# How to Tax the Rich

By David Kamin

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In this article, Kamin reviews options for increasing tax liabilities for the richest Americans. He concludes that several options that have received considerable attention and support are not viable as a practical matter — taking into account amounts of revenue raised and administrative considerations. Those options include taxing capital gains as ordinary income, annual wealth taxes, and broad mark-to-market accounting. Kamin identifies more viable options, including substantially expanding transfer taxes, increasing the tax rate on ordinary income, and taxing — at least partially — unrealized gains at death or gift, which may be the most promising.



As a purely practical matter, raising taxes for the richest Americans is harder than it might seem. Several options that have received considerable attention and some support either would not raise much revenue or are unadministrable (or close to it). Much of the problem comes down to the challenge of taxing capital. In particular, increasing the tax rate on capital gains income is problematic because it would generate little revenue, despite claims based on official tax expenditure tables that doing so would generate tens of billions of dollars per year.[1] Other options suffer from the same problem, including the Obama administration's proposed new minimum taxes.[2] Some, like the now-renowned Thomas Piketty, have suggested more radical measures like annual wealth taxation or mark-to-market income tax accounting;[3] however, these options seem troubled, if nothing else, by the considerable challenge of administration.

What are viable options for raising revenue from the most-well-off individuals in the country? Perhaps the most promising option is to treat gifts and bequests as realization events, at least partially and at least for substantial transfers of wealth. Other options include significantly expanding transfer taxes, raising the top individual income tax rate, and limiting deductions and exclusions.

There is a broader debate about whether the best-off Americans should pay more in taxes, which I do not engage here. Instead, this article focuses on the menu of options for raising revenue from those Americans and emphasizes that how to do so is more difficult than it might seem — especially when it comes to taxing capital. The article also discusses why some of the most-discussed options are thus not as promising as sometimes claimed and why the starting place for raising taxes should probably be realization of gains at death or bequest.

I focus this analysis on best-off Americans, often using a threshold of those making more than $1 million per year and sometimes defining in terms of wealth. This is not to suggest that tax burdens should remain the same below these thresholds or that those making less than $1 million are not well-off. Instead, I mean to separately discuss the most well off Americans because they tend to differ from others toward the top of the distribution. In particular, they have more capital gains and benefit less from specific tax expenditures like the home mortgage interest deduction. The challenge of taxing them is, thus, different.

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[1] *See, e.g.*, Felix Salmon, "Why Capital Gains Should Be Taxed as Income," Reuters, June 5, 2013, *available at* http://blogs.reuters.com/felix-salmon/2013/06/05/why-capital-gains-should-be-taxed-as-income/ ("Normalizing the capital-gains tax rate so that it's the same as the income-tax rate is an easy way to bring a lot of money into the public fisc — some $161 billion per year, according to the CBO."); Diane Lim Rogers, "Who Wants to Tax a Millionaire?" *Tax Notes*, Feb. 6, 2012, p. 725 (reporting that taxing capital gains and dividends as ordinary income would raise revenue by $72 billion per year in 2011 — $52 billion

(Footnote continued in next column.)

of that from those making more than $1 million per year); Committee for a Responsible Federal Budget, "The Tax Break-Down: Preferential Rates on Capital Gains," Aug. 27, 2013, *available at* http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains ("by our estimates the capital gains preference costs an average of $120 billion per year from 2013-2017 and will cost about $1 trillion from 2014-2023").

[2] Treasury, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals," at 156-157 (Mar. 2014).

[3] Piketty, *Capital in the Twenty-First Century*, 515-539 (2014).

### A. The Struggle to Tax Capital

This section describes the challenge of raising more taxes from capital. The main source of this challenge is the realization requirement, which allows property holders to defer the taxation of their gains. Because of this, the current capital gains rate is near the revenue-maximizing point, at least according to the assumptions used by the official budget scorekeepers. Further, proposals to overcome the realization requirement through mechanisms like broad use of annual mark-to-market accounting or wealth taxes face considerable administrative (and possibly legal) barriers.

**1. The capital gains rate.** Those wanting to increase taxes on Americans with the highest incomes will sometimes look at the official tax expenditure tables and believe that there is a large amount of revenue to be raised from taxing capital gains as ordinary income or from, at least, raising the rate.[4] However, the vast majority of that revenue is a mirage — at least in the eyes of the budget scorekeepers and perhaps in reality.

The official tax expenditure table from the Joint Committee on Taxation shows that the preferential rates on capital gains and dividends cost $120 billion in 2015 alone.[5] Distribution tables further indicate that almost all of that tax expenditure benefits those at the top of the income distribution. The Urban-Brookings Tax Policy Center (TPC) suggests that nearly 70 percent of that amount — or more than $80 billion in 2015 — benefits the 0.4 percent of households that have more than $1 million per year in income. That amount represents about 6 percent of their after-tax income.[6] Based on figures like those, it is perhaps no surprise that raising the rate on capital gains and dividends can seem like an attractive way to increase taxes on the highest-income Americans.

However, the tax expenditure estimates do not indicate the amount of revenue that would be raised by eliminating the preferential rate. That is because they are static estimates, which do not take into account behavioral changes that could occur if the rate increased, including the degree to which owners of capital assets would respond by reducing the rate at which they realize accrued gains. The budget offices do consider that effect when estimating the revenue generated by legislation, unlike the estimated tax expenditure table numbers. The JCT and Treasury both assume that the revenue-maximizing rate for capital gains revenue ranges from 28 to 32 percent.[7]

While that revenue-maximizing range is above the current rate, it is not dramatically so. The top capital gains rate is currently 23.8 percent (taking into account the 3.8-percentage-point Medicare surtax on unearned income) — and so the current top rate is only 4 to 8 percentage points away from the revenue-maximizing point. If the budget offices were to take into account the effect on total revenue rather than just capital gains revenue (and substitution between ordinary and capital income), the revenue-maximizing rate may be higher — but probably not dramatically so.[8] In other words, when it comes to capital gains and realizations, the Laffer curve lives, and the current rate is within striking distance of the top of the curve.

Notably, the JCT and Treasury assume that qualified dividends are less sensitive to the tax rate than capital gains realizations.[9] However, qualified dividends are not as large as capital gains realizations in terms of volume, and they are less concentrated at

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[4]*See supra* note 1.

[5]JCT, ''Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018,'' at 27 (Aug. 8, 2014).

[6]The TPC estimates appear consistent with the JCT estimates, since the TPC also finds that the total value of the preference for capital gains and dividends is about $120 billion as of 2015. Urban-Brookings Tax Policy Center, Table T13-0258, ''Tax Benefits of the Preferential Rates on Long-Term Capital Gains and Qualified Dividends, Distribution of Federal Tax Change by Expanded Cash Income Level, 2015, Detail Table,'' Dec. 18, 2013, *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0258.pdf.

[7]I give a range because reports vary on the exact revenue-maximizing tax rate under their assumptions. For instance, Leonard Burman reports the revenue-maximizing rate to be about 28 percent for the JCT and Treasury. *See* Burman, ''Tax Reform and the Tax Treatment of Capital Gains, Statement Before the House Committee on Ways and Means and the Senate Committee on Finance,'' at 8 (Sept. 20, 2012). Discussions between this author and officials familiar with capital gains estimates suggest a revenue-maximizing rate in the range of 28 to 30 percent. However — and somewhat inconsistent with these reports — Jane G. Gravelle describes elasticity assumptions consistent with a revenue-maximizing rate of 31 percent in the case of the JCT and 32.5 percent in the case of Treasury. Gravelle, ''Capital Gains Tax Options: Behavioral Responses and Revenues,'' at 7, Table 1, R41364 (Aug. 10, 2010).

[8]Burman speculates that ''there might be a small additional revenue gain from deterring income tax sheltering.'' *See* Burman, *supra* note 7, at 8.

[9]For instance, a Treasury estimate from 2012 suggested that at the time, taxing dividends as ordinary income for families making more than $250,000 would raise about $200 billion over 10 years, as compared to taxing them at 15 percent. Treasury, ''General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals,'' at 203, Table 1 (Feb. 2012). This is significantly more revenue than Treasury suggests can be raised by increasing the tax rate on capital gains for this income class — and despite capital gains being much larger in total volume. *See infra* text accompanying note 12. With that said, there is at least some evidence that dividends are — in actuality — relatively sensitive to the tax rate. *See, e.g.*, Raj Chetty and Emanuel Saez, ''Dividend and Corporate Taxation in an Agency Model of the Firm,'' *Am. Econ. J.: Econ. Pol'y*, Aug. 2010, at 1.

the top of the income distribution. For instance, according to the IRS, long-term capital gains averaged about $300 billion per year from 2003-2011 for those making more than $1 million, whereas qualified dividends averaged about $50 billion per year.[10]

Thus, according to the official estimates, there is relatively little revenue to generate from the highest-income Americans by increasing the tax rate on dividends and, especially, capital gains. Whereas the static estimate suggests that taxing those sources as ordinary income would raise about $80 billion from those making $1 million or more in 2015,[11] the actual maximum amount of additional revenue that could be raised from millionaires would probably be much less. There is no publicly available score, but it is likely between $10 billion and $15 billion in 2015, using the budget offices' assumptions — with less than $5 billion coming from increasing the tax rate on capital gains and about $10 billion or less coming from increasing the tax rate on dividends.[12] This assumes that the capital gains rate is set at the revenue-maximizing rate of 28 to 32 percent and that dividends are taxed as ordinary income.

The extent of this assumed behavioral effect, and the fact that the official budget offices would take it into account, may seem surprising. The more extreme versions of supply-side theory — which suggests that many tax cuts could pay for themselves or come close to doing so — have generally been rejected, and rightly so.[13] It is often said that the official budget offices do not do dynamic estimates that take into account the effects of tax changes on behavior.[14] However some behaviors are more sensitive to tax rates than others. And while underlying labor effort and savings rates have been shown to be relatively insensitive to tax rates, there is evidence to suggest that tax-planning behaviors, like holding property longer to avoid realizing accrued gains, are considerably more sensitive.[15] Further, when scoring legislation the official budget offices *do* take into account what are called microdynamic behavioral effects; these are behavioral changes that do not affect macroeconomic variables like productivity, savings rates, and labor force participation. These microdynamic effects include changes in the rate at which owners of property realize accrued gains.[16]

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[10]These figures come from IRS Statistics of Income. *See* SOI, "Individual Income Tax Returns Filed and Sources of Income," Table 1.4, *available at* http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income.

[11]*See supra* text accompanying note 6.

[12]For most revenue estimates in this article, I report the increase in tax liability in 2015 attributed to a particular tax change. This is different than the amount that would actually be collected in that year, because collections lag behind liability, especially if 2015 were the first year a change were implemented.

The estimate of $10 billion to $15 billion is a rough guess at the increased tax liability from raising capital gains and dividends tax rates under official budget office assumptions. This reflects the following steps:

First, this assumes that about $10 billion could be raised by taxing dividends as ordinary income for those making more than $1 million. As reported *supra* note 9, Treasury had estimated that taxing dividends earned by families making more than $250,000 would raise about $200 billion over 10 years as of 2012. However, about 20 percent of this revenue has already been raised as the top dividends tax rate rose from 15 percent to 20 percent in 2013. Further, this original estimate includes families making more than $250,000 and not just those making more than $1 million. The IRS reports that, as of 2011, about 40 percent of qualified dividends earned by those making more than $200,000 came from those in the $200,000-to-$1 million range. *See* SOI, *supra* note 10. Thus, discounting the 2012 score suggests revenue in the range of $10 billion per year. Estimates from the JCT issued at the same time as Treasury's imply that revenue from dividends is somewhat less.

Second, this reflects an assumption of maximum additional capital gains revenue of less than $5 billion from those making more than $1 million. As of 2012, Treasury estimated that a 5-percentage-point increase in capital gains rates for families making more than $250,000 would raise only $35 billion over 10 years. *See* Treasury, *supra* note 9, at 203, Table 1. Thus, an increase of 4 to 8 percentage points in the capital gains rate — and for those making only more than $1 million — seems likely to raise significantly less than $5 billion per year. This is especially the case given the diminishing revenue that would be generated for increases in the top capital gains rate as the rate approaches the revenue-maximizing point.

[13]*See, e.g.*, Simon Johnson, "Can Tax Cuts Pay for Themselves?" *The New York Times*, Oct. 13, 2011, *available at* http://economix.blogs.nytimes.com/2011/10/13/can-tax-cuts-pay-for-themselves/ ("Can tax cuts 'pay for themselves,' inducing so much additional economic growth that government revenue actually increases, rather than decreases? The evidence clearly says no."); Chad Stone, "Economists Agree: Tax Cuts Cost Revenue," *U.S. News & World Report*, June 29, 2012, *available at* http://www.usnews.com/opinion/blogs/economic-intelligence/2012/06/29/economists-agree-tax-cuts-cost-revenue---.

[14]*See, e.g.*, Americans for Prosperity Foundation, "Inside the Congressional Budget Office: Static vs. Dynamic Scoring," Nov. 2011, *available at* http://americansforprosperityfoundation.com/files/NtK_19_Static_Dynamic_Scoring.pdf ("The CBO currently prepares its cost estimates using 'static' analysis.").

[15]*See, e.g.*, Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review," 51 *J. of Econ. Lit.* 3, 42 (2012) ("While there is compelling U.S. evidence of strong behavioral responses to taxation at the upper end of the distribution around the main tax reform episodes since 1980, in all cases those responses fall in the first two tiers of the Slemrod . . . hierarchy — timing and avoidance. In contrast, there is no compelling evidence to date of real economic responses to tax rates (the bottom tier in Slemrod's hierarchy) at the top of the income distribution.").

[16]Alan J. Auerbach, "Dynamic Scoring: An Introduction to the Issues," 95 *Am. Econ. Rev.* 421, 422 (2005), *available at* http://eml.berkeley.edu/~auerbach/dynamscor.pdf.

To be sure, there is significant controversy over the degree to which capital gains realizations are sensitive to the tax rate. A recent paper by analysts at the Congressional Budget Office and the JCT implies that the current scorekeeping assumptions underestimate the sensitivity of realizations.[17] However, a prominent analyst at the Congressional Research Service has criticized the current assumptions used by the official budget offices and, based on a review of the literature, suggested that the revenue-maximizing capital gains rate is significantly above 28 percent.[18] This is an important debate, and economists should continue to engage this issue. But, for the time being, the scorekeeping assumptions seem unlikely to change, and they reflect at least some credible economic evidence. While this is the case, legislation to further increase the tax rate on capital gains will not be credited with producing much revenue and so should not be thought of as a viable way to substantially increase the tax liabilities of the wealthiest Americans.

**2. Minimum taxes and the Buffett rule.** Imposing minimum taxes is another method to raise taxes on the highest-income Americans that has received considerable notice. For the most part, attention has focused on the Obama administration's proposed "Buffett rule" (famously named after Warren Buffett since he proposed something of this ilk). However, according to estimates from the official budget offices, relatively little revenue would be raised by this instrument — at least given the rates that are under discussion. This is because this minimum tax would largely affect high-income Americans by increasing the effective marginal tax rate on capital gains, and, as discussed, that would prompt a reduction in realizations.

As proposed by the administration, the Buffett rule would set a minimum tax rate of 30 percent for those making more than $1 million, with this phased in between $1 million and $2 million in income.[19] Importantly, it is 30 percent of adjusted gross income after subtracting charitable contributions — and so it does not limit the deduction for charitable giving. Depending on the incarnation, estimates have varied, but the JCT's latest estimate suggests that the tax would raise under $10 billion annually for the years 2015 to 2024.[20]

Again, the reason that method raises relatively little revenue is largely because of the effect on realizations. The JCT assumes that the tax would result in a significant decrease in realizations relative to its baseline.[21] Or, to put it differently, the minimum tax does not apply to 30 percent of *economic* income — including unrealized gains and losses — but rather applies to 30 percent of AGI. First, economic income tends to be higher than AGI because of the accrual of unrealized gains. Second, and more important, AGI can be manipulated by holding gains (and selling losses) without much effect on economic income. That is what the JCT predicts would happen if a minimum tax were imposed. In short, this specific minimum tax is fairly ineffective at raising revenue because it is imposed on a tax base that is easily manipulated through tax planning.

**3. Annual wealth taxes and mark-to-market income tax accounting.** The key problem in raising revenue through either higher capital gains rates or a minimum tax that targets capital gains is the ability of high-income Americans to adjust their realization behavior. This can be avoided by either imposing wealth taxes on the entire corpus of wealth or implementing an income tax system using mark-to-market accounting. Both overcome the realization barrier. Piketty brought wealth taxes back to prominence with his proposal to address inequality through an annual global wealth tax.[22] Mark-to-market income tax accounting has also received considerable attention recently — including one proposal to replace the corporate income

[17]*See* Burman, *supra* note 7, at 8; Timothy Dowd, Robert McClelland, and Athiphat Muthitacharoen, "New Evidence on the Tax Elasticity of Capital Gains: A Joint Working Paper of the Staff of the Joint Committee on Taxation and the Congressional Budget Office," CBO Working Paper 2012-09 (June 2012).

[18]*See* Gravelle, *supra* note 7, at 10 ("Thus, the Administration's projections and those of the JCT, absent a change in their realizations response, may likely understate revenue gains from allowing lower capital gains tax rates to expire.").

[19]*See* Treasury, *supra* note 2, at 156-157.

[20]In its estimate of the president's budget, the JCT finds that the minimum tax would raise about $70 billion from 2015-2024. JCT, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal," JCX-36-14, at 6 (Apr. 15, 2014). If the proposal were estimated alone — and not in interaction with some of the other proposals in the president's budget — the revenue raised would probably be somewhat higher than this. That is because some of the other budget proposals — in particular, the limit on the value of certain deductions and exclusions — raise taxes on high-income Americans and thus reduce the revenue raised by the Buffett rule if implemented after these other reforms (as this estimate appears to assume). Unlike with the other estimates in this article, I do not report the effect in 2015 alone since there are significant short-term timing effects attributable to the JCT assuming a sell-off in capital assets before implementation of the tax (to avoid the increase in the effective capital gains rate).

[21]Letter to Senator Sheldon Whitehouse, D-R.I., from the JCT (Mar. 14, 2012) ("We estimate that your proposal would result in a significant shift in capital gains realizations from tax year 2013 to tax year 2012 and a significant decrease in capital gains realizations in capital gains realizations in 2013 and years thereafter relative to our baseline forecast.").

[22]Piketty, *supra* note 3, at 515-539.

tax with mark-to-market accounting for publicly traded stocks and proposed expansions in mark-to-market accounting for derivatives.[23]

Unlike the other options discussed so far, annual wealth taxes or mark-to-market income tax accounting on all assets have the potential to raise very large amounts from the richest Americans *if the systems could be administered effectively*. However, administrability poses a major barrier to the universal application of these systems.

The problem — one of several long-standing objections to mark-to-market accounting and annual wealth taxes — is valuation.[24] It is important to emphasize that there is a significant share of wealth in the United States that is neither publicly traded nor otherwise relatively easily valued. According to IRS estimates based on estate tax returns, about 50 percent of gross wealth held by those with a net value exceeding $2 million in 2007 — or about the top 1 percent of the U.S. population in terms of wealth — is held in assets not easily valued.[25] Even though the valuation problem is well known, that significant share has not been highlighted recently.

Table 1 illustrates shares of gross wealth using data from the IRS's *Winter 2012 SOI Bulletin*.[26] The categories provided by the IRS are not precise in determining what exactly is publicly traded or readily valued. Based on the categories of assets given by the IRS, I have roughly decomposed between assets that are publicly traded or readily valued and those that are not.

**Table 1. Shares of Gross Wealth: Gross Wealth Greater Than $2 Million in 2007**

| | |
|---|---|
| **Neither publicly traded nor readily valued** | **49%** |
| Real estate | 22% |
| Closely held stock | 12% |
| Noncorporate business assets | 7% |
| Farm assets | 3% |
| Private equity and hedge funds | 3% |
| Other (other limited partnerships, art) | 2% |
| **Publicly traded or readily valued** | **51%** |
| Publicly traded stock | 19% |
| Bonds (government, corporate, funds) | 9% |
| Retirement assets | 9% |
| Cash | 8% |
| Mortgages and notes | 2% |
| Other (mutual funds, insurance, other assets) | 4% |
| *Source*: IRS, Personal Wealth, 2007. | |

The administrative barriers to valuation could be overcome — as they are upon gift or bequest (the source of the IRS estimates in Table 1) — but it certainly would not be easy. The challenges of valuation in the estate and gift tax system and, at the local level, in the property tax system are instructional,[27] and it is difficult to imagine going through the valuation process annually. Of course, it is possible to apply a system only to assets that are publicly traded or otherwise readily valued, and some have proposed such mark-to-market systems.[28] That is a plausible approach, but it would limit the possible revenue generation and create an opportunity for gamesmanship as the wealthy could adjust their portfolios — and how they structure transactions — to avoid holding assets subject to a more limited mark-to-market or wealth tax.[29]

[23]*See* Eric Toder and Alan Viard, "Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax," Apr. 4, 2014, *available at* http://www.aei.org/files/2014/04/03/-toder-viard-report_132524981261.pdf; House Ways and Means Committee, "Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary," at 97 (Feb. 26, 2014).

[24]In his paper advocating mark-to-market for publicly traded assets, David S. Miller nicely summarizes some of the long-standing objections to such systems — in particular, concerns about valuation, liquidity, and the psychology of paying tax on "paper returns." *See* Miller, "A Progressive System of Mark-to-Market Taxation," *Tax Notes*, Nov. 22, 2005, p. 1047, at p. 1053. However, in advocating for a system that applies only to publicly traded assets, Miller appears to substantially underestimate the share of wealth not publicly traded. Based on data from the *Forbes* top 25, Miller guesses that about 14 percent of the wealth of the top 0.1 percent is held either in real estate or privately held assets. *Id.* at 1054-1055, n.52. By contrast, the IRS data suggest that significantly more than this share for the richest Americans — in the range of 20 percent — is held in real estate *alone*. *See infra* note 25.

[25]These are the author's tabulations based on the IRS estimates of wealth held by the richest Americans. The IRS estimates are made based on estate tax returns but are intended to capture wealth for the population as a whole and not just decedents. For a description of the IRS method, see Brian Raub and Joseph Newcomb, "Personal Wealth, 2007," 31 *SOI Bull.* 156 (Winter 2012).

[26]Raub and Newcomb, "Personal Wealth, 2007," 31 *SOI Bull.* 156 (Winter 2012).

[27]For instance, Richard Epstein discusses the problem of valuation and describes how valuation disputes in the context of the estate and gift tax can take years to resolve — and even up to a decade or more in the case of litigation. *See* Richard Epstein, "Death by Wealth Tax," *Defining Ideas*, Jan. 17, 2012, *available at* http://www.hoover.org/research/death-wealth-tax. *See also* James R. Repetti, "Commentary, It's All About Valuation," 53 *Tax L. Rev.* 607, 611-614 (2000) (cataloguing the potential valuation problems of wealth taxes); William S. Blatt, "Minority Discounts, Fair Market Value, and the Culture of Estate Taxation," 52 *Tax L. Rev.* 225 (1997) (discussing problems and possible responses related to one particular game played by taxpayers to reduce value of assets — namely, splitting ownership into minority shares).

[28]*See generally* Miller, *supra* note 24; David A. Weisbach, "A Partial Mark-to-Market Tax System," 53 *Tax L. Rev.* 95 (1999).

[29]In proposing a partial mark-to-market income tax system, Weisbach suggests addressing this problem of substitution toward non-traded assets by taxing gains subject to mark-to-market accounting and those subject to the old realization

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In terms of practical concerns, it is worth noting that a broadly applied wealth tax would be subject to constitutional challenge. Absent a constitutional amendment, a federal wealth tax is vulnerable to attack as a ''direct tax'' requiring apportionment among the states according to population, and courts may not save the tax as they did with the estate and gift tax.[30] A mark-to-market system may be challenged under the same doctrine, and several lawyers have written that it would represent a direct tax and not an income tax under the 16th Amendment.[31] However, mark-to-market income tax accounting seems much more likely to survive court review than a wealth tax (and should survive).[32]

The point of my discussion here is not to fully delve into the many details and arguments surrounding wealth taxes or mark-to-market systems. Instead, I mean to emphasize that proposals like those from Piketty face a major, and potentially fatal, administrative barrier because a large proportion of wealth, at least in this country, is not easy to value. So, while realization behavior is not a problem in this context, administration is a major one.

### B. More Promising Options

This section describes four options for raising revenue from the highest-income Americans that are more promising in terms of the revenue that could be raised and administrability. All four are familiar to those who follow tax debates, but deserve to be separately highlighted.

The first of these options returns to the realization problem that plagues taxation of capital income. Instead of eliminating realization for many assets, this option would instead treat death and bequest as realization events. This is perhaps the best option, in light of its potential to raise substantial revenue and reduce inefficient behavior of owners who delay sale of property with built-in gains. The other options focus on either broadening the base or raising rates in the transfer tax or income tax systems. Those options could also raise substantial revenue but with some important caveats.

**1. Realization on bequest or gift.** As noted above, attacking the realization problem through annual wealth taxes or mark-to-market income taxes faces a major administrative hurdle (and possible constitutional challenges). An alternative, or at least a waypoint, is to designate bequests and gifts of property as realization events. If all of the accrued gains were realized at those times, the revenue gains would be substantial — at least $40 billion per year from 2014-2018 — and the policy also could come with important efficiency benefits.[33] For those who want to increase the tax liabilities of the most-well-off Americans, this is probably the place to start. There are ways to adopt this policy partially and in a targeted fashion, which may make it more viable as an administrative and political matter.[34]

Currently, gains (and losses) are wiped away upon the death of the holder of the property — a policy known as step-up in basis because the basis of the property increases to the fair market value at time of the death of the holder.[35] For gifts, any accrued gains carry over to the new holder of the property and are not realized at the time of the gift.[36]

There are two main alternatives to change this policy to enhance revenue. First, a step-up in basis at death could be changed to carryover basis — meaning the gain is not realized but is preserved — which has been attempted before.[37] Alternatively,

system at different rates — so that the *average* tax rate is the same. Weisbach, *supra* note 28. Such an approach might help to minimize such planning (although certainly not eliminate it — since taxpayers will try to plan to still take advantage of the choice between systems), but it also highlights a significant downside of such a mixed system. In particular, the realization problem remains for a very large share of assets, and that will still limit the overall revenue that could be generated. The revenue-maximizing rate of the mixed system should be above that of the pure realization system, but it would still be subject to the constraint that higher rates will encourage holding onto assets in the realization-based system for longer, including until death, at which point the gains would be wiped away. *See infra* Section B.1 for a discussion of step up in basis at death.

[30]For a brief history of the ''direct tax'' doctrine, see Alan O. Dixler, ''Direct Taxes Under the Constitution: A Review of the Precedents,'' *Tax Notes*, Dec. 25, 2006, p. 1177. Dixler concludes that a federal tax on net worth should not be treated as a direct tax and *upheld* as constitutional without apportionment. However, Dixler also notes that this ''would surely test the meaning of direct tax'' and require overruling some Supreme Court precedent. *Id.* at 1190.

[31]*See generally* Gene Magidenko, ''Is a Broadly Based Mark-to-Market Tax Unconstitutional?'' *Tax Notes*, May 26, 2014, p. 952; Erik M. Jensen, ''The Constitutionality of a Mark-to-Market Taxing System,'' *Tax Notes*, June 16, 2014, p. 1299.

[32]For a discussion of why a mark-to-market system should be upheld as constitutional (and how several courts already have), see Miller, *supra* note 24, at 1053, n.6.

[33]*See infra* text accompanying notes 39-40.

[34]I am by no means the first (nor hopefully the last) to describe this as one of the best places to start if policymakers want to increase tax liabilities of the best-off Americans. *See, e.g.*, Edward J. McCaffery, ''A Progressive's Silver Linings Playbook: Repeal Stepped-Up Basis,'' *Tax Notes*, Feb. 25, 2013, p. 969; Lawrence Summers, ''How to Target Untaxed Wealth,'' *Reuters*, Dec. 17, 2012, *available at* http://blogs.reuters.com/lawrencesummers/2012/12/17/how-to-target-untaxed-wealth/.

[35]Section 1014.

[36]Section 1015.

[37]Carryover basis was enacted in the Tax Reform Act of 1976 but ultimately repealed. Senate Budget Committee, ''Tax Expenditures, Compendium of Background Material on Individual

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the bequest or gift of property could be designated as realization events, in which case accrued gains (and losses) would be realized at that point; this should raise considerably more revenue. This second option is essentially a way of moving closer to a mark-to-market income tax accounting system. The accounting would not occur annually but at death or upon gift.

While essentially acting as a partial mark-to-market system, realization at death or gift addresses the key administrative barrier described earlier. In particular, while valuation remains a significant challenge for both the IRS and taxpayers, valuation of those assets would occur only once per generation rather than annually, and our current system already requires this valuation in the estate and gift tax system for large transfers of wealth. Thus, the additional administrative burden should be significantly less than in attempting a move to an annual mark-to-market or a wealth tax system. Notably, it should also avoid any of the constitutional legal challenges that may arise in the context of mark-to-market systems or federal wealth taxes.[38]

Such a reform could be targeted in at least two ways. First, the realization requirement could apply only over a certain threshold. For instance, the law could allow a specific amount of basis step-up at death and a certain amount of gains to be deferred upon gift; above that threshold, gains would be realized. There is a strong administrative argument for a limitation like this. Second, realized gains need not be fully included in income. For instance, only some share of the accrued gains might be realized. Such a limit might be appealing to policymakers to the extent that they did not want raise as much revenue as would come from full realization and inclusion.

Without such limits, the revenue gains from realization upon bequest or gift would be substantial. Static tax-expenditure estimates from the JCT suggest that realization of gains upon bequest would generate about $35 billion per year from 2014-2018, and that realization of gains upon gift would generate about an additional $7 billion per year over this period.[39] The estimates from Treasury are in the same range, averaging revenue of about $37 billion per year for the two policies.[40] What's important is that these static estimates may very well underestimate the revenue generated. That is because such a change in policy would tend to *increase* realizations before death or gift. In other words, the effect on realizations should be the opposite of an increase in the rate, because it would reduce the tax-created incentive to hold onto assets with appreciated gains. The additional revenue from such an effect should be included in any official scores of legislation because it comes from a microdynamic change.

The point about additional realizations is important not just because of the additional revenue generated but also because this reflects an enhancement in efficiency. As tax scholars have long noted, carryover basis upon gift and, especially, a step-up in basis at death generates inefficient behavior by worsening the ''lock-in'' effect, which is the incentive in the realization-based system to defer gains for as long as possible and, therefore, to hold onto property that would otherwise be sold and put to higher and better use. Such incentive is inevitable in a realization-based system because of the time value of money and the benefit of paying taxes later, but a step-up in basis exacerbates the incentive, since gains are entirely wiped out if the property is held until death. A step-up in basis is not just a question of deferral; it has the potential to wipe out such gains.

Given its relative administrability as compared to broader mark-to-market regimes, the considerable revenue potential, and efficiency gains, realization

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Provisions'' (Dec. 28, 2012) (''The Tax Reform Act of 1976 provided that the heir's basis in property transferred at death would be determined by reference to the decedent's basis. This carryover basis provision was not permitted to take effect and was repealed in 1980. The primary stated rationale for repeal was the concern that carryover basis created substantial administrative burdens for estates, heirs, and the Treasury Department.''). And, again, carryover basis was enacted for 2010 when the estate tax was supposed to be repealed (for one year), but this turned out to be only a one-year phenomenon (and even then estates were given a choice whether to use carryover or step-up combined with a low estate tax.). Justin P. Ransome and Frances Schafer, ''Estate Tax or Carryover Basis?'' *J. of Acct.*, July 2011, at 28, *available at* http://www.journalofaccountancy.com/Issues/2011/Jul/20113784.htm.

[38]Even if courts were to decide that the realization is a constitutional requirement in an income tax system (which they should not), bequest and gift can readily be characterized as realization events.

[39]*See* JCT, *supra* note 5, at 26-27. I do not report the amounts for 2015 alone because the JCT seems to assume that ending carryover basis for gifts leads to timing effects that make the annual figures less meaningful. For realization upon bequest, the figure for 2015 is basically the same as the five-year average. Importantly, the tax expenditure table does not indicate whether the estimate takes into account a possible interaction with the estate tax, because taxes paid on gains should reduce the size of estate and thus the amount of taxes raised through the estate tax. To the extent that is not taken into account, the estimates are too high for that reason. However, as I explain above, the estimates do not take into account the effect of reduced lock-in, which would enhance revenue, and, thus, cut in the opposite direction.

[40]Office of Management and Budget, ''Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015,'' at 206 (Mar. 2014).

at bequest or gift seems like a particularly opportune starting place if policymakers seek to raise the tax liabilities of the most well-to-do Americans. Again, this is not a take-it-or-leave-it type of reform. As described above, the policy could be modulated to be as broad or narrow as policymakers desire.

Some may object to any such realization requirement combined with an existing estate and gift tax. It might be framed as a double tax on bequests and gifts. That objection, however, ignores the separate goals of the two tax systems (goals that admittedly could be debated). The estate and gift tax is designed to tax transfers of wealth across generations. Realization upon bequest or gift is designed to tax previously accrued income that was deferred because of the realization rules. As discussed, such income could alternatively be taxed through annual mark-to-market systems — a more aggressive approach — in which case there would not be a timing alignment with the estate and gift tax. However, from an administrative point of view, the timing alignment is in fact a major boon. It allows the income tax system to take advantage of the estate tax's valuation requirements, at least for the highest-value estates. Thus, the alignment should, in substance, be seen not as a bug but rather as a benefit of subjecting gains at bequest or gift to tax.

**2. Transfer taxes.** Transfer taxes can be a significant source of additional revenue from the highest-income Americans, but only at rates and exemption levels that significantly differ from those in place in the estate and gift tax system. Table 2 summarizes some possible options in the estate and gift tax system and the amounts they would raise in 2015.

Based on estimates from the TPC — which appear similar to those from the JCT — an increase in the tax rate on estates and gifts of 5 percentage points (consistent with the rate in 2009 of 45 percent), along with keeping the current exemption level constant (of nearly $11 million for a married couple), would raise $2 billion in 2015. Decreasing the estate tax exemption by $3 million to more than $7.5 million per married couple (consistent with the 2009 exemption level indexed with inflation) would raise about $3 billion in 2015. And the combination of the two policies — thus, returning the estate tax to its 2009 parameters indexed for inflation — would raise about $6 billion in 2015. More dramatic moves would, of course, produce considerably more revenue. For instance, returning to the 2001 tax parameters (a $2 million exemption for married couples and a 55 percent top rate) — a move far larger than has been under discussion recently — would generate nearly $30 billion in revenue in 2015 according to the TPC.[41]

**Table 2. Revenue from Estate Tax Options (in billions, in 2015)**

| | |
|---|---|
| 1. Raise estate tax rate to 45 percent (from 40 percent) | $2 |
| 2. Decrease the exemption by $3 million (to more than $7.5 million per married couple) | $3 |
| 3. Combine 1 and 2 (return to 2009 parameters with exemption indexed to inflation) | $6 |
| 4. Exemption of $2 million per married couple and top rate of 55 percent (pre-2001 parameters) | $28 |

*Source*: Author's calculations based on Tax Policy Center data.

Thus, relatively small changes in the rate and the exemption level compared with the current estate tax would produce limited revenue. Here, it is important to remember that very few estates are subject to the estate tax under current law. Less than 0.2 percent of estates have taxable returns.[42] In addition to that, these taxable estates benefit from the large exemption, meaning that a large share of the wealth in taxable estates is not subject to tax at all; only wealth exceeding the exemption is. This explains, for instance, why increasing the rate alone produces less revenue than might be expected, unless also combined with changes in the exemption.

In the estate tax space, there are other ways to raise revenue as well. As has been described in these pages, the estate tax is long overdue for reforms to try to limit the valuation games that many play.[43] It is unclear how much revenue would be raised, but these reforms seem worth pursuing in any case as an administrative matter. Another option (potentially in combination with reforms to

[41]All of these are the author's estimates using data from the Tax Policy Center. TPC, "Table T13-0019, Estate Tax Returns and Liability Under Current Law and Various Reform Proposals, 2011-2022" (Jan. 9, 2013), *available at* http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0019.pdf. As noted, they seem roughly consistent with recent estimates from the JCT on estate tax changes. For instance, the JCT also estimated that the 2012 deal to continue an increased estate tax exemption and lower rate cost somewhat more than $30 billion in 2015 as compared to returning to the 2001 parameters. JCT, "Estimated Revenue Effects of the Revenue Provisions Contained in an Amendment in the Nature of a Substitute to H.R. 8, the 'American Taxpayer Relief Act of 2012,' as Passed by the Senate on January 1, 2013," JCX-1-13, at 3 (Jan. 1, 2013).

[42]TPC, *supra* note 41.

[43]*See, e.g.*, James R. Repetti and Paul L. Caron, "Revitalizing the Estate Tax: 5 Easy Pieces," *Tax Notes*, Mar. 17, 2014, p. 1231 (describing several reforms targeted at valuation games including eliminating minority discounts and restricting grantor retained annuity trusts).

valuation) is to fundamentally reform the transfer tax system and replace the current one with an inheritance tax — a system in which the liability is imposed on the recipient of the transfer, potentially taxing it as a form of income, rather than the estate itself.[44] This may be a superior way of taxing wealth transfers especially to the extent that a goal is to encourage the breakup of inherited wealth across generations. However, an inheritance tax system does not overcome the fundamental dynamic described here. In particular, a much larger share of wealth transferred in gifts or bequests must be subject to tax at current or higher rates to generate substantial additional revenue, and this is true whether done through the current estate and gift tax system or an inheritance tax system.

While the official revenue estimates do not take into account the effects of the transfer taxes on saving and other behavior, it is ambiguous how these behavioral effects would affect the amount of revenue raised. For instance, one possibility is that those affected by an increased estate tax rate would reduce the gross amount they wish to bequest to their heirs given the increased tax cost, thus cutting revenue. Another possibility is that they *increase* the gross amount they wish to bequest to help maintain the after-tax amount that gets passed on, thus further increasing estate tax revenue. Thus, the direction and size of the response is a question to which economic theory does not provide a clear answer.[45]

**3. Ordinary income tax rate.** Increasing the top ordinary income tax rate — as opposed to the capital gains tax rate — is another approach that can generate substantial revenue. For each percentage point increase in the top ordinary income tax rate, those making more than $1 million would pay about $7 billion to $10 billion per year in additional taxes in 2015, according to estimates from the JCT and TPC.[46] To put this in terms of their after-tax income, each percentage point increase in the top tax rate produces a reduction in after-tax income in the range of 0.5 percent.[47] (The decrease is well below 1 percent primarily because so much annual income for the highest-income households comes from capital gains — and, of course, the reduction would be even smaller if unrealized gains were taken into account.)

While these estimates do not take into account some of the behavioral changes that would occur as a result of a change in the tax rate, much of the economic evidence suggests that — with behavioral changes incorporated — the revenue-maximizing tax rate on ordinary income is well above the current level. This is in contrast to the capital gains rate. In a recent paper, Emanuel Saez and Peter Diamond concluded that the current system's revenue-maximizing ordinary income tax rate is about 73 percent (inclusive of all federal and state taxes) — using a midpoint estimate for the responsiveness of taxable income to the tax rate.[48] Others, like Joel Slemrod, have offered revenue-maximizing rates in a similar range, with Slemrod saying that it is likely 60 percent or higher.[49] The bottom line is that, given the current top rate, increases seem likely to produce substantial revenue and to continue doing so until the rate is much higher than it is now.

This conclusion, however, deserves a caveat. These estimates do not account for the degree to which taxpayers' ability to use tax-planning techniques to avoid the ordinary income tax rate varies with the differential between the ordinary income tax rate and other tax rates. In particular, to the extent that the ordinary income tax rate increases relative to the capital gains rate or the corporate income tax rate, this increases the incentive to engage in tax-planning techniques to shift individual ordinary income into other forms. Taxpayers will have greater incentive to try to convert ordinary income into capital gains; businesses will have

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[44] *See generally* Lily L. Batchelder, ''Taxing Privilege More Effectively: Replacing the Estate Tax With an Inheritance Tax,'' Hamilton Project, June 2007, *available at* http://www.hamiltonproject.org/files/downloads_and_links/Taxing_Privilege_More_Effectively-_Replacing_the_Estate_Tax_with_an_Inheritance_Tax.pdf (proposing a switch to inheritance taxation).

[45] Jason L. Furman, ''Treasury Dynamic Scoring Analysis Refutes Claims by Supporters of the Tax Cuts,'' Center on Budget and Policy Priorities, July 27, 2006, at 4, n.4, *available at* http://www.cbpp.org/files/7-27-06tax.pdf (''Economic theory does not have a clear prediction about whether the economic impact of estate tax repeal is positive or negative'').

[46] The JCT has estimated that increasing the top two rates by 1 percentage point would raise about $7 billion in 2015. *See* CBO, ''Options for Reducing the Deficit: 2014 to 2023,'' at 106 (Nov. 13, 2013). The TPC distributional estimates suggest that more than 90 percent of this would come from those making more than $1 million per year. The same TPC estimates indicate that a reduction of 1 percentage point in the top rate would reduce tax liabilities of those making more than $1 million by about $10 billion in 2015. TPC, ''Table T14-0109, Decrease 39.6 Percent Individual Income Tax Rate to 38.6 Percent,'' Aug. 20, 2014, *available at* http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=4166&topic2ID=150&topic3ID=164&DocTypeID=.

[47] TPC, *supra* note 46.

[48] Diamond and Saez, ''The Case for a Progressive Tax: From Basic Research to Policy Recommendations,'' 25 *J. Econ. Persp.* 165, 171 (2011).

[49] Dylan Matthews, ''Where Does the Laffer Curve Bend?'' *The Washington Post*, Aug. 9, 2010, *available at* http://voices.washingtonpost.com/ezra-klein/2010/08/where_does_the_laffer_curve_be.html.

| Table 3. Major Itemized Deductions and Exclusions for Millionaires Versus Rest of Population in 2015 | | | | |
|---|---|---|---|---|
| | Greater Than $1 Million Per Year in Income | | Less Than $1 Million Per Year in Income | |
| | Billions | Percentage of After-Tax Income | Billions | Percentage of After-Tax Income |
| Deduction for state and local taxes | $26 | 1.9% | $66 | 0.6% |
| Deduction for charitable giving | $18 | 1.3% | $35 | 0.3% |
| Retirement preferences (NPV) | $9 | 0.7% | $140 | 1.3% |
| Deduction for home mortgage interest | $4 | 0.3% | $84 | 0.8% |
| Exclusion for health insurance | $3 | 0.2% | $151 | 1.4% |
| *Total* | *$60* | *4.4%* | *$476* | *4.6%* |
| Note: | | | | |
| Total, excluding deduction for charitable giving | $42 | 3.1% | $441 | 4.2% |
| Total, excluding deductions for charitable giving and state and local taxes | $16 | 1.2% | $375 | 3.6% |
| *Source*: Author's calculations based on estimates from Urban-Brookings Tax Policy Center. | | | | |

greater incentive to form as C corporations rather than passthroughs; and individuals will have greater incentive to ''stuff'' their compensation into C corporations to the extent they are able.

Many of the estimates do not account for these kinds of interactions among the different tax rates. This is important since the capital gains rate seems unlikely to increase significantly for the reasons described before, and the corporate income tax rate seems much more likely to decrease than increase given international competition and proposals to cut the rate from Republicans and Democrats. Diamond and Saez explicitly address this caveat concerning capital gains. They write that ''plausibly, it is . . . an argument for a somewhat lower labor income tax, assuming that labor income should be taxed more heavily than capital income.''[50] They describe this as a reason to limit the difference between the rates but do not face up to the conundrum that substantially increasing the capital gains rate may reduce overall revenue because of realization behavior. The same logic applies in the case of the differential in rates between the individual income tax and the corporate income tax (although Diamond and Saez do not mention that).

Without more research, it is difficult to assess how important these interactions are. But there are limits to the degree that taxpayers can engage in activities that shift income in this way. And, it seems likely that, despite these caveats, increasing the ordinary income tax rate would significantly increase revenue on net — even if, taking into account these interactions, the revenue-maximizing rate is below the 73 percent midpoint identified by Diamond and Saez.

[50]Diamond and Saez, *supra* note 48, at 175.

**4. Limiting itemized deductions and exclusions.** Another possible revenue source from the highest-income Americans is broadening the base by limiting or eliminating itemized deductions and exclusions. Altogether, eliminating the major itemized deductions and exclusions for those making more than $1 million would generate roughly $60 billion per year as of 2015, according to TPC estimates.[51] That is between 4 and 5 percent of after-tax income from these high-income households. The table above shows the composition of this by policy and compares the magnitude of these items for those making more than $1 million to the rest of the population.

The TPC estimates are static, but there is little reason to think that dynamic estimates would be much different from this. That is because much of this revenue comes from base broadening rather than a change in marginal tax rates. Further, while limiting the deduction for state and local income taxes could increase effective marginal rates, the evidence suggests that the tax system is far off from the revenue-maximizing rate on ordinary income, as noted previously.

However, the availability of revenue here may be significantly limited by broader policy considerations, and this is a major caveat. In particular, the majority of the value of these tax expenditures for millionaires — or 70 percent — comes from two tax sources: the deduction for state and local taxes and the deduction for charitable giving. The wisdom of limiting or eliminating these tax expenditures is the

[51]All of these estimates come from author's calculations based on estimates from the TPC. The TPC estimates can be found here: TPC, ''Distribution of Individual Income Tax Expenditures in 2015,'' *available at* http://www.taxpolicycenter.org/taxtopics/Tax-Expenditures-2013-2.cfm.

subject of considerable dispute that goes well beyond the issue of whether to increase tax liabilities for the highest-income taxpayers. Especially in the case of the charitable deduction, this involves larger social policy considerations. If the charitable deduction were entirely protected, the amount of revenue available would fall to $44 billion per year as of 2015, and, if the deduction for state and local taxes were protected as well, the amount available would fall to only $16 billion from complete elimination of the major remaining preferences for those making over $1 million per year.

It is noteworthy that some of the largest tax expenditures for the population as a whole give relatively little benefit to those with the highest incomes. The value of the combination of retirement preferences, the deduction for home mortgage interest, and the exclusion for employer-provided health insurance add up to this $16 billion figure. This is equivalent to about 1.2 percent of after-tax income for those making over $1 million per year. This is as compared to a total of $375 billion, or 3.6 percent of after-tax income for the rest of the population.

### C. Conclusion

Raising taxes on the very richest Americans is not on Congress's agenda, nor will it be for the near future. However, whether to do so will continue to be a matter of considerable debate in this country, and the issue might return as one of real policy relevance. In the midst of the debate about whether to raise taxes on the wealthiest Americans, this article focuses on the how, which can sometimes get lost.

This article does not address all possible options; for instance, the much-discussed carried interest loophole is not listed above. That is because, while taxing carried interest as ordinary income is worthwhile, the JCT estimates that this would raise about $2 billion per year. It cannot be mistaken for a broad-based and significant increase in tax liabilities for the richest Americans. This article also does not include options for increasing taxes at the corporate level for two reasons: First, there is not much discussion at the moment — even among academics — about increasing entity-level taxes. Second, the distribution of such a change, while probably disproportionately born by capital and thus the richest Americans, is hotly debated.

For those deeply involved in tax debates, the options presented here should seem familiar. This article does not introduce any new and exciting tax instruments. Rather, it is an annotated menu — describing why some of the most-discussed options would not actually raise much revenue or are administratively challenging, potentially fatally so. And, it highlights more viable options from the perspective of revenue generation and administration, concluding that the most promising place to start is probably realization of gains upon bequest or gift.