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Professor of Law, Temple University Beasley School of Law. I want to thank Karen Hawkins, Chair of the ABA Section on Taxation, for inviting me to participate in a panel discussion at the Council Lunch held during the Section's Winter Meeting on February 8, 2018, which led me to write this Essay. I am grateful to my colleagues Rick Greenstein, Andrea (Andy) Monroe, and Rachel Rebouche for careful reading and constructive comments on prior drafts. Thanks also to Marty McMahon, who taught me much that is in this Essay over the course of our various collaborations, and who shared a draft of a then-unfinished article that provided valuable background on the development of the dependency exemptions, standard deduction, and zero bracket amounts, as well as relevant citations, many of which I have used here. John Richey (Temple '18), once again provided exemplary research assistance. All errors, regrettably, are my own.

TAX 2018: REQUIEM FOR ABILITY TO PAY

Alice G. Abreu∗

Enactment of the TCJA was followed by a mad dash to understand its effects. The speed and process of enactment left no time for serious attempts to analyze whether the TCJA transforms the income tax system in any fundamental way. This Essay is a first step in that analysis. Although some of the most important changes I discuss are set to expire or phase out after 2025, understanding their policy implications is important, not only because they are the law now but also because Congress may extend them, perhaps indefinitely.

The TCJA has changed the way the tax system operationalizes the principles of horizontal equity and ability to pay, has brought the base of the regular tax closer to the base of the AMT, and has increased the number of tax provisions that have been promulgated in the form of standards, which will require the deployment of significant administrative and judicial resources before they can be implemented effectively. By removing consideration of taxpayers' support obligations from the tax base (except as relevant to the determination of filing status in the case of taxpayers who might qualify for the statuses of head of household or surviving spouse), the TCJA has jettisoned the value of ability to pay. It has unmoored the tax base zero bracket from the poverty level and created a system in which two taxpayers with very different ability to pay as a result of

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support obligations will be taxed the same, and in which two taxpayers with the same ability to pay will be taxed differently. The TCJA has turned the concept of horizontal equity on its head. In some cases the tax base will even be the taxpayer's gross income in its entirety, subjecting to taxation even the amount needed for minimal subsistence.

Under the TCJA the income tax will tax income from labor differently depending on the form in which the labor is performed. Labor income earned in the form of wages—by the performance of services as an employee—will be fully taxed at ordinary income rates. But some income earned by the performance of labor in any other way—as an independent contractor, for example—will be taxed at only 80 percent of the rate that would otherwise apply. Ability to pay is irrelevant.

Although the foregoing fundamental changes to the tax system were not clearly identified and debated by scholars and tax professionals prior to enactment, the idea of shifting to a territorial system was. The TCJA rejects the principle of capital export neutrality, thereby creating a dramatic difference in the tax burden placed on income as a result of its source: henceforth, much foreign source income received by some U.S. persons, in the U.S., will not be subject to U.S. income tax, ever. But the shift to territorial is incomplete. The TCJA distinguishes between the taxation of foreign and domestic source income only for some taxpayers. It lacks a comprehensive policy foundation either domestically, or internationally.

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I. INTRODUCTION

Just about everyone knows that the tax system changed at midnight on New Year's Eve, 2017, and much intellectual firepower has been deployed in the service of understanding the new provisions. Tax scholars and practitioners have already written what amounts to volumes both describing the new law (informally known as the Tax Cuts and Jobs Act, ("TCJA"))[1] and suggesting ways in which taxpayers will likely exploit its provisions.[2] But in the flurry of activity to understand the TCJA and its effects, almost no attention has been paid to analyzing whether the TCJA transforms the income tax system in any fundamental way.[3] This Essay is a first step in that analysis.

The TCJA transforms the income tax system in at least four fundamental ways, significantly undermining one of the bedrock principles of our tax system—horizontal equity[4]—and ignoring one of its most important animating principles—ability to pay. It does this in several ways. First, the TCJA eliminates consideration of a taxpayer's support obligations in determining the tax base, thereby creating a situation in which two taxpayers with wildly differing ability to pay will nevertheless face equal tax burdens. Second, the TCJA unmoors the zero bracket—the amount of income that will never be included in

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1. An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017). Although the legislation included the short title "Tax Cuts and Jobs Act," and is often referred to by that name, a practice which I will follow here, the name was stricken by the Senate Parliamentarian immediately prior to the Senate's passage of the final bill.

2. Reuven S. Avi-Yonah et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, SSRN (Dec. 22, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

3. A notable exception is the Griswold Lecture, delivered by Professor Marty McMahon to the American College of Tax Counsel on February 10, 2018. Martin J. McMahon, Jr., *2018 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Tax Policy Elegy*, 71 TAX L. 421, 430–35 (2018).

4. Horizontal equity is the concept that similarly situated taxpayers ought to be treated similarly and is one of the three fundamental tenets of U.S. tax policy. David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43 (2006). The other two bedrock principles are vertical equity and simplicity (or administrability). *See* Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006). Vertical equity is the concept that tax burdens should vary with ability to pay, or put another way, that dissimilarly situated taxpayers ought to be treated dissimilarly. R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45 (1967). Simplicity is the concept that the tax system should be simple enough to be understood by taxpayers and administered by the IRS. *See* Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1270–71 (1990).

the tax base—from the poverty level, which means that taxpayers with income significantly below the poverty level may nevertheless face positive tax liabilities.[5] Third, the TCJA creates a distinction between types of income from labor, reserving for employees the highest possible rate and making the rate dependent on the form in which personal services are rendered. Fourth, the TCJA rejects the principle of capital export neutrality, thereby creating a dramatic difference in the tax burden placed on income as a result of its source. Henceforth, much foreign source income received by some U.S. persons in the U.S. will not be subject to U.S. income tax, ever. And despite the importance of these four effects, only the last was widely anticipated (at least in part), and debated and analyzed by tax scholars and professionals prior to enactment.

In the six parts that follow I will discuss each of these changes (Parts II–V), make some additional general observations (Part VI), and conclude (Part VII). Although some of the most important changes I discuss are set to expire or phase out after 2025, understanding their policy implications is important, not only because they are the law now but also because Congress may extend them, perhaps indefinitely.[6]

II. ERADICATING SUPPORT OBLIGATIONS FROM THE TAX BASE

A. Eliminating the Deduction for Support

The TCJA almost doubles the standard deduction and completely eliminates the deductions for personal and dependency exemptions,[7] thereby changing the tax base from one in which taxpayers with like support obligations were treated alike, into its antithesis. Under the

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5. *See* JOINT COMM. ON TAX'N, JCX-3-17, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016–2020 4 (2017) [hereinafter JCT Tax Expenditure Estimates 2017].

6. *See, e.g.*, Tony Nitti, *Tax Reform Phase 2: Pending Reality or Political Posturing?*, FORBES (May 16, 2018), https://www.forbes.com/sites/anthonynitti/2018/05/16/tax-reform-phase-2-pending-reality-or-political-posturing/#144b88387e01; Jeff Stein, *Republicans Explain Why Their Tax Cuts Are Temporary, But Not Really Temporary*, WASH. POST (Nov. 30, 2017), https://www.washingtonpost.com/news/wonk/wp/2017/11/30/republicans-explain-why-their-tax-cuts-are-temporary-but-not-really-temporary/?noredirect=on&utm_term=.4500cc673285*; see also infra* note 46 and accompanying text.

7. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11021(a)(7)(A), 131 Stat. 2054, 2072 (2017); *id*. § 11041(a)(5)(A), 131 Stat. at 2082. Technically, it must be noted that the deduction for personal and dependence exemptions is not eliminated, as section 151 remains a part of the Code. Nevertheless, section 151(d)(5) provides that for the years 2018–2025, the exemption amount will be zero, thus eliminating the deduction in fact.

TCJA, taxpayers with very different non-discretionary legal obligations will have equivalent tax bases, thereby turning the principle of horizontal equity on its head. As a result, the TCJA changes the tax system from one which endeavored to calibrate the tax base to a taxpayer's ability to pay, into one which now provides close to a one-size-fits-all definition of the tax base.

This is especially salient when it comes to determining the amount of subsistence that should not bear any income tax burden at all. Although horizontal equity and ability to pay still underlie the determination of filing status and some of the itemized deductions that remain, the elimination of the personal and dependency exemptions means that only the vertical aspect of equity continues to exert significant influence on the design of the tax base.

Moreover, when the elimination of the deduction for alimony becomes effective in 2019,[8] the TCJA will have succeeded in eradicating support obligations from the determination of the tax base (except to the extent implicit in the determination of filing status).[9] The tax system will then determine the tax base of *dis*-similarly situated taxpayers similarly—precisely the opposite of what the principles of horizontal equity and ability to pay require.

Without a deduction for alimony or for personal and dependency exemptions, two single individuals who take the basic standard deduction can have identical tax bases even though they differ dramatically in their ability to pay. If, for example, those two individuals have $100,000 of wage income and no adjustments to income or qualified business income, their tax base will be the same even though one has an obligation to support a former spouse and one does not, and even if one has several children or other dependents to support, and the other does not.[10] The tax system did not achieve perfect horizontal equity before the TCJA, but in removing consideration of a taxpayer's obligations of support in the determination of the tax base (except as they affect filing status), the TCJA deals horizontal equity a near-fatal blow.

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8. *Id*. § 11051(a).

9. Support obligations are relevant to determining whether a taxpayer qualifies for the filing status of head of household and surviving spouse, because both statuses require that the taxpayer have a particular type of dependent. I.R.C. §§ 2(a)–(b) (2018).

10. This assumes that both individuals are the same age and are both either blind, or sighted. *See id*. § 63(c)(2).

The effect of removing consideration of support obligations from the tax base is especially dramatic for some nonresident aliens who are living and working legally in the U.S. but who will now be taxed on their gross income—full stop.[11] This will occur because nonresident aliens cannot take the standard deduction, even if they are subject to full U.S. taxation on their income effectively connected with the conduct of a trade or business in the U.S. at regular U.S. tax rates and have no other source of income.[12] Therefore, now that the deduction for personal and dependency exemptions has been eliminated, some nonresident aliens will have to pay U.S. tax at regular ordinary income rates on their U.S. gross income, with no regard whatsoever for their obligations to support themselves or any dependents. Indeed, because the TCJA also eliminated the deduction for unreimbursed employee business expenses as well as the deduction for expenses paid or incurred for the production of income,[13] nonresident aliens subject to U.S. tax on effectively connected income will not even be able to take into account unreimbursed costs of earning the income they are being taxed on, unless they are independent contractors.[14]

This might not seem troubling because most aliens who are physically present in the U.S for more than half of the taxable year will become U.S. residents for tax purposes regardless of their immigration status;[15] they will therefore be able to take the standard deduction if their tax liability is attributable to relatively substantial participation in the U.S. labor market. But this will not occur in cases where the nonresident individual is exempt from the physical presence

11. Thanks to Carol P. Tello, a tax partner in the Washington, D.C. office of Eversheds-Sutherland, for this insight.

12. I.R.C. § 63(c)(6) (2018) (denying the standard deduction to nonresident aliens); *id.* § 871(b)(1) (taxing nonresident aliens on their income effectively connected with the conduct of a trade or business in the U.S. at the rates provided in sections 1 and 55). Of course, providing services as an employee is a trade or business.

13. Both of those deductions are miscellaneous itemized deductions, defined in § 67(b); § 67(g), added by the TCJA, eliminates the deduction of miscellaneous itemized deductions for the years 2018–2025.

14. An independent contractor, not an employee, will be able to deduct the ordinary and necessary expenses of carrying on her trade or business above the line (that is, from adjusted gross income). *Id.* § 62(a)(1). As with the other TCJA changes to the individual provisions of the Code, the fact that they are scheduled to sunset in 2025 does not diminish their importance, not only because they have real impact on real taxpayers until then, but also because members of Congress have made no secret of their intention to make the changes permanent.

15. *Id.* § 7701(b)(1)(ii), (b)(3).

test for U.S. tax residency.[16] These exempt individuals are students, researchers, diplomats, and others who enjoy immigration statuses that cause them to be regarded as nonresident aliens for tax purposes even though they are legally living and working in the United States for substantial periods of time. Still, because they are classified as nonresidents they will now be taxed without any regard to ability to pay—no standard deduction and no personal or dependency exemptions.[17] For them, the repeal of the personal and dependency exemptions magnifies the extent to which the heretofore bedrock concept of ability to pay is no longer at the core of the U.S. income tax system.[18]

B. Effect of Eliminating the Inclusion of Alimony in the Recipient's Income

Moreover, by eliminating the deduction for alimony, the TCJA undermines horizontal equity in an additional way. Eliminating the deduction for alimony requires eliminating the correlative inclusion of alimony in the recipient's income, and the TCJA does just that.[19] But excluding alimony from income will produce a situation in which taxpayers with wildly disparate ability to pay, as measured by economic income, will appear to have equivalent ability to pay, as measured by taxable income. This will occur because the receipt of the alimony, which necessarily increases a taxpayer's ability to pay as measured by economic income, will be ignored in the determination of the tax base—alimony will not be treated as income. Therefore, an individual who receives $40,000 of alimony *in addition* to $40,000 of wages will look to the tax system precisely like one who receives *only*

16. *Id.* § 7701(b)(3)(B) (individual is present in the U.S. for less than half of the year and has closer connection to another country); *id*. § 7701(b)(5) (exempt individuals).

17. This will not occur in cases where the individual is entitled to the benefits of an income tax treaty that exempts him or her income from U.S. taxation. *See, e.g.*, UNITED STATES MODEL INCOME TAX CONVENTION, ARTICLES 19 AND 20 (2006).

18. This is particularly ironic because the exemption of certain individuals from the operation of the provisions that would make them U.S. residents based on physical presence alone otherwise has the salutary effect of protecting them from the worldwide reach of U.S. taxation of residents. *Compare* I.R.C. § 61 (2018), *with id.* § 871. The repeal of the dependency exemption turns the pro-taxpayer effect of the residency exemption provisions on its head.

19. The TCJA does just that by repealing section 71, which provides that alimony will be included in the recipient's income unless the taxpayer provides otherwise. *Id.* § 71(b)(1)(B); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11051(b)(1), 131 Stat. 2054, 2089 (2017). Without section 71 alimony will be treated as support, which has never been regarded as gross income; even if that proposition were debatable, non-inclusion is the only conclusion that can follow from the deliberate repeal of section 71.

$40,000 of wages, even though the first individual has $80,000 of economic income and therefore has twice as much ability to pay as the first.

Conversely, two individuals with the same economic income and hence the same ability to pay will be treated for tax purposes as if they had wildly differing ability to pay. For example, an individual who receives $40,000 of alimony arguably has the same ability to pay as one who receives $40,000 of wages. Yet, the two individuals will be treated very differently by the income tax system. The first individual—the alimony recipient—will be seen by the tax system as having zero income, and hence zero ability to pay. The second individual—the wage earner—will be seen by the tax system as having $40,000 of ability to pay, even though based on economic income she has the same ability to pay as the alimony recipient.

The picture worsens if employment taxes (principally social security and medicare) are considered. The wages will be reduced by the employment taxes, so that the $40,000 wage earner will have less ability to pay than the alimony recipient, who receives $40,000 of alimony without deduction for employment taxes. That well-advised divorcing couples will be able to factor tax effects into amounts actually paid does not alter the normative import of the change.[20]

C. Availability of Credits Does Not Erase the Normative Import of the Change

Moreover, that credits take into account family size and other obligations in determining the amount of tax actually paid does not alter the fact that the TCJA has changed the determinants of a key component of the fundamental structure of the tax system: the tax base. First, the two large refundable credits that take into account family size—the Earned Income Tax Credit ("EITC") and the Child Tax Credit ("CTC")—are available only with respect to qualifying children, not other dependents, with two relatively small exceptions.[21]

20. For additional illustrations of the effect of this change, see Neil Buchanan, *The Ability to Pay Principle and the Counterintuitive Distributive Justice Analysis of Alimony Payments,* JOTWELL (July 2, 2018), https://tax.jotwell.com/the-ability-to-pay-principle-and-the-counter intuitive-distributive-justice-analysis-of-alimony-payments/ (reviewing a draft of this Article).

21. The first exception is that the CTC now provides a $500 credit for dependents who are not qualifying children. I.R.C § 24(h)(4) (2018). That is only 25% of the $2,000 credit allowed for qualifying children, up to $1,400 of which is refundable; the $500 dependent credit is not refundable. I.R.C § 24(h)(5)(A) (2018). The second exception is that a very small EITC ($519 in 2018) is available to single individuals without children; single individuals with up to three children

In addition, qualifying children that allow taxpayers to claim the CTC must be under 17 regardless of their status as students, unlike dependents. Moreover, neither the EITC nor the CTC take into account obligations to support dependent non-children, including individuals who are members of the taxpayer's household even though they are not lineal descendants and in other cases are not members of the taxpayer's physical household at all but are nevertheless dependents.[22] The latter would include support obligations to former spouses and relatives whom the taxpayer supports even though they do not live with the taxpayer, such as elderly parents. Finally, the ETIC is available only to taxpayers who have earned income that does not exceed certain thresholds, which range from $15,010 for a single individual with no qualifying children to $53,930 for a married couple with three children.[23] In addition, neither credit is available to individuals with income above the phaseout amounts, or to those who are U.S. residents for tax purposes but who lack social security numbers.[24]

Perhaps more importantly from a normative standpoint, even if refundable credits could compensate completely for the elimination of support obligations as determinants of the tax base (except with respect to filing status), that elimination will have effected a fundamental change in the structure of the tax system. Personal and dependency exemptions were such an integral part of the determination of the tax base that the Joint Committee on Taxation did not score them as tax expenditures.[25] As the Joint Committee has explained,

> Under the Joint Committee staff methodology, the normal structure of the individual income tax includes the following

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may receive an EITC of $6,431 in 2018, however. I.R.C § 32 (2018); *see* https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year.

22. I.R.C. §§ 152(b)(3)(A) (contiguous country exception), 152(d)(2)(h) (qualifying relative) (2018).

23. *2017 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, IRS (Jan. 23, 2018), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts.

24. I.R.C. § 32 (2018).

25. JCT Tax Expenditure Estimates 2017, *supra* note 5, at 3. Indeed, the JCT classifies the phase-out of personal and dependency exemptions under the regular tax and their complete disallowance under the AMT as negative tax expenditures. *Id.* at 39. That follows logically from the definition of tax expenditures: the phase-out and disallowance raise revenue that the normal tax would not.

> major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax benefits for individual taxpayers are classified as exceptions to normal income tax law.[26]

By contrast, most credits, especially refundable credits like the EITC and the CTC, which take family size into account in determining final tax liability, are tax expenditures. But tax expenditures are not considered part of "the normal structure of the individual income tax."[27] On the contrary, tax expenditures are generally regarded by scholars as interlopers—blots upon the "normal structure" of the tax system.[28]

Eliminating the deductions for personal and dependency exemptions therefore represents a change to the "normal structure of the individual income tax."[29] Even if the effect of that change is ameliorated by the operation of a tax expenditure, the change remains important. A shift in the values that inhere in the tax system occurs when the tax base—the normal tax system—changes, even if the ultimate effect of that change is ameliorated by tax expenditures that

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26. *Id.* The JCT's description of its methodology suggests that the features it identifies, including the personal and dependency exemptions, are conceptually inseparable from the very idea of an income tax and that, therefore, an income tax lacking these features would be, if not abnormal, then at least something other than the income tax as we have known it.

27. *Id.* at 3, 39.

28. *See, e.g.*, Edward D. Kleinbard, Lecture, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 1–3 (2010); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 188–89 (2004). Although my colleague, Rick Greenstein, and I have argued in recently published work that this characterization of tax expenditures as something other than a proper part of the normal tax structure is misguided, that is not the general view now, and tax expenditures continue to play a role in the way tax provisions are conceptualized. *See* Alice G. Abreu and Richard K. Greenstein, *Rebranding Tax / Increasing Diversity*, 96 DENVER L. REV. 1 (2018). Unless and until Congress repeals the 1974 Budget Act which requires the promulgation of a Tax Expenditure Budget, the concept of tax expenditures and its bifurcation of tax provisions into "normal" and "other" will likely remain at the heart of mainstream tax analysis. I therefore treat it as such here.

29. JCT Tax Expenditure Estimates 2017, *supra* note 5, at 3. The phaseout of the personal and dependency exemptions produced by section 151(d)(3) did not cause the kind of fundamental shift I am discussing here. Even though it could result in the complete elimination of any deduction for personal and dependency exemptions, the provision had no effect until a taxpayer's AGI reached a certain amount, $100,000, adjusted for inflation provided in section 68. That phaseout, like the phaseout of some itemized deductions under section 68 itself, was intended to raise the tax rate of high-income individuals, without changing the section 1 rates themselves. It was part of the erstwhile progressivity-through-the-back-door that made the Tax Reform Act of 1986 possible. *See* Michael J. Graetz, *Tax Reform Unraveling*, 21 J. ECON. PERSP. 69, 69 (2007).

reduce the final tax liability of some taxpayers. Moreover, no tax expenditure ameliorates the change to the normal structure of the tax system wrought by the elimination of the deduction for alimony—spousal support—which is also not classified as a tax expenditure.[30]

Hence, even if the EITC and CTC had been expanded to compensate fully for the elimination of the personal and dependency exemptions—and they have not been—and even if they were available to all taxpayers—which they are not[31]—and even if the TCJA had introduced a credit for alimony paid—which it did not—the dramatic change to the "normal structure of the tax system" would endure. That tax expenditures might ameliorate the effect of the fundamental change in the normal structure of the tax system cannot eradicate the importance of the change. The change downgrades important values that have animated the tax system almost from its inception so that they are no longer a proper part of the tax party—they have become party crashers, if they are present at all.[32]

The values reflected by a tax system that takes support obligations into account in determining one of its most fundamental components—the tax base—are substantially different from those of a system that does not value the importance of support obligation enough to take it into account in the determination of the tax base. Accounting for support obligations in determining the tax base operationalizes the value of horizontal equity, which goes to the heart of the fairness, and hence the legitimacy, of the tax system. By disregarding such obligations and leaving a taxpayer who has three

30. *See* JCT Tax Expenditure Estimates 2017, *supra* note 5, at 3, which does not treat I.R.C. § 215, which provided a deduction for alimony, as a tax expenditure.

31. *See supra* Part II.C. Moreover, provisions like the EITC and CTC cannot account for support obligations in the way that dependency exemptions did because they are specifically designed to apply only to a segment of the taxpaying population. By design, the EITC and the CTC apply only to taxpayers who fall within a defined income range and who possess certain other characteristics. For example, both phase in and phase out, and neither applies to all individuals who bear full U.S. tax liability because they are U.S. residents for tax purposes. The EITC does not apply to individuals who do not have social security numbers and file using an ITIN, I.R.C. § 32(m), or to married taxpayers who must file separately, I.R.C. § 32(d); as of 2018, the CTC does not apply with respect to any child who has an ITIN, I.R.C. § 24(h)(7), and only applies with respect to children under 17, I.R.C. § 24(c)(1). Moreover, the additional $500 nonrefundable credit provided by section 34(h) in lieu of the CTC makes up for the loss of a deduction of a dependency exemption of $4,000. *See supra* note 21 and accompanying text.

32. The 1913 income tax, the first constitutional income tax, provided personal exemptions. Act of Oct. 3, 1913, ch. 16, § 2(C), 38 Stat. 114. Dependency exemptions have been allowed since 1917. Act of Oct. 3, 1917, ch. 63, § 1203(1), 40 Stat. 300, 331. The standard deduction was added in 1944. Individual Income Tax Act of 1944, ch. 210, §§ 5, 10(a), 58 Stat. 231.

children with a tax base that is the same as that of a taxpayer with no children at all, the tax system is devaluing the obligation of support and undermining the fairness, and hence the legitimacy, of the tax system. That in a given year for a given type of taxpayer tax expenditures may alleviate the sting of a horizontally inequitable tax base is irrelevant as a normative matter, at least as long as tax expenditures are not viewed as part of the "normal" structure of the tax system.[33] With the TCJA the "normal" structure of the tax system has been transformed from one in which the determination of the tax base was calibrated to the circumstances of the taxpayer, into one in which one type is supposed to fit, if not all, then at least many.

III. UNMOORING THE ZERO BRACKET FROM THE POVERTY LEVEL

Despite nearly doubling the standard deduction, the TCJA changes the normal structure of the tax system in another important way: it significantly reduces the zero bracket that ensured that taxpayers with a limited amount of income—aspirationally amounting to bare subsistence no higher than the poverty level—would bear no income tax liability on the receipt of that income.[34] As the Joint

33. Contemporary tax analysis distinguishes between tax expenditures—provisions aimed at promoting social policies for purposes other than raising revenue—and provisions which are directed at "the fundamental purposes of the tax law: accurately measuring income and collecting revenue." Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 4 (2011). In other work, my colleague, Rick Greenstein, and I have suggested a way in which the conceptual bifurcation of the tax law which follows from the concept of tax expenditures may contribute to the relative lack of diversity in the tax bar. *See* Alice G. Abreu & Richard K. Greenstein, *Rebranding Tax / Increasing Diversity,* 96 DENVER. L. REV. 1 (2018). The concept of tax expenditures may do that because it treats provisions that overtly implicate social values as unwelcome interlopers into a tax system that would otherwise be a pristine revenue raising machine. *Id.* at 4. We argue against such a conceptual bifurcation and show that all Code provisions implicate social values. However, unless and until our more holistic view of the tax system becomes more widely disseminated and eventually accepted, analysis has to proceed on the current view of the tax system, and that view treats tax expenditures as extraneous to the tax system.

34. Congress first sought to designate an amount of income representing subsistence that would never be subject to tax in 1964 with the introduction of a "minimum standard deduction." H.R. REP. NO. 749, at 148 (1963), *reprinted in* 1964-1 C.B. pt. 2 125, 148–49; S. REP. NO. 88-830, at 29–30 (1964), *reprinted in* 1964-1 C.B. pt. 2 505, 533–34. In 1969, Congress replaced that minimum standard deduction with a "low income allowance" that was pegged to the poverty level and intended to ensure that income below that level remained tax free. Tax Reform Act of 1969, Pub. L. No. 91-552, § 802, 83 Stat. 487, 675–76; H.R. REP. NO. 99-413, pt. 1 (1969); S. REP. NO. 91-552, at 257–260 (1969), *reprinted in* 1969-3 C.B. 423, 586–87. In 1976, Congress changed the functional zero bracket created by the low-income allowance into an actual zero bracket, which lasted until 1986, when it was replaced by the standard deduction. *See* Tax Reform Act of 1986, Pub. L. 99-841, 100 Stat. 682; H.R. REP. NO. 99-841, pt. 2 at 5–7; JOINT COMM. ON TAX'N, JCS-10-87, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 15 (1987). Since 1986, a *de-facto* zero bracket is the result of the standard deduction and personal exemptions; the sum of those

Committee has explained, its staff viewed "the personal exemptions and the standard deduction as defining the zero-rate bracket that is a part of normal tax law."[35] But the TCJA changes the size of that zero bracket not only dramatically but in a way that produces the antithesis of horizontal equity and ignores a taxpayer's ability to pay. For example, a single individual with no children, who would have had a zero bracket of $10,400 in 2017,[36] and would have had a zero bracket of $10,650 in 2018 without the TCJA,[37] will have a zero bracket of $12,000 in 2018. That is obviously an increase and brings the zero bracket closer to the poverty level ($12,060 for 2017),[38] and that is good.[39]

However, if that individual did not qualify for head of household filing status despite having two dependents, in 2018 her zero bracket amount would remain at $12,000.[40] That individual would be treated just like one who had no dependents even though her support of the two dependents puts her in an economic position that is substantially different. Without the TCJA her 2018 zero bracket amount would have been $18,950,[41] but with the TCJA it is only $12,000. Her tax base has increased significantly even though her ability to pay, as measured by her obligations of support, has not. Her zero tax base of $12,000 is

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two amounts create a *de-facto* zero bracket because all individual taxpayers are entitled to them, which ensures that an amount of gross income equal to the sum of the standard deduction and personal and dependency exemptions will never be included in the tax base.

35. JCT Tax Expenditure Report, *supra* note 5, at 4.

36. This zero bracket is the sum of the standard deduction of $6,350 plus a personal exemption of $4,050. Rev. Proc. 2016-55, 2016-2 C.B. 707.

37. This zero bracket is the sum of the standard deduction of $6,500 (which is the amount that would have applied in 2018), plus the personal/dependency exemptions of $4,150 that would have applied in 2018 ($12,450). Rev. Proc. 2017-58, 2017-40 I.R.B. 489.

38. U.S. CENTERS FOR MEDICARE & MEDICAID SERVICES, FEDERAL POVERTY LEVEL (2017), https://www.healthcare.gov/glossary/federal-poverty-level-FPL/.

39. That the result—greater congruency between the zero bracket amount and the poverty level—is good, is separate from the question of whether the particular measure of the poverty level is a good one. Whether this measure of the poverty level adequately reflects subsistence is an important question but further analysis of it is beyond the scope of this Essay. For a thoughtful analysis *see, e.g.*, Francine J. Lipman, *(Anti)Poverty Measures Exposed*, 21 FLA. TAX REV. 389, 399 (2017).

40. That could occur because not all dependents qualify an individual for head of household filing status. For example, a brother or sister of the taxpayer could be a dependent if they are disabled and the taxpayer pays more than half of their support, but if they do not live in the taxpayer's household for more than half of the taxable year, they will not enable the taxpayer to claim head of household status. I.R.C. § 2 (b)(1).

41. That is the sum of the $6,500 standard deduction plus three personal exemptions of $4,150 as provided by Rev. Proc. 2017-58, 2017-40 I.R.B. 489.

now also significantly below the poverty level for a household of three people: $20,420.[42]

The more dependents the taxpayer has the more pronounced the disjunction between the zero bracket and the poverty level. And that is no accident. It happens because the poverty level increases as household size increases. The poverty level goes up by just over $4,000 for each additional member of the household, which is almost precisely the inflation-adjusted amount of the pre-2018 personal and dependency exemptions ($4,050 for 2017). But after 2017, the tax base does not go up at all unless the other member of the household is the taxpayer's spouse (increased standard deduction), or a dependent who qualifies the taxpayer for head of household filing status (increased, though not double, standard deduction and immutable despite the number of qualifying dependents) or qualifying widow(er) status (double standard deduction).[43] Although the poverty level will continue to rise with household size, the amount the tax system regards as bare subsistence that should not be subject to tax will remain unchanged after the TCJA. Therefore the gulf between what the tax system regards as subsistence and what is actually required for subsistence, as measured by the poverty level, will widen.

The effects are similar for married couples: the zero bracket was $20,080 for a couple with no dependents in 2017 but it is $24,000 in 2018. That is a meaningful increase. It raises the zero bracket from the $21,300 it would have been in 2018 without the TCJA and brings it significantly above the poverty level of $16,240 for 2017. But for a couple with two dependents the picture is starkly different. That couple would have had a zero bracket of $29,600 in 2018 without the TCJA,[44] but they will now have a zero bracket of only $24,000 in 2018—and $5,600 of their income that would not have been subject to any income tax in 2017 will be subject to tax in 2018.[45] Although

42. *See supra* note 38.

43. *See* I.R.C. § 63(c)(2) (2018).

44. This is the sum of the standard deduction of $13,000, which is the 2018 amount under Rev. Proc. 2017-58, 2017-40 I.R.B. 489, plus four personal/dependency exemptions of $4,150 each, which means that the total deduction attributable to personal/dependency exemptions in 2018 would have been $16,600.

45. The $5,600 is the difference between what would have been the zero bracket amount without the TCJA ($29,600) and what is the zero bracket amount in light of the TCJA ($24,000). Whether such couple will receive any relief from the EITC or CTC is far from clear. The CTC does not apply if the dependents are children over 16, I.R.C. § 24(c)(1), and neither it nor the EITC apply if the dependents do not fit the definition of "qualifying child," I.R.C. §§ 24(c)(1), 32(c)(1),

that couple's zero bracket is only a little less than the poverty level of $24,600, if they have another child their zero bracket will remain the same even though the poverty level for their family would now rise to $28,780, and the obligation to support the third child will have significantly reduced their ability to pay.[46]

In setting the zero bracket the tax system makes an important normative determination of how much income a taxpayer should be able to receive before having positive tax liability. It is saying something about subsistence. By ignoring family size except as it affects filing status, the tax system is ignoring the impact of family size on subsistence, and hence on ability to pay. As with the determination of the tax base discussed above, that tax expenditures may ameliorate this effect does not detract from the conclusion that the TCJA has made a profound change in the extent to which the normal tax system values the principles of horizontal equity and ability to pay.

Whether that difference is positive or negative is an important question, but I do not intend to engage with it here. My purpose is much more limited. I simply want to point out that the TCJA has made a fundamental change in the determination of the tax base—one that reflects a fundamental change in the values the income tax system is founded on. That fundamental change was neither specifically identified nor discussed or debated publicly as the legislation made its quick trip through Congress and on to the President's desk. Of course, reasonable people can certainly differ on the question whether the simplicity and administrability gains that follow from eliminating the personal and dependency exemptions and the deduction for alimony are worth the horizontal equity costs of measuring the tax base without reference to those support obligations. But my point is that this

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whereas the dependency exemption was available with respect to dependents who were not qualifying children, I.R.C. § 152(a)). Moreover, the CTC is not available if the child does not have a social security number, I.R.C. § 24(h)(7), and the EITC is not available if anyone listed on the return does not have a social security number, I.R.C. § 32(m). As stated earlier, it is unlikely that the $500 CTC available for non-qualifying children dependents would put such taxpayers in the same position they would have been in had the TCJA not been enacted. *See supra* note 31. And even if it did, and reduced the amount of tax the taxpayers would pay, it would not change their zero bracket amount and the policy implications of having produced a tax system does not consider support obligations in the determination of the normative tax base.

46. U.S. CENTERS FOR MEDICARE & MEDICAID SERVICES, FEDERAL POVERTY LEVEL (2017), https://www.healthcare.gov/glossary/federal-poverty-level-FPL/. The poverty level numbers used are 2017 numbers because no such numbers existed for 2018 when this Essay was written.

specific tradeoff was neither identified nor debated before the TCJA became law. And that is unfortunate.

The fact that these fundamental changes are temporary, because they disappear when the provisions that effectuate them sunset after 2025,[47] does not alter this conclusion. The sunset resulted from a desire to avoid the constraints imposed by the Senate's "Byrd Rule," which limited the amount of revenue the legislation could lose overall,[48] not from any suggestion that policy changes reflected by the legislation should not be made a permanent part of the Code. On the contrary, members of Congress expressed the expectation that future Congresses would enact legislation to remove the sunset,[49] which only increases the importance of debating the policy choices that the changes reflect.

The policy choices made in the TCJA implicate fundamental principles of tax policy. For example, the elimination of the role of support in the measure of the tax base (other than in the determination of filing status), might be analyzed and justified as the price of simplifying the tax law by removing a taxpayer's need to determine which individuals qualify as her dependents. But not only does that assume that simplification gains justify equity losses, it also elides the question of how extensive any simplification gains really are. And if the role of refundable credits is to be taken into account in determining the equity tradeoff on the ground that credits restore the support concerns previously operationalized by deductions, then the simplicity costs of administering those credits have to be taken into account as well.

Accounting for the role of refundable credits in restoring support obligations as an important determinant of the tax base changes the equity/simplicity trade-off. Even if credits could completely make up

47. I.R.C. § 63(c)(7) (2018).

48. *See* Jonathan Curry, *Senate Republicans Contort Tax Bill to Fit Byrd Rule Box*, TAX NOTES (Nov. 16, 2017), https://www.taxnotes.com/editors-pick/senate-republicans-contort-tax-bill-fit-byrd-rule-box; *see also* Danielle Kurtzleben & Scott Neuman, *Senate Approves Landmark Tax Overhaul, Bill Returns to House*, NPR (Dec. 19, 2017), https://www.npr.org/2017/12/19/571982251/republicans-set-to-pass-tax-overhaul-as-early-as-tuesday-night. The Byrd Rule prohibits reconciliation legislation, legislation which can be passed with a simple majority, from increasing deficits beyond the 10-year budget window. By having certain revenue-losing provisions in the bill sunset before the end of that 10-year period, drafters were able to comply with the rule.

49. *See* Kurtzleben & Neuman, *supra* note 48. House Speaker Paul Ryan stated, "We have every intent of making those permanent—because of the Senate rules, you know why that sunset is there." *Id.*

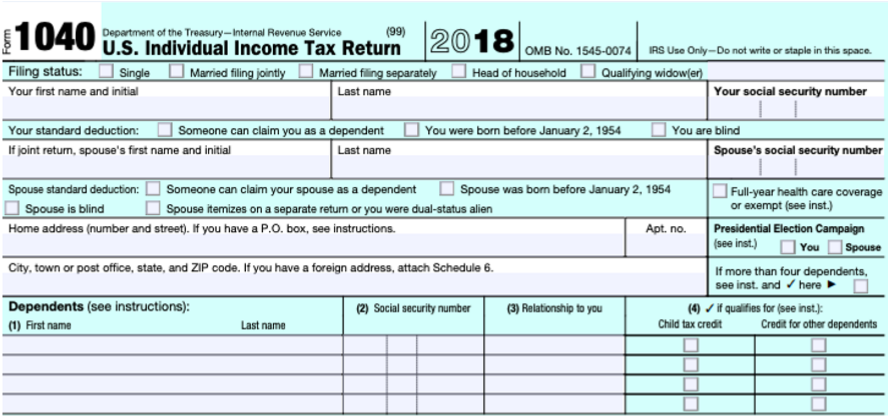
for the lost dependency deductions (and in a substantial number of cases, e.g., non-children, they cannot), the complexity inherent in the operation of the credits makes nearly irrelevant any simplicity gains from the elimination of the deductions. The reason is that determining eligibility for the most fiscally significant portion of both the EITC and the CTC requires that the taxpayer determine if she has a "qualifying child."[50] But to do that, the taxpayer has to make *precisely the same determination* she would have had to make to determine whether she could take a dependency exemption for that child. The Code defines a dependent as a qualifying child or a qualifying relative, and having a qualifying child is what makes a taxpayer eligible for the fiscally significant portions of the EITC and CTC.[51] This means that removing the dependency exemption produces exactly zero simplicity gains. The only simplicity gain that actually follows from eliminating the dependency exemption while retaining the EITC (for individuals with children) and the large and refundable portions of the CTC, is that determination of dependency status for "qualifying relatives" is no longer necessary.[52] Although eliminating the deduction for alimony does offer simplicity gains, no credit allows the taxpayer to account for that support obligation in determining tax liability. Indeed, the new and supposedly much simpler (and shorter) Form 1040 (depicted below) allocates what seems to be the same amount of space for entering information about dependents as the old Form 1040.[53]

50. *See supra* note 48. By 'fiscally significant' I mean the portion of the EITC that is large, and the portion of the CTC that is both large and refundable. Although the EITC is available to single individuals with no qualifying children, its amount in such cases is dramatically smaller than the amount that would go to the same individual if she had a qualifying child. For 2018, the difference is $2,942 (that is the difference between $519, the maximum credit amount for a single individual, and $3,461, the maximum credit amount for an individual with one qualifying child. *2018 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, IRS, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year. In the case of the CTC, the maximum amount available for a non-child is $500, and it is not refundable. I.R.C. § 24(h)(2), (4)(A).

51. I.R.C. § 152(a).

52. I.R.C. § 152(d)(1). Making the determination of who is a qualifying relative can be mind-numbingly complex. Even a quick perusal of section 152(d) reveals why.

53. *Form 1040*, https://www.irs.gov/pub/irs-pdf/f1040.pdf.



Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2018** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial | Last name | **Your social security number**

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial | Last name | **Spouse's social security number**

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 | ☐ Full-year health care coverage or exempt (see inst.)

☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | **Presidential Election Campaign** (see inst.) ☐ **You** ☐ **Spouse**

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. | If more than four dependents, see inst. and ✓ here ► ☐

Dependents (see instructions): (1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

In more general terms, many of the simplification gains exist on the surface only. Analysis of the statutory language of the TCJA reveals that the architecture of the Code on the question of who is a dependent remains unchanged; the need to determine who is a dependent has not been eliminated at all. The determination of whether one individual is the dependent of another is pivotal not only for the determination of filing status (both the head of household and surviving spouse statuses require that the taxpayer have a particular kind of dependent),[54] but also for determining eligibility for the EITC and CTC, as discussed above.[55] Hence, even if the provisions eliminating the deduction for dependency exemptions did not sunset, the complex web of rules that determine whether an individual is a dependent would need to remain.[56] Although there are some simplicity gains from not having to take the exemptions, precisely how large the simplicity gains are is not at all clear. Moreover, even if the simplicity gains were substantial, no pointed debate over the merits of sacrificing equity on the altar of simplicity took place. And that should distress anyone who cares about tax policy. What the TCJA does to the taxation of income from labor, discussed below, should as well.

IV. CREATING TWO TYPES OF INCOME FROM LABOR

The TCJA creates a new category of income that distinguishes between types of income from labor. Before the TCJA, the tax system

54. I.R.C. § 2(a)–(b) (2018).
55. *See supra* text accompanying notes 50–52.
56. This would be true even if the changes to the amount of the exemption had been made permanent.

distinguished between income from capital and income from labor, taxing much of the income from capital at a preferential rate.[57] But the same rates of tax applied to all income from labor.[58] Indeed, much of the kerfuffle over the tax treatment of carried interests can be seen as proceeding from the conviction that such amounts represented

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57. Generally, the maximum rate on long-term capital gains is 20%. *See* I.R.C. § 1(h)(1) (2018). Although the net investment income tax imposed by section 1411 increases the rate of tax on some investment income by 3.8%, that increase does not apply to all investment income. It only applies to investment income above a certain threshold amount ($250,000) and is therefore more appropriately characterized as a mechanism to increase the progressivity of the tax system rather than as a structural feature of the taxation of income from capital. Through the capital gains preference, the tax system distinguishes between the taxation of income from labor and a large swath of income from capital. It leaves only interest, rents, annuities, some royalties, and non-qualified dividends as the categories of income from capital that are not taxed at a preferential rate. Admittedly, those categories of income are subject to possibly higher marginal rates than income from labor because they produce ordinary income that could also be subject to the section 1411 tax. When that occurs, that income from capital could be taxed at a higher rate than income from labor if one considers only the income tax. Adding the employment taxes changes that picture considerably. It is unclear whether by making carried interest short-term capital gain for three years the TCJA will also result in converting that income into investment income for purposes of the section 1411 tax. Moreover, the social security and self-employment taxes, which are substantial, only apply to income from labor. I.R.C. §§ 3101, 1401.

58. Before the TCJA the Code distinguished between types of labor income, but it did so in more attenuated ways. First, the Code distinguished between employees and independent contractors by allowing the latter to deduct ordinary and necessary business expenses from gross income in arriving at adjusted gross income, I.R.C. § 62(a)1)—making those expenses so-called above-the-line deductions—while relegating unreimbursed employee business expenses to the worst possible status, short of non-deductibility. Unreimbursed employee business expenses were not only itemized deductions (not useful to anyone who took the standard deduction, I.R.C. § 63(b), (d)), but they were miscellaneous itemized deductions, which were only deductible to the extent that they exceeded 2% of the taxpayer's adjusted gross income, I.R.C. §67, and were not deductible at all for any taxpayer subject to the alternative minimum tax ("AMT"), I.R.C. §§ 55, 56(b)(1)(A)(i). Hence, whereas independent contractors could always use their ordinary and necessary business expenses in determining their tax base, employees in many cases could not, and even if they could, they would not be able to deduct all of them because of the section 67 two percent floor.

Although that was an important difference, which provided a clear preference for independent contractors over employees, the distinction could be justified on at least two policy grounds. First, the restrictions applicable to the deductibility of unreimbursed employee business expenses improved the administrability of the tax system by relieving many employees of the need to keep records of their unreimbursed employee business expenses. For example, employees who knew they were subject to the AMT didn't need to bother keeping track of their unreimbursed employee business expenses because they knew they were not going to be able to deduct them anyway. Nondeductibility also enhanced administrability on the government's side because the IRS would not need to audit the propriety of a deduction which could not be taken.

Second, the distinction could also be justified by the fact that it neutralized, at least on a system wide basis, to some extent the advantage provided to employees as a result of the many fringe benefits that the Code excludes from gross income. *See, e.g.*, I.R.C. §§ 106, 119, 132. Those same benefits, if provided to an independent contractor, would be income to them. And only employees can benefit from employer-provided retirement plans, which do not result in current income to them. *See, e.g.*, I.R.C. § 401.

compensation for labor, not capital, and were being taxed inappropriately when the application of subchapter K allowed them to be taxed as income from capital. To the extent that the TCJA will cause more of that income to be taxed at the same rate as income from labor (by treating it as short-term capital gain, and hence taxable at ordinary income rates for the first three years),[59] the TCJA removes that disparate treatment. The problem is that by adding a deduction of 20 percent of a taxpayer's "Qualified Business Income" (section 199A), the TCJA introduces a more pervasive distinction.

The deduction provided by section 199A (the "QBI deduction") distinguishes between income from labor that is paid in the form of wages and income from labor that is paid in any other form—because the business of being an employee can never constitute a "qualified trade or business," wages, the income from that business, can never be QBI.[60] And because the business of performing services as an employee can never produce QBI, employees will never be entitled to the QBI deduction.

By stark contrast, many individuals who are independent contractors and other unincorporated service providers will be entitled to the QBI deduction. Therefore, section 199A creates a difference in the maximum rate of tax that will apply to labor income received by employees and non-employee service providers (independent contractors, sole proprietors, and members of any other entity that has not elected to be treated as a corporation for income tax purposes).[61] While wages remain subject to tax as ordinary income in full, section 199A reduces the maximum rate of tax on QBI from 37% to 29.6% (20% of 37%). And although section 199A contains "guardrails" designed to prevent application of the deduction to some types of personal service income which is often received in the form of wages, it is far from clear how effective those guardrails will be.[62]

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59. I.R.C. § 1061 (2018).

60. I.R.C. § 199A(d) (2018).

61. Treas. Reg. § 301.7701-3 (2006).

62. One such guardrail is section 199A(c)(4)(A), which excludes from the definition of QBI "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." *See* Shu-Yi Oei & Diane Ring, *Is New Code Section 199A Really Going to Turn Us All into Independent Contractors?*, SSRN (Jan. 12, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101180. Section 199A excludes from the definition of "qualified business" certain "specified businesses" which are then defined as "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or

Distinguishing between wages and other forms of compensation for personal services in such a salient way dramatically changes the values that the tax system reflects. It magnifies the ways in which wage income is disfavored because it categorically excludes employees from its benefits, no matter what.[63] The values proclaimed by an income tax system that assigns to employees some of the highest effective rates of income tax possible are fundamentally different from those proclaimed by an income tax system that treats all—or even most—compensation for personal services alike.[64]

Although section 199A is not the first income tax provision that disfavors employees,[65] it does so in a particularly salient way.[66] It reduces the effective rate of tax on a particular type of compensation for services rendered and therefore represents a frontal attack on the principles of horizontal equity and ability to pay. And unlike some of the other ways in which the income tax disfavors employee compensation, section 199A cannot be justified on the ground of

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any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees . . . ." I.R.C. §§ 199A(d), 1202(e)(3)(A) (2018). The reason may be that the identified fields are ones in which many individuals perform services as employees; the dramatic difference in treatment afforded by section 199A based on worker classification may have been thought unwarranted in those circumstances. Nevertheless, at certain relatively low income levels, the difference will exist. *See* I.R.C. § 199A(d)(3) (2018).

63. *See* I.R.C. § 67 (2018). Although wage income was disfavored under prior law because of the limited deductibility of unreimbursed employee business expenses under the regular tax, which became full non-deductibility for taxpayers who paid the AMT, the TCJA exacerbates the disfavored status of wages. Under prior law, only employees who had unreimbursed business expenses felt the effect of the disfavored status of wage income. But because the TCJA makes miscellaneous itemized deductions not deductible in all cases (until 2025), it magnifies the disfavor in which the tax system seems to hold wage income for those who itemize while also extending that disfavor to those who don't by denying them the QBI deduction. The TCJA now disfavors all wage income, for all taxpayers.

64. The only income that might be taxed more heavily than wages *under the income tax*, at least in some cases, is income from interest, royalties, and non-qualified dividends (not subject to tax as net capital gain under section 1(h)(11). Such income is ordinary income and could be subject to the net investment income tax provided under section 1411 if, together with other net investment income, it exceeds the threshold amount in section 1411. In that case, such income would be subject to the additional tax of 3.8% provided by that section bringing the marginal rate to 40.8%—obviously higher than the maximum rate of 37% which applies to ordinary income. I.R.C. §§ 1, 1411(a)(1).

65. As discussed more fully in note 58, *supra*, by relegating unreimbursed employee business expenses to the category not only of itemized deductions but also of miscellaneous itemized deductions subject to the 2% floor of section 67 and non-deductible under the AMT, the tax system quite explicitly disfavors employees over independent contractors, although it does so in a way many taxpayers neither realize nor understand. I.R.C. §§ 67, 55.

66. Other provisions of the TCJA which reduce excludable fringe benefits contribute to the unfavorable tax treatment of employees. *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 11047, 13304, 131 Stat. 2088, 2124 (2017).

administrability or being the flip side of the excludability of fringe benefits.[67] Even if the reason for the distinction is grounded in economics—the relative inelasticity of the labor supply—the result remains that the TCJA is saying to employees that they are less worthy of tax relief than other labor providers.

V. ZERO-TAXING FOREIGN SOURCE INCOME—THE DEMISE OF CAPITAL EXPORT NEUTRALITY

The TCJA creates a permanent and structural distinction based on the source of income. Thanks to the deduction provided by new section 245A, the U.S. income tax system will for the first time not include in the tax base some income from non-U.S. sources—ever—for some taxpayers. Taxpayers to whom new section 245A applies will be able to receive dividends consisting of income earned abroad, but because section 245A will allow them to deduct the amount of such dividends received, no amount of the dividend will become taxable income. Therefore, no amount of the dividend will be subject to U.S. income tax. That is a significant change in the law, although it is a change of degree, not kind.

Since the enactment of Subpart F in 1962, the U.S. tax system had sought to subject income earned by U.S. persons operating abroad to U.S. tax, but had settled on doing so only when that income was brought back into the U.S.[68] Subpart F brokered a compromise between capital import neutrality and capital export neutrality by deferring U.S. taxation of foreign source income earned abroad until that income was repatriated.[69] The U.S. tax system was a hybrid—nominally worldwide because active business foreign source income would be subject to U.S. tax eventually, when it was repatriated, but temporally territorial because active business foreign source income would not be subject to U.S. tax unless it was repatriated.

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67. *See supra* note 58 and accompanying text.

68. Revenue Act of 1962, Pub. L. No. 87-834, §§ 11, 12, 76 Stat. 960 (1962).

69. Capital import neutrality is the concept that all income derived from one location ought to bear the same tax burden. *See* David A. Weisbach, *The Use of Neutralities in International Tax Policy*, 68 NAT'L TAX J. 635, 637 (2015). Capital export neutrality is the concept that all income derived by U.S. persons ought to bear the same amount of tax. *Id.* The two concepts cannot be operationalized simultaneously, and Subpart F brokered a compromise by deferring U.S. taxation of the active income of U.S persons until the income was repatriated to the U.S. Capital import neutrality reigned while the income remained abroad, but capital export neutrality reigned when it arrived in the U.S.

The enactment of new section 245A produces a system in which some foreign source income will never be subject to U.S. tax despite being brought into the U.S., and that is a change, even though it is not a change that converts the U.S. tax system into a territorial system. The new system is not territorial because the distinction the TCJA creates only applies to some foreign source income and anti-abuse rules will ensure that other foreign source income will be subject to U.S. tax.[70] Hence, the foreign source income of a foreign corporation owned by U.S. corporate shareholders will escape U.S. taxation when distributed as a dividend to its U.S. corporate shareholders, but other foreign source income beneficially owned by U.S. persons will not meet that happy fate. That other foreign source income will continue to be subject to the Subpart F regime as well as to the new taxes imposed as anti-abuse measures. The shift to a territorial system is, at best, incomplete.

By distinguishing between foreign and domestic source income and subjecting one to U.S. taxation at some point while completely freeing the other from such taxation, the TCJA has vanquished capital export neutrality and the domestic horizontal equity values it represents. That could be understandable as an alternative resolution of the conflict between capital income and capital export neutrality, but the TCJA does not resolve the conflict. The TCJA has created a system in which foreign source income earned in *corporate* form and distributed to *corporate* owners will not be subject to U.S. tax, but other foreign source income will be. Subpart F remains in place. By declaring capital import neutrality the victor in some cases but leaving the Subpart F compromise intact in others, the TCJA has produced a system in which U.S. taxation will depend on a combination of the source of the income and the form in which the income is produced and owned.

This is haphazard tax policy at best. Under the TCJA, horizontal equity is turned on its head: U.S. taxpayers with equal incomes will be treated dissimilarly based on the source of their income and the type of entity that generates it. Ironically, the fundamental policy change that was most extensively analyzed and debated in the run-up to

70. These include the tax on "global intangible low tax income"—GILTI—imposed by new section 951A, a tax on some foreign source income, and the "base erosion anti abuse tax" imposed by new section 59A on certain U.S. taxpayers who make relatively large, deductible payments to related foreign entities.

enactment[71]—the shift to territorial taxation—is one of the least complete. Because the TCJA operationalizes the concept of territorial taxation through the mechanism of a deduction, and a dividends received deduction ("DRD") at that, it operationalizes the concept only partially. The DRD is only available with respect to income earned in corporate form and paid to owners whose investment is also held in corporate form. There can hardly be a sound policy basis for such a distinction.

Whether this will lead to the incorporation of most foreign activities of U.S. persons is beside the point made here. The point is that although the fundamental structure of the international tax system remains the same—worldwide taxation implemented by the provisions of subpart F and the PFIC regime[72] and ameliorated by the foreign tax credit—there is now an exception to U.S. taxation in certain cases. That exception allows the repatriation of earnings in the form of dividends that entitle a corporate recipient to the new DRD provided by section 245A. The incomplete transformation of the income tax from worldwide to territorial taxation exacerbates, without any apparent policy foundation whatsoever, the disparate ways in which the tax system taxes income generated in corporate form and income generated by pass-through entities or by individuals.[73]

VI. ADDITIONAL OBSERVATIONS

A. Adopting the AMT Base

Some of the changes that I have described as fundamental policy shifts made by the TCJA are not, in isolation, new to the tax system. They are only new to the "regular" tax system—but that is an

71. *See* J. Clifton Fleming, Jr. & Robert J. Peroni, *A Hitchhiker's Guide to Outbound International Tax Reform*, 18 CHAP. L. REV. 133, 136 (2014); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1088 (2009); Stephen E. Shay et al., *Designing a 21st Century Corporate Tax – An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX REV. 669, 684 (2015); Tax Reform Task Force, *A Better Way: Our Vision for a Confident America*, BETTER OFF NOW (2016), https://www.novoco.com/sites/default/files/atoms/files/ryan_a_better_way_policy_paper_062416.pdf.

72. The Passive Foreign Investment Company provisions were designed to prevent erosion of the U.S. tax base by the creation of foreign companies to hold investments of U.S. persons. *See* Phil Jelsma, *Understanding PFICs and QEFs*, 14 INT'L TAX J. 317, 319 (1988).

73. For an excellent discussion of this point, see Mindy Herzfeld, *How Some Taxpayers Got Cut Out of the Tax Cuts and Jobs Act*, TAX NOTES (Jan. 23, 2018), https://www.taxnotes.com/tax-reform/news-analysis-how-some-taxpayers-got-cut-out-tax-cuts-and-jobs-act.

important point. The denial of personal and dependency exemptions, miscellaneous itemized deductions (including unreimbursed employee business expenses and section 212 expenses), and the near-elimination of the deduction for state and local taxes, all features of the tax law post-TCJA, reflect a decision to jettison the regular tax base and adopt the base of the Alternative Minimum Tax ("AMT") in its stead.[74] But it is one thing to have provisions that are *alternative* to what is considered the regular base and quite another to make those provisions the *regular* base, especially when the alternative—the AMT—is retained. When the provisions are alternatives that serve only to increase a taxpayer's final tax liability, they are mere rate increases that operationalize the principle of vertical equity (also a measure of ability to pay). As such they do no violence to the fundamental principles of the tax system and the values it reflects by the way it determines the tax base. But when those provisions determine the regular tax base they change the fundamental principles and values of the tax system. And those changes are important. As Professor Ed Kleinbard has recently observed, "Fiscal policy is an exercise in applied economics, but also in applied moral philosophy. We define ourselves as a country through the covenantal bonds we construct for our society by means of the fiscal policies we adopt."[75]

A country that is indifferent to the support obligations of its constituents in determining their ability to pay taxes devalues those obligations. It discards the duty of support and communitarianism as a "covenantal bond" and reaffirms insular individualism. Whether that is good or bad is open to debate, but my concern is that the debate was not had before these changes became the law. The AMT base is undoubtedly simpler to administer and to comply with than the regular tax base, but that simplicity comes with significant costs to the principles of horizontal equity and ability to pay. It is unfortunate that it was adopted without a careful weighing of its costs as well as its benefits.

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74. I.R.C. §§ 55–56 (2018). In this respect, the TCJA reflects adoption of portions of both the Camp and Graetz proposals, including in the case of the latter, the expansion of the standard deduction. Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014); MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008).

75. Edward D. Kleinbard, *What's a Government Good For? Fiscal Policy in an Age of Inequality*, USC LEGAL STUDIES RESEARCH PAPERS SERIES NO. 18-2 (Feb. 5, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3118406.

B. Reliance on Standards

Second, the TCJA contains many provisions that invite interpretation as standards, rather than as rules. The need to determine what constitutes a trade or business for purposes of determining the amounts deductible as QBI under new section 199A is only one example of Congress' use of a standard to determine the contours of a provision that will affect a large swath of the taxpaying population. Reasonable compensation, also important in section 199A, is another one, as is earnings and profits, key to some of the new international provisions.

Standards are easy to promulgate but hard to administer, whereas rules are hard to promulgate but easy to administer. As Louis Kaplow long ago observed, "[r]ules are more costly to promulgate than standards because rules involve advance determinations of the law's content, whereas standards are more costly for legal advisors to predict or enforcement authorities to apply because they require later determinations of the law's content."[76] In applying a standard, taxpayers, their advisors, courts, and administrators must weigh multiple competing factors and values, and they must do that ex-post, after taxpayers have acted. Standards can therefore create uncertainty, which is disconcerting to taxpayers and their advisors, who are left to interpret the standard when deciding how to treat particular items when filing tax returns.

The Internal Revenue Code contains many provisions that are more properly interpreted as standards rather than as rules, so what Congress did in the TCJA is not new.[77] It is also not surprising, given that the TCJA proceeded through the legislative process with unprecedented speed. But by using easy-to-create standards in many key provisions, the TCJA has imposed significant new burdens on

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76. Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 562–63 (1992). In other work, Rick Greenstein and I have challenged the binary classification of legal provisions into rules and standards, arguing that those are end points on what is more accurately analyzed as a continuum. *See* Alice G. Abreu & Richard K. Greenstein, *The Rule of Law as a Law of Standards: Interpreting the Internal Revenue Code*, 64 DUKE L.J. ONLINE 53, 73 n.83 (2015); Alice G. Abreu & Richard K. Greenstein, *It's Not a Rule: A Better Way to Understand the Definition of Income*, 13 FLA. TAX REV. 101, 124 (2012); Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 330 (2011) [hereinafter Abreu & Greenstein, *Defining Income*]. Nevertheless, although we have not retreated from our claim regarding the benefits of that more nuanced analysis, for purposes of evaluating the TCJA, that nuance is unnecessary. The binary analysis employed by Kaplow suffices.

77. *See* Abreu & Greenstein, *Defining Income*, *supra* note 76 at 300.

taxpayers and their advisors. Those constituencies are left to hope that Congress will provide the Treasury and the IRS with the funds necessary to allow them to provide the interpretive guidance needed to ensure uniform interpretation of the law. I can only hope that the Treasury and the IRS will be able to write regulations that craft simplifying conventions and de minimis rules that interpret the broad standards in ways that make them administrable, as they did with the so-called INDOPCO regulations over a decade ago.[78]

VII. CONCLUSION

The TCJA has changed the way the tax system operationalizes the principles of horizontal equity and ability to pay, has brought the base of the regular tax closer to the base of the AMT, and has increased the number of tax provisions that have been promulgated in the form of standards, which will require the deployment of significant administrative and judicial resources before they can be implemented effectively. By removing consideration of taxpayers' support obligations from the tax base (except as relevant to the determination of filing status in the case of taxpayers who might qualify for the statuses of head of household or surviving spouse), the TCJA has jettisoned the value of ability to pay. It has created a system in which two taxpayers with very different ability to pay as a result of support obligations will be taxed the same, and in which two taxpayers with the same ability to pay will be taxed differently. It has therefore turned the concept of horizontal equity on its head. In some cases the tax base will be the taxpayer's gross income in its entirety, subjecting to taxation even the amount needed for minimal subsistence.

Those effects are exacerbated by the creation of a distinction in the taxation of income from labor, which will now depend on the form in which that income is earned. Labor income earned in the form of wages—by the performance of services as an employee—will be fully taxed at ordinary income rates. But some labor income earned by the performance of services in any other way—by the performance of services as an independent contractor, proprietorship, partnership, or

78. *See, e.g.*, Treas. Reg. §§ 1.263(a)–4(d)(6)(v) (creating a de minimis rule allowing expensing of amounts of $5,000 or less used to financial intangible assets); Treas. Reg. §§ 1.263(a)–4(e)(4)(iii) (creating another de minimis rule allowing expensing of $5,000 or less of investigatory transaction costs); Treas. Reg. §§ 1.263(a)–4(f)(1) (creating a "12-month rule" that allows expensing of amounts that create or facilitate the creation of rights that extend up to 12 months beyond the year in which the taxpayer pays or incurs the expense).

S Corporation—will be taxed at only 80 percent of the ordinary income rate that would otherwise apply. That last caveat, which highlights the muddiness of the application of the new deduction for Qualified Business Income, only exacerbates the serendipity of the policy effects and the disconnect between taxation and ability to pay under the TCJA.

The foregoing fundamental changes to the tax system were not clearly identified and debated by scholars and tax professionals prior to enactment, but the idea of shifting to a territorial system was.[79] Ironically, that change was incompletely accomplished. That incompleteness has only added to the serendipity with which the TCJA imposes its burdens and distributes its benefits. The TCJA distinguishes between the taxation of foreign and domestic source income only for some taxpayers. It lacks a comprehensive policy foundation either domestically, or internationally.

Reform is a value-laden term. It implies a change for the better. The TCJA was billed as Tax Reform, but it will take scholars years to tease out and analyze all of the policy implications of all of the changes wrought by the TCJA. In this Essay, I have tried to begin the evolutionary progression from discussion of how the new provisions operate to discussion of fundamental policy shifts. Only by engaging in the latter discussion can we answer the question whether the TCJA has reformed anything at all. My feeling at the moment is that it has not, or it has not reformed a lot. On the contrary, it has deformed the operation of the principles of horizontal equity and ability to pay. I will have to wait and see if a consensus develops around these observations.

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79. *See supra* note 58.