stranglehold of Health Costs on American Families, Medium* (Nov. 1, 2019), https://medium-com@teamwarren/ending-the-stranglehold-of-health-care-costs-on-american-families-bf8286b13086 (describing the wealth tax component of the Medicare-for-all tax).

47 *See* Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 Duke L.J. 1267, 1321 (2013) ("Notice also that a state's ease of deviation [from the federal tax base] varies with its resources. California may have the resources to administer a deviation that North Dakota could not.") It is worth noting that the California legislature seriously considered a proposal that would impose an annual wealth tax not only on current California residents, but also for a ten year period following former residents' cessation of residence status. *See* Hank Adler, *A California Plan to Chase Away the Rich, Then Keep Stalking Them*, Wall Street Journal, Dec. 18, 2020; Chris Micheli, *California Legislators Propose Wealth Tax*, Calif. Globe (Aug. 13, 2020), https://californiaglobe.com/section-2/california-legislators-propose-wealth-tax/.

The federal government does not have the same fiscal concern that states do about revenue losses due to expatriating taxpayers. It has enacted an exit tax to solve its version of that problem. There is no reason to expect the federal government to move away from realization based taxation to deal with a purely state-level concern. As a result, neither states nor taxpayers would be able to rely on the information returns calculated by third parties for federal tax purposes to aid them in making the calculations necessary to determine the amount of tax owed to the state under a mark-to-market regime.[48] Not only would this disparity in tax systems lead to differences—and perhaps dramatic differences—between taxpayers' state and federal income calculations, but also, over time differences would develop between the federal and state tax bases of affected assets,[49] requiring taxpayers to maintain separate books and records for state and federal tax purposes.

It is also possible to structure tax regimes which fall into an intermediate position between a realization-based regime and a mark-to-market regime. For example, the amount of tax due may be determined annually on a mark-to-market basis, but the obligation to pay the tax may be delayed until a cash-generating realization event occurs. As long as the taxpayer has to pay interest on the unpaid balance of this tax obligation, the economic effect is identical to a mark-to-market regime. The federal government maintains such a regime as an option for investors in foreign passive investment companies.[50] The point of the federal regime is to equalize the tax treatment of investors in foreign and domestic mutual funds. The income of domestic funds is computed and passed through to U.S. shareholders to be taxed on an annual basis. The Code allows investors in foreign mutual funds to defer payment of U.S.

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48 *See* Mason, *supra* note 47, at 1329.

> [moving to a partial mark-to-market system would entail changing] significant aspects of its tax base as compared to the federal tax base… [and] as the calculation of taxable income at the state level diverges from its calculation at the federal level, the state is able to rely less and less upon federal resources, including federal tax legislative drafting expertise, federal tax information collection, federal enforcement, and so on.

49 Taxpayers would be entitled to add any gains taxed to them, and not withdrawn from the property, to their basis in the property for state (but not federal) tax purposes, at least in the state using the mark-to-market tax system. Whether other states, operating under realization-based regimes, would accept these basis adjustments is an open question. *See infra* note 63 (discussing possible interactions of conflicting state rules).

50 *See* I.R.C. §§ 1291-1298 (2019). Foreign passive investment corporations are foreign corporations most of whose assets consist of passive investment assets. *See* I.R.C. §1297(a) (2019) (at least 50 percent of assets produce passive income and at least 75 percent of income is passive income).

taxes until they receive actual distributions from the fund. However, actual distributions are pro-rated with an aliquot part allocated to each year during which taxpayers owned shares in the fund.[51] Any taxes deemed due with respect to income deemed earned in a prior year have to be paid with interest dating from the due date of the returns to which the investment gains are assigned.[52] For example, if a 2020 distribution was deemed to increase a taxpayer's 2016 tax obligation by $20, the taxpayer would become responsible for paying not only the $20 of tax liability in 2020, but also four years of interest calculated with respect to the 2016 tax "deficiency." A similar computation would have to be made regarding the portion of the distribution deemed allocable to the 2017, 2018 and 2019 tax years. In practice, application of the regime is fiendishly complex, with the result that "they are complied with only in the easiest cases and are fairly routinely overlooked by IRS agents in the field."[53] Many taxpayers avoid the problem entirely by investing in PFICs opting to be treated as "qualified electing funds." To become a "qualified electing fund," a fund must provide the IRS with enough information to allow its U.S. investors to be taxed on the funds' income on a current basis, just like investors in U.S. mutual funds.[54]

States wishing to implement a deferred payment regime would have some advantages, but also face some disadvantages, relative to this federal effort. On the plus side, if the attempt to enforce mark-to-market taxation is limited to gain accrued with respect to publicly traded stocks and securities, the amount of the accrued but untaxed gain should be relatively easy to compute.[55] Taxpayers could be required to include this amount on their final state income tax return. They could also calculate the amount of tax that would have been due with respect to such income had they sold their assets before leaving the state. And the eventual interest computation would be relatively simple, since it would require the calculation of only one year's underpayment. However, U.S. taxpayers file tax returns with the U.S. government every single year (at least they are supposed to!). Those returns would typically include the amount

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51 *See* I.R.C. § 1291(a)(1) (2019) (allocating "excess distributions…ratably to each day in the taxpayer's holding period for the stock.").

52 *See* I.R.C. § 1291(c)(3) (2019) (describing computation of interest).

53 Kimberly S. Blanchard, *PFICs*, Taxes – The Tax Magazine 47, 47 (March 1, 2012).

54 *See* I.R.C. § 1293 (2019) ("current taxation of income from qualified electing funds.") It is worth noting that investors in both U.S. and qualified electing funds are taxable only on realized capital gains, which is why taxpayers may derive gain from the sale of their mutual fund shares.

55 Such a regime might be extended to less easy to value assets if those valuation issues can be solved by relying on wealth tax valuations.

of any distributions actually received from PFICs, making it relatively easy to identify those taxpayers subject to the PFIC regime. By contrast, most individuals cease filing tax returns to states when they become nonresidents. In the absence of such filings, it is hard for a state to know when, or if, a taxpayer actually disposes of the underlying securities or other property, triggering his or her deferred tax obligation.[56] One could imagine states sending former residents annual reminders of their deferred tax obligations (perhaps even with the accrued interest amounts)—but one can also imagine states losing track of former residents, particularly those who are not interested in being found. In the (often extended) time between the year in which they leave a jurisdiction and the year in which they sell their assets, many taxpayers will forget about (or simply choose to ignore) their obligation to make this delayed tax payment to their former state. It would likely require a substantial increase in state tax authorities' budgets to track such individuals and to try to collect the appropriate tax amounts.[57]

If every state with an income tax adopted the same mark-to-market or deferred payment regime, some of these administrative problems could be ameliorated. If there were enough demand by taxpayers, the financial institutions that serve as intermediaries for so many publicly traded stock and security transactions could keep track of, and annually distribute to taxpayers, separate information returns relevant to the determination of their state tax liabilities, i.e., the amount of gain accrued and allocated to the relevant state during each year.[58] These intermediaries have, after all, all the information necessary to make these calculations. In most cases, they have records of the taxpayers' original basis in shares, and they track the changes in market value for each investor. It should not be terribly complicated for them to report the annual change in market value, and then to add that number to each client's basis for state tax purposes.[59] Taxpayers would want financial intermediaries

56 Although states have the ability to enforce tax judgements against out-of-state individuals, see Walter Hellerstein, *Reflections on the Cross-Border Tax Challenges Of the Digital Economy*, 96 Tax Notes Int'l 671, 680-81 (2019) (describing a process for enforcing state tax judgments against out-of-state taxpayers), the state tax authorities first have to know that an enforcement action is warranted.

57 *See* Mason, *supra* note 47, at 1321 (describing the limited resources of state tax authorities).

58 Some additional complexity would be introduced by the need to deal with intra-year moves. Presumably, a taxpayer's tax year for state tax purposes would end on their last day of in-state residency, with gains (or losses) measured as of that date for tax purposes.

59 Whether taxpayers will understand that they have different tax bases for federal and state income tax purposes is another matter entirely.

to provide this information because they would need this information to determine not only the current year's tax obligation, but also future years' state tax obligations. Someone, after all, needs to keep track of how much gain has already been included in taxpayers' income for state tax purposes to ensure that it is not taxed a second time. Just as intermediaries' calculation of the federal tax basis relieves investors of the need to self-generate and store such information for purposes of calculating the gain includable in income in the year such property is sold for federal tax purposes, financial intermediaries' calculation of the state tax basis would relieve taxpayers of the need to self-generate and store the information necessary to determine future years' mark-to-market gains or losses for state tax purposes. Although the federal government's imposition of reporting requirements on financial intermediaries undoubtedly increases tax collections, to the dismay of those who would otherwise evade their tax obligations, those information reports vastly simplify the administrative tasks facing taxpayers interested in filing accurate returns. So too would financial intermediary documentation of mark-to-market gains and losses for state tax purposes.

But would every state maintaining an income tax adopt any mark-to-market tax regime, let alone the same regime? Although all states, like the federal government, lose tax revenues to the normal operation of the realization doctrine, those losses have not yet been sufficient to bring about serious consideration of adopting a mark-to-market system. States that believe they are losing large amounts of tax revenue to low-tax states—revenue that is not being recouped through their ability to tax previously accrued, but untaxed, gains of new entrants—might well decide that these additional revenue losses warrant moving to a mark-to-market system. But inasmuch as some states are winners because of the inclination of taxpayers to move to low-tax states, it is plain that not every state would adopt a mark-to-market regime. Some states have to be net "winners" under the current legal regime for other states to be net "losers" and it is hard to believe that the (perceived)[60] net winners

60 In fact, it is unclear how significant these revenue losses actually are. There are certainly well-publicized examples of extremely wealthy individuals moving to low-tax states. *See The Country Home of Capital: Why So Many of America's Financial Elite Have Left Greenwich*, The Economist, 62 (Jan. 11, 2020) (attributing Connecticut's loss of 20,000 residents, including 2,050 earning more than $200,000 per year, to increases in state taxes); Chris Edwards, *Tax Reform and Interstate Migration*, Cato Inst. (Sept. 6, 2018), https://www.cato.org/publications/tax-budget-bulletin/tax-reform-interstate-migration (listing "[v]ery wealthy entrepreneurs… gravitating to Florida, which has no income tax or estate tax"). Numerous websites tout the tax advantages of moving to low-tax states. *See, e.g.*, Rocky Mengle & David Muhlbaum, *The 10 Most Tax-*

would be willing to sacrifice the administrative and competitive advantages of the current realization-based system unless the federal government adopted such a system. The most likely outcome in the absence of a federal mandate[61] would be a "mixed" system, with some states moving to a mark-to-market system while others continued to follow the federal realization standard for including gains in the income tax base.

The evolution to a mixed system as just described comes with another discontinuity, as it creates another opportunity for clever taxpayers to avoid or minimize taxes by strategically moving from one jurisdiction to another. If a taxpayer accrued gains while living in a realization state, and is now motivated to move to a state operating under a mark-to-market regime, the mark-to-market state should not have any right to tax the gain that accrued

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Friendly States in the U.S., Kiplinger (Oct. 1, 2019), https://www.kiplinger.com/slideshow/taxes/T054-S001-10-most-tax-friendly-states-in-the-u-s-2019/index.html (advising people to "consider the impact of state and local taxes on your bottom line" when considering a move). There is actually relatively little evidence that the level of state taxes systematically influences interstate moves. *See* Michael Mazerov, *State Taxes Have a Negligible Impact on Americans' Interstate Moves*, Ctr. on Budget & Pol'y Priorities 1 (2014), http://www.cbpp.org/sites/default/files/atoms/files/5-8-14sfp.pdf ("Differences in tax levels among states have little to no effect on whether and where people move, contrary to claims by some conservative economists and elected officials."); Karen Smith Conway & Jonathan C. Rork, *No Country for Old Men (Or Women) — Do State Tax Policies Drive Away the Elderly?*, 65 Nat'l Tax J. 313, 315 (2012) ("Our results are overwhelming in their failure to reveal any consistent effect of state tax policies on elderly migration across state lines.") This may be particularly true of retirees since many states partially or fully exempt retirement income from their income tax bases. *See Deciding Where to Retire: Finding a Tax-Friendly State to Call Home*, WoltersKluwer (Jan. 2018), https://taxna.wolterskluwer.com/whole-ball-of-tax-2018/state-retirement-taxes [hereinafter *Deciding Where to Retire*] (charts listing state tax policies). Of course, competition (or the fear of competition) with other states may be one reason why so many states provide preferential tax treatment for retirees. Such fears would be eased if the majority of the taxing rights were allocated to the state in which such income was earned rather than allocated to the taxpayer's current state of residence.

61 Assuming some states moved to a mark-to-market system. Actually, the most likely result is probably the universal continuation of the present realization-based system, unless the federal government moves to limit or eliminate the realization requirement for federal income tax purposes. *See* Erica York & Garrett Watson, *Reviewing Elizabeth Warren's Tax Proposals to Fund Medicare for All*, *Tax Found.* (Nov. 1, 2019), https://taxfoundation.org/elizabeth-warren-medicare-for-all-tax-proposals (describing Elizabeth Warren's tax proposals).

in the first state. Under its own tax rules, that income arose and was realized in, and should have been taxed by, another state in an earlier year; the current state is effectively a stranger to any income accrued while the taxpayer resided in another state. Applying a different set of tax rules to new residents, in the form of a mark-to-market scheme for its longtime residents and a realization rule for new residents, would surely be deemed to violate the Privileges and Immunities Clause, and possibly the Due Process Clause as well.[62] The same conclusion holds if the only grounds for imposing a tax on such gains was residency; the state in which the taxpayer formerly resided also would not have any claim to tax this income, because the income was not realized (under its rules) while the taxpayer was a resident there.

Not only might some taxpayers avoid paying any state tax on their gains, others might find themselves subject to double state taxation. A taxpayer moving from a mark-to-market state to a realization state might find that her new state refuses to take the prior state's tax into account when calculating the tax due at the time of an actual realization event. Under the new state's rules, no realization event occurred in the previous state, and the asset's basis should remain its federally calculated basis up until the time of the actual realization event; thus, the entire difference in value accruing between the time of its initial purchase or acquisition and its actual sale would constitute gain taxable at source in the second state. The fact that discrepancies between states' rules for determining the source of income lead to duplicative taxation may "appear unfair to the individual taxpayer who is compelled to pay tax on the same income to two states," but it is not necessarily illegal.[63]

In sum, moving in the direction of mark-to-market taxation[64] would not provide a solution to the discontinuity problem. Like an exit tax, it would simply

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62 *See* Smith & Hellerstein, *supra* note 14, at 371-72 (describing California and Oregon cases holding that the state in which a taxpayer resided when a nonrecognition period came to an end could not tax gains that were realized in—but because of a nonrecognition rule not taxed by – another state).

63 Walter Hellerstein, Kirk J. Stark, John A. Swain & Joan M. Youngman, State and Local Taxation: Cases and Materials 434 (11th ed. 2019). The Supreme Court's acceptance of duplicative taxation due to conflicting source rules in the corporate income tax context stretches at least as far back as its decision in Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978), which upheld Iowa's use of a single-factor formula for allocating income against claims that it would lead to duplicative taxation because of other states' use of three-factor allocation formulas. Later cases extended this policy of noninterference to other situations. *See infra* note 80.

64 To be clear, the complete elimination of the realization requirement—universal adoption of mark-to-market taxation of all property gains for all taxpayers, enacted

exchange one distortion for another, and it is unclear whether the distortions created by this new discontinuity would be smaller than those created under current law. It is possible, however, that less systemic changes could reduce the impact of the realization requirement. It is to those possibilities that we now turn.

B. Expanding Source Taxation

One of the reasons why the residence of a taxpayer (and any change in residence of a taxpayer) matters so much for state tax purposes is because the rules for determining the source of some types of income are so weak. Specifically, most income generated by investment assets is sourced not to where such income arises as an economic matter, but rather, under the previously discussed doctrine of "*mobilia sequuntur personam*," to the residence of the owner of such property.[65] If more of the income currently sourced under this doctrine was instead sourced based on the location of some underlying economic activity—a location determined independently of the investor's state of residence—most of the tax revenue would go to the state in which this economic activity occurred. Relatively little tax revenue would be collected by the investor's state of residence, or be affected by a change in that investor's state of residence. The investor's state of residence simply would not much matter if relatively little tax revenue depended on the identity of the investor's state of residence.

The relative irrelevance of the investor's state of residence would follow from the fact that source taxation takes precedence over residence taxation. What "precedence" means is that source jurisdictions have the first right to tax income, while residence jurisdictions must provide some sort of accommodation, typically in the form of a tax credit against its own taxes for those paid to the source jurisdiction. Alternatively, the residence jurisdiction may offer an exclusion from its tax base for previously taxed income.[66] Often, there is little room left for residence jurisdictions to impose tax on income that is sourced and taxed elsewhere. The financial stakes of residency thus decline precipitously.

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at the federal level and imposed on all states—would completely eliminate this distortion. But not even Elizabeth Warren's tax proposals would go this far. *See* York & Watson, *supra* note 61 (describing the proposals).

65 *See supra* note 37.

66 *See* Zelinsky, *supra* note 4, at 542 ("The domestic (and international) norm is for the jurisdiction of residence to extend to its resident an income tax credit for income taxes the resident pays to the jurisdiction of source.")

But it is hard to assign an economic source to income which is attributable to activities undertaken in multiple jurisdictions.[67] That sourcing dilemma is the underpinning of the "'long-recognized doctrine of '*mobilia sequuntur personam'* … under which income derived from intangible assets like stocks and bonds is sited to, and thus taxed by, the state (or states) of residence of the owner of such assets."[68] The question is whether the reach of that doctrine can be narrowed. The narrower its reach, the more income is taxed at a source determined by something other than the investor's state of residence, and the fewer the economic distortions caused by tax discontinuities between old and new residence states.

In theory, it would be possible to assign a source to income generated from publicly traded intangible assets, like stocks and bonds. The underlying business entities, after all, have to allocate their income among the many source jurisdictions for tax purposes; distributions such as dividends, interest, and gains generated from the sale of those interests could be allocated on the same basis as the underlying income. If, for example, ten percent of the income of Caterpillar, Inc. is allocated to the state of Indiana for tax purposes, then ten percent of all dividend and interest distributions, and ten percent of the gains generated from the sale of those financial instruments, could also be treated as Indiana source income. The corporation could withhold from any distributions it made, and pay over to state treasuries the amounts of tax due, on amounts sourced under these rules. There is a timing issue here, of course. Distributions, particularly dividend distributions, may not be made out of current year income, so strictly speaking, the "sources" of such a distribution would depend on the sources of the income out of which distributions were made. And the source of the current year's income typically is not known or knowable until the time at which the tax returns for the corporation are filed, which would make it impossible for such entities to know how much to withhold and pay over for distributions made during the taxable year. In the interests of simplicity, perhaps the previous year's sourcing allocations should be used. Even this would be complex because it would require recalculating or reprogramming the withholding formula on a yearly basis. It is worth noting that for federal tax purposes, interest and dividends are generally sourced to the country in which the underlying entities are incorporated,[69] suggesting that allocating income in the fashion just described may be unduly complicated.

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67 *See id.* at 540-41 (discussing why "investment intangibles like stocks and bonds" are "difficult-to-source.")

68 *Id.* at 541.

69 *See* I.R.C. § 861(a)(1) (2019) (interest); I.R.C. § 861(a)(2) (2019) (dividends). However, there are exceptions to these rules. Taxpayers receiving dividends,

An additional complication is that many such instruments are owned by tax-exempt entities or pension plans. Integrating ownership information into the withholding rules would present another layer of difficulty. It is unlikely to be an insuperable barrier; after all, the process for informing payors of withholding relief provided under tax treaties seems to work reasonably well. However, the number of taxpayers involved in any state scheme of this sort would likely be vastly greater, increasing administrative difficulties and costs.

As a practical matter, it is unrealistic to expect individual owners of investment assets to file returns in each state to which taxes have been paid on their behalf. Indeed, it may even be too much to expect them to list each of these payments on the returns they file with their own residence states for purposes of obtaining a tax credit against their residence tax obligation for taxes paid to other jurisdictions. However, if most shares are held by intermediaries such as mutual funds, those intermediaries could keep track of the total amounts withheld, and report the appropriate shares of such withheld amounts to their customers. Residence states could allow such source taxes to be credited as an undifferentiated whole against the residence tax due on this investment income. This would parallel the existing practice of the federal government for persons earning small amounts of foreign investment income and paying small amounts of foreign tax.[70] Although this might result in some taxes paid to high-tax source states effectively offsetting residence tax that would have been payable to a residence state with regard to income earned in a low-tax source state, the administrative costs of perfection would likely be too high to countenance. This complicated system sounds clever, but it may be too costly to implement and monitor.

Whether residence states would be happy with such an approach (even if it is simplified) is uncertain. It would likely depend on how much additional tax revenue they would collect by expanding their source tax jurisdiction as compared to the amount they would lose by virtue of (essentially) giving up their residence tax jurisdiction. Some jurisdictions would likely profit from such a change, while others would see their revenues decrease.

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interest and royalties from closely held and controlled corporations are sometimes required to "look through" to the income generated by the underlying corporation for purposes such as determining the application of foreign tax credit rules. *See* I.R.C. § 904(d)(3) (2019) (looking through dividends, interests, rents and royalties received from controlled foreign corporations to determine relevant tax credit limitation category).

70 *See* Daniel Kurt, *Understanding Taxation of Foreign Investments*, Investopedia (Jan. 31, 2020), https://www.investopedia.com/articles/personal-finance/012214/understanding-taxation-foreign-investments.asp (describing the de minimis exception for individual taxpayers claiming less than $300 of foreign tax credits).

Perhaps most importantly, the scheme outlined here would not help with the taxation of gains generated from the sale of financial instruments, since the issuing corporations are not involved in these transactions and would rarely be in a position to withhold funds to pay over to state authorities. It is unclear how, or even whether, exchanges would be able to bring about a complex withholding regime. To the extent that the sales were effected through sophisticated intermediaries, these intermediaries might be able to play the role of the withholding agent. Then again, particularly if the withholding formula is complex, it might be asking entirely too much of the intermediaries.[71]

If expanding source taxation generally seems unattractive, a more limited approach—taking a limited number of transactions outside the reach of the *mobilia sequuntur personam* paradigm—might be an acceptable alternative. Under current law, any gain generated from the sale of the tangible assets of a business is attributed to their physical location.[72] However, if instead of selling the assets of a business, its owners sell stock or partnership interests, the gain from the sale is taxed at the residence of the taxpayer, which may be different from the location of the business, because stock and partnership interests are deemed to be intangible property, subject to tax under the *mobilia sequuntur personam* doctrine. While the distinction between the tax treatment of the sale of a multinational company's stock and of its assets may make sense, it makes much less sense to treat gains generated from the sale of stock of or partnership assets in a largely or entirely local business differently from the sale of its underlying assets.

It is worth noting that in the 2017 Tax Cut and Jobs Act, Congress enacted a new section of the tax code, I.R.C. § 864(c)(8), to ensure that a foreign partner's capital gain or loss on the sale of a partnership interest would be

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71 This might be another reason to opt for a simpler sourcing rule such as the place-of-incorporation rule the federal government uses. However, since a very significant percentage of U.S. corporations are incorporated in Delaware, a low-tax jurisdiction, following in the federal government's footsteps, may not advance the ball very far.

72 Goodwill, however, which is often a substantial component of the value of a business, is considered an intangible asset, and many states do not tax nonresidents on gains from the sale of such assets. *See, e.g.*, Wis. Dep't of Revenue, Tax Information for Part-Year Residents and Nonresidents of Wisconsin for 2019 19 (2019), http://revenue.wi.gov/DOR Publications/pb122.pdf ("Your share of the gain or loss from the sale of each partnership's goodwill is not taxable income….for Wisconsin purposes. Since the goodwill is intangible property, your share of the gain or loss from its sale is not taxable by Wisconsin.") Of course, this rule could be changed for goodwill associated with the operation of an in-state business.

treated as "effectively connected with a U.S. trade or business" and thus be subject to tax in the U.S. to the same extent that a sale of the underlying assets by the partnership would have generated effectively connected income.[73] The tax obligation is enforced through a withholding tax obligation placed on transferees (buyers).[74] The provision was added to reverse the outcome of a case holding that a foreign partner was not subject to U.S. tax on the sale of a U.S. partnership interest.[75]

States too could enact legislation to treat gains from the sale of stock and partnership interests in local businesses—those deriving more than fifty percent of their income from local sources, or having more than fifty percent of their assets physically located in the state[76]—as sourced at least partially within the state, and subject to tax.[77] Such a tax could be enforced through a

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73 *KPMG report: Initial impressions of proposed regulations under section 864(c)(8)*, KPMG Tax (Dec. 21, 2018), https://tax.kpmg.us/taxnewsflash/taxnewsflash-tax-reform/tnf-kpmg-report-initial-impressions-of-proposed-regulations-under-section-864c8.html.

74 *See id.* ("section 1446(f) — requires that the transferee of a partnership interest withhold 10% of the amount realized on a sale or exchange of the interest.")

75 *See* Staff of the Joint Committee On taxation , General Explanation of Public Law 115-97, 220 (2017):

> The provision overturns the result in *Grecian Magnesite* [Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner, 149 T.C. 63 (2017), *aff'd* 926 F.3d 819 (D.C. Cir. 2019)] by treating gain or loss from the sale or exchange of a partnership interest as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets.

Structuring the disposition of businesses to avoid taxation at source is a worldwide, and oft-challenged, practice. When the British "telecom giant" Vodaphone disposed of its (very profitable) investment in its Indian subsidiary through an offshore sale of stock in an intermediary corporation to avoid incurring an Indian source tax obligation, India enacted retrospective legislation seeking to tax the transaction. The validity of the retrospective aspects of that law went to an international arbitration panel, which (in an unpublished opinion) decided in favor of the taxpayer. *See* Nikos Lavronos, *Vodafone v India award: risky business of retroactive taxation,* Thomson Reuters Practical Law Arbitration Blog, December 21, 2020, http://arbitrationblog.practicallaw.com/vodafone-v-india-award-risky-business-of-retroactive-taxation/ (describing dispute).

76 There is nothing magical about the 50 percent cutoff.

77 New York currently treats a pro-rated portion of the gains from the sale of interests in S-corporations as New York source income when 50 percent or more of the S-corporation's assets consist of New York real estate. *See* N.Y. Tax Law § 631(a); Jeff Glickman, *New York Rules That a Nonresident's Sale*

withholding obligation placed on sellers.[78] Indeed, a few states already have done just that.[79] While this would not entirely eliminate the incentive to move to low-tax jurisdictions, it would generate a publicly acceptable outcome with regard to some instances of flagrant tax avoidance. This acceptability might, however, come to an end if sellers learned that they ought to merge their local businesses with others that do business in other jurisdictions to dilute the local character of the business prior to a sale, and avoid the source tax regime. Tax law is, of course, a messy and ever-changing business.

Expanding taxation at source is just one mechanism for reducing the tax significance of tax residence, and thus the benefits (or burdens) of changes in tax residence. Another approach involves reducing the significance of tax residence itself by expanding the concept of part-year residence. At present, taxpayers are part-year residents of states (and countries) only in the year in which they cease being a resident of one jurisdiction and establish residency in a new jurisdiction. People are supposed to be residents of only one state at a time. And the consequences of being considered a resident of more than one state at a time—a situation that can exist because of differences in state

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of S-Corporation Stock Constituted New York Source Income, Aprio.com (Sept. 2016), https://www.aprio.com/new-york-rules-nonresidents-sale-s-corporation-stock-constituted-new-york-source-income/ (explaining statute). And the U.S. government treats gains generated from the sale of certain U.S. corporations by foreigners as U.S. source gain when a high percentage of their underlying assets consist of U.S. real estate. *See* I.R.C. § 897(c)(2) (2019) (defining "United States real property holding corporation.")

78 States have devised legally acceptable withholding tax regimes to ensure that nonresident sellers of in-state real estate pay the applicable source tax. *See* Kyle J. Sweeney, *The Nonresident Real Estate Withholding: An Exit Tax In Disguise?*, 26 Geo. Mason L. Rev. 549, 584-85 (2018) (surveying and evaluating state real estate withholding regimes). Buyers of interests in businesses consisting largely of assets or income derived in one state presumably are sufficiently aware of the local connection to warrant imposing such a withholding obligation on them. It is unclear how successful states are at collecting taxes imposed on nonresidents in the absence of withholding.

79 These taxes have been held to meet constitutional standards. *See* Hellerstein & Smith, *supra* note 15, at 226 (citing International Harvester Co. v. Wisconsin Department of Revenue, 322 U.S. 435 (1944) and Anderson v. Lambert, 494 So. 2d 370 (Miss. 1986)). But more could take advantage of this taxing opportunity. Of course, as discussed earlier *supra* note 63, this only helps if the new state accepts the source rules promulgated by the first state and reduces its own tax claim accordingly. If it does not, such an expansion may simply lead to the different discontinuity of duplicative state taxation.

laws regarding the definition of "residency"[80]—can be dire. Both states may tax the same income, with no offset for taxes paid to the other.[81] There is a solution that is capable of solving both the dual resident and, to some extent, the change in residence problem. As described below, states could agree to treat taxpayers who spend significant amounts of time in more than one state as part-year residents of each of the states, and then apportion their personal income tax liabilities in accordance with the time spent in each state. This possibility is described and evaluated in the next section.

C. Dual Residency and Income Apportionment

Changes in residency matter so much because tax residency is regarded as an all-or-nothing, or discontinuous, proposition. Individuals are either residents of a state or not. In reality, many individuals spend considerable amounts of time in two or more jurisdictions. For example, many retirees are seasonal movers, with retained homes in their original states of residence. Some of these individuals find themselves in the unfortunate position of being considered residents of more than one state for tax purposes; others pay close attention to state definitions of residency and manage to become residents only of the lower-tax state. Unsurprisingly, states that find themselves on the losing end of these residency changes, and especially those that provide significant benefits to seasonal residents, have explored the possibility of "snowbird taxes." In 2013, Governor Mark Drayton of Minnesota proposed legislation which would have treated individuals spending two months or more and with a permanent abode in Minnesota as a "part-year" resident of Minnesota, subject

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80 The Supreme Court has been resistant, at least up until now, of wading into disputes involving inconsistent definitions of "source" or "residence," preferring to avoid choosing between two different, but otherwise acceptable, state statutes. *See, e.g.*, Moorman Mfg. Co. v. Bair, 437 U.S. 267, 278 (1978) (upholding Iowa's single factor apportionment formula despite the "risk of duplication" created by its use when other states use three factor apportionment); State Tax Comm'n of Utah v. Aldrich, 316 U.S. 174, 181 (1942) ("no constitutional rule of immunity from taxation of intangibles by more than one State"); Texas v. Florida, 306 U.S. 398, 410 (1939) (same); Zelinsky, *supra* note 4, at 546 ("Residence-based double taxation has been accepted as constitutional.")

81 For an example of a taxpayer caught in this situation, see Edelman v. N.Y. State Dept. of Taxation and Finance, 162 A.D.3d 574 (2018), *appeal dismissed* 122 N.E.3d 557 (2019), *cert. denied* 140 S.Ct. 134 (2019) (petitioners taxed in both Connecticut and New York on gains generated through the sale of their business because of inconsistent state definitions of residency).

to a proportional individual income tax.[82] The legislation was not enacted, but it caught the eye of a noted tax scholar, Edward Zelinsky, who then advocated the adoption of such "apportioned residence-based income taxation"[83] by any and all possible means.[84] Although the focus of his work was on reducing the burdens imposed on double-taxed, multi-state residents, the same approach could be used to expand the taxing jurisdiction of states that would not, under current conceptions of residence, qualify as residence states. The proportional approach would allow states to tax some of the investment income and gains of former residents, and reduce the tax incentive for (inefficiently) moving to another jurisdiction before selling appreciated assets.

Allowing residence taxation based on part-year residence is no panacea. For one thing, an individual may reduce (or even eliminate) the amount of time spent in the state of original residence to stay below the established cutoff for becoming a part-year resident. The resulting loss of in-state economic activity might outweigh the tax gains gleaned from taxes imposed on other taxpayers. Any rule establishing a principle of minimum or maximum presence for residency would create a new discontinuity. On the other hand, part-year residence rules might encourage other taxpayers to spend more time with old friends and neighbors (and possibly relatives) in their old neighborhoods if the consequences of flunking a time-limited residency rule are less draconian. They might stay a few extra days if the price is part-year, rather than full-year, residency. It is hard to know which effect will predominate.

Moreover, a part-year, proportional regime will not allow the original residence state to tax all the gain accrued with respect to investment assets while a taxpayer was a full-time resident; part of the tax on that gain still will be diverted to the state to which the taxpayer has (partially) moved by the time the asset was sold. On the other hand, the original state of residence could have an offsetting benefit from its ability to tax some of the ongoing income generated from those investment assets (including newly accrued

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82 *See* H.B. 677, 88th Leg., Reg. Sess. art. I, § 2 (Minn. 2013) (creating a category of "part-year resident"); *Id.* at art. I, § 13 (describing income taxable to part-year residents).

83 *See* Zelinsky, *supra* note 4, at 572.

84 *See id.* at 572-73.

> The best way to achieve apportioned residence-based income taxation is by federal legislation under Congress's Commerce Clause power. If Congress won't adopt such legislation, the U.S. Supreme Court should require such taxation via its Commerce Clause and Due Process doctrines. If neither Congress nor the Court will act… the states on their own can agree that a state without source jurisdiction over part or all of a dual resident's income should only tax its pro rata share of the income which the state taxes on the basis of residence.

gain) following the relocation. The concept of residency would be more like a sliding scale, leading to less discontinuous tax results. Overall, a state might collect more tax than if it had been allowed to levy an exit tax on the accrued gains, and then lost all taxing jurisdiction. The gain or loss to the state depends on the underlying facts.

For example, imagine a taxpayer, T, who moves from Illinois to Florida on January 1, 2020, but continues to spend three months in Illinois each summer. Suppose further that T bought two shares of stock on January 1, 2019, one share in X Corp and one share in Y Corp. T sells both shares on December 31, 2020. The share of X Corp increased in value by $100 in 2019, but stayed flat in 2020; by contrast, the share of Y Corp did not gain value in 2019, but increased in value by $140 in 2020. Under a realization-based regime, but applying a part-year residency rule, T would have $240 of taxable income in 2020, one-quarter of which, or $60 would be subject to tax in Illinois. The remainder. $180, would be subject to tax in Florida. $60 is less than $100 (what would have been taxed in Illinois under a mark-to-market tax system) but it is more than $0—and T might earn additional profits on stock investments in future years, some of which would be taxed by Illinois under the part-year residence rule.

The operation of a proportional, perhaps continuous, tax regime would not be easy for either taxpayers or governments. The initial burden will fall on the taxpayers, who will find themselves responsible for filing multiple state tax returns.[85] They will need to keep track of their days of presence in each of the states in which they were "part-year" residents.[86] Even developing a common definition of "days of presence" may not be easy. There may be many days on which a mobile taxpayer is in both states. Then there is the question of how to treat commuters who are "domiciled" in one state and work in another. The problem is compounded where spouses do not work in the same state or do not always travel together. Another question is how to account for days spent in neither residence state.[87] States will need to agree

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85 Highly paid athletes, artists, consultants and attorneys already face this burden, because their income is often sourced to many jurisdictions.

86 This task may be made easier by the ubiquity of smartphones and related devices which routinely track users' locations. However, taxpayers will be quite averse to being forced to hand their devices over to state tax officials as part of an audit process. The potential for political blowback may make this an unwise auditing technique.

87 This problem would be analogous to the "throw-back" versus "throw-out" problem encountered when taxpayers allocate multistate income using the formulary method. *See* Jared Walczak, *Throwback and Throwout Rules: A Primer*, Tax Found. (July 2, 2019), https://taxfoundation.org/throwback-rules-

on all of these issues in order to avoid double and under-taxation. Again, every non-uniformity will, like the exit tax, substitute one set of distortions for another. Discontinuities are hard to eliminate.

In short, there is much to be said for a part-year residence regime, but it comes with significant problems. This relatively continuous approach comes with its own discontinuities. The multi-state approach is probably most interesting when it comes to investment income, as just described, and when it comes to retirement income, the subject to which we now turn. As we will see, mechanisms directly focused on the taxation of retirement income may operate independently or alongside a part-year residence regime.

III. Taxing Retirement Income

While many individuals directly own assets that give rise to income taxed under the *mobilia sequuntur personam* doctrine, many more are beneficiaries of qualified retirement arrangements owning such assets.[88] Under federal law, contributions to most qualified pension plans are deducted from the income of the payor and excluded from the income of covered individuals; the beneficiaries become taxable only as they receive distributions from such plans.[89] As a general rule, the income derived from such arrangements, if taxed at the state level,[90] is taxed by the state in which the taxpayer is residing

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throwout-rules-2019/ (describing the use of rules to tax "nowhere income"); Katherine Loughead, *Does Your State Have a Throwback or Throwout Rule?*, Tax Found. (Dec. 5, 2018), https://taxfoundation.org/throwback-rule-throwout-rule/ (mapping out distribution of such rules).

88 As of June 20, 2019, U.S. individuals had accumulated approximately $29.8 trillion in retirement assets. *See Investment Company Institute, Frequently Asked Questions About 401(k) Plan Research*, ICIGlobal (Apr. 9, 2020), https://www.ici.org/policy/retirement/plan/401k/faqs_401k.This figure includes "employer-sponsored retirement plans (both defined benefit (DB) and defined contribution (DC) plans with private- and public-sector employers), individual retirement accounts (IRAs), and annuities."

89 *See* Peter J. Wiedenbeck, ERISA: Principles of Employee Benefit Law 296-97 (2010). *But see infra* text at notes 100-103 (describing "Roth" plans).

90 Many states exempt some or all income derived from such arrangements from their income tax bases. *See* Rocky Mengle, *12 States That Won't Tax Your Retirement Income*, Kiplinger (Feb. 12, 2019), https://www.kiplinger.com/slideshow/retirement/T047-S001-12-states-that-won-t-tax-your-retirement-income/index.html ("Twelve states....completely exempt the most common types of retirement income—410(k)s, IRAs and pensions—from taxation."); *Deciding Where to Retire*, *supra* note 60 (a chart of state tax provisions).

when he or she receives the retirement distribution. States that do not tax distributions from retirement plans lose nothing when retirees relocate prior to receiving distributions under these arrangements.[91] But a state that does tax such distributions is understandably aggrieved when a taxpayer first excludes portions of state-taxable wage income from its tax base as contributions to a qualified retirement arrangement, and then relocates to another jurisdiction before the accumulated funds are distributed. When a retiree moves, both the diverted wage income and associated investment income disappear from the tax base of the state in which the wages were earned.

The federal government does not tolerate such revenue losses, at least when high-income taxpayers are involved. U.S. accrued retirement benefits are included in the expatriation tax regime contained in section 877A of the Internal Revenue Code. Section 877A provides expatriates covered by such arrangements with a choice. Covered expatriates[92] may notify the administrators of their plans regarding their status as covered expatriates, authorize those administrators to withhold and pay over to the U.S. Treasury 30 percent of any payments made under the plan, and waive any treaty right to a lower withholding rate.[93] If an individual fails to make the required notification and waiver within the time prescribed under the regulations, the individual is immediately taxed on the amount of the "accrued benefit" as a distribution under the plan "received by such individual on the day before the expatriation date."[94] The federal government views retirement income as properly sourced to, and taxable by, the country in which the underlying income was earned.

But the federal government has not taken the same approach when the question is which state ought to have jurisdiction to tax retirement income. In

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91 This assumes, of course, that their decision to refrain from taxing retirement distributions does not stem from the fear that if they tried to impose such a tax, retirees would seek out a lower-tax jurisdiction.

92 *See* I.R.C. §§ 877A(g), 877(a)(2) (2019) (defining "covered expatriate.")

93 *See* I.R.C. §§ 877A(d)(1), 877A(d)(3) (2019) (establishing a withholding tax regime for distributions from "eligible deferred compensation items.")

94 *See* I.R.C. § 877A(d)(2)(A) (2019) (rules for taxation of deferred compensation item which is not an "eligible deferred compensation item.") The sole relief provided to affected taxpayers is that such deemed distributions are exempt from the early distribution taxes which would have been levied on an actual distribution from such plans. I.R.C. § 877A(d)(2)(B) (2019). *See* Phil Hodgen, *Income Taxation of a Covered Expatriate's 401(k) Plan*, HODGENLAW PC (Jan. 12, 2015), https://hodgen.com/income-taxation-of-a-covered-expatriates-401k-plan/ ("The paperwork you should **not** screw up is Form W-8CE. You should give this to the 401(k) plan administrator within 30 days of renouncing your U.S. citizenship or abandoning your green card visa.")

the 1990s, some states started to tax nonresidents on retirement income paid with respect to services performed within their borders, conceptualizing such payments as delayed wages. By 1996, six states had enacted such taxes.[95] These efforts to broaden the scope of state income taxation came to a screeching halt when Congress enacted a law explicitly limiting states' authority to tax the pension income of nonresidents.[96] It specifically forbids states from imposing income taxes on nonresidents' retirement income.[97] The statute contains an expansive definition of "retirement income."[98]

Given that the imposition of a source-based tax upon distributions is foreclosed by this legislation, the question is whether such a tax can be accelerated. Specifically, the question is whether such a tax can be imposed

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95 *See* SCHOETTLE, *supra* note 4, at 568 (California, Colorado, Kansas, Louisiana, New York and Oregon "sought to tax the deferred income of former residents.") It is worth noting that the state in which a taxpayer performed the services giving rise to the pension benefits may not, strictly speaking, be the sole source of subsequent pension distributions since some benefits are paid out of the investment earnings generated with respect to employer and employee contributions. Like all investment income, those benefits should in the first instance be sourced to the state in which the beneficiary was resident in the year the investment income was realized under the *mobilia sequuntur personam* doctrine. Under current doctrine, benefits paid out of all investment income should be sourced to the new state of residence; even if one wants to adhere to a more mark-to-market approach to the taxation of investment income, one would source the investment income accrued post-move to the new state of residence. Depending on the number of post-retirement years involved, such post-retirement investment income could represent a substantial portion of the actual distribution amounts. *See* Hellerstein & Smith, *supra* note 15, at 226.

> Because states generally lack the constitutional power to tax the portion of a former resident's pension income that reflects accumulations after the taxpayer's change of residence, states must limit their taxation of nonresident pension income to the deferred employment income and the income accumulated prior to the retiree's change of residence.

96 Pub. L. No. 104-95 (1996) (codified as 4 U.S.C. § 114).

97 *Id.* at § 114(a) ("No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).")

98 *Id.* at § 114(b) (definition of "retirement income includes amounts distributed from qualified pension trusts, simplified employee pension arrangements, IRA's, 403(b) annuities and annuity contracts, governmental plans, and "any plan, program, or arrangement….if such income…is part of a series of substantially equal periodic payments…made for…the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or…a period of not less than 10 years.")

and collected when funds are put into retirement arrangements.[99] It is worth noting that federal law specifically allows some pension arrangements to be financed on a post-tax basis. These Roth arrangements,[100] as they are called, allow taxpayers to fund retirement accounts out of post-tax money, while excluding distributions from later taxation.[101] In theory, the tax advantage of Roth plans is identical to that of a more traditional pension arrangement,[102] so that a state adopting such a tax regime could not be accused of undermining the federal tax preference for qualified retirement plans.[103] Taxation at this

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99 This possibility appeared to have been discussed at the time the legislation was passed. *See* Pillsbury Tax Page, *Federal Statute Enacted Prohibiting State Income Taxation of Certain Pension Income of Nonresidents*, St. & Loc. Tax Bull. (1996), http://pmstax.com/state/bull9602.shtml (explaining AARP opposition to the legislation due to "concern[ed] that the affected states could respond by limiting deferred compensation deductions to make up for the lost revenue.") Another alternative would be for states to impose an exit tax on the untaxed value of accumulated pension benefits at the time a taxpayer moved to another state. Although such a tax might not fall afoul of Pub. L. No. 104-95 (codified as 4 U.S.C. § 114) because it would not be levied on a pension "distribution," presumably it would raise the same constitutional issues discussed earlier, see *supra* notes 17-29 (discussing the Dormant Commerce Clause and Privileges and Immunities issues), in the context of an exit tax imposed on unrealized gains.

100 William Roth, a former Senator from Delaware, sponsored the bills authorizing such arrangements in the IRA and 401(k) contexts.

101 *See* I.R.C. § 408A (2019) (statutory authority for Roth IRAs); I.R.C. § 402A (2019) (statutory authority for Roth 401(k) and 403(b) contributions).

102 *See* Julie Roin, *Planning Past Pensions*, 46 Loy. U. Chi. L.J. 747, 782 (2015) ("If one assumes constant tax rates and normal rates of return, this [Roth] tax treatment is indistinguishable from that accorded other qualified pension plans for which a deduction for contributions is allowed up-front and distributions are fully taxable.") In practice, Roth-type arrangements may actually benefit taxpayers more than the more traditional qualified plan *See* Wiedenbeck, *supra* note 89, at 299 (explaining why immediate deduction and yield exemption often lead to different results).

103 Actually, nothing that a state did short of imposing heavier taxes on retirement arrangements would undercut the federal tax preference. There does not appear to be any law requiring states to magnify the federal tax preference by providing state tax relief for such arrangements. *See* De Buono v. NYSA-ILA Medical and Clinical Services Fund, 520 U.S. 806 (1997) (ERISA preemption does not preclude state taxation of hospitals); Self-Insurance Institute of America, Inc. v. Snyder, 827 F.3d 549 (6th Cir. 2016), *cert. denied* 137 S. Ct. 660 (2017), ERISA preemption does not preclude state taxation of health insurers).

earlier point in time can be justified (in most situations) on both source and residence grounds.

Effecting such a tax would be complicated by the fact that there are two types of qualified pension arrangements: defined contribution plans and defined benefit plans. Most employees are currently covered by defined contribution arrangements, which create individual accounts for each plan beneficiary.[104] Employers and employees make contributions to these accounts in accordance with the terms of the applicable plan. The accounts grow over time both through additional employer (and sometimes employee) contributions and from investment returns earned with respect to the investment of the accounts' assets. Each beneficiary's retirement benefit consists of the balance contained in his or her account at the time of retirement.[105] By contrast, a defined benefit plan promises covered employees a retirement benefit calculated according to a pre-established formula, often based on some combination of salary and years of employment.[106] Employers maintaining such plans are required to contribute amounts to a dedicated pension trust in accordance with actuarial estimates of the amount needed to defray their pension obligations to all covered employees.[107] The benefits, however, are supposed to be paid regardless of whether the employer has set aside enough funds in the trust to do so.[108] Neither the employer contributions nor the assets in the trust are allocated to, or owned by, particular beneficiaries.[109] As explained below, any regime attempting to tax contributions would entail the development of different rules for the two plan types.

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104 Indeed, the beneficiaries of most such accounts are allowed to direct the investment of the assets contained therein. *See* Wiedenbeck, *supra* note 89, at 137 ("by 2005, about 95 percent of participants had some say over the investment of their accounts.")

105 *See* Wiedenbeck, *supra* note 89, at 7 ("benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.") This benefit is increased or decreased by post-retirement investment earnings and losses with respect to funds remaining in the account.

106 *Id.* at 8-9 (describing different benefit formulas).

107 *Id.* at 9 (describing the need for actuarial estimates).

108 *Id*. at 7 ("a defined benefit plan is an employer's commitment to make specified future payments; the employer is contractually obligated to make those payments even if the assets set aside to finance them prove to be inadequate.")

109 *Id.* (distinguishing defined contribution plans from defined benefit plans).

A. Defined Contribution Plans

It would be relatively simple for a state to tax contributions to a defined contribution plan on a current basis. It would merely have to eliminate the current exclusion of contributions from the beneficiaries' income. The amount of such contributions is known, and could easily be incorporated in current information returns provided to employees. There would be a mismatch between the gross amount of income reported for federal and state tax purposes, but there is already (often) a difference between the amount of income reported for federal and state tax purposes.

To be sure, there is some complexity. Issues arise if, for example, a taxpayer works in several states. If one state taxes the wages of nonresidents under a source tax rationale, its claim to tax the associated amount of retirement income should be both expected and honored; the state claiming only residence taxing jurisdiction should then either exclude the contributions taxed by the other state from its own tax base or grant a tax credit for the other state's taxes against its own tax obligation.

The more difficult problems involve the decisions that must be made about the taxation of actual distributions. These problems come in two varieties. The first is the transition problem. The second is an ongoing issue that will arise from the likely disparity in state taxing regimes.

The transition issue comes first. A state that begins including retirement plan contributions in income is unlikely to include all past years' contributions in the income of an account's owner in the year it adopts the new rule.[110] For one thing, a taxpayer may not have the records necessary to determine the amount of past contributions to the account. Under current law, there has been no need to track the share of a retirement account's assets attributable to contributions as opposed to the returns from investing those contributions, since both amounts are taxable in full at ordinary income rates when distributed. Moreover, the amounts involved could be quite large, and the individual involved may lack the liquid assets necessary to defray the large tax liability that would result from such an inclusion. As a result, a taxpayer might have to withdraw funds from retirement accounts in order to pay the tax due to the state—and withdrawals from qualified retirement accounts trigger a contemporaneous federal tax obligation,[111] possibly up to and including a ten percent penalty

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110 There would be no constitutional objection to doing this, as long as the rule applied to all account holders and not just those leaving the state.

111 I.R.C. § 402(a) (2019) ("distributions from an employee's trust…exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed…") Alternatively, a state might assess a tax based on the pre-effective-date balance in the account but allow taxpayers

tax.[112] For that reason, states adopting such a regime will probably want to reserve the right to tax distributions attributable to pre-change contributions, and the associated investment returns. That will require states to come up with some mechanism for allocating actual distributions between the pre-change taxable distributions and the post-change exempt distributions.

As a practical matter, the easiest mechanism for dealing with the transition issue would be to require taxpayers to create a separate retirement account to hold the contributions made on a post-tax basis along with the investment returns derived from those contributions. Distributions from accounts paid out of pre-tax contributions could continue to be taxed (or not) as they were made. Distributions from the post-tax account, and only the post-tax account, would be received tax-free. Although states would be able to tax the distributions from the pre-change accumulations of their residents, they would still be unable to tax distributions made to former residents. This means that a considerable amount of tax discontinuity would exist for many years, although its significance would gradually diminish.

The mechanics would be easy if every state adopted the same new regime in one given year. If they do not—if this new pattern of taxation is not imposed by federal law—a plethora of new discontinuities are created. Some taxpayers could be double taxed on their retirement contributions, if they moved from a state which taxed retirement contributions but not distributions, to another, which allowed for tax-free contributions and taxed distributions. Contributions could then be taxed both by the state in which someone lived in the year contributions were made, and again by another state in the year such a distribution took place. We might hope that the distribution state would allow a credit or exclusion for the taxes paid to the first state on the contributions, on grounds that the income was sourced in that state, but it is unlikely to do so because under state law (not to mention the federal statute) such income seems to be deemed

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to delay payment of the tax by agreeing to the imposition of an interest charge. Such a tax might not be deemed to run afoul of the Act to Amend title 4 of the United States Code to Limit State Taxation of certain Pension Income, Pub. L. No. 104-95 (codified as 4 U.S.C. §114), as the levy would not (technically) be imposed on retirement distributions. However, states may find enforcement of these deferred tax obligations difficult for the reasons laid out in *supra* text at notes 55-57: they may lose track of taxpayers once they leave the state, and there is no guarantee that those taxpayers will be in a position to pay the sums owed at a later date. Placing a withholding responsibility on retirement plan fiduciaries (the easiest way to effect compliance) would bring the whole scheme uncomfortably close to the tax scheme explicitly forbidden by Pub. L. No. 104-95.

112 I.R.C. § 72(t) (2019) (imposing 10% additional tax on most distributions made to participants who had not attained the age of 59 ½ at the time of the distribution).

sourced within the distribution state's borders.[113] Nor would federal courts be likely to provide relief from this duplicative taxation.[114] Both sourcing rules would probably pass constitutional muster because neither would lead to duplicative taxation if uniformly adopted and applied.[115] If all states taxed retirement distributions, such distributions would be taxed by only one state. If all states taxed retirement contributions, such contributions would be taxed by only one state. When faced with two legitimate but conflicting state tax rules, the Supreme Court prefers allowing duplicative state taxation to striking down a facially legitimate state statute.[116]

While taxpayers moving from a tax-at-contribution state to a tax-at-distribution state would be subject to duplicative taxation, those moving from a tax-at-distribution state to a tax-at-contribution state could completely escape state taxation. It would depend on whether states maintaining tax-at-contribution rules taxed all distributions received by their residents from accounts funded by tax-deductible contributions; the question would be whether accounts earned by new residents would be treated the way "transitional" accounts are treated. As a legal matter, states should be able to tax distributions made out of any accounts accrued prior to the date of the adoption of their new taxing regimes, whether those accounts are owned by existing or new residents. This treatment would not require any discrimination between old and new residents, thereby eliminating possible objections to such taxation under the rubric of the Privileges and Immunities Clause. As an economic matter, of course, the income inherent in such accounts accrued before the taxpayers became residents of the second state. However, to claim that the second state of residence lacks the ability to assert taxing jurisdiction over retirement benefits earned in a pre-residence year (under the Due Process Clause or otherwise) would undercut the validity of Pub. L. No. 104-95. Alternatively, it would mean that Pub. L. No. 104-95 prevents both states—the original state and the second state—from taxing retirement benefits received by a person after moving to a state other than that in which his retirement benefits had been

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113 *See* Hellerstein et al., *supra* note 63, at 434.

> In general, it is the credit-granting state that determines the sourcing rules that are employed to determine whether the state that is purporting to tax on a source basis is taxing income that has its source in that country for tax credit purposes. As the cases below reveal, this can result in double taxation.

114 *See supra* note 63 (describing legality of duplicative taxation).

115 Each would meet what is known as the test of "internal consistency." *See* Ruth Mason, *Made In America for European Tax: The Internal Consistency Test*, 49 B.C. L. Rev. 1277, 1283 (2008) (describing the "internal consistency test.")

116 *See supra* note 80.

earned.[117] But what about benefits earned out-of-state after enactment of the tax-at-contribution rule by the second state? Could those be subject to tax in the second state? The grounds for doing so would be questionable. Not only would the second state be treating new residents differently from old residents, but if retirement income is sufficiently "realized" (deemed earned and received) to be subject to tax at the time contributions are made to the account, that income should have been deemed earned and received for the second state's tax purposes while the taxpayer was a resident of another state, and thus outside the taxing jurisdiction of that second state. The second state would not have a sufficient relationship to that income to warrant its taxation as a constitutional matter.[118]

Once again the mechanism required to remedy one set of tax discontinuities caused by a taxpayer's change in residence gives rise to another set of discontinuities. To make matters worse, defined contribution plans present more tractable problems than do defined benefit plans, as described in the next section.

B. Defined Benefit Plans

Beneficiaries of defined benefit plans do not have individual retirement accounts, nor do they own any particular assets of the pension trust(s) established to fund their benefits.[119] In addition, it is impossible to determine with any certainty the amount contributed to such trusts on a yearly basis on a particular beneficiary's behalf, as contributions are computed with reference to the characteristics of the entire participant base and expectations about future investment earnings, employment patterns, and mortality rates.[120] Thus, treating pension contributions as income to potential beneficiaries in the

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117 *See* Hellerstein et al., *supra* note 63, at 413-14 (defending the right of states to tax pension benefits earned before, but distributed after, the taxpayer became a resident).

118 *See* Smith & Hellerstein, *supra* note 14, at 371-72 (explaining why a new state of residence lacks jurisdiction to tax gain from the sale of a primary residence located in another state that was realized but not recognized while the taxpayer was a resident of that other state).

119 *See* Eric D. Chason, *Lemon Socialism and The Federal Guaranty of Private Pension Obligations* (2006), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=887405 ("Employees have few claims against plan assets, except to enforce benefit payments fiduciary obligations. They have no enforceable claim to any surplus funding before a plan terminates…")

120 *See* Wiedenbeck, *supra* note 89, at 9 (listing factors that must be estimated to actuarially determine contribution).

year contributions are made seems implausible as an administrative matter. That does not mean that contributions cannot be taxed by states when made. It does mean that the tax has to be imposed on, and collected by, employers. States may require employers to add back any deductions they claimed for federal tax purposes for contributions to defined benefit plans, just as they require individual taxpayers to add back amounts from state and local bond interest exempted from their federally defined income when calculating their state income taxes.

If an employer has employees working in multiple jurisdictions, the amount of pension contributions added back to any particular jurisdiction must be limited to the amount of the contributions related to in-state employees.[121] A perfectly accurate allocation is impossible for the reasons already mentioned. However, a formulaic allocation could be close enough to be acceptable. Several plausible bases for such an allocation formula exist, including the following: the number of in-state employees covered by the plan relative to the total number of plan participants, the in-state payroll of plan participants relative to the total payroll of plan participants, the in-state covered payroll[122] of plan participants relative to the total covered payroll of plan participants, or simply the percentage of income apportioned to the state for tax purposes relative to the employer's total income. These are imperfect solutions, and allowing choice would obviously increase the imperfection. Still, a state could mandate one approach, and fairly think it had improved things as compared to the current system.

On the other hand, there is the annoying fact that employers and their employees may be subject to tax at different rates. These rate differentials may lead to significant shortfalls (or excesses) in the amount of tax collected from employers, relative to taxes imposed on employees. After the Tax Cut and Jobs Act of 2017, most corporations pay federal tax at rates lower than individuals;[123] the relationship between state corporate and individual income tax rates is

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121 *See* Hellerstein & Smith, *supra* note 15, at 227 (explaining the allocation problem facing states seeking to impose a source tax on the retirement income of individuals who worked in several states).

122 The Internal Revenue Code caps the amount of compensation that can be taken into account under a qualified plan. See I.R.C. § 401(a)(17) (2019). The annual compensation limit in 2021 is $290,000. I.R.S. Notice 202020-79, 2020-46 I.R.B. 1014.

123 The top marginal rate of tax on individuals in 2020 is 37 percent, see Rev. Proc. 2019-44, § 3.01, 2019-47 I.R.B. 1, while the corporate tax rate is 21 percent. I.R.C. § 11 (2019).

more mixed.[124] The income of non-corporate employers is included in the income of the company's owner, who may pay tax at higher marginal rates than many covered employees. The most extreme example of the differential concerns government employees and employees of nonprofit organizations. Inasmuch as neither governments nor nonprofit organizations pay taxes, their loss of deductions costs them nothing and correspondingly raises no revenue for the tax authorities. At present, almost half of the individuals covered by traditional defined benefit pension plans are employees of state and local governments,[125] and many of them retire to low-tax states.[126]

The disparate tax rate problem could be ameliorated if instead of eliminating the deduction for pension contributions, the state levied an excise tax on employers equal to a stated percentage of pension contributions allocated to the state. The federal government included such a device in the Tax Cut and Jobs Act of 2017 to tax nonprofit employers on the cost of providing certain income-excludable fringe benefits.[127] Of course, this option will not help the

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124 *See* Janelle Cammenga, *State Corporate Income Tax Rates and Brackets for 2020*, Tax Found.)Jan. 28, 2020(, https://taxfoundation.org/state-corporate-rates-brackets-2020/ (listing state corporate income tax rates).

125 Approximately 15,340,000 private-sector employees (13 percent of 118 million workers) and 14,630,000 governmental employees (77 percent of 19 million workers) are covered by traditional pension plans. *See How many American workers participate in workplace retirement plans?*, Pension Rights Center (July 15, 2019), http://www.pensionrights.org/publications/statistic/how-many-american-workers-participate-workplace-retirement-plans (information drawn from Bureau of Labor Statistics' National Compensation Survey for 2018).

126 About 18 percent of Illinois public-sector retirees have moved out of state. *See* Jake Griffin, *About 18 Percent of Public Employee Retirees Move Out of State*, CapitolFax (June 24, 2019), https://capitolfax.com/2019/06/24/about-18-percent-of-public-employee-retirees-move-out-of-state/ ("Florida leads all migration destinations, followed by Arizona….") This is higher than some states, see *id.* (16% of Iowa's, 15% of California's) and lower than others, see *A Snapshot of NYSLRS Retirees*, N.Y. Retirement News (Oct. 30, 2019), https://www.nyretirementnews.com/ (21 percent of retirees live out of state). Interestingly, Illinois currently exempts all retirement income from its income tax base, while New York exempts government-funded pensions from its income tax base.

127 *See* I.R.C. § 512(a)(7) (2017) (including the cost of providing qualified transportation fringe benefits as "unrelated business taxable income" of nonprofit employers). However, Congress retroactively repealed this provision on December 20, 2019. Taxpayer Certainty and Disaster Tax Relief Act of 2019, Pub. L. 116-94, Div. Q, Title III, § 302, 133 Stat. 2534 (2019) (enacted as part of the Further Consolidated Appropriations Act, 2020); Amanda H. Nussbaum & Amy Zelcer, *Repeal of Unrelated Business Income Tax on Qualified Transportation Fringe*

finances of a state government unless the economic burden of this tax with respect to its own employees can be transferred to state employees. Otherwise, a state will simply find itself paying a tax to itself, generating a circular flow of money slightly diminished by enforcement costs.

The structure of defined benefit plans also makes it more difficult, and certainly more expensive, to design a workable transition rule. It is not enough to tell employers to set up a new, separate pension trust to cover future earned benefits, and to treat any benefits paid out of it as exempt from tax, while benefits paid out of the first trust would be taxable upon receipt. How would an employer know whose benefits ought to be payable out of the assets of each trust? Surely it would not be acceptable to spend down the assets of the first trust, so that the entirety of early retirees' benefits are taxable (even if some of the contributions made on their behalf had been taxed), while later retirees' benefits are wholly excludable from income (even though some might have been financed out of nondeductible contributions). Yet to create equity among employees, the employer would have to calculate the amount of pension benefits that each employee would be entitled to, had he or she terminated employment on the date the law changed. Then that amount of each benefit distribution would be includable in the beneficiary's income for tax purposes, with the rest of any eventual distribution excludable. This sort of calculation can be done, as it is when employers terminate defined pension plans,[128] but it is expensive.

In sum, the above-described techniques for taxing contributions to defined benefit plans, in lieu of taxing distributions from such plans, create the same potential for duplicative or nonexistent taxation as explored in detail in connection with the taxation of contributions to defined benefit plans. The type of plan neither ameliorates nor exaggerates the problems caused by inconsistencies in state taxing rules. And as an administrative matter, it would be considerably more difficult to treat the participants in defined benefit plans in a fair and equitable manner.

Conclusion

Interjurisdictional mobility is a desirable feature of political economy. It allows for better matching between governments and individual residents,

Benefits, Nat'l L. Rev. (Dec. 26, 2019), http://natlawreview.com/article/repeal-unrelated-business-income-tax-qualified-transportation-fringe-benefits.

128 *See* Wiedenbeck, *supra* note 89, at 278 (describing "notice of plan benefits" that must be distributed to employees prior to termination of a defined benefit pension plan).

and is a mechanism for providing individual feedback to those governments. However, when interjurisdictional mobility is paired with less than perfect tax systems—tax systems which allow taxpayers to break the temporal connection between the earning and taxing of income—bad things can happen. Individuals can exploit tax discontinuities to reduce—and reallocate--the tax burden imposed on income earned while a resident of another jurisdiction. That is, they can extract benefits from one jurisdiction while escaping some of the costs of providing those benefits. Instead of trading future tax reductions for future losses in government benefits, they may claim what amounts to tax reductions on past income earned while still receiving a high level of government benefits. Not only are such one-sided trades unfair to those left behind in the old jurisdiction, they may encourage otherwise inefficient cross-jurisdictional moves and distort state taxing structures.

Although the empirical work to date suggests that the fiscal effects of the current discontinuities are relatively minor,[129] there are sufficient high-profile examples of taxpayer moves to generate societal concern. President Trump's recent decision to change his legal residency from New York, a high-tax state, to Florida, a state with no state income tax,[130] is merely the latest and perhaps most newsworthy example of such behavior. News coverage of such legal tax dodging breeds cynicism, undermining societal trust. Nor is it clear that the current empirical work is the last word on the fiscal consequences of such mobility; a different design might lead to a different result. In addition, studies thus far have not looked at whether states have reconfigured their tax structures to minimize the costs of interstate mobility. The current studies' failure to answer the empirical questions raised in this Article does not mean that those questions cannot be answered. Future studies may have more success in isolating the magnitude of the behavioral incentives provided by current legal rules, as well as the effects of various proposals discussed in this Article.

The question raised by this Article is whether better tax rules could be developed which would allow beneficial interjurisdictional mobility without encouraging exploitative mobility. Is there a way to ensure that individuals cannot recharacterize income earned as an economic matter while still living in a high-tax state as income earned in a low-tax state? The Article makes clear that such a task is harder than it looks, and perhaps impossible. Tax rules that eliminate this tax discontinuity cannot be devised in a world in which

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129 *See supra* note 60 (empirical studies of the effect of tax rate differentials on interstate mobility).

130 *See* Maggie Haberman, *Trump Makes Florida Resort His New Home*, N.Y. Times, at A-1, A-18 (Nov. 1, 2019), https://nyti.ms/3lKcv1z ("a person close to the president said the reasons were primarily for tax purposes.")

valuation issues make universal mark-to-market taxation impossible, and states can maintain different tax bases and rates. Any change less comprehensive than universal mark-to-market taxation merely creates different inefficiencies and distortions. In the absence of empirical data, it is a matter of opinion as to whether familiar or unfamiliar distortions are preferable. Nor is the alternative of eliminating these discontinuities by forcing the states to "harmonize" their tax rates and tax bases any less problematic. Forcing harmonization would undercut states' ability to cater to the desires of heterogeneous populations, with different preferences regarding the scope and cost of government services, creating other inefficiencies. Sensible policies and tax reforms can and ought to take inefficiencies and discontinuities into account, and aim for the least objectionable combination of them, rather than struggle to achieve their complete elimination. No doubt that "least objectionable combination" will differ over time as economic and social conditions change, but that is what legislatures are for.