GROSS MISCALCULATION: TAXING EXEMPT INDIVIDUALS ON GROSS INCOME

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ABSTRACT

The Tax Cuts and Jobs Act of 2017 was hastily pushed through Congress amid intense political controversy. At this point, both sides of the aisle would agree that the Act was not perfect. One such imperfection is the treatment of Exempt Individuals as defined in Section 7701(b)(5). Because Exempt Individuals, also described as quasi-NRAs throughout this Comment, are treated as nonresident aliens, despite their substantial presence in the United States, they are not permitted to claim the standard deduction. As of the Act taking effect in 2018, nobody is permitted to take the personal exemptions. Therefore, Exempt Individuals are being taxed on their gross income. But Exempt Individuals are not the average nonresident alien. They are the diplomats, students, teachers, doctors, and scholars that come to the United States to live, learn, and contribute meaningfully to American society.

When Congress first enacted the Exempt Individual exception in the 1984 tax overhaul, it was meant to provide them a benefit by exempting them from full worldwide taxation. The personal exemption, however, was the only tool which operated to create a zero-bracket amount for the Exempt Individuals – the only mechanism through which the tax code recognized and respected their obligations of support. It is simply bad policy to tax an individual, in these circumstances, on gross income, and may in fact violate the nondiscrimination clauses in tax treaties. The effect of the 2017 Act was not explained in the legislation's Bluebook and appears to be an unintended consequence that remains unnoticed by the Joint Committee.

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I. INTRODUCTION

Every year, hundreds of thousands of foreigners come to the United States on J-Visas[1] to teach, research, train, study, and practice in their fields.[2] These types of visitors are considered Exempt Individuals,[3] a designation which is supposed to

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1. J-1 Visas are meant to facilitate the "exchange of ideas, research, mutual enrichment and linkages between research and academic institutions in the United States and foreign countries." J-1 VISA Exchange Visitor Program, *Research Scholar Program*, U.S. DEP'T STATE, https://j1visa.state.gov/programs/research-scholar (last visited Oct. 18, 2019).

2. *See, e.g.*, J-1 VISA Exchange Visitor Program, *Facts and Figures*, U.S. DEP'T STATE, https://j1visa.state.gov/basics/facts-and-figures/ (last visited Sept. 29, 2019) (listing all 330,890 participants, locations, and programs of 2017 J-Visa holders).

3. 26 U.S.C. § 7701(b)(5) (2017); *see Substantial Presence Test*, IRS, https://www.irs.gov/individuals/international-taxpayers/substantial-presence-test (last updated Mar. 18, 2019) (explaining how teachers, trainees, and students temporarily present in the United States under certain "A," G," "Q," "F," and "M" visas are considered exempt individuals for the days in which they are in the United States).

benefit them.[4] Exempt Individuals, regardless of their legal immigration status, are treated as nonresident aliens[5] (NRAs) rather than resident aliens for tax purposes.[6] After the 2017 Tax Cuts and Jobs Act (TCJA) was passed,[7] the Exempt Individual designation resulted in, presumably, an unintended disparate treatment of Exempt Individuals compared to similarly situated taxpayers.[8] Exempt Individuals are now taxed on gross income, unlike any other taxable entity living in the United States.[9]

Consider the following scenario—an NRA, who we will call Tina Taxpayer, comes to the United States on a J-Visa to research cures for cancer at a university. Tina's work at the university is funded through a grant. In most cases, this type of grant is taxable as U.S.-source income.[10] If there is no treaty exemption, Tina may not claim a standard deduction.[11] In addition, from 2018 through 2025, she may not

4. *See* STAFF OF THE J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 387-88 (Comm. Print 1984) [hereinafter GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF 1984], *available at* https://www.jct.gov/publications.html?func=startdown&id=2376 (explaining how the U.S. withholds tax on certain foreign persons, including those from countries with which the United States have an income tax treaty).

5. *See Nonresident Aliens*, IRS, https://www.irs.gov/individuals/international-taxpayers/nonresident-aliens (last updated July 17, 2019) ("An alien is any individual who is not a U.S. citizen or U.S. national.").

6. *Id*.; *see* 26 U.S.C. § 7701(b)(3)(D) (2017) (explaining that the exemption also applies to individuals who were unable to leave the United States due to a medical condition, in addition to the exempt individuals detailed in 26 U.S.C. §7701(b)(5)).

7. An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017) [hereinafter TCJA]. This Comment acknowledges that TCJA was not the name to ultimately appear on this legislation but recognizes that it is used almost universally by academics and legislators alike. *See generally* Paul Starr, *The Tax Act That Lost Its Name*, AM. PROSPECT (June 28, 2018), http://prospect.org/article/tax-act-lost-its-name.

8. *See* Zdravka Zlateva, *How the 'Tax Cuts and Jobs Act' Affects Every Nonresident Student in the US*, SPRINTAX: NON-RESIDENT TAX PREPARATION (Jan. 17, 2018), http://blog.*sprintax*.com/gop-tax-reform-effects-taxation-foreign-students-non-resident-aliens/ (explaining how the TCJA affects nonresident students by disallowing miscellaneous itemized deductions, taxing tuition waivers, suspending deductions related to moving expenses).

9. *Id.*

10. 26 U.S.C. § 61(a) (2017). Notably, while NRAs are taxed unfairly, employers enjoy tax benefits by hiring NRAs because they do not have to pay payroll tax, Medicare, Social Security, or federal unemployment tax, which fosters an environment of exploitation and the potential for human trafficking. *See* Meredith B. Stewart, *Culture Shock: The Exploitation of J-1 Cultural Exchange Workers*, SOUTHERN POVERTY L. CTR. (Feb. 1, 2014), https://www.splcenter.org/20140201/culture-shock-exploitation-j-1-cultural-exchange-workers.

11. *See Nonresident Alien Figuring Your Tax*, IRS, https://www.irs.gov/individuals/international-taxpayers/nonresident-alien-figuring-your-tax (last updated June 28, 2019) (explaining that India is the only country with a tax treaty allowing their students and apprentices in the United States to claim the standard deduction). *See also* Convention Between the Government of the United States of America and the Government of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, India-U.S., art. 21, Sept. 12, 1989, T.I.A.S. No. 90-1218 [hereinafter India-U.S. Tax Convention] (entitling all students and business apprentices to the same exemptions, reliefs and reductions as the residents of the State which they are visiting).

claim personal or dependency exemptions (collectively, the Exemptions).[12]

Under pre-2018 law, Tina was entitled to one personal exemption for herself but no standard deduction.[13] Some exceptions applied to permit additional Exemptions,[14] but those exceptions are not operative under current law.[15] With the TCJA, Congress eliminated the Exemptions by reducing the amount to zero dollars through 2025.[16] Now imagine that Tina also brings a dependent child with her. Though her grant is taxed as income, the tax system will not recognize her support obligations to her dependent child. If there are no deductible business expenses,[17] Tina and others in a similar position face taxes on their gross income as a result of the suspension of the Exemptions, giving rise to a hefty tax liability.[18]

Before the TCJA, an NRA that engaged in a trade or business in the United States was entitled to deduct one personal exemption from taxable income.[19] Some NRAs were also permitted exemptions for dependents and a spouse,[20] and in rare circumstances could take the standard deduction.[21] The Exemptions operated to create a zero-bracket amount (ZBA)[22] for NRAs—if their gross income was less than the exemption amount, they were not required to file a tax return.[23] In addition

12. 26 U.S.C. § 151(d)(5) (2018).

13. *Nonresident Alien Figuring Your Tax*, *supra* note 11.

14. *See id.* (listing certain additional exemptions for residents of Mexico and Canada, as well as certain spouses and dependents of individuals from South Korea and India based on these countries' tax treaties). See *infra* Part II.B for a discussion on the legislative history of these exemptions.

15. 26 U.S.C. § 151.

16. Richard C. Auxier, *The TCJA Eliminated Personal Exemptions. Why Are States Still Using Them?*, TAX POL'Y CTR. (Dec. 17, 2018), https://www.taxpolicycenter.org/taxvox/tcja-eliminated-personal-exemptions-why-are-states-still-using-them.

17. *See* Bill Bischoff, *The Little Noticed Tax Change That Could Affect Your Return*, MARKETWATCH (Sept. 9, 2018), https://www.marketwatch.com/story/the-little-noticed-tax-change-that-could-affect-your-return-2018-03-19 (listing that the most important affected MIDs are unreimbursed employee business expenses, tax and investment related expenses, and hobby-related expenses); 26 U.S.C. § 67(g) (2017) (the provision which suspends miscellaneous itemized deductions (MIDs) through 2025).

18. *See* Zlateva, *supra* note 8 (explaining that although some NRAs have deductible business expenses, Exempt Individuals likely will not have deductible business expenses because MIDs are suspended). See *infra* Part III for a discussion on exemptions in consideration of ability to pay.

19. *See Nonresident Alien Figuring Your Tax*, *supra* note 11 (noting that NRAs can no longer claim a personal exemption for themselves, their spouses, or their dependents after 2017).

20. Residents of Mexico or Canada may claim additional exemptions for spouse and defendants as part of the contiguous country rules. Certain residents of South Korea and certain students and business apprentices from India may be able to claim spouse and dependents exemptions pursuant to the respective tax treaties. *Id.*

21. *See id.* ("[S]tudents and business apprentices from India may be eligible to claim the standard deduction under Article 21 of the U.S.A.-India Income Tax Treaty.").

22. A zero-bracket amount or ZBA refers to an amount of income that a taxpayer may earn without any federal income tax liability. *Zero Bracket Amount*, FREE DICTIONARY, https://legal-dictionary.thefreedictionary.com/Zero+Bracket+Amount (last visited Oct. 8, 2019).

23. *US Tax Guide for Foreign Nationals*, GW CARTER, LTD., https://form1040nr.com/foreignnationaltaxguide/ (last visited Oct. 10, 2019); *see generally Taxation of Nonresident Aliens*, IRS, https://www.irs.gov/individuals/international-taxpayers/taxation-of-nonresident-aliens (last

to the Exemptions, NRAs were eligible for certain deductions and credits, and tax liability could be reduced or eliminated by any applicable tax treaty.[24]

For example, the 2017 Form 1040NR allowed an NRA to claim a personal exemption, one exemption for their spouse, and at least four qualifying dependents.[25] This is a clear indication of the tax system placing value on an individual's burdens of support. Even in 2018, a nonresident alien was still eligible for the child tax credit (CTC)[26] if the qualifying child had a U.S. social security number.[27] The CTC would alleviate the burden of being taxed on gross income, but the stringent requirements of the CTC will prevent many NRAs from receiving the benefit.[28] Additionally, this would be an after-tax credit, rather than directly reducing taxable income; in other words, the NRA will still be taxed on a gross basis regardless of whether they qualify for the CTC.[29]

Before the TCJA, NRAs were also entitled to certain itemized deductions.[30] These deductions included: "state and local income taxes, charitable contributions to U.S. non-profit organizations, casualty and theft losses, miscellaneous itemized deductions, and the ordinary and necessary expenses related to a U.S. trade or business."[31] In addition to the itemized deductions, NRAs were also permitted certain adjustments to gross income, provided they met the qualifications for each adjustment. These adjustments included: "IRA deduction, Archer MSA deduction, Health Savings Account deduction, Student Loan Interest deduction, moving expenses, self-employed health insurance deduction, self-employed SEP, SIMPLE, and Qualified Plans, penalty for early withdrawal of Savings, scholarship and fellowship grants excluded from income, and domestic production activities deduction."[32] Many of these deductions were changed or eliminated by the TCJA, leaving them unavailable to NRAs. Conversely, NRAs have never been permitted to claim the standard deduction, which had not been problematic in the past because of

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updated July 10, 2019).

24. *Resident Alien Claiming a Treaty Exemption for a Scholarship or Fellowship*, IRS, https://www.irs.gov/individuals/international-taxpayers/resident-alien-claiming-a-treaty-exemption-for-a-scholarship-or-fellowship (last updated Feb. 26, 2019).

25. *See* INTERNAL REVENUE SERV., 1040 INSTRUCTIONS: 2017 17 (2017), *available at* https://www.irs.gov/pub/irs-prior/i1040gi--2017.pdf (laying out the lengthy three-step process of claiming an exemption for a qualifying dependent: determining whether a taxpayer has a qualifying child, whether the qualifying child can be considered a dependent, and whether the qualifying child entitles the taxpayer to the child tax credit); *see generally* INTERNAL REVENUE SERV., FORM 1040 NR 2017 (2017), *available at* https://www.irs.gov/pub/irs-prior/f1040--2017.pdf.

26. *Five Things to Know About the Child Tax Credit*, IRS, https://www.irs.gov/newsroom/five-things-to-know-about-the-child-tax-credit (last updated June 28, 2019) ("The Child Tax Credit is a tax credit that may save taxpayers up to $1,000 for each eligible qualifying child.").

27. 26 U.S.C. § 24(h)(7) (2017).

28. *Ten Facts About the Child Tax Credit*, IRS, https://www.irs.gov/newsroom/ten-facts-about-the-child-tax-credit (last updated June 28, 2019).

29. *See Nonresident Alien Figuring Your Tax*, *supra* note 11 (distinguishing adjustments to gross income from tax credits).

30. *Id.*

31. *Id.*

32. *Id.*

the availability of the Exemptions.[33]

No other group or entity in the United States is taxed on gross income as a matter of policy.[34] Despite the patina of precision promoted by the lawmakers of the TCJA, the effect of taxing NRAs on their gross income, and Exempt Individuals specifically, appears to be inadvertent. Normatively, it is important to note that we now have a tax system that can, with respect to some individuals, tax on a gross basis. Moreover, the effect on the Exempt Individuals is most concerning because Congress intended to relieve, not increase, some of their tax burden by designating them as exempt.[35] This result is entirely unfair and contrary to what Congress envisioned with respect to eliminating the Exemptions.

To demonstrate this glaring inequity, this Comment first discusses NRAs and Exempt Individuals in Part II, illustrating the policy background that shaped their historic tax treatment. Part III examines the zero-bracket policy and the mechanisms for achieving such a bracket. This includes an examination of the standard deduction and the Exemptions. Part IV turns to why the policy adopted by the TCJA is problematic, unfair, and potentially a violation of several U.S. tax treaties. Finally, Part V proposes a potential solution for revising the policies directed at Exempt Individuals.

II. NONRESIDENT ALIENS FACE U.S. TAXES TO A LIMITED EXTENT

While the unintended result of the TCJA is an unfair taxation of Exempt Individuals, that does not mean that NRAs should not pay their fair share of U.S. taxes. For example, there are certain types of NRAs that have no real connection to the United States. Individuals or entities that are engaged only in foreign direct investment (FDI)[36] do not have a substantial connection to and are not present in the United States.[37] These NRAs usually hold stock or marketable securities in the United States, for which their taxes are withheld at the source.[38] In this case, it is perfectly acceptable to tax these NRAs on gross income, as the United States is

33. *See* STAFF OF J. COMM. ON TAXATION, 78TH CONG., COMPARISON OF THE INTERNAL REVENUE CODE BEFORE AND AFTER ITS AMENDMENT BY THE INDIVIDUAL INCOME TAX BILL 22 (Comm. Print 1944), *available at* https://www.jct.gov/publications.html?func=startdown&id=4228 (explaining how NRAs are prohibited from claiming the standard deduction in Supplement H § 213).

34. *See* Aaron Schrank, *The History of Income Tax's Standard Deduction Is More Interesting Than You Think*, MARKETPLACE (May 9, 2017, 4:00 PM), https://www.marketplace.org/2017/05/09/economy/history-income-taxs-standard-deduction-more-interesting-than-you-think (explaining how some middle class Americans with large families might have increased tax burdens if the standard deduction is increased and exemptions are cut).

35. See *infra* Part II.B for reference to Congress' recognition that taxation of aliens who come to the United States to teach and learn is inappropriate.

36. *See* James Chen, *Foreign Direct Investment (FDI)*, INVESTOPEDIA, https://www.investopedia.com/terms/f/fdi.asp (last updated Feb. 21, 2019) ("An investment made by a firm or individual in one country into business interests located in another country.").

37. *LB&I International Practice Service Concept Unit*, IRS, https://www.irs.gov/pub/int_practice_units/RPWCUP_081_02.pdf (last updated Jan. 6, 2016).

38. *Id.*

merely viewing a sliver of their overall taxable income.[39]

Essentially, the tax system is only considering a portion of the NRAs' tax base, treating them as partial base payers (PBP).[40] NRAs are not treated as full taxpayers because they do not have a substantial presence or connection in the United States, which justifies taxing them on their worldwide income.[41] Therefore, the United States looks only at a slice of the NRAs' financial profile, or just a portion of their tax base.[42] Under this model, it is acceptable to exclude a PBP or NRA from receiving the standard deduction.

Conversely, Exempt Individuals do not fit neatly into the PBP theory because they do have a substantial presence in the United States. They are not true NRAs but rather quasi-NRAs.[43] The United States was not completely confiscatory by disallowing NRAs the standard deduction because quasi-NRAs were eligible for the Exemptions, which effectively created a zero bracket.[44] However, a disconnect now exists.

Refer again to Tina Taxpayer from Part I, who is representative of the group of Exempt Individuals Congress has identified as deserving of preferential tax treatment.[45] She is in the country with many connections to the United States, but the tax system still treats her as a PBP. Although she would technically qualify as a resident alien under the Substantial Presence Test, Congress excluded her from that test as an Exempt Individual, intending for the exception to benefit Tina.[46] However, as a quasi-NRA, Tina is also caught by the inability of NRAs to claim the standard deduction. This fact was not fatal when the Exemptions were in effect, but without the Exemptions, Tina is now being taxed on her gross income.[47] As is detailed below,

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39. *Aliens – Which Income to Report*, IRS, https://www.irs.gov/individuals/international-taxpayers/aliens-which-income-to-report (last updated June 27, 2019) (outlining how NRAs, as partial base payers, report only income sourced in the United States or effectively connected with a U.S. trade or business).

40. *See id.* (summarizing how partial base payers are not subject to the full weight of worldwide taxation so the IRS is considering only a small sliver of the partial base payer's annual income).

41. *Determining Alien Tax Status*, IRS, https://www.irs.gov/individuals/international-taxpayers/determining-alien-tax-status (last updated Mar. 18, 2019).

42. *Aliens – Which Income to Report*, *supra* note 39.

43. See *infra* Part III for a discussion of Exempt Individuals. This Comment refers to Exempt Individuals as quasi-NRAs because quasi-NRAs have a substantial presence in the U.S. but are excepted from paying taxes on their gross worldwide income due to the respectable reason for their presence in the U.S. But for the Exempt Individual exception, NRAs would be considered Resident Aliens, and therefore eligible to claim the standard deduction. Part II.B discusses how Exempt Individuals, also called quasi-NRAs, find themselves being treated as an NRA despite their substantial presence in the United States.

44. *The Tax Policy Center's Briefing Book: Key Elements of the U.S. Tax System*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/what-personal-exemption (last visited Oct. 4, 2019).

45. *Substantial Presence Test*, *supra* note 3.

46. *Id.*

47. See *supra* Part I, which asserts that quasi-NRAs are also suspended from claiming miscellaneous itemized deductions in addition to the standard deduction.

this result is not what Congress intended for the Exempt Individuals.[48]

A. Resident Aliens and Nonresident Aliens Face Different U.S. Tax Consequences

Non-U.S. citizen taxpayers are classified into two categories: resident aliens and NRAs.[49] As discussed, an NRA is any individual who does not possess U.S. citizenship or legal permanent resident status and is not physically present in the United States for the period of time required to satisfy the Substantial Presence Test.[50] A non-citizen is considered a resident alien of the United States for tax purposes if they meet either the Green Card Test or the Substantial Presence Test.[51]

The purpose of distinguishing between a resident and NRA is to establish which individuals have a substantial presence in the United States[52] to the extent that they should be taxed on an equal basis as citizens.[53] For example, resident aliens are "present" in the country if they are able to take regular advantage of public resources, such as police, firefighters, roads, bridges, and libraries, to the same extent as citizens.[54] Conversely, nonresidents are theoretically not present in the United States enough to take advantage of these public resources, so taxing them on an equal basis with citizens would not be justified.[55] In this way, basing tax liability on one's level of connection to the United States enhances the system's equitability.[56]

Aside from attaining citizenship, there are two primary ways for an alien to qualify as a resident for U.S. tax purposes: the Green Card Test and the Substantial Presence Test.[57] The Green Card Test follows an established policy where form

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48. See *infra* Part II.B which summarizes how Congress created the Exempt Individuals exception because it believed that Exempt Individuals' closer connection to another country meant that they did not deserve the weight of full taxation on worldwide income.

49. *See id.* (laying out that determining tax burden is related to the amount of time spent in the United States, not an alien's immigration status).

50. *Determining Alien Tax Status*, *supra* note 41.

51. *Id.*

52. *Substantial Presence Test*, *supra* note 3.

53. *See* Andrew Henderson, *Non-US Citizens: How to Avoid Becoming a Tax Resident in the US*, NOMAD CAPITALIST, http://nomadcapitalist.com/2017/10/23/non-us-citizens-avoid-becoming-us-tax-resident/ (last visited Sept. 12, 2019) ("If you qualify as a tax resident in the United States, you will be subject to the same rules as US citizens in regards to filing and paying taxes.").

54. *See, e.g.*, Javed A. Khokar, *New Definition of a Resident Alien*, 1986 IMMIGR. & NAT'LITY L. REV. 357, 358 (1986) (discussing how an alien could traditionally be classified as a resident through participation in the community and enrollment of children in local schools).

55. *Id.*

56. *See* Kimberly Amadeo, *Why Do We Pay Taxes?*, THE BALANCE, https://www.thebalance.com/why-do-we-pay-taxes-4067684 (last updated Apr. 18, 2019) (discussing how taxes are spent by U.S. federal, state, and municipal governments); *see also* Julia Kagan, *Ability-to-Pay Taxation*, INVESTOPEDIA, https://www.investopedia.com/terms/a/ability-to-pay-taxation.asp (last updated May 2, 2018) (comparing the equitability of taxation by benefit received to taxation by ability to pay).

57. 26 U.S.C. § 7701(b)(1)(A) (2006); *Alien Residency - Green Card Test*, IRS, https://www.irs.gov/individuals/international-taxpayers/alien-residency-green-card-test (last updated Jan. 29, 2019); *Substantial Presence Test*, *supra* note 3.

matches substance, meaning it is designed to align with immigration and tax law.[58] When an alien has legal U.S. status, they are taxed matching that status.[59] For example, an alien who has applied for and been issued an alien registration card (also known as a Green Card) has satisfied the Green Card Test and is considered a resident alien for tax purposes.[60]

The second way to qualify as a resident is by establishing a substantial presence in the United States.[61] An alien is treated as a U.S. resident for tax purposes if they are physically present on at least:

> [Thirty one] days during the current year, and . . . 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting: all the days you were present in the current year, and 1/3 of the days you were present in the first year before the current year, and 1/6 of the days you were present in the second year before the current year.[62]

Essentially, an alien is treated as present in the United States on any day during which they are "physically present in the country."[63] There are several exceptions to this rule which do not count towards the number of days an alien is present in the United States.[64]

As discussed in Part II.A, Exempt Individuals meet the requirements of the Substantial Presence Test, which normally renders them resident aliens. However, the Exempt Individual exception essentially creates a third category of taxpayer—the quasi-NRA.

Residency determination directly impacts tax liability. First, resident aliens, like citizens, are taxed on worldwide income and may claim the standard deduction.[65] Conversely, NRAs are taxed only on U.S. source income, or Effectively Connected Income (ECI), which is "all income from sources within the United States connected with the conduct of [a] trade or business."[66] In addition to income connected to a domestic trade or business, certain types of fixed, determinable,

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58. *See* 26 U.S.C. § 7701(b)(1)(A) (detailing how an alien can be treated as a resident); *see also Alien Residency - Green Card Test*, *supra* note 57 (explaining how a green card can give resident status).

59. *See id.* (listing the requirements for an alien to be taxed as a resident).

60. *Determining Alien Tax Status*, *supra* note 41.

61. 26 U.S.C. §§ 7701(b)(1)(a)(ii), 7701 (b)(3); *Substantial Presence Test*, *supra* note 3.

62. *Substantial Presence Test*, *supra* note 3.

63. *Id*.

64. *See, e.g.*, *id.* ("Days you commute to work in the U.S. from a resident in Canada or Mexico, if you regularly commute from Canada or Mexico. Days you are in the U.S. for less than 24 hours, when you are in transit between two places outside the United States. Days you are in the U.S. as a crew member of a foreign vessel. Days you are unable to leave the U.S. because a of a medical condition that develops while you are in the United States. *Days you are an exempt individual.*" (emphasis added)).

65. *Taxation of U.S. Resident Aliens*, IRS, https://www.irs.gov/individuals/international-taxpayers/taxation-of-resident-aliens (last updated Mar. 18, 2018).

66. *Effectively Connected Income (ECI)*, IRS, https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci (last updated Jan. 30, 2019).

annual, or periodical (FDAP)[67] income are treated as ECI.[68] FDAP income[69] is the primary source of FDI income that is withheld at the source.[70] Conceptually, NRAs do not deserve the full weight of worldwide income taxation due to their minimal connections to the United States, just as they do not deserve the benefit of the standard deduction. But in the case of quasi-NRAs, it is unjust to ignore their ability to pay in accordance with the Ability to Pay doctrine.[71] Congress has recognized this since the inception of the resident versus nonresident status distinction, as described in the following Part II.B.

B. The Legislative History Concerning the Taxation of NRAs and Exempt Individuals

The general system of taxing people based on their level of connection to the United States is sound tax policy, just as exempting certain classes of individuals from the resident alien calculations is good policy.[72] Even before the 1984 legislation, Exempt Individuals would not have been subjected to taxation on worldwide income.[73] Prior to enacting the Substantial Presence Test in 26 U.S.C. § 7701(b), the definition of a resident was someone who was not "a mere transient or sojourner."[74]

This transient-sojourner standard was heavily fact dependent and not easy to administer.[75] An alien in the United States:

> [F]or a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned.[76]

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67. *Fixed, Determinable, Annual, Periodical (FDAP) Income*, IRS, https://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income (last updated Nov. 29, 2018) ("Income is fixed when it is paid in amounts known ahead of time. Income is determinable whenever there is a basis for figuring the amount to be paid. Income can be periodic if it is paid from time to time. It does not have to be paid annually or at regular intervals. Income can be determinable or periodic, even if the length of time during which the payments are made is increased or decreased.").

68. *Effectively Connected Income (ECI)*, *supra* note 66.

69. FDAP income is not addressed in this paper. It is collected by withholding from the source and mostly applies to foreign persons. *LB&I International Practice Service Concept Unit*, *supra* note 37.

70. See *supra* Part II for a discussion of foreign direct investment.

71. See *infra* Part IV for a discussion on the doctrine of Ability to Pay as a doctrine of taxation that promotes a progressive tax rate levied according to a taxpayer's ability to pay based on the notion that individuals (or entities) who earn more money can afford to pay more in taxes.

72. *See Substantial Presence Test*, *supra* note 3 (listing closer connection exceptions).

73. *See* 26 C.F.R. § 1.871-2(b) (1992) (setting out the criteria for resident alien individuals for taxable years prior to 1985).

74. *Id.*

75. *See id.* (setting the transient-sojourner standard by defining a resident).

76. *Id.*

Notably, under the transient-sojourner standard, an Exempt Individual would not have been considered a resident.[77]

The 1984 legislation sought to turn the broad statutory standard into an easily administered rule.[78] It provided for an arithmetic way to determine who was a transient or sojourner using the Substantial Presence Test.[79] However, if applying the Substantial Presence Test strictly through calculations, an Exempt Individual would be considered a resident for tax purposes due to their extended stays in the United States.[80] Noting that the Exempt Individuals were not intended to be caught by the new rule, Congress created the Exempt Individuals exception in 26 U.S.C. § 7701(b)(5).[81] This exception recognized that Exempt Individuals who had a closer connection to another country would have been considered mere transients or sojourners under previous legislation and do not deserve the weight of full taxation on worldwide income.[82]

The exceptions to the Substantial Presence Test allow several categories of noncitizens to avoid taxation on worldwide income, even when they are physically present in the United States for periods that would otherwise qualify them as residents under the Substantial Presence Test.[83] For example, teachers and trainees, students, professional athletes, and foreign government-related officials, such as ambassadors, are considered Exempt Individuals for purposes of the resident alien tests, rendering them quasi-NRAs.[84] Previously, this resulted in a benefit to the Exempt Individuals who have significant foreign-source income.[85] Instead of facing taxation on their worldwide income, Exempt Individuals were treated as NRAs for tax purposes and thus were not taxed on foreign-source income[86] but rather only on ECI.[87] If they had not been afforded NRA status, the Exempt Individuals could have taken the standard deduction but would have also faced taxation on worldwide income, subject to the graduated tax rates that apply to U.S. citizens.[88] In 1984, Congress was trying to do Exempt Individuals a favor by treating them as quasi-

77. *See id.* (setting transient-sojourner standard without exceptions for Exempt Individuals).

78. *See* Deficit Reduction Act of 1984, H.R. 4170, 98th Cong. § 138 (1984) (amending 26 U.S.C. § 7701 to define resident alien and nonresident alien).

79. *Id.*; *see Substantial Presence Test*, *supra* note 3 (describing the process to calculate residence status for tax purposes).

80. *Substantial Presence Test*, *supra* note 3 (listing exemptions from Substantial Presence Test residence calculation).

81. *See* GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF 1984, *supra* note 4, at 464 (explaining congressional reasoning for including exceptions).

82. *Id.* at 464–65.

83. *See* 26 U.S.C. § 872(a) (effective Oct. 23, 2004) (prescribing general definition of gross income for nonresident individuals that includes only income derived from sources within the United States).

84. *Substantial Presence Test*, *supra* note 3.

85. *Cf.* Khokar, *supra* note 54, at 366 (commenting that Exempt Individuals usually do not benefit from NRA status because they generally do not have much foreign income).

86. *Id.* at 357.

87. *Id.*

88. *Taxation of U.S. Resident Aliens*, *supra* note 65.

NRAs.[89] Now, however, the Exempt Individuals face the harsh consequence of the TCJA—taxation on gross income.

Taxing quasi-NRAs on gross income is an abrupt shift in policy that has thus far remained unexplained. Historically, Congress has preferred to provide tax breaks for Exempt Individuals.[90] After each Congressional session, the staff of the Joint Committee on Taxation (JCT)[91] works with the House Committee on Ways and Means, and the Senate Committee on Finance, to publish explanations of any enacted tax legislation.[92] These publications, titled "Bluebooks," provide insight into the purpose and reasoning behind changes in the tax code.[93]

Following the 1984 tax overhaul, the JCT released a Bluebook which directly addressed the legislative intent and reasoning behind the Exempt Individuals.[94] The JCT Bluebook explains:

> Congress recognized that there are cases in which, because of the reason for the alien's stay in the United States, full U.S. taxation is inappropriate. Accordingly, the Act provides exceptions when aliens come to the United States to teach or to learn rather than for employment, business, economic opportunity, pleasure, personal or family reasons, political stability, or other reasons.[95]

The exceptions to the Substantial Presence Test and application of worldwide income taxation served to "help the United States to maintain its paramount position in the field of education. Exceptions also seemed appropriate for diplomats and for some persons physically unable to leave the United States."[96] The tax code considered NRAs as PBPs by only looking at the slice of their income that is related to sources within the United States.[97] It was intended to be beneficial because the tax system was recognizing that these people were only in the United States temporarily, and thus subjecting them to the full weight of U.S. taxation was inappropriate, unfair, and inefficient.[98]

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89. *See* 26 U.S.C. § 872(a) (effective Oct. 23, 2004) (prescribing the general definition of gross income for nonresident individuals that includes only income derived from sources within the United States).

90. *Id.*

91. The JCT is an entity in Congress responsible for designing the tax code. It is a nonpartisan committee composed of members from both houses of Congress, closely involved with every aspect of the tax legislative process. The members of the Committee work with experienced professional staff of Ph.D. economists, attorneys, and accountants. *Overview*, THE JOINT COMMITTEE ON TAX'N: CONGRESS OF THE U.S. (Feb. 18, 1970), https://www.jct.gov/about-us/overview.html (click "View this as PDF").

92. *Joint Committee Bluebooks*, JOINT COMMITTEE ON TAX'N: CONGRESS U.S., https://www.jct.gov/publications.html?func=select&id=9 (last visited Sept. 10, 2019).

93. *Id.*

94. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF 1984, *supra* note 4, at 464.

95. *Id.*

96. *Id.*

97. See *supra* Part II.A for a definition of the types of income for which NRAs must pay taxes.

98. Worldwide economic efficiency demands capital export neutrality, which typically means giving a taxpayer's country of residence primacy to tax foreign-source income. *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 270–71 (2001) (providing a detailed explanation and

The Exemptions were the only tool that operated to create a ZBA for the quasi-NRAs.[99] Thus, what was once preferential treatment for Exempt Individuals has devolved into a tax penalty with the elimination of the Exemptions and the continuance of the rule prohibiting quasi-NRAs from claiming the standard deduction.[100] If this was Congress's intent, it has yet to explain this decision and stark policy shift.[101] The Bluebook for the TCJA was released in December 2018, and it contained no explanation for this divergent policy.[102] Therefore, taxing NRAs on gross income is likely an unintended consequence of the TCJA that remains unnoticed by the Joint Committee since it went into effect.

III. ACHIEVING A ZERO-BRACKET: CONSIDERING A TAXPAYER'S ABILITY TO PAY

A ZBA refers to an amount of income that a taxpayer may earn without any federal income tax liability.[103] There are three mechanisms through which a tax system may provide a zero bracket. The first mechanism is to enact an actual 0% bracket in the rate schedule so there would be an amount of taxable income that is subject to a tax rate of 0%.[104] The second way provides a ZBA by creating no tax liability below a certain amount of gross or taxable income.[105] Both of these mechanisms achieve a ZBA through changes in the rate structure. The third way to provide a ZBA is through the tax base; for a ZBA may, in fact, be achieved through the definition of taxable income.[106] If taxable income is defined as gross income minus an amount that all taxpayers will always be entitled to deduct, such as a standard deduction or personal exemption, there is a de facto zero bracket because a

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background of the dueling international income tax policies including capital export neutrality and capital import neutrality). Taxing NRAs on worldwide income would discourage economic efficiency. *See id.* at 271.

99. Considering the length of their presence in the United States, most Exempt Individuals likely would not have much (if any) income from non-U.S. sources. *See Substantial Presence Test*, *supra* note 3 (listing the qualifications for Exempt Individual status). Therefore, by taxing them on gross income derived from U.S.-sources, the code may effectively be taxing quasi-NRAs on gross worldwide income without consideration of ability to pay. *See* 26 U.S.C. § 61 (2016) (defining gross income).

100. 26 U.S.C. § 63(c)(6)(B) (2018).

101. *See* Stephanie Cumings, *Coming Soon: Congress's Explanation of the TCJA*, TAX NOTES (Oct. 30, 2018), https://www.taxnotes.com/tax-notes-today/tax-cuts-and-jobs-act/coming-soon-congresss-explanation-tcja/2018/10/30/28k70 (discussing how practitioners have been anxiously waiting for the Joint Committee on Taxation's Blue Book on the TCJA).

102. STAFF OF THE J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97 331-38 (2018), [hereinafter GENERAL EXPLANATION OF PUBLIC LAW 115-97] https://www.jct.gov/publications.html?func=startdown&id=5152.

103. *Zero Bracket Amount*, *supra* note 22.

104. *See* Meghan Ashford-Grooms, *Ron Paul Says Federal Income Tax Rate Was 0 Percent Until 1913*, POLITIFACT (Jan. 31, 2012, 11:31 AM), https://www.politifact.com/texas/statements/2012/jan/31/ron-paul/ron-paul-says-federal-income-tax-rate-was-0-percen/ (discussing federal tax prior to the constitutional amendment permitting a federal income tax).

105. *See id.* (discussing early federal income tax law with zero percent rates up to certain amounts).

106. *See* 26 U.S.C. § 61(b) (2012).

certain amount of gross income will never be part of the tax base.[107]

The specific amount of gross income that will never be part of the tax base *is* the ZBA.[108] Technically, there is no zero bracket in the U.S. rate structure, but functionally there is a zero bracket because of the definition of taxable income.[109] If everyone is entitled to a standard deduction, there is a zero bracket.[110] Or, as historically done, if everyone is entitled to the Exemptions, or a combination of the standard deduction and the Exemption, there is a zero bracket.[111]

The policy that there is no tax liability for gross income under a certain amount has long been the standard in the United States.[112] Historically, Congress viewed the ZBA as a way to honor the minimum income required for an American family to have a proper standard of living.[113] The ZBA was meant to help exclude the poor from the tax rolls and to ease administration.[114]

Table 1 in the Appendix details the history of the U.S. ZBA and the mechanisms through which it was achieved. The nation's first federal income tax was enacted in 1861, and it set a flat tax rate of 3% on incomes higher than $800.[115] In operation, this meant that taxpayers earning between $0 and $799 were in a 0% tax bracket.[116] When the Sixteenth Amendment was ratified in 1913 allowing the federal government to enact a modern, nationwide income tax,[117] the personal exemption created a ZBA by changing the definition of the tax base.[118]

For example, in 1913, the personal exemption affected a ZBA of $70,593 (inflation-adjusted dollars in 2013).[119] It was not until the Revenue Act of 1944 that the ZBA shifted to the hybrid system that uses both the standard deduction and the

107. *See id.* (cross-referencing to statutory exclusions from gross income).

108. By providing an amount of income to be excluded from the taxpayer's tax base, the U.S. tax code essentially states that a taxpayer may earn a certain amount without that amount being subject to federal income tax liability—the definition of a ZBA. *Zero Bracket Amount*, *supra* note 22.

109. Taxable income is defined as gross income minus above-the-line deductions and the standard deduction. 26 U.S.C. § 63 (2018).

110. *See generally id.*

111. Tracey M. Roberts, *Brackets: A Historical Perspective*, 108 NW. U. L. REV. 925, 942 (2014).

112. *See* Ashford-Grooms, *supra* note 104 (illustrating that the tax law passed in 1913 included tax exemptions for specific income earners).

113. Paul Terrell, *Taxing the Poor*, 60 U. CHI. SOC. SERV. REV. 272, 278 (1986).

114. *Id.*; *see generally* Ashford-Grooms, *supra* note 104 (arguing Congress was eager to reduce the tax burden).

115. Ashford-Grooms, *supra* note 104.

116. *See id.* (illustrating that taxes would begin at the 3% for earners of $800 or more).

117. *See The Sixteenth Amendment*, CONST. CTR., https://constitutioncenter.org/interactive-constitution/amendments/amendment-xvi (last visited Sept. 30, 2019) (explaining that the 16th Amendment changed Article I, Section 9 of the Constitution and allowed Congress to levy an income tax).

118. Roberts, *supra* note 111, at 940 (noting that in the year 1913 the personal exemption was equal to approximately $70,600 in 2013).

119. *Id.* at 930 (noting that the personal exemption was $70,593 and the total personal exemption plus the standard deduction was $70,593).

Exemptions.

The JCT defines the normal structure of the income tax as including the following major elements: one personal exemption for each taxpayer, spouse, and each dependent; the standard deduction; the existing tax rate schedule; and deductions for investment and business expenses.[120] The JCT thus considers the zero-bracket as "a part of normal tax law."[121] With the passage and implementation of the TCJA in 2018, the new ZBA is $24,000 through the standard deduction alone.[122] Considering that the Exemptions long predate the standard deduction, this is a concerning shift in tax policy.

A. The Standard Deduction: One Half of the Zero-Bracket Determination for U.S. Federal Income Taxation

The bread and butter of U.S. taxation law consists of three principle criteria for evaluating tax law: equity, efficiency, and administrability/simplicity.[123] For both simplicity and equity, the standard deduction was introduced in 1944[124] to help manage the shift from a class tax to a mass tax.[125] It served two main purposes: to create a zero bracket and to simplify returns by minimizing the need for itemized deductions.[126]

In its first year, the standard deduction was set at 10% of adjusted gross income up to a maximum of $5,000.[127] This was supposed to allow for "taxation without irritation."[128] The main motivation, therefore, was to simplify tax payments for the taxpayers by allowing them to simply deduct 10% from their taxable income

120. STAFF OF J. COMM. ON TAXATION, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS, 110TH CONG., JCX-37-08, at 22 (Comm. Print 2008) [hereinafter RECONSIDERATION OF TAX EXPENDITURE]; *see* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, SPECIAL ANALYSES BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 1976, at 102–05 [hereinafter SPECIAL ANALYSES] (outlining the elements of a normal tax rate structure).

121. RECONSIDERATION OF TAX EXPENDITURE, *supra* note 120, at 22.

122. Mitchell Franklin & Michaele L. Morrow, *Sneaky Tax Increases: Ignored Provisions in the TCJA*, TAX NOTES (Sept. 11, 2018), https://www.taxnotes.com/tax-notes-today/tax-cuts-and-jobs-act/sneaky-tax-increases-ignored-provisions-tcja/2018/08/27/2899l.

123. *See* Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1 (2006) (contending that the traditional grounds for evaluating tax policy are efficiency, equity, and administrability).

124. But there was considerable tension between congressional lawmakers and charity lobbyists when the standard deduction was created. Charities argued that the standard deduction abandoned the longstanding policy of exempting charitable contributions from taxation. Joseph J. Thorndike, *Tax History: The Love-Hate Relationship with the Standard Deduction*, TAX HIST. PROJECT (Mar. 27, 2014), http://www.taxhistory.org/thp/readings.nsf/ArtWeb/FD4865793851996185257D1B0041C875?OpenDocument; *see also* Table 1.

125. *See* Schrank, *supra* note 34 (describing a shift in income tax with the income tax originally paid by only a small percentage of wealthy Americans but later shifting to roughly 70% of Americans to help finance World War II and create a stronger federal government).

126. John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 205 (2011).

127. Individual Income Tax Act of 1944, Pub. L. No. 315, § 9, 58 Stat. 231, 236 (1944).

128. Thorndike, *supra* note 124 (quoting language from a 1944 article entitled '*Easy*' *Tax Bill Moves Toward Senate Action* published by The Christian Science Monitor).

"instead of keeping shoe boxes full of receipts."[129] However, in 1964, Congress moved away from the income percentage and created a minimum standard deduction which reflected an acknowledgment of the cost of living.[130]

From time to time, Congress adjusted the standard deduction to promote prosperity in the middle class and to administer a zero bracket.[131] The standard deduction provides U.S. "taxpayers with a minimum amount of untaxed income, effectively creating a 'zero-bracket amount'" especially in previous conjunction with the Exemptions.[132] The ZBA acts as an element of progressivity by providing for a minimum amount of untaxed income and ensuring that high income taxpayers pay a higher share of income tax.[133] The purpose of progressivity is in conflict with the ZBA's other primary purpose: simplification.[134] "If the standard deduction reduces taxable income—by approximating itemized deductions—then it is defining the base; but if it is stating an amount of taxable income not subject to tax—a ZBA—then it is part of the rate structure."[135] However, the majority of analysts and commentators view the combined standard deduction-Exemption ZBA as "primarily a tool of progressivity" defining the rate structure.[136]

In 2018, the new standard deduction amount was $24,000 for a married couple filing jointly, and $12,000 for a single individual.[137] That is nearly double the amount of the standard deduction available prior to the TCJA.[138] The driving forces behind this change, and the TCJA generally, were "policy, process, and politics."[139] The Trump Administration released a nine-page framework for "fixing our broken tax code."[140] Two of the four principles laid out therein were meant to justify this change in the ZBA. The first principle was to make the tax code "simple, fair and easy to understand," and the second was to "give American workers a pay raise by allowing them to keep more of their hard-earned paychecks."[141] By raising the standard deduction, the Administration reasoned that they were increasing the ZBA

129. Schrank, *supra* note 34.

130. *Id.*

131. *See id.* (contending inflation motivated Congress to incorporate the minimum standard deduction).

132. Brooks, *supra* note 126, at 203.

133. *Id.* at 205.

134. *Id.* at 206.

135. *Id.*

136. *Id.*

137. Amir El-Sibaie, *2018 Tax Brackets*, TAX FOUND. (Jan. 2, 2018), https://taxfoundation.org/2018-tax-brackets/.

138. William G. Gale et al., *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis*, TAX POL'Y CTR. (June 13, 2019), https://www.taxpolicycenter.org/sites/default/files/publication/155349/2018.06.08_tcja_summary_paper_final.pdf.

139. Eric Solomon, Drivers and Effects of the 2017 Tax Act, Georgetown Tax Law and Public Finance Workshop (Mar. 6, 2018) (slides on file with author) (quoting Mark Prater, Deputy Staff Director and Chief Tax Counsel for the Senate Finance Committee).

140. *United Framework for Fixing Our Broken Tax Code*, U.S. DEP'T OF THE TREASURY (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/documents/tax-framework.pdf.

141. *Id.* at 2.

and allowing middle-class families to have less of their income subject to federal income tax.[142] However, as discussed briefly below, this is not the outcome achieved by the TCJA.[143]

B. The Personal and Dependency Exemptions: Other, Integral Components of the U.S. Zero-Bracket Amount

Like the standard deduction, the Exemptions are the other main tax tool for achieving progressivity.[144] Before the TCJA, and in combination with the standard deduction, the Exemptions operated to define the ZBA.[145] Notably, the dependency exemption was the other main deduction for which non-itemizers were eligible—$4,050 in 2017—[146] for each of their dependent family members.[147] The goal of the Exemptions, as with most provisions of the tax code, was to promote both horizontal and vertical equity by recognizing a taxpayer's obligations of support in accordance with the Ability to Pay doctrine.[148]

1. Exemptions and the Preserved Consideration of a Taxpayer's Ability to Pay

The federal government has long recognized that the power to tax is also "the power to destroy."[149] In recognizing that there is an inherent "limit beyond which no institution and no property can bear taxation,"[150] the Supreme Court cautioned against adopting abusive or repugnant tax schemes which would operate to "banish that confidence which is essential to all government."[151] Therefore, to tax an individual or entity beyond its capacity is a self-defeating and "repugnant" policy that would only operate to undermine the government's power and sow distrust.[152] This is an outcome that was to be avoided at all costs. Hence, the adoption of the

142. *Id.*

143. Though some taxpayers may see more tax savings with these changes, taxpayers with multiple dependents will face an increase in tax liability. *See, e.g.*, Bill Bischoff, *Have Kids? 5 Ways the New Tax Law Affects You*, MARKETWATCH (Mar. 30, 2018, 1:10 PM ET), https://www.marketwatch.com/story/have-kids-5-ways-the-new-tax-law-affects-you-2018-02-21 (discussing how families with children will not benefit from the increased standard deduction).

144. Brooks, *supra* note 126, at 206.

145. *See id.* at 209 (showing that the standard deduction and personal exemptions allow for particular taxpayers to pay no income tax).

146. Emily Cauble, *Itemized Deductions in a High Standard Deduction World*, 70 STAN. L. REV. ONLINE 146, 148 (2018).

147. Brooks, *supra* note 126, at 213 (citing H.R. Rep. No. 91-412 (1969)).

148. Horizontal equity is the principle that people who are similarly situated should pay similar amounts. Vertical equity is the principle that people with a greater ability to pay should pay more taxes. Alice G. Abreu, *Tax 2018: Requiem for Ability to Pay*, 52 LOY. L.A. L. REV. 61, 64 n.4 (2018) (citing David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43 (2006)); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45 (1967).

149. McCulloch v. Maryland, 17 U.S. 316, 431 (1819).

150. *Id.* at 327.

151. *Id.* at 431.

152. *See id.* at 347 (discussing the importance of trust and reasonable confidence amongst citizens in all relations in society).

Ability to Pay doctrine.

Referring to Table 1, Congress employed the Exemptions to create a portion of income that is not subject to taxation—a ZBA.[153] The main theory validating the Exemptions is drawn from fairness, or one's "ability to pay."[154] There are two components of the Exemptions. First, each taxpayer is entitled to one personal exemption for the taxpayer themselves, and a second exemption for the spouse if the taxpayer is married and filing jointly.[155] Second, the number of Exemptions increase with family size in the form of dependency exemptions.[156] Importantly, this second aspect of the Exemptions serves the purpose of considering a taxpayer's burdens of support.[157] The TCJA departs from this foundational tax policy norm.

There are four possible views on the wisdom of dependent deductions. The first view is that dependents are a form of consumption, and that accordingly, no deduction should be offered for them.[158] Cynically speaking, dependents as a form of pleasurable consumption are considered "an indulgence in personal preferences because the decision to procreate is voluntary."[159] Support for non-offspring dependents, like siblings or other relatives, may be viewed as even more voluntary as those obligations may be terminated at any time without violating a legal obligation.[160]

The second view, that dependents are a form of investment, suggests that a taxpayer's present-day expenditures on dependents will be reciprocated at some point in the future in the form of financial aid from the grown dependents.[161] "So viewed, the cost of supporting dependents should no more be deductible than premiums paid for insurance against personal calamities or amounts invested in marketable securities."[162] This could essentially be thought of as a different form of retirement plan.

The third viewpoint that the dependency exemption may correlate with the current population policy assumes a highly rational taxpayer.[163] "If a rising birth rate

153. *See* Brooks, *supra* note 126, at 220 (discussing the elements of simplicity and progressivity as justification for the zero bracket created through exemptions).

154. C. Garrison Lepow, *Teenagers, Twenty Somethings, and Tax Inequality: A Proposal to Simplify the Age Requirements of the Dependency Exemption*, 19 N.Y.U. J. LEGIS. & PUB. POL'Y 797, 803 (2016).

155. *Key Elements of the U.S. Tax System*, TAX POL'Y CTR., https://www.taxpolicycenter.org/sites/default/files/briefing-book/key_elements_of_the_us_tax_system_1.pdf.

156. *See* Brooks, *supra* note 126, at 235 (contending that rates can change for progressivity without raising rates due to the size of a family).

157. Abreu, *supra* note 148, at 66.

158. Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1445 (1975).

159. *Id.* at 1446 ("Even before the advent of the Pill, it was argued that couples who preferred action to abstinence should not be rewarded by the Treasury.").

160. *Id.*

161. *Id.* at 1447.

162. *Id.*

163. *See id.* at 1449 ("While neither side of this argument can offer any statistical evidence of the effect of tax allowances on the national birth rate, I doubt that even the most computerized econometrician weighs the value of a dependency exemption before procreation.").

is a Good Thing for the nation, generous dependency allowances seem appropriate, but if a reduction in the birth rate is the desired national objective, dependency allowances may be criticized as counterproductive."[164] However, this line of thinking does not track with reality. It is unlikely that a taxpayer would make reproductive decisions to terminate or prevent a pregnancy based solely on tax policy.[165]

A more familiar theory for the dependency exemptions is the aforementioned Ability to Pay concept. A taxpayer's capacity to pay taxes is directly affected by "the number of mouths that the taxpayer feels legally or morally obligated to feed."[166] Ability to Pay seems to be the predominant view towards not just the Exemptions but many provisions of the tax code.[167] As depicted in Table 1, Congress has considered a taxpayer's ability to pay since 1913 when they allowed personal exemptions for taxpayers and their spouses, which was later expanded to include children in 1917.[168] "The dependency exemption reflects the philosophy that once children are born, society feels an obligation to support them."[169] When a parent must provide for their children, their ability to pay tax is reduced,[170] which should be reflected in their tax liability. Allowing exemptions for this change in financial burden has been an integral element of the U.S. income tax for over 100 years.[171]

In fact, "[p]ersonal and dependency exemptions were such an integral part of the determination of the tax base that the JCT did not score them as tax expenditures."[172] Before the TCJA, the JCT considered the Exemptions a part of the normal structure of the individual income tax.[173] "By contrast, most credits, especially refundable credits like the Earned Income Tax Credit and the CTC, which take family size into account in determining final tax liability, are tax expenditures."[174] Therefore, Congress made a substantial change to the normal

164. *Id.*

165. *Cf.* Kyle Pomerleau, *Understanding the Marriage Penalty and Marriage Bonus*, TAX FOUND. (Apr. 23, 2015), https://taxfoundation.org/understanding-marriage-penalty-and-marriage-bonus/ (noting that the tax consequences of marriage do not appear to change marriage decisions).

166. Bittker, *supra* note 158, at 1448.

167. *See* Abreu, *supra* note 148, at 64 ("The TCJA transforms the income tax system . . . ignoring one of its most important animating principles—ability to pay.").

168. See Appendix Table 1 for a timeline of the zero-based amounts in U.S. income tax.

169. Lepow, *supra* note 154, at 803.

170. Bittker, *supra* note 158, at 1448.

171. *See id.* 1450 ("The allowance could vary with the taxpayer's income, or with the actual or estimated amount of support provided by him, but Congress has consistently fixed the allowance at a flat amount, regardless of the taxpayer's income, ever since it first authorized a dependency exemption in 1917.").

172. Abreu, *supra* note 148, at 70.

173. *See* STAFF OF J. COMM. ON TAXATION, 115TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016-2020, JCX-3-17, at 3 (Comm. Print 2017) ("Under the Joint Committee staff methodology, the normal structure of the individual income tax includes the following 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.").

174. Abreu, *supra* note 148, at 71.

structure of the tax system when it eliminated the deductions for personal and dependency exemptions.[175] "The change downgrades important values that have animated the tax system almost from its inception"[176] and instead ignores a taxpayer's obligation of support.[177] Eliminating the Exemptions[178] produces a situation that ignores a taxpayer's economic reality[179] resulting in a major shift in U.S. tax policy. The effect of the elimination is highlighted further in the next Section.

1. Effects of Eliminating the Exemptions

With the elimination of the Exemptions, there has been a fundamental shift in tax policy.[180] The Trump Administration argues that doubling the standard deduction is sufficient to account for what amounts to an attack on the principle of fairness.[181] The new policy devalues the obligation of support and undermines the legitimacy of the tax system.[182] In fact:

> Using 2017 numbers, a family of five would be allowed a standard deduction of $12,700, plus an additional two personal exemptions and three dependency exemptions of $4,050 each—a $32,950 reduction in taxable income. Under the TCJA, by contrast, that reduction in taxable income would be limited to the $24,000 standard deduction and thus increase taxable income by $8,950.[183]

The elimination of the dependency exemptions results in a de facto child tax. While changes to the standard deduction and the CTC may partially offset this for families with fewer or no children, the special rules of § 24 severely limit the

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175. *Id.*

176. *Id.* at 72.

177. *See id.* at 64–65 (arguing that TCJA fails to account for ability to pay by excluding consideration of support obligations, including the personal and dependent exemptions).

178. In combination with the elimination of the deduction for alimony, these changes completely unmoor the tax system from a taxpayer's economic reality. *See id.* at 69 ("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."); *see id.* at 70 ("[N]either the [Earned Income Tax Credit] 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.").

179. *See id*. at 66 ("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.").

180. *Id.* at 64–65.

181. *See id.* at 65–66 ("Under the TCJA, taxpayers with very different non-discretionary legal obligations will have equivalent tax bases, thereby turning the principle of horizontal equity on its head.").

182. *Id.* at 64. See *supra* Part I for a discussion of how even if a quasi-NRA is eligible for the CTC, that is an after-tax credit and would still result in taxation on gross income.

183. Franklin & Morrow, *supra* note 122.

eligibility of the CTC.[184] Notably, NRAs are not eligible for the CTC unless the qualifying child is a U.S. citizen, national, or lawful resident.[185] Additionally, NRAs are not eligible for the standard deduction, except for students and business apprentices from India.[186] Previously, this did not present an issue for quasi-NRAs because they could use the Exemptions to create a ZBA.[187] Now, without the standard deduction or the Exemptions, quasi-NRAs have no ZBA and are taxed on gross income.[188]

Consider the above example, described by some as "the TCJA's sneakiest increase to tax liability."[189] Eliminating the Exemptions results in a married couple with three children who file a joint return having a tax base equal to that of a married couple who also file a joint return but have no children and thus no obligation of support.[190] In operation, this is a penalty for having children. A family's ability to pay is not considered in determining its taxable income, a result that lacks horizontal equity.[191] Although no taxpayer is entitled to the Exemptions, there are alternatives for resident aliens and U.S. citizens that may help to alleviate this burden.[192] The alternatives are not available to the quasi-NRAs, resulting in the inequitable taxation of those individuals.[193]

IV. TAXING EXEMPT INDIVIDUALS ON GROSS INCOME: UNFAIR AND LIKELY IN VIOLATION OF SEVERAL U.S. TAX TREATIES

The result of the TCJA is that quasi-NRAs continue to be ineligible for the standard deduction in 2018 and may no longer claim the Exemptions, effectively taxing this group of individuals on their gross income.[194] The Bluebook for the TCJA does not go into detail on the reasons for the elimination of the Exemptions. The

184. *See* 26 U.S.C. § 24(h) (2019) (detailing special rules for claiming the CTC between 2018-2019); *see also* 26 U.S.C. § 152(c) (2019) (defining "qualifying child" for purposes of Subtitle A of the Internal Revenue Code, including § 24).

185. 26 U.S.C. § 24(c)(2) (referencing 26 U.S.C. § 152(b)(3)(A) to define the limitations of a "qualifying child").

186. *Nonresident Alien Figuring Your Tax*, *supra* note 11; *see* India-U.S. Tax Convention, *supra* note 11, art. 21(2) (noting that Indian citizens in United States as students or business apprentices are entitled to claim all tax privilege of U.S. citizens on income not otherwise exempt from taxation under the Convention).

187. *See* Brooks, *supra* note 126, at 205 (noting that exemptions were part of the mechanism for achieving a zero bracket). See Appendix Table 1 for a discussion of the exemptions over time.

188. *See* Zlateva, *supra* note 8 (presenting how the lack of exemptions and the standard reduction results in NRAs paying tax based on gross income).

189. Franklin & Morrow, *supra* note 122.

190. *See id*. (noting that after the TCJA, a family with three children will have a flat exemption from income of $24,000, which is a decrease of $8,950 from the same family's 2017 exemption).

191. *See* Abreu, *supra* note 148, at 64 (noting how ignoring a taxpayer's ability to pay undermines the principles of horizontal equity).

192. *See supra* Part II.B for a discussion of the partial offset effect from increasing the standard deduction.

193. *See supra* Part I for a discussion on the general unavailability of standard deduction to NRAs.

194. Abreu, *supra* note 148, at 67.

explanation of the provision is limited to its application without touching on its genesis.[195] Congress and the Trump Administration claim that eliminating the Exemptions will increase the administrability of the tax code by doubling the standard deduction and reducing the need for itemized deductions, thus simplifying the tax system.[196]

However, this idea of simplicity diminishes upon closer scrutiny. For example, the JCT goes on to explain that although the personal exemption amount is reduced to zero, it does not alter the eligibility of qualifying children, as defined in 26 U.S.C. § 151, for the CTC.[197] Instead of a simple calculation totaling the number of exemptions for dependent children, taxpayers must still wade through the complicated legislative architecture to determine eligibility for the refundable credits.[198] Specifically, taxpayers must still struggle with the definitions of a qualifying child under the otherwise useless exemption rules in § 151 in order to apply them to the determination for the CTC.[199]

Overall, the elimination of the Exemptions, in combination with 26 U.S.C. § 63(c)(6) which prohibits Exempt Individuals such as quasi-NRAs from claiming the standard deduction, results in a confusing jumble of provisions that ultimately leads to the unfair taxation of quasi-NRAs. The remainder of Part IV details how taxing quasi-NRAs on gross income is unfair. Then, it discusses the potential international law transgressions based on the tax treaties to which the United States is a party.

A. Violation of the Principles of Fairness

"At their core, taxpayer rights are human rights."[200] The Internal Revenue Code lists dozens of taxpayer rights, which have since been grouped together into ten fundamental rights by the National Taxpayer Advocate.[201] The rights contained in the Taxpayer Bill of Rights (TBOR) are:

> [T]he right to be informed, the right to quality service, the right to pay no more than the correct amount of tax, the right to challenge the IRS's position and be heard, the right to appeal an IRS decision in an

195. *See* GENERAL EXPLANATION OF PUBLIC LAW 115-97, *supra* note 102, at 66 (explaining elimination of exemptions without offering rationale).

196. *United Framework for Fixing Our Broken Tax Code supra* note 140, at 4.

197. *See* GENERAL EXPLANATION OF PUBLIC LAW 115-97, *supra* note 102, at 66 n.283 (noting that CTC may still be claimed, notwithstanding elimination of exemptions).

198. *See id.* at 43–45 (explaining the steps to claim the CTC). However, if the Exempt Individuals are not eligible for social security numbers, or if their social security numbers are excepted under 26 U.S.C. § 32(m), the availability of the earned income tax credit, the most substantial refundable credit, is unlikely. *See* 26 U.S.C. §§ 32(a)(1), 32(m) (2018) (showing how the rules regarding social security numbers may act as a bar against receiving the earned income tax credit).

199. GENERAL EXPLANATION OF PUBLIC LAW 115-97, *supra* note 102, at 45.

200. National Taxpayer Advocate, *Taxpayer Rights*, IRS (quoting Nina Olson, Nat'l Taxpayer Advocate, Bar Assoc. Section of Taxation, Laurence Neal Woodworth Memorial Lecture: A Brave New World: The Taxpayer Experience in a Post-Sequester IRS (May 9, 2013)), https://www.irs.gov/advocate/taxpayer-rights (last updated July 17, 2019).

201. *See id.* (noting that the National Taxpayer Advocate has classified rights into ten categories).

> independent forum, the right to finality, the right to privacy, the right to confidentiality, the right to retain representation, and the right to a fair and just tax system.[202]

Yet quasi-NRAs do not experience a fair and just tax system. Exempt Individuals are the only individuals or entities in the United States taxed on gross income.[203] For some NRAs, this is inconsequential. Nonresident investors are taxed on their gross dividends and interest received from U.S. sources by way of withholding under 26 U.S.C. § 871.[204] The taxation must occur through withholding mechanisms because the NRA investors never step foot in the United States, rendering it virtually impossible to enforce tax collection under alternative methods.[205] However, the Exempt Individuals, by definition, are physically present enough to render them a resident under the Substantial Presence Test.[206] But for the special exception labeling them Exempt Individuals, and thus quasi-NRAs, they would be eligible to claim the standard deduction to reduce their taxable income; instead, due to the elimination of the Exemptions, the Exempt Individuals are the only domestic taxpayers who are taxed on gross income.[207]

In a fair and just tax system, all "taxpayers have the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, *ability to pay*, or ability to provide information timely."[208] As established in Section III, the combination of the Exemptions and the standard deduction was the mechanism through which the tax system considered a taxpayer's ability to pay.[209]

The Ability to Pay doctrine is a fundamental presumption of the U.S. tax system which dates back to medieval roots.[210] In his eighteenth century treatise, *The Wealth of Nations*, Adam Smith stated that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their

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202. *Taxpayer Bill of Rights*, TAXPAYER ADVOC. SERV. (July 2017) https://www.irs.gov/pub/irs-pdf/p5170.pdf.

203. See *supra* Part I detailing how NRAs are taxed on gross income because they are denied the standard deduction in addition to the Exemptions.

204. 26 U.S.C. § 871(a) (2018).

205. *See id.* (discussing how FDAP is taxed, at the source, at a 30% (or lower) treaty rate).

206. *Substantial Presence Test*, *supra* note 3.

207. *See* Abreu, *supra* note 148, at 68.

208. *Taxpayer Bill of Rights*, *supra* note 202 (emphasis added). *But see* Abreu, *supra* note 148, at 64 (noting the TCJA violates this fairness principle by avoiding ability to pay). However, much to the chagrin of academics in the tax field, taxpayers are not permitted to rely on the TBOR or any information listed on the IRS website as this information is not officially law. Robert W. Wood, *IRS Warns Don't Rely on IRS.Gov -- It Isn't Authority*, FORBES (Jun. 20, 2017, 8:42 AM), https://www.forbes.com/sites/robertwood/2017/06/20/irs-warns-dont-rely-on-irs-gov-it-isnt-authority/#7e2c83bd7c17.

209. See *supra* Section III outlining how the tax code used the standard deduction and the Exemptions as a tool to reflect changes in a tax-payers ability to pay.

210. *See* Edwin R.A. Seligman, *Progressive Taxation in Theory and Practice*, *in* PUBLICATIONS OF THE AMERICAN ECONOMIC ASSOCIATION 15–21 (2d ed. Princeton Univ. Press 1908) (exploring how societies have considered a taxpayer's ability to pay throughout history).

respective abilities."[211] Throughout history, writers would often invoke this doctrine, which states that a just tax system requires that people pay taxes according to "faculty."[212]

The doctrine of paying taxes according to "faculty" continues to surface in modern scholarship, with scholars accepting it as dogma.[213] For over a century, there has been a universal acceptance in recognizing an individual's taxable capacity "not only amongst political and economic writers, but amongst the public at large."[214] Socioeconomic scholars in the United States have long recognized that comparative economic wellbeing should determine the basis for a taxpayer's rate.[215] Thus, the Ability to Pay concept of "fairness" has historically played a pivotal role in shaping U.S. tax policy.[216] This widespread U.S. belief is evidenced by the inclusion of the right to a fair and just tax system, as outlined in the TBOR.[217]

Both egalitarian and utilitarian schools of thought support the construction of a country's tax system in a manner that incorporates the taxpayers' ability to pay.[218] Philosopher John Stuart Mill expressed that the goal of egalitarianism is to prevent the subordination of persons—meaning that every person gives an "equal sacrifice."[219] To achieve the most efficient results for society, the tax system must impose taxes on people "in accordance with the principle of equal sacrifice."[220] Adherence to the utilitarian principle requires taxing people "in terms of quantity of utility per person."[221] Pursuing the utilitarian goal leads to "the least sacrifice in society on the whole."[222] Regardless of the philosophical approach, an individual's ability to pay is universally acknowledged to constitute a key component in designing a fair and just tax system.[223]

Therefore, Congress's sudden departure from centuries-old tax policy is

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211. ADAM SMITH, THE WEALTH OF NATIONS 498 (Cosimo 2013) (1776).

212. Seligman, *supra* note 210, at 131.

213. *See* Steven Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 868–69 n.3 (2002) (tracing the historical pattern of the doctrine's acceptance in academia).

214. NICHOLAS KALDOR, AN EXPENDITURE TAX 26 (Routledge 2003) (1955).

215. J. Clifton Fleming et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 306 (2001).

216. *Id.*

217. *See generally Taxpayer Bill of Rights*, *supra* note 202.

218. *See* Michael Pressman, *"The Ability to Pay" in Tax Law: Clarifying the Concepts of Egalitarian and Utilitarian Justifications and the Interactions Between the Two*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 141, 141 (2018) ("Distributing the tax burden according to people's ability to pay furthers both egalitarian and utilitarian ideals.").

219. *See id.* at 145–46 (introducing Daniel Markovit's analyses of egalitarianism and the egalitarian project pertaining to selection and proper redistribution of wealth).

220. *Id.* at 155 (citing JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 804 (W. J. Ashley ed., Longmans, Green & Co. 1909) (1848)).

221. *Id.*

222. *Id.*

223. *See id.* at 143 ("Despite the broad-based assent to the importance of 'ability to pay,' however, there has been far from a consensus on why it is important, or even on what the term means.").

alarming.[224] Ability to Pay switched from playing a prominent role in guiding U.S. tax policy to no longer being considered with respect to certain individuals.[225] Quasi-NRAs are not entitled to the standard deduction,[226] and Congress rendered the Exemptions ineffective until 2026.[227] In no way does the current U.S. tax system consider a quasi-NRA's ability to pay. This disparate treatment does more than ring of inequity—it may very well violate the nondiscrimination clauses of many U.S. tax treaties.

B. Violation of Tax Treaties

The United States is a party to over sixty bilateral tax treaties.[228] Many of these tax treaties contain a nondiscrimination clause.[229] The average nondiscrimination clause closely resembles the Organisation for Economic Co-operation and Development (OECD) Model Tax Treaty: "A State shall not subject non-nationals to 'other or more burdensome taxation' than nationals who are 'in the same circumstances.'"[230] However, the Model Tax Treaty's nondiscrimination clause does not overtly apply to nonresidents.[231] In fact, differences in tax treatment between a resident and a nonresident are viewed "as entirely permissible under tax treaties."[232]

The Chairman of the OECD addressed the issue of nondiscrimination clauses in bilateral tax conventions.[233] The Chairman recognized that residents and nonresidents are not in the same circumstances, thus justifying disparate tax treatments despite nondiscrimination clauses.[234] The purpose of a nondiscrimination clause is to "provide national treatment" covering tax entities "with a significant presence" in a state.[235] Nondiscrimination clauses in tax conventions are limited and

224. *See* Abreu, *supra* note 148, at 66 (noting that Congress eliminated not only personal exemptions but even items such as alimony deductions).

225. *Id.* at 61–62 (arguing the change in policy is detrimental to the tax system and taxpayers).

226. *Topic No. 551 Standard Deduction*, IRS, https://www.irs.gov/taxtopics/tc551(last updated Aug. 23, 2019). *But see* India-U.S. Tax Convention, *supra* note 11 (establishing that students and business apprentices who are residents of India are eligible for the standard deduction).

227. 26 U.S.C. § 151(d)(5) (2018).

228. *See, e.g.*, *United States Income Tax Treaties – A to Z*, IRS https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z (last visited Nov. 27, 2018).

229. *See* Catherine A. Brown, *Taxation and the Cross-Border Trade in Services: Rethinking Non-Discrimination Obligations*, 21 FLA. TAX REV. 715, 723 (2018) (discussing inconsistencies in nondiscrimination obligations in various U.S. tax treaties).

230. *See id.* at 717 n.5 (citing OECD Model Tax Convention on Income and on Capital, art. 24(1), July 15, 2014 [hereinafter OECD Model Tax Treaty], http://dx.doi.org/10.1787/mtc_cond-2014-en) (explaining prohibitions laid out in Article 24 the OECD Model Tax Treaty).

231. *Id.* at 715.

232. *Id.* at 717–18.

233. CHAIRMAN OF THE OECD, NON-DISCRIMINATION IN BILATERAL TAX CONVENTIONS, DAFFE/MAI/EG2/RD(96)1 (1996) [hereinafter OECD Chairman Note], https://www.oecd.org/daf/mai/pdf/eg2/eg2rd961e.pdf.

234. *Id.* ¶ 2.

235. *Id.* ¶ 3.

"reflect the practical problems of cross-border taxation."[236]

However, Exempt Individuals are not the average NRA. Exempt Individuals for whom days of presence in the United States do not count towards the Substantial Presence Test include: certain employees of foreign governments, teachers or trainees, some student visa holders, and professional athletes visiting the United States for charitable events.[237] They are the quasi-NRAs. As established in Part II.B, Congress's intent in identifying the Exempt Individuals was to relieve them of a heavier tax burden.[238] Congress wanted to reward and incentivize these individuals.[239] Thus, while it may be permissible under tax treaties to subject true NRAs to taxation on gross income, it does not necessarily follow that Congress should also subject the quasi-NRAs to the same burden.[240]

In reality, Exempt Individuals are more similarly situated to resident aliens and citizens than they are to NRAs.[241] They are in the United States for extended periods of time and actively participate in the economic, political, and social communities.[242] But for the Exempt Individual Exception, they would qualify as resident aliens and would be afforded the standard deduction.[243] However, these individuals are now, in effect, taxed on their gross income, which poses a significantly higher burden than any other similarly-situated taxable entity under the U.S. tax code.[244] In function, if not in terms, this is a violation of the nondiscrimination clauses in the bilateral tax conventions to which the United States is a party.[245]

V. PROPOSED SOLUTION

There are two methods to remedy this inadvertent injustice. The first proposed method is editing § 151 of the Internal Revenue Code to continue to allow quasi-

236. *Id.* ¶ 6.

237. *See Exempt Individuals: Teachers and Trainees*, IRS https://www.irs.gov/individuals/international-taxpayers/exempt-individuals-teachers-and-trainees (last updated June 27, 2019) ("Any nonimmigrant temporarily present in the U.S. in "J" or "Q" status who is not a student is included within the definition of 'Teacher or Trainee.'"); *see also Substantial Presence Test*, *supra* note 3 (explaining the rules that determine exemption and if a person is considered a resident in the United States for tax purposes).

238. *See* GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF 1984, *supra* note 4, at 464 (explaining Congress's recognition that a standard tax burden required exceptions for aliens on certain visa programs).

239. *See id.* ("Exceptions to the general rules of the provision for some students, teachers, and trainees help the United States to maintain its paramount position in the field of education.").

240. *Id.*

241. *See id.* at 465 (Congress reasoned that if a person is benefitting from the protections of living within the U.S., they should participate in paying for the system that protects them).

242. *See generally id.* at 463–65.

243. *See* INTERNAL REVENUE SERV., PUBLICATION 519: U.S. TAX GUIDE FOR ALIENS 28 (2019), https://www.irs.gov/pub/irs-pdf/p519.pdf (explaining that resident aliens qualify for the standard deduction).

244. *See, e.g.*, Abreu, *supra* note 148, at 67 ("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.").

245. *See generally* OECD Chairman Note, *supra* note 233.

NRA Exempt Individuals to claim a meaningful Exemption.[246] The second proposed method is to modify § 63 of the Code by carving out a modified standard deduction for quasi-NRA Exempt Individuals.[247] Both options raise issues of equity among taxpayers and questions regarding policy. Modifying § 63 to allow Exempt Individuals to claim the standard deduction satisfies both equity and policy concerns.

A. A Solution in the Exemptions

Section 151 remains largely unchanged by the TCJA.[248] The exemption amount is defined in subpart (d) of the Code, and, consequently, this is where the TCJA had some effect on the section.[249] "Special rules for taxable years 2018 through 2025[:] In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026 . . . the term 'exemption amount' means zero."[250] Instead of repealing the personal exemption, the TCJA merely renders it irrelevant until the 2026 tax year by reducing the exemption amount to zero.[251] Unless Congress renews this provision of the TCJA, the exemption will revert back to normal calculations resulting in a $4,050 exemption.[252]

Congress could choose to remedy the situation for quasi-NRAs under this subheading. The easiest method would be to create an additional provision under the "Special rules for taxable years 2018 through 2025" subheading.[253] Subheading A defines the exemption amount for 2018-2025 (zero dollars).[254] Subheading B references how the special rules apply to other aspects of § 151.[255] The following is suggested text to insert as a new subheading C:

> (C) **Exempt Individuals**
>
> In the case of an exempt individual (defined in section 7701(b)(5)), the reduction of the exemption amount to zero under subparagraph (A) shall not apply. Exempt individuals shall calculate their personal exemption for purposes of subparagraph (A) according to the rules set out in section 151(d)(1)-(4).

The benefit of modifying § 151 to continue offering the personal exemption is that it gives quasi-NRA Exempt Individuals no more than what they had in 2017. A special allowance for the Exemptions would honor the original legislative intent behind designating Exempt Individuals—people with many connections to the United States that are here for a significant amount of time. Additionally, it preserves

246. 26 U.S.C. § 151 (2018).
247. 26 U.S.C. § 63 (2018).
248. Auxier, *supra* note 16.
249. 26 U.S.C. § 151(d).
250. *Id.*
251. *Id.*
252. *Id.* § 151(d)(4) (noting that dollar amounts are to be adjusted for inflation).
253. *Id.* § 151(d)(5).
254. *Id.* § 151(d)(5)(A).
255. *Id.* § 151(d)(5)(B) ("For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.").

the historic tax policy of refusing NRAs the standard deduction.

However, this creates a question of horizontal inequity.[256] An NRA would be receiving a deduction that no other taxpayer facing the full weight of U.S. taxation is permitted to take. Politically speaking, this results in poor "optics."[257] Offering Exempt Individuals a modified standard deduction would not only be more appealing to the general public but would also be consistent with current policy.

B. A Solution in the Standard Deduction

A better alternative for resolving the tax on NRA gross income is to design a modified standard deduction specific to the Exempt Individuals. Section 63(c) defines the standard deduction.[258] NRAs are explicitly prohibited from claiming the standard deduction.[259] But there is a relatively easy fix. Section 63(c)(7) contains "Special rules for taxable years 2018 through 2025," the same years for which the personal exemption amount is reduced to zero.[260] This provides the ideal location to insert a provision for the Exempt Individuals. Section 63(c)(7)(A) increases the standard deduction for the years 2018-2025.[261] Section 63(c)(7)(B) provides adjustment for inflation.[262] Inserting a subheading (C) to address the Exempt Individuals could resemble language like this:

> (C) **Exempt Individuals**
>
> In the case of an exempt individual (defined in section 7701(b)(5)), with respect to whom a deduction under section 151 is allowable, paragraph (c)(6)(B) shall not apply and the exempt individual shall be entitled to a standard deduction in the amount of $4,050 for each deduction allowable under section 151, but for which the total standard deduction shall not exceed the basic standard deduction defined in paragraph (c)(2). This amount will be adjusted for inflation according to the rules set out in section 151(d)(1)-(4).

This scenario avoids the appearance of impropriety that offering quasi-NRAs an exemption not available to U.S. citizens and residents would create. Instead, the standard deduction route has the benefit of equity—quasi-NRA Exempt Individuals are offered relief from taxation on gross income but in an amount that does not exceed the amounts available to citizens and residents who are facing worldwide taxation.

Additionally, a modified standard deduction amount would be preferable to affording quasi-NRAs the full standard deduction. By definition, the United States does not tax Exempt Individuals on worldwide income,[263] and therefore a standard

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256. *See* Abreu, *supra* note 148, at 64 (giving a detailed description of what constitutes horizontal equity).

257. *See* Brooks, *supra* note 126, at 236 (noting that tax proposals must be considered in light of their substance but also their political optics).

258. 26 U.S.C. § 63(c) (2018).

259. *Id.* § 63(c)(6)(B).

260. *Id.* §§ 63(c)(7), 151(d)(5).

261. *Id.* § 63(c)(7)(A).

262. *Id.* § 63(c)(7)(B).

263. *See Taxation of Nonresident Aliens*, *supra* note 23 (dividing taxable income for NRAs

deduction of that magnitude would be unnecessary. Because their worldwide income is unknown, an Exempt Individual may very well have the ability to pay without the United States being aware. Allowing them a standard deduction equal to citizens and resident aliens, all of whom are being taxed on worldwide income, could improperly shift income out of the U.S. Treasury. A modified standard deduction protects the U.S. tax system from over-exempting on the low end, while not requiring a claw back of taxes on the high end.

However, not providing any standard deduction is adding an insult to the injury of the elimination of the Exemptions. Without the Exemptions or the standard deduction, and thus a ZBA, which represents necessary subsistence costs, tax liability is completely detached from the Ability to Pay.[264]

VI. CONCLUSION

It is alarming that the U.S. tax code is imposing the full weight of the tax system on the gross income of certain individuals who have substantial connections to the United States, which in many cases make them indistinguishable from U.S. citizens and residents. This staggering departure from centuries-old, basic taxation principles is not only inexplicable and unfair but is punishing a group of people that Congress intended to protect. Eliminating the Exemptions "unmoor[s] the zero-bracket from the poverty level," a result that may be partially alleviated by the standard deduction but not for quasi-NRAs.[265] An individual's ability to pay is the bedrock of a progressive taxation system.[266]

The simplest solution in this situation is to modify § 63 and permit Exempt Individuals to claim a modified standard deduction. In this case, the Exempt Individuals will not be receiving any tax benefit not also afforded to citizens, thereby preserving horizontal equity. Exempt Individuals, like all taxpayers, have the right to a fair and just tax system which considers their ability to pay.[267]

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into two categories: (i) income connected with a U.S. trade or business, and (ii) U.S. income that is FDAP income).

264. *See generally* Abreu, *supra* note 148, at 73 ("Despite nearly doubling the standard deduction, the TCJA . . . 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.").

265. *See id*. at 61–62 ("[The TCJA] 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 support obligations will be taxed the same, and in which two taxpayers with the same ability to pay will be taxed differently.").

266. *See* Kagan, *supra* note 56 ("Ability-to-pay taxation is a progressive taxation principle that maintains that taxes should be levied according to a taxpayer's ability to pay.").

267. *See Taxpayer Bill of Rights*, *supra* note 202 ("Taxpayers have the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely.").

APPENDIX

Table 1[268]

A Timeline of the Zero-Bracket Amount in U.S. Income Tax		
Year	**Mechanism**	**Zero Bracket Definition**
1861	Rate structure	The First federal income tax set a flat rate of 3% on incomes higher than $800. Effective ZBA was $799 as defined by the rate structure.
1913	Personal exemption and spousal exemption	The Sixteenth Amendment was ratified and the effective ZBA was implemented through the personal exemption, which changed the definition of the tax base. Each taxpayer was allowed a $3,000 personal exemption and an additional $1,000 exemption for a spouse.
1917	Personal exemption, spousal exemption and dependency exemptions (Exemptions)	An additional deduction for dependents was added.
1920s and '30s	Exemptions	Amounts allowed for the Exemptions varied, depending on revenue needs. The exemption amount allowed a married couple was more than double the exemption amount allowed a single taxpayer.
1944	Exemptions and standard deduction	The Revenue Act of 1944 introduced the standard deduction. All taxpayers could deduct up to 10% of AGI, up to a maximum of $500.
1964	Exemptions and standard deduction	The Revenue Act of 1964, with the Exemptions and the standard deduction operating together to create a ZBA, intended to eliminate much or all the tax liability of persons at or near the

268. Ashford-Grooms, *supra* note 104; *The Sixteenth Amendment*, *supra* note 117; Roberts, *supra* note 111, at 930, 940; Thomas L. Hungerford & Rebecca Thiess, *The Earned Income Tax Credit and the Child Tax Credit*, ECON. POL'Y INST. (Sept. 25, 2015), https://www.epi.org/publication/ib370-earned-income-tax-credit-and-the-child-tax-credit-history-purpose-goals-and-effectiveness/; SPECIAL ANALYSES, *supra* note 120, at 101 (explaining that tax expenditures from items, such as deductions and Exemptions, are a result of the government's objectives in achieving certain public policies); Auxier, *supra* note 16.

		subsistence level. The standard deduction moved to a flat amount rather than a percentage.
1976		The ZBA was recognized as a matter of policy. Revisions to the amount allowed under the Exemptions and the standard deduction reflected the philosophy that all income received by taxpayers below the poverty level ought to be tax-free.
2018	Standard deduction	The TCJA effectively eliminated the Exemptions by reducing their value to zero. The ZBA is achieved by standard deduction alone.