The Ability-to-Pay Principle and the Counterintuitive Distributive Justice Analysis of Alimony Payments

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Alice Abreu, *Tax 2018: Requiem for Ability to Pay*, 52 **Loyola L.A. L. Rev.** (forthcoming 2018), available at SSRN.

The tax bill that Republicans in Congress passed, and that Donald Trump signed in December 2017, might end up being one of the shortest-lived tax laws in U.S. history. Not only are large elements of it explicitly temporary, but the political moment that led to its passage seems already to be passing, quite likely to be followed by a time when progressive tax policy will once again be politically viable.

However, even if this bill lapses or is repealed (in whole or in part), Alice Abreu provides an important contribution to our understanding of what just happened in *Tax 2018: Requiem for Ability to Pay*. The title of the article telegraphs the importance of the issue that she identifies as the most unfortunate aspect of the new tax law. Whereas objective analysts knew that the bill's changes would make the tax system less progressive than it had been, Abreu explains that seemingly unrelated elements of the bill add up to a repudiation of the very idea of progressive taxation.

On the surface, that might seem to be an extreme claim. After all, the individual tax brackets maintain a structure of marginal tax rates that rise progressively from 10 percent to 37 percent, barely different from the structure that existed before. Abreu's article, however, describes how the rules have changed in a way that breaks the connection between ability-to-pay and the taxable income to which those progressive rates apply.

On a theoretical level, Abreu explains how the canonical separation of distributional analysis into questions of *horizontal* and *vertical* equity is highly artificial. In essence, she shows that people who are horizontally dissimilar are now being treated as if they are similar. For example, by giving everyone the same standard deduction without taking account of family size, two taxpayers can pay the same tax bill because their taxable incomes are identical, even though their true abilities to pay are not at all the same. A taxpayer who is truly richer than another person in the economic sense receives preferential tax treatment, because we are ignoring what makes him richer.

The article includes important discussions about several violations of the ability-to-pay principle, including the new law's change to the zero bracket that will cause some people in poverty to pay more taxes, the creation of artificial distinctions in the tax rates faced by various types of labor income, and the rejection of capital export neutrality. In this short review, however, I will focus only on Abreu's analysis of the surprising effects of the repeal of the deduction for alimony and the concomitant repeal of the inclusion of alimony in the gross income of the recipient ex-spouse, and I will add a further consideration into the analysis.

Abreu explains her concern about how those two changes regarding alimony will result in inappropriately equal tax treatment of dissimilar taxpayers:

> "[T]axpayers with wildly disparate ability to pay as measured by economic income will seem to have equivalent ability to pay, as measured by taxable income. This will occur because the

> receipt of the alimony that increases ability to pay will be ignored in the determination of the tax base. For example, an individual who receives $40,000 of alimony in addition to $40,000 of wages will look to the tax system precisely like one who receives only $40,000 of wages, even though the first individual has $80,000 of economic income and therefore has twice the ability to pay of the first." (P. 3.)

In one sense, however, this move could be seen as a pro-feminist adjustment to the tax code (even though it would be difficult to imagine that the current congressional majority was looking to use the tax system to fight the patriarchy). After all, because of the realities of wealth and income maldistribution in the U.S., the typical alimony payment is received by a woman in a lower tax bracket and paid by a man in a higher tax bracket. Taking the deduction away from (mostly) men and allowing (mostly) women to exclude alimony from gross income could partially make up for the income inequality that led to the alimony arrangement in the first place.

For example, suppose that the ex-husband who is paying $40,000 per year in alimony was in the top tax bracket (which, under the pre-2018 code, was 39.6 percent of income in excess of $418,400). His tax liability would thus have been reduced by almost $16,000 per year (nearly 40 percent of $40,000). His ex-wife, meanwhile, included $40,000 in alimony payments in her gross income. In Abreu's example above, the payee also earns $40,000 in labor income, for a gross income of $80,000. The entire $40,000 of added gross income from alimony would have been subject to a marginal rate of 28 percent under the old system, for a total increased tax liability of $11,200.

Under the new rule, by contrast, a $40,000 alimony payment actually costs the payor spouse $40,000, rather than the $24,000 net amount after taking account of the value of the deduction. The payee, similarly, nets the entire $40,000 rather than $28,800, which is what she would have had after paying the $11,200 in taxes under the old rule. This, therefore, would appear to result in a net transfer of $11,200 from the payor spouse to the payee spouse—plus the added bonus of $4800 net transferred from the payor spouse to the Treasury (which is surely why the law's congressional sponsors included these new rules in a bill that needed revenue offsets).

This, however, assumes that divorcing couples will continue to make the same deals under the new rules that they would have made under the old, which is exceedingly unlikely. The more likely result is that the payor spouse—who is, almost by definition, the party to the divorce with greater bargaining power—will insist on paying as close to $24,000 as possible. "I was willing to end up $24,000 down after tax from paying alimony, and that's as far as I'll go." If the divorce settlement lands on that end of the spectrum, the payee spouse will lose compared to the old system ($24,000 net after taxes instead of $28,800), even though she does not have to pay taxes on her alimony income.

The point here is that a change that looks like it favors one party over another might not do so. This in turn clears the decks to allow us to appreciate Abreu's focus on ability to pay: a person who receives $80,000 in income should be treated as if they have $80,000 in income, not $40,000; and a person who receives, say, $540,000 in income but is legally required to transfer $40,000 to another person should be treated as a person who has $500,000 in income. It is certainly true that those incomes should be taxed at different rates, but the incomes must be measured correctly in the first place.

I encourage readers to engage with the other arguments in Abreu's admirably parsimonious (17 page) article. Without any real debate, our tax system has been transformed from one that at least aimed to impose equal tax rates on people with equal ability to pay into a system that makes a mockery of that notion of distributive justice by deliberately mismeasuring people's true incomes. Abreu makes us aware of what has just happened in the name of the American people.

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