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## **TAX 2018: REQUIEM FOR ABILITY TO PAY**

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## TAX 2018: REQUIEM FOR ABILITY TO PAY

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

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

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

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

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

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

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## I. INTRODUCTION

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

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

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

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

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

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

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

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

## II. ERADICATING SUPPORT OBLIGATIONS FROM THE TAX BASE

### A. *Eliminating the Deduction for Support*

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

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

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

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

Also available as part of the eCourse

[Continued Impacts of the Tax Cuts and Jobs Act \(TCJA\)](#)

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