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Good Hybrids/Bad Hybrids

By Edward J. McCaffery

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In the second article I published as an academic, in 1992, "Tax Policy Under a Hybrid Income-Consumption Tax," I wrote that:

the tax policy literature has spent decades, and by some measures centuries, discussing the relative merits of an income versus a consumption tax. It may be time to stop. We should accept the fact of a hybrid income-consumption tax and begin to figure out how best to structure it.¹

My ears thus perked up when I heard discussion of hybrids again, with the President's Advisory Panel on Federal Tax Reform considering them as a way out of the current morass of tax.² Meantime, in the (gulp) more than a decade since I wrote those lines, I have refined my thoughts on hybrid income-consumption taxes. I now see that some hybrid tax systems — combinations of income and consumption taxes — lead to confusion, inefficiency, and unfairness, because they do not differentiate in the taxation of savings in any principled way. Those "bad" hybrids are worse than any "pure" tax system. Other hybrids indeed mark principled distinctions among savings and are thus very much worth implementing. When the panel asked me to testify, I took a few of my 10 minutes in the sun to explain good and bad hybrids.³

¹Edward J. McCaffery, "Tax Policy Under a Hybrid Income-Consumption Tax," 70 *Tex. L. Rev.* 1145, 1216 (1992).

²See Rob Wells, "Bush's Tax Panel's Breaux Seeks Income-Consumption Hybrid," *The Wall Street Journal*, Feb. 17, 2005, at A2.

³For information on the panel generally, see <http://www.taxreformpanel.gov/index.html>; for the slides from my testimony in particular, see http://www.taxreformpanel.gov/meetings/docs/mccaffery_052005.ppt.

I. Three Types of Tax

The first point to understand is that there are three — not two — choices of comprehensive tax base: income, prepaid consumption, and postpaid consumption taxes.⁴

Income taxes follow the Haig-Simons definition: In short, income equals consumption plus savings ($I = C + S$). An ideal income tax includes all net receipts that come into a taxpayer's possession or control as income, whether from labor earnings, capital, beneficence, or otherwise ("from whatever source derived," in the language of the 16th Amendment and Internal Revenue Code section 61). Income taxes, by their very nature, run into John Stuart Mill's noted "double tax" criticism when it comes to savings, because an income tax falls both on the initial receipt of wealth and on the subsequent yield to savings, that is, nonconsumed wealth. Savers are taxed more heavily than spenders.

It appears from the Haig-Simons definition that all consumption taxes exempt savings; by rearranging terms, we see that consumption equals income minus savings ($C = I - S$). From Mill's perspective, consumption taxes are single taxes on wealth that is saved. It seems to be just a matter of timing, between the two canonical forms of consumption tax, as to when to impose that single tax.

Prepaid consumption taxes are the equivalent of wage taxes such as the payroll tax and work on the Roth IRA model: Pay the single tax up-front — on the initial receipt of labor market earnings — and never again.

Postpaid consumption taxes are imposed later, on outflow, not inflow. They are equivalent to sales or spending taxes — and what the panel labeled "consumed income" taxes.⁵ Postpaid consumption taxes work like traditional IRAs or 401(k)s: Do not pay tax now — on account of the deductions for savings — but rather pay the single tax later, when money is withdrawn from the qualified, tax-deferred account and spent.

⁴For a longer treatment of these ideas, see Edward J. McCaffery, "Three Views of Tax," 18 *Canadian Journal of Law & Jurisprudence* 153 (2005); for a still longer treatment, see Edward J. McCaffery, "A New Understanding of Tax," 103 *Mich. L. Rev.* 807 (2005).

⁵See the panel's Web site, *supra* note 3, May 11 hearing. See also Al Ehrbar, "Consumption Tax," in *The Concise Encyclopedia of Economics* at <http://www.econlib.org/library/Enc/ConsumptionTax.html> (last visited May 19, 2005) ("A consumption tax — also known as an expenditures tax, consumed-income tax, or cash-flow tax — is a tax on what people spend instead of on what they earn.").

It is a standard result in traditional tax policy terms that prepaid and postpaid consumption taxes are generally equivalent under constant tax rates.⁶

But the fact of the matter is that we do not have, and have never had, constant tax rates under our major comprehensive individual tax system. Things are likely to stay this way. The president's advisory panel was specifically requested to develop plans for tax reform that would "share the burdens and benefits of the Federal tax structure in an appropriately progressive manner."⁷ The implications of progressive rates for comprehensive tax design are little known but profound. To wit, under progressive or nonconstant rates, the two forms of consumption taxes are *not* equivalent, as I have been working out in much greater detail in more formal academic work.⁸ Given progressive rates, an income tax double-taxes all savings. A prepaid consumption tax ignores all savings. A postpaid consumption or consumed income tax, in contrast, splits the difference, in a principled way, and by design. Capital transactions (savings, borrowing, and investing) that are ultimately used to smooth consumption profiles lower the burden of taxation; those that are used to enhance lifestyles raise them. I will explain this more in section IV.

With that basic understanding of the three types of tax as background, we can explore good and bad hybrids.

II. 'Good' and 'Bad' in Hybrid Tax Design

What do I mean by "good" and "bad" hybrids? That language seems unduly explicitly moral for the normally neutral-sounding rhetoric of tax, although tax is an inevitably moral subject. But there is no reason to invoke high concepts or deep philosophic debates about truth and justice when it comes to evaluating hybrid tax system proposals, because the reason for seeking some kind of hybrid is clear enough. People advocating hybrids are thinking of the classic income versus consumption debate, in which the difference is whether or not savings, or the yield to capital, is included in the tax base.⁹ The reason for advocating a hybrid is simply that we want to tax *some* savings, under the income tax model, but not *other* savings, under a consumption tax model. The new three-tax perspective on comprehensive tax system design, which distinguishes among income, prepaid consumption, and postpaid consumption taxes, does not change this fundamental fact: The intended effect of mixing and matching among the types of broad-based tax is to affect savings differently.

Without getting into more fundamental debates such as those about the appropriate degree of progressivity in

the tax-rate structure, we can ask a simple question: How do various hybrids tax savings, if at all?

A "bad" hybrid is one that fails effectively to differentiate among types of savings in any principled manner. There are two broad ways to go bad. Some "bad" hybrids lead to the elimination of all taxes on capital, leaving us with a prepaid consumption or wage tax: not a hybrid at all. Other bad hybrids can lead to the elimination of *all* tax by simple arbitrage operations: resulting in no tax at all. Both forms of "bad" hybrids fail to encourage new savings, are neutral or worse when it comes to dissavings, or debt, and fail to mark distinctions among savings in any principled fashion.

A "good" hybrid is one that, in contrast, effectively differentiates among savings in a principled fashion. We'll see more detail on what that might mean later, after first looking at the wrong ways to go.

III. Bad Hybrids

A. The Hybrid We Have

Before examining any more conscious, deliberate mixing and matching of income and consumption taxes, consider the basic "income" tax, unadorned with particular, ad hoc pro-savings provisions such as IRAs — traditional, Roth-style, or otherwise. The reason to start here is that what we call an "income tax" is not, in fact, an income tax, in the Haig-Simons sense. It is a hybrid income-consumption tax — and a bad one.

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To see this, let's back up about 85 years. Ever since *Eisner v. Macomber*¹⁰ gave birth to the "realization requirement" in 1920 — what William Andrews has called the Achilles' heel of the income tax¹¹ — we have not had a true income tax. Capital appreciation escapes Mill's second tax until — and unless — it is realized. Further, the stepped-up basis for assets transferred on death¹² means that the second tax, like Godot, may never come. Add a third element of a structural income tax — the nontaxation of debt — and you have what I have called Tax Planning 101, the three-step guide to avoiding all taxation for those with stocks of financial capital: Buy, borrow, and die.¹³

⁶See McCaffery, "A New Understanding of Tax," *supra* note 4 at 824-827.

⁷See President Bush's executive order of January 7, 2005, reprinted in full on the panel's Web site, *supra* note 3.

⁸See McCaffery, "Three Views of Tax," *supra* note 4; McCaffery, "A New Understanding of Tax," *supra* note 4.

⁹I include many sources in McCaffery, "A New Understanding of Tax," *supra* note 4; see, e.g., nn.7-11 and accompanying text.

¹⁰252 U.S. 189 (1920).

¹¹See William D. Andrews, "The Achilles' Heel of the Comprehensive Income Tax," in *New Directions on Federal Tax Policy for the 1980s*, at 278, 280 (Charles E. Walker and Mark A. Bloomfield eds., 1983).

¹²IRC section 1014.

¹³See Edward J. McCaffery, *Fair Not Flat: How to Make the Tax System Better and Simpler* (2002), at 32-34; "A New Understanding of Tax," *supra* note 4 at 888-899.

That's it. By buying capital-appreciating assets, borrowing against them to finance present consumption needs, and dying with both assets and debt in tow, one can avoid all federal taxation. The rub — an annoying one for my law students, about to become high-wage earners — is that the game works only for those with financial capital. It does not apply to labor earnings.

Three points follow:

First, Tax Planning 101 alone converts the “income” tax into a prepaid consumption or wage tax. You pay taxes on your wages but need never pay them again. Second taxes on the yield to savings are becoming increasingly voluntary.¹⁴

Second, like all of the analysis in this article, Tax Planning 101 is merely an analytic possibility, based on the logical structure of an income-with-realization tax. I am not presenting data on how much capital is or is not taxed under the income tax.¹⁵ But structure matters. We do not necessarily need to ask how many people with capital take advantage of Tax Planning 101 to pay no taxes, and to what extent — although I suspect, based on the fact that the basic advice can be gleaned from such hugely popular bestsellers as *Rich Dad/Poor Dad*, that many do.¹⁶ What is at least as important as the empirical quest to discover how much capital is or is not taxed is the fact that the very possibility of Tax Planning 101 constrains tax system design. Most importantly, we cannot raise taxes on capital too much, or taxpayers will use readily available planning techniques to avoid paying those taxes at all. Thus we are left, for a major example, with a 15 percent capital gains rate. The fact that the “second” tax, the tax on the yield to capital, comes, when it comes, at a lower rate is yet another step toward a consumption tax, along a prepaid model. Therefore we have a hybrid income tax, before we get to any special pro-savings provision, simply because of the realization requirement (compounded by the stepped-up basis rule) within the nominal income tax.

Third, note that there is no strong incentive actually to save under the status quo, in large part because there is no disincentive to *dissave*, that is, to borrow. The taxpayer following Tax Planning 101 is not saving; she is consuming, tax-free. The actual “income” tax as a hybrid tax is in effect very close to a prepaid consumption or wage tax, which imposes no tax on the yield to capital, but also generates no marginal incentive to save, or, what is the same thing, not to *dissave*.

¹⁴See Edward J. McCaffery, “A Voluntary Tax? Revisited,” in *Proceedings, 93rd Annual Conference of the National Tax Association, 2000*, 268 (2001).

¹⁵For a look at that issue, see, e.g., Roger Gordon et al., “Do We Now Collect Any Revenue From Taxing Capital Income?” 89 *J. Pub. Econ.* 981 (2004) (modifying prior result, which found that the U.S. raised no net revenue from capital taxation in 1983, to find that it raised some in 1995), and sources cited therein.

¹⁶See Robert T. Kiyosaki and Sharon Lechter, *Rich Dad/Poor Dad* (1997), discussed in passing throughout *Fair Not Flat*, *supra* note 13.

B. Income Plus Prepaid Consumption Tax

But of course we go beyond the de facto hybrid that the so-called income tax gives us, consciously to add pro-savings provisions to the code. When we do, we follow one of the two standard consumption tax models — prepaid, like Roth IRAs, or postpaid, like traditional IRAs. Both approaches have severe problems.

Consider first that if we simply add prepaid consumption tax accounts like Roth IRAs onto the income tax, we generate no strong incentive for new savings. Taxpayers can merely move old savings into the accounts and thereby escape all future taxes on the yield to capital. Some plans would impose “toll charges” on the conversion of assets into Roth-style accounts,¹⁷ but those are complex and all but certain to be porous. Further, if we place too many restrictions on the accounts — including restrictions on getting into them — taxpayers will not even bother to convert, because they can get the same effect with proper planning under the income-with-realization tax, using Tax Planning 101 or some variant, as noted above.

Meanwhile, the vast masses of middle- and lower-income Americans, struggling to make ends meet from paycheck to paycheck, get no immediate cash-flow reason to save now under a prepaid consumption tax model. They have to pay taxes on their wages (under both the payroll and the comprehensive individual tax, whatever we call it) and then living expenses. If they have anything left — they usually do not — they might save. But they are more likely to play the lottery with the spare change. Prepaid accounts do them no real good.

Engrafting prepaid consumption savings accounts onto the income tax only makes more obvious what is happening: We are moving toward a wage tax system, one that taxes workers heavily as labor earnings come into households, but never again. There is no tax on the yield to capital, however it is used; no marginal incentive to save;¹⁸ and no marginal disincentive to *dissave*, or borrow.

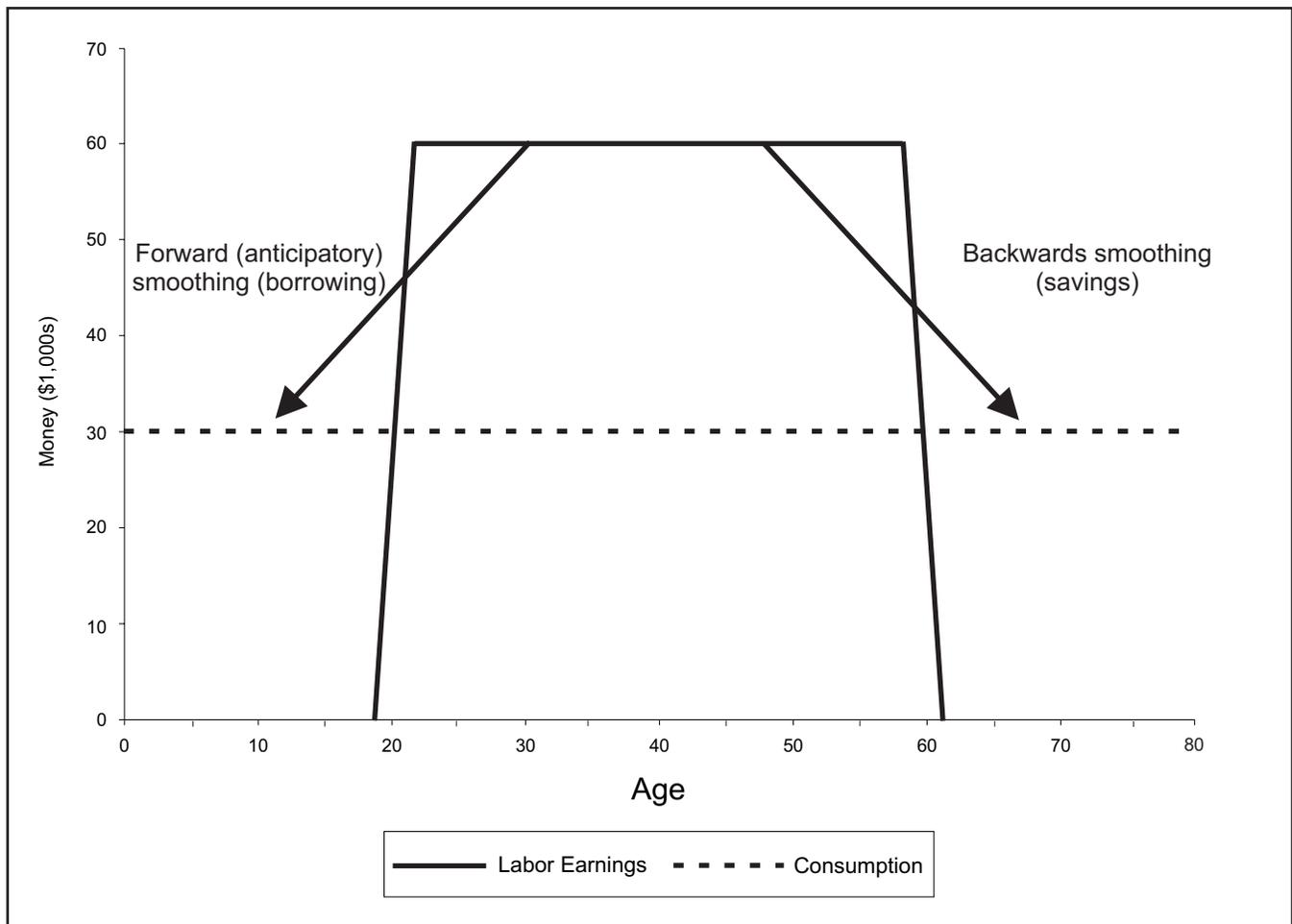
C. Income Plus Postpaid Consumption Tax

Adding prepaid consumption savings accounts to our current income tax is simply ineffective as a way to encourage new savings or to differentiate among types of savings. Adding postpaid consumption tax savings such as traditional IRAs or 401(k)s is worse. It is counterproductive.

That is because taxpayers can “save” on one hand, taking advantage of the deduction afforded by the postpaid consumption tax model, and borrow on the other, taking advantage of the nontaxation of debt under an

¹⁷See, e.g., the testimony of Ernest Christian, executive director of the Center for Strategic Tax Reform, on the Freedom to Save Act, to the President's Advisory Panel on Federal Tax Reform, May 11, 2005; overview available at http://www.taxreformpanel.gov/meetings/docs/christian_052005.ppt.

¹⁸The incentive to save comes from the hope of getting off the treadmill of constantly paying taxes on labor earnings. But there is no immediate assistance in doing that, because the act of saving does not generate any additional resources in the current period.



income tax. The result of that simple arbitrage is an immediate tax deduction, current consumption — and no new savings. While the first two instances of “bad” hybrids — the income-with-realization tax and the income-plus-prepaid-consumption tax — end up becoming wage taxes that exempt all the yield to capital, engrafting a postpaid consumption tax onto the existing income tax goes one step further: Taken to its limit, it eliminates all taxes.

D. Mishmash

Perhaps the only thing worse than an income-postpaid-consumption-tax hybrid — which as we have just seen would make all taxation voluntary — is the mishmash we now have: a tax system that, in its basic structure, is drifting toward a wage tax for structural reasons, combined with a panoply of confusing, overlapping, and intersecting ad hoc pro-savings provisions, along both a prepaid and a postpaid consumption tax model. All that, analytically, is not designed to encourage new savings, to discourage dissavings, or to distinguish among types of savings in any principled fashion, when viewed as a whole. Yet that is, of course, largely the tax system we have.

E. The Facts

The above analysis sets out the law and its possibilities. Others would have to “crank the numbers” to see the precise expected effects of reforms. But here are some facts: Our national savings rate is abysmally low. Consumer debt is at an all-time high. Our tax policy is not addressing either trend, in practice. Recent analysis by the Urban Institute has shown that the U.S. Treasury spent more money in foregone tax revenues last year than the country generated in new savings.¹⁹

And — this is also a fact — there is no analytic reason why we should get new savings under the hybrids in place, and as proposed. Tax policy, which could be a cure for our national epidemics of low savings and high debt, is in fact a *cause* of them, because the existing hybrid — in theory — encourages just such behavior.

¹⁹See Elizabeth Bell, Adam Carasso, and C. Eugene Steuerle, “Retirement Saving Incentives and Personal Saving,” *Tax Notes*, Dec. 20, 2004, p. 1689 (reporting that tax breaks for retirement programs cost \$112 billion in 2004, according to the Office of Management and Budget; personal savings, for all purposes, totaled \$100.8 billion).

IV. The Good Hybrid

There is hope.

The answer — the “good” hybrid — lies, surprisingly, in a consistent postpaid, cash-flow, or (all equivalently) consumed income tax. Such a tax is predicated on the simple rearrangement of the Haig-Simons definition, $C = I - S$. Getting to there from where we are is simple enough.²⁰ We need allow only an unlimited deduction for savings, along the postpaid consumption tax model — traditional IRA treatment — and pick up debt in the tax base. I will say a few more things about debt below, but, briefly, debt that is used to consume will be taxed currently. Debt that is used to save will be a wash: an inclusion as dissavings, a subtraction as savings. Repayments of principal and interest will be deductible. Such a tax taxes people when and only when they spend. And, in doing so, a consistent, progressive consumed income tax is a hybrid tax, in that it taxes some but not all savings. But unlike the “bad” hybrids, a consistent consumed income tax differentiates among types of savings in a principled fashion.

Unlike the ‘bad’ hybrids, a consistent consumed income tax differentiates among types of savings in a principled fashion.

As noted above, a consistent progressive consumed income tax stands between an income tax, which double taxes all savings, come what may, and a prepaid consumption tax, which exempts all savings. A consistent postpaid consumption tax splits the difference, by design. To better understand that point, consider two broad uses of savings. One is to *smooth* out uneven labor market earnings — to translate periods of high wages into steady spending patterns. The other use of capital transactions is to *shift* one’s level of consumption or spending — to enable one to live better, or worse, than she could on the basis of wages alone. Consider the graphic on the previous page, illustrating a typical life in simple financial terms.

Under progressive rates, “smoothing” transactions lower the burden of taxation in a consumed income tax. Suppose Sally, who will live to age 80 in a mythical world of no inflation, earned \$60,000 a year for half her life, say from the ages of 20 to 60, but spent \$30,000 a year for all her life, from cradle to grave. An income or a prepaid consumption tax (a wage tax) would look at the middle earning years and make its judgments about a fair tax burden accordingly. But a postpaid consumption or consumed income (spending) tax would look at Sally’s \$30,000 spending level and make its judgments accordingly. By saving in midlife to fund her retirement, Sally would lower her aggregate lifetime burden of taxation *under progressive marginal rates*. That was, indeed, a large part of the initial reason for traditional pension plan

²⁰See Edward J. McCaffery, “Ten Facts About Fundamental Tax Reform,” *Tax Notes*, Dec. 22, 2003, p. 1463.

treatment, and the original IRAs and 401(k)s work this way, in theory (although the ability to run up debts while “saving” in those plans undercuts their true effects). High-wage earners can defer tax to times of retirement, and hence adjust the *rate* of taxation as well.

An interesting feature of consumed income taxes is that they allow traditional IRA/401(k)-type treatment *in reverse*. That is, by borrowing in her youth, and repaying principal in midlife — recall that a consumed income tax includes debt in the base, but allows a deduction for repayment of principal and interest — Sally can shift some taxation forward in time, once again lowering her aggregate tax burden. (In my longer work, I explain how that “forward shifting” can occur through the intergenerational transmission of wealth, as well; parents pay for the consumption of their children, on and on, in an overlapping-generations model.)

A consistent consumed income tax encourages savings to smooth out a taxpayer’s lifestyle or for other times of extraordinary need, such as education or medical needs. The way it does that is to allow unlimited deductions for contributions into tax-favored savings accounts, and then to lower the taxation for certain types of withdrawals — for medical needs, say.

But something besides consumption-smoothing can happen to Sally. She can get lucky, or unlucky, in the capital markets. Suppose that her midlife savings strike gold and Sally becomes wealthy. She can now live at a higher lifestyle than \$30,000 a year — that is, higher than what her labor market earnings alone would support. That is what I call shifting, meaning that consumption patterns — real spending, or lifestyles — can move up or down on account of capital market transactions. Under a consistent and progressive consumed income tax, that extra yield to capital, as and when used to finance Sally’s lifestyle, *increases* her tax. A consumed income or spending tax does not differentiate among sources of lifestyle: It falls on labor market earnings, the yield to capital, and even gifts and inheritances, as and when those are used to support spending. The yield to capital as a source of increased spending power bears a positive tax burden.

Now we have a “hybrid” tax, in that it taxes some but not all savings, but in a principled manner. And now we can also say more about what “principle” means when it comes to the taxation of savings.

Specifically, we can discern, from a century of experience, two norms about savings. The first, which I call the “ordinary-savings norm,” is that people should not be double-taxed or discouraged from saving in the ordinary course of their lives, for times of special need or urgency, such as retirement, medical, and educational needs. (In the language of traditional tax policy, that is often seen as a “horizontal equity” norm, though I do not prefer that vocabulary.) The second, which I call the “yield-to-capital norm,” is that the earnings to capital are a source of value, which should factor into an “ability to pay” or any other norm leading to the imposition of tax burdens. (We can think of that as a “vertical equity” norm.) The ordinary-savings norm is manifest in the various IRA, pension plans, medical, and educational savings provisions in the code today. The yield-to-capital norm is manifest in the very choice of an income tax, in theory,

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and in the continued attempt — however futile — to impose taxes on the yield to capital.

People who want a “hybrid” want to implement both norms simultaneously. They want to tax the yield to capital but they do not want to burden ordinary savings. Trouble is, the two norms are in fatal tension under an income tax, which double-taxes all savings, and under a prepaid consumption tax, which taxes no savings. Bad hybrids converge toward the prepaid consumption tax model, make all taxes voluntary, or wreak havoc, generally. But a consistent, progressive consumed income tax gets matters just right. It favors — or ceases to disfavor — ordinary savings. But by consistently including the yield to capital when used to finance personal consumption in the tax base, it also implements the yield-to-capital norm. And it does that simply, by design, and without the need for special rules for different types of savings accounts.

V. Debt Again

The careful reader will note the importance of debt — which is nothing more or less than negative savings, or dissavings — in the analysis. Including debt in the tax base is essential to the efficacy of a consumed income or postpaid consumption tax model. Failure to do so was the critical flaw in the Nunn-Domenici USA tax plan;²¹ it leads to the arbitrage tactic noted above in the bad income-plus-postpaid-consumption tax hybrid — taxpayers can both “save” and “dissave” at the same time, avoiding all tax while consuming away and saving nothing.

Including debt in the tax base sounds counterintuitive, and even punitive at first, in both theory and practice. But it is neither. Note, first, that sales taxes or VATs — which, as spending taxes, are analytically equivalent to consumed income taxes and therefore can be used as substitutes for the lower levels of a comprehensive consumed income tax — work this way.²² Debt that is used to spend generates sales or other spending tax; no one asks the shopper whether she intends to pay off her credit card when ringing up sales tax on the transaction. And also note, second, that prudent borrowing, as to build human capital by financing education, for example, will lower the lifetime aggregate burden of taxation, under a consistent progressive consumed income tax, as the diagram above helped to illustrate.

As a practical matter, it may sound daunting to include debt in the tax base, although the issue has been discussed, by Andrews, in *Blueprints*, and elsewhere.²³ The complexity may lead one to want to implement a dual-tax structure, with a sales tax or VAT plus a rebate taking care of the vast majority of taxpayers, obviating

most returns.²⁴ For the rest, debt can be picked up by financial intermediary reporting, using standard informational returns such as Forms 1099. For consumer credit cards, the company need simply report the balance outstanding at the end of each year, subtracting the balance from the preceding end of year, to reflect net savings/dissavings throughout the time period. (It is also worth noting that “lifestyle audits” become more straightforward: A taxpayer is supposed to pay tax on all that he spends, and so consumer purchases are direct, not indirect, evidence of taxable consumed income.) The “problem” of including debt in the tax base, that is, seems solvable, especially considering the considerable simplification of a consistent consumed income tax, which I discuss in the next section.

Most important, however, is including debt in the tax base. We simply cannot encourage or reward savings without deterring consumptive dissavings. That is an analytic fact. Not to include debt is to live with a “bad” hybrid, as chronicled above — it is, quite simply, not a principled option for tax reform.

VI. Bye-Bye, Basis

Finally, aware that the preceding analysis may seem complex to those unfamiliar with thinking about things in this manner, I would like to say a few simple words about how a consistent consumed income tax could, indeed, simplify tax considerably.

The above understanding helps to show that a consistent progressive consumed income tax is a tax on the yield to capital, under compelling conditions, and not otherwise. Therefore all other taxes on capital — including capital gains tax under the remaining “income” tax, the corporate income tax, and any separate gift and estate tax — can be repealed. As a practical matter, a consistent consumed income tax eliminates the concept of “basis”: think again of traditional IRAs or 401(k) plans. Savings are not taxed until spent, and so have no tax basis. That allows for the elimination of the gift and estate tax, because a consistent consumed income tax is, in effect, an accessions tax: Heirs can take savings, with no basis (a very simple carryover regime!),²⁵ and be taxed when and as they spend, at progressive rates.

There need be no special rules or limits on contributions into or withdrawals from the savings accounts. Provisions about like-kind exchanges and other tax-deferred transactions can be repealed. Various doctrines and statutes meant to police the labor/capital and gift/labor distinctions can be removed. The principle of a consumed income tax is simple: Tax people when and only when they spend, not when they work, save, give,

²¹USA Tax of 1995, S. 722, 104th Cong. (1995); see generally Laurence Seidman, *The USA Tax* (1995).

²²See *Fair Not Flat*, *supra* note 13 at chapter 6.

²³See William D. Andrews, “A Consumption-Type or Cash-Flow Personal Income Tax,” 87 *Harv. L. Rev.* 1187 (1974); David Bradford et al., *Blueprints for Basic Tax Reform* (2d ed. 1984).

²⁴This was an option I discussed in *Fair Not Flat*, *supra* note 13. See also Michael J. Graetz, “100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System,” 112 *Yale L. J.* 261 (2002).

²⁵Thus solving the problem of overstated basis noted by Professors Dodge and Soled in these pages. See Joseph M. Dodge and Jay A. Soled, “Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question,” *Tax Notes*, Jan. 24, 2005, p. 453.

or die. And, best of all, the principle is principled: We don't need any bad hybrids to implement it.

VII. Conclusions

Emerson warned us that a "foolish consistency is the hobgoblin of little minds."²⁶ In recalling that chestnut, people almost always forget the "foolish" word. Sticking to a pure "income" or "consumption" tax just because it is a pure tax — because it is consistent — is foolish. But mixing and matching income and consumption tax elements without thinking it through is not wise either. Ad hoc, unprincipled hybrid income-consumption taxes lead to complexity without principle:

- tax systems that effectively fail to reach any savings, leaving us with high and inescapable wage taxes;
- do not encourage new savings;
- do not discourage consumptive debt;
- do not mark whatever distinctions they make among savings in any principled way; and,
- in a limiting case, undercut the entire tax system.

That is foolish inconsistency.

But Emerson does not begrudge us a wise consistency. It turns out that by sticking to a consistent, progressive, consumed income tax, we effect a "hybrid," because we tax some but not all savings, and we do so in a principled and surprisingly simple way. A consistent consumed income tax with progressive rates allows individuals to lower the burden of taxation by borrowing and saving prudently, to finance their lifestyles over time, and to save for rainy days such as times of retirement, medical need, or for education. But such a tax falls on the fortunate few who can live off the yield to capital, elevating their lifestyles on account of their good fortune. Such a tax indeed encourages prudent saving, discourages imprudent debt, and marks distinctions among taxpayers, savers, and spenders alike, all in a principled way. Here is a wise consistency and principle with grace: a good hybrid we can live with, for generations to come.

²⁶Ralph Waldo Emerson, "Self-Reliance," in *Essays and Lectures*, p. 259 at 265 (Library of Congress Edition, 1983 (1841)).

Undocumented, Working Poor and Refundable Tax Credits

By Francine J. Lipman

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Introduction

More than 43 million individuals are working in the United States for wages that cannot sustain the basic necessities of life.¹ Full-time, annual employment at minimum wage provides a family of three with less than 70 percent of the Federal Poverty Income Guideline.² Disproportionately more low-wage workers, almost nine million, are immigrants.³ While the economic situation of millions of documented immigrant workers is bleak, undocumented immigrant workers face overwhelming financial and legal hardships. The steadily growing population of undocumented workers is estimated to exceed five million.⁴

Immigrant workers with and without authorization to work in the United States are disproportionately represented among the lowest earners.⁵ Immigrants toil in sweatshops for long days at subminimum wages that may or may not be paid with little meaningful recourse.⁶

¹In 2003, a head of household working 40 hours per week at minimum wage would attain only 70 percent of the Federal Poverty Income Guideline for a family of three." Sharon M. Dietrich, "When Working Isn't Enough: Low-Wage Workers Struggle to Survive," 6 *U. Pa. J. Lab. & Emp. L.* 613, 619 (Spring 2004) (citing the Federal Poverty Income Guideline for a family of three at \$15,260 and full-time minimum wage earnings at \$10,609). Randy Capps et al., *A Profile of the Low-Wage Immigrant Workforce 2* (the Urban Institute, Immigration Studies Program, "Immigrant Families and Workers: Facts and Perspectives" Brief No. 4, November 2003).

²*Id.*

³*Id.*

⁴B. Lindsay Lowell and Roberto Suro, Pew Hispanic Center Report, "How Many Undocumented: The Numbers Behind the U.S.-Mexico Migration Talks" at 3, 5, 7 (March 2002) (finding that out of the approximately nine million unauthorized residents more than five million are working), available at <http://www.pewhispanic.org/site/docs/pdf/howmanyundocumented.pdf> (last visited Oct. 12, 2004).

⁵See Dietrich, *supra* note 1 at 618.

⁶See *Hoffman Plastic Compounds v. NLRB*, 535 U.S. 137 (2002).

The average wage among all low-wage immigrant workers was \$14,400 in 2001.⁷ Moreover, almost half of immigrant workers earned less than twice the minimum wage.⁸ These hard working individuals and their families are living in poverty.

In an effort to lift the working poor out of poverty, approximately eighteen million taxpayers received \$32 billion in earned income tax credits (EITC) in 2003 as an alternative to traditional welfare. The EITC is a refundable tax credit that provides cash refunds of up to \$4,300 (for 2004) to ensure that working poor families pay no taxes.⁹ For many working poor families the EITC provides a refund in excess of their tax payments providing a wage subsidy.

The Problem

To qualify for the EITC, among other requirements, an individual, her spouse, if married, and any qualifying children must have a valid Social Security number.¹⁰ Accordingly, undocumented or documented workers whose spouse or qualifying child does not have a valid Social Security number cannot qualify for the EITC and will not receive any of its tax relief or wage subsidy benefits.¹¹ Even if those working poor families satisfy every other requirement for the EITC, they will fail to receive those critical benefits if they do not have valid Social Security numbers.

Limited Relief Under the Child Tax Credit

Under certain circumstances some of these taxpayers will qualify for the refundable child tax credit (CTC). The CTC was enacted by Congress and signed into law by President Clinton in 1997 to provide tax relief for middle-income families with children. The CTC offsets a taxpayer's income tax liability dollar-for-dollar up to \$1,000 per qualifying child.¹² For this purpose, a qualifying child is the taxpayer's dependent child¹³ who is under age 17 as

of the end of the year.¹⁴ Also, the child must be a U.S. citizen or resident.¹⁵

In addition to satisfying the substantive requirements for a qualifying child, the taxpayer must provide the name and taxpayer identification number of each qualifying child to receive the benefits of the CTC.¹⁶ The identification requirement under the CTC is less restrictive than the identification requirement under the EITC. Taxpayers who do not qualify for the EITC solely because they, their spouse, or their children do not have a valid Social Security number should qualify for the CTC. Either a Social Security number or an individual taxpayer identification number (an ITIN) qualifies for the CTC. Since 1995 the Internal Revenue Service has issued ITINs to resident or nonresident aliens¹⁷ who do not qualify for a Social Security number because they are not authorized to work in the United States.¹⁸

The CTC is phased out at higher income levels and provides little or no tax relief for higher-income families.¹⁹ The CTC is phased out by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income²⁰ exceeds \$110,000 for a married filing jointly return; \$75,000 for an unmarried filing status return; and \$55,000 for married filing separately return. Therefore, the CTC is phased out completely at a modified adjusted gross income level of \$129,001 for a family with one child, \$149,001 for a family with two children, and \$169,001 for a family with three children. Neither the phase out thresholds nor the CTC amount is indexed for inflation.

Congress designed the CTC to provide tax relief for middle-income families with children. The CTC was not designed to provide additional relief for working poor families who qualify for meaningful EITC benefits. Seemingly consistent with that goal, the CTC is refundable under limited circumstances.²¹

How the Refundable CTC Works

Refundable tax credits (like the EITC) provide taxpayers with cash refunds even if their tax liability is zero. At lower income levels, the standard deduction and personal and dependency exemptions will eliminate any income tax liability making the CTC available only to the extent it is refundable. If a taxpayer's CTC exceeds her tax liability, the 2004 CTC is refundable at a rate of 15

⁷See Dietrich, *supra* note 1 at 618.

⁸*Id.*

⁹See section 32.

¹⁰Section 32(c)(1)(F), (G). For purposes of this article a family in which every member has a valid Social Security number will be described as documented and a family in which at least one member does not have a valid Social Security number will be described as undocumented.

¹¹Section 32(c)(1)(F)(ii).

¹²Section 24(a), (b)(3).

¹³A qualifying child is a son, daughter, grandchild, stepchild, adopted child, or eligible foster child. Foster children can be claimed if they live with the worker for the entire year (and are claimed as dependents) but only if they are placed with the worker by an authorized government or private placement agency. The Center on Budget and Policy Priorities, *Facts About the Child Tax Credit: Tax Time Can Pay Even More for Working Families*. The qualifying child must also qualify as the taxpayer's dependent. For tax years beginning after 2004, to qualify as a dependent for this purpose the qualifying child must live with the taxpayer for more than half of the tax year in the United States and be a U.S. citizen or resident. Under the newly enacted uniform definition of a child, any qualifying child for the EITC, will be a qualifying child for purposes of the CTC.

¹⁴Section 24(c)(1)(B).

¹⁵Section 24(c)(2).

¹⁶Section 24(e).

¹⁷For this purpose, resident and nonresident alien are tax terms, which are not consistent with immigration law terms.

¹⁸Paula N. Singer and Linda Dodd-Major, "Identification Numbers and U.S. Government Compliance Initiatives," *Tax Notes*, Sept. 20, 2004, p. 1429, 1432.

¹⁹Section 24(b).

²⁰For this purpose, adjusted gross income is increased for any excludible foreign source income of citizens residing in other countries under section 911, and bona fide residents of Guam, American Samoa, or the Northern Mariana Islands, section 931, or residents of Puerto Rico, section 933. Section 24(b)(1), (2).

²¹Section 24(d).

cents for every dollar her income level is above \$10,750,²² not to exceed an aggregate CTC benefit of \$1,000 per qualifying child.²³ Alternatively, if a taxpayer has three or more qualifying children the refundable CTC is equal to any excess of the taxpayer's "Social Security taxes"²⁴ for the year over her EITC benefits received (again limited to an aggregate CTC benefit of \$1,000 per qualifying child). That "large family" alternative generally applies only to working poor families that do not qualify for the EITC because if a family qualifies for EITC benefits those benefits usually exceed the family's annual Social Security tax expense. Accordingly, if a working poor family qualifies for the EITC, they generally will not qualify for a meaningful, refundable CTC.

For example, a working married couple with one qualifying child and poverty-level wages of \$12,000 will receive a refundable CTC of \$188 and a refundable EITC of approximately \$2,600. If the same couple has two or more children their refundable CTC would remain at \$188 and they would receive a refundable EITC of \$4,300. That poverty-level family would pay no federal income taxes, but would pay \$918 in Social Security taxes.²⁵ Therefore, that working poor family would be reimbursed in full for their Social Security taxes and would receive a relatively substantial additional wage subsidy.

If the same working family with one or two children did not qualify for the EITC because one or more family members did not have a valid Social Security number, the family would receive no EITC, but would receive the same amount, or \$188 of refundable CTC and would pay the same amount, or \$918 of Social Security taxes. If the family had three or more children, the refundable CTC would increase from \$188 to \$918, effectively reimbursing them for their annual Social Security tax expense. Notably, the best-case scenario for an undocumented working poor family is full reimbursement of Social Security taxes paid without any possibility of a wage subsidy.

How the CTC Fails

Because undocumented working families do not qualify for the EITC they do not receive any meaningful reimbursement of regressive Social Security taxes. Only if those working poor families have three or more children do they qualify for a refundable CTC that effectively reimburses them for their Social Security tax payments.²⁶

²²This threshold amount is indexed for inflation. Section 24(d)(3).

²³Section 24(d)(1)(B)(i).

²⁴Section 24(d)(2) (defining Social Security taxes for this purpose as including taxes imposed by sections 3101 and 3201 and 50 percent of the taxes imposed by sections 1401 and 3211(a) on self-employment and employee representatives income). This definition of Social Security taxes will be used throughout this article.

²⁵As defined in section 24(d)(2).

²⁶For example, an undocumented working poor family with three qualifying children and \$10,750 of income will pay \$822 of Social Security taxes and will receive \$822 refundable CTC. If the same family has less than \$31,250 of income, all of their Social Security taxes will be reimbursed in full; if the family has four qualifying children and less than \$38,700 of income or five

(Footnote continued in next column.)

If the undocumented working poor family has fewer than three qualifying children, then the refundable CTC will meaningfully reimburse them for their Social Security taxes paid only when their income level significantly exceeds \$10,750.

Undocumented working families with fewer than three children and income levels at or below \$10,750 pay Social Security taxes at 7.65 percent or up to \$822 and receive no tax relief or wage subsidy. As income levels increase above \$10,750 to approximately \$23,500, the percentage of Social Security taxes that are reimbursed increases from 0 percent to just over 100 percent.²⁷ As income levels increase above \$23,500, more of the CTC is used to offset increasing income tax liabilities and the percentage of Social Security taxes that are reimbursed decreases from just over 100 percent to 0 percent.²⁸

Ironically, some of the poorest undocumented working families pay more in taxes than their richer (either in income level or number of children) low-income neighbors because they do not qualify for either the refundable EITC or the refundable CTC. While those working poor families do not pay income taxes, they do pay regressive Social Security taxes. Notably, workers who are authorized to work in the United States will probably qualify for Social Security retirement benefits, but undocumented workers will never qualify for any benefits from the contributions they make to the Social Security retirement system. The amount of Social Security taxes paid by undocumented workers and their employers has been increasing steadily and is now in the billions of dollars.

In 2003 the government collected an estimated \$7 billion in Social Security taxes, or approximately 1 percent of Social Security's overall revenue, from 7.5 million workers and their employers for Social Security numbers that did not match valid accounts.²⁹ That dollar amount has more than tripled in the last decade.³⁰ Some of the

qualifying children and less than \$46,000 of income, all of their Social Security taxes will be reimbursed in full. At income levels above these amounts the family is not reimbursed in full because of the overall \$1,000 limit on the CTC.

²⁷For example, an undocumented working poor family with two qualifying children and \$10,750 of income will pay \$822 of Social Security taxes and will receive no refundable CTC. Alternatively, the same family with \$20,000 of income will pay \$1,530 of Social Security taxes and will receive \$1,388 of refundable CTC. At the \$22,000 income level the Social Security taxes are \$1,683 and the refundable CTC is \$1,688.

²⁸For example, an undocumented working poor family with two qualifying children and \$23,500 of income will pay \$1,798 of Social Security taxes and will receive \$1,860 of refundable CTC. Alternatively, the same family at \$35,000 of income will pay \$2,678 of Social Security taxes and will receive \$710 of refundable CTC. At \$40,200 of income, the family will pay \$3,075 of Social Security taxes and will receive no refundable CTC because all \$2,000 of the CTC offsets the family's income tax liability of \$2,000.

²⁹See Alan Zarembo, "Garment Laborers Say Bush Guest-Worker Plan an Ill Fit," *Los Angeles Times*, Feb. 8, 2004, at A1, A16; see also Singer and Dodd-Major, *supra* note 18 at 1435 n.9 (citing \$7 billion in Social Security payroll taxes and \$56.1 billion in wages in 2001).

³⁰See Zarembo, *supra* note 29.

mismatches are due to clerical errors, but many are due to widespread use of counterfeit Social Security numbers and false use of valid numbers.³¹ Undocumented workers who pay Social Security taxes through withholding using invalid numbers will never receive any retirement benefits from those payments.³²

Proposal for Refundable CTC Reform

The structure of the refundable portion of the CTC causes the poorest undocumented working families to pay a significantly higher percentage of their income in taxes than higher-income working poor families. If, however, an undocumented working poor family has three or more qualifying children they will be reimbursed in full for all taxes paid. Accordingly, the addition of one qualifying child (from two to three qualifying children) causes most of these families' effective tax rates to drop from 7.65 percent to 0 percent. That result is inconsistent with welfare reform and fundamental tax policy.

Fundamental Tax Policy Goals

Fundamental tax policy includes horizontal and vertical equity as goals for a fair and effective tax system. Horizontal equity provides that similarly situated persons should be treated similarly. Correspondingly, vertical equity requires that persons who are not similarly situated should be treated differently. Vertical equity should be implemented consistently with a taxpayer's ability to pay. In our federal income tax system, ability to pay is determined generally by a taxpayer's income level. Taxpayers with higher levels of income have a greater income tax liability than taxpayers with lower amounts of income. Moreover, at income levels at or below poverty individuals should not pay any taxes because they have neither the ability nor the wherewithal to pay.

At poverty income levels, all cash flow is required for the basic necessities of life. Federal and state governments provide supplemental assistance to these individuals, or welfare, based on their meager financial resources as compared with a minimum standard of living. Under our welfare-to-work approach to fighting poverty, the government encourages individuals to work by reimbursing regressive payroll taxes and providing a wage subsidy through the EITC. Congress enacted the EITC in 1975 and over the last 30 years, with bipartisan support, has enhanced its benefits to lift working poor families, including millions of children, out of poverty.

The exclusion of undocumented working poor families from the EITC and the targeting of the CTC for middle-income families has created an abyss in federal relief for these families. Undocumented working poor

families have higher effective income tax rates than their neighbors who enjoy higher income levels. Undocumented working families at the lowest income levels without the ability to pay are subject to regressive Social Security taxes without any government relief. Moreover, the structure of the CTC creates an incentive to increase family size for the poorest of all families.

Revised Refundable CTC

Fundamental tax policy demands a remedy for the misapplication of the refundable CTC. One solution would be for Congress to eliminate the family size requirement for the calculation of refundable CTC when Social Security taxes exceed the EITC. As a result, the CTC would be refundable to the extent of the greater of 15 percent of the excess of earned income over \$10,750 (as indexed for inflation) or the excess of Social Security taxes paid less any EITC benefits received. The refundable portion of the CTC could continue to be limited to an aggregate benefit of \$1,000 for each qualifying child.

In many cases when a working poor family qualifies for the EITC, option one will provide the greatest CTC refund because under option two EITC benefits will exceed Social Security taxes paid. However, this amendment should provide critical tax relief for undocumented working families in the lowest income levels who do not qualify for the EITC. The revised structure should assure that all working families at or below the poverty level do not bear the burden of income or Social Security taxes.

Example of Revised Refundable CTC

For example, under the proposed amendment an undocumented working family with one qualifying child and income of \$10,750 would pay \$822 of Social Security taxes, no income taxes, and would receive a refundable CTC of \$822. That family would receive no refundable CTC under current law. Under the amended provision, undocumented families with one qualifying child and income up to approximately \$13,000 would pay neither income nor Social Security taxes.

Above that income level, three-person families would pay some amount of tax. For example, if the same family had \$15,000 of income, Social Security taxes would be \$1,148 and the refundable CTC would be capped at its maximum benefit of \$1,000. Therefore, because of the maximum \$1,000 benefit under the CTC for each qualifying child, this undocumented working poor family would pay \$148 in Social Security taxes, but no income taxes. As income levels increased and the CTC benefit remained capped at \$1,000, the family would pay greater amounts in Social Security taxes and eventually income taxes.

However, as family size increases, CTC benefits also increase. For example, an undocumented working poor family with two qualifying children and \$22,100 of income would pay Social Security taxes of \$1,691 with a refundable CTC of \$1,691. If the same family had \$26,200 of income, Social Security taxes would be \$2,004 and the refundable CTC would be \$1,590. The remaining CTC of \$410 (\$2,000 aggregate tax benefit for two qualifying children) would offset the family's \$410 of income tax. Accordingly, the family would pay no income taxes, but

³¹*Id.* Singer and Dodd-Major, *supra* note 18 at 1435 (describing proliferation of false use of Social Security numbers and Social Security cards).

³²The Social Security Administration posts mismatched earnings to a suspense account until and unless it can allocate the earnings to the appropriate worker. "In 2003, SSA reported unposted earnings of \$421 billion. Earnings posted to SSA's suspense file grew by \$94 billion (22 percent) from 2002 to 2003 alone." *Id.* at 1433.

would pay some amount of Social Security taxes. Nevertheless, under the proposed amendment the poorest undocumented (and documented) working families would pay no taxes. Consistent with horizontal and vertical equity goals, all poverty-level working families would be relieved from any tax burden. As income levels increased and ability to pay was enhanced, overall tax liabilities would increase.

Conclusion

Under the current design of the EITC and the CTC, some working poor families at and below poverty are paying regressive Social Security taxes. In cases in which the worker is undocumented, those taxpayers will never realize retirement benefits from the billions of dollars they pay annually into the Social Security system. Moreover in some cases, the poorest undocumented working families are subject to a higher tax rate than their less destitute undocumented working poor neighbors. Congress could not have intended that the poorest working

families pay more than their more fortunate working colleagues. That irrational result may be an unintended consequence of an incomprehensible tax system.

The proposed amendment to the refundable CTC should ensure that the lowest income level working families pay neither income nor payroll taxes. Congress's failure to provide a refund of those tax payments may have been an unintended consequence of the complexity of the interaction of the EITC and the refundable CTC. However, the proposed amendment should begin to remedy the problem. As demonstrated above, even with the amendment many undocumented working poor families will not be reimbursed in full for their Social Security taxes. That results from the \$1,000 ceiling on the CTC and the denial of EITC benefits for undocumented working poor families. As President Bush fulfills his promise to reform and simplify our tax system, we must encourage him to provide tax relief for all poor families working in the United States.