How Should the US Tax System Respond to the Growing Wealth Gap:
The Continuing Debate over Wealth Taxes and Other Tax Proposals to Narrow the Gap Between Rich and Poor

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Some Sources on Income and Wealth Gaps


• Pedro da Costa, America’s Humongous Wealth Gap is Widening Further, FORBES (May 29, 2019, at https://forbes.com/sites/pedrodacosta/2019/05/29/Americas-humongous-wealth-gap-is-widening-further/#7cf2c1d342ee


What Wealth Inequality in the U.S. Looks Like

Wealth Distribution

1989
The top 10% of Americans owned the majority of U.S. wealth
- 67% of wealth

The next 40% owned less than a third
- 30% of wealth

The bottom 50% owned a sliver
- 3% of wealth

2016
The top 10% of Americans owned more of total U.S. wealth
- 77% of wealth

The next 40% owned less
- 22% of wealth

The bottom 50% saw its sliver of wealth shrink
- 1% of wealth

Also, about 1 in 10 families in 2016 had negative net worth

= Represents 9.3 million families
= Total U.S. household wealth in 1989: $32.87 trillion (2016 adj. $)
= Represents 12.6 million families
= Total U.S. household wealth in 2016: $86.87 trillion

Wealth Concentration at the Top in the US

The top 1% holds as much wealth as the bottom 90%. The top 10% (starting with incomes of $942,000) holds 76% of total wealth. The bottom 50% holds only 1% of total wealth. The 400 wealthiest families hold about the same wealth as the entire African-American population of the country plus a third of the Latinx population.

Three ways to measure a cohort’s share of wealth:

1. Estate tax and mortality data (biased downward due to evasion)
   a. Kupczuk & Saez 2004

2. Fed’s Survey of Consumer Finances (SCF) (biased downward due to voluntary nature and exclusion of wealthiest 400)

3. Capitalization of income from tax returns to estimate wealth (uncertainty from estimating IRRs)
   a. Saez & Zucman 2016: top 0.1% spectacular surge from 1980—to above 20% in 2014
   b. Smith, Zidar & Zwick 2019: to above 15% (with conservative accounting for heterogeneity of returns, and assumption of larger role for private business wealth)

Key Idea: “All sources of information point to an increase in wealth inequality. Exactly how much is very much uncertain and should not be presented as certain.”

“Income and wealth inequality in the United States have increased over several decades. While income inequality in the United States was relatively stable from the 1940s to the 1970s, since then wage growth at the top of the income distribution has outpaced the rest of the distribution, and inequality has risen. Wealth has become increasingly concentrated . . . .”

“Further, income, wealth, and longevity are each interconnected.”

“[P]eople who have lower incomes tend to live shorter lives than those with higher incomes.”
GAO 19-587 Fig. 5, at 19, Income and Wealth of Older Americans, Estimated Average Wealth plus PV of future income, by quintile, in millions (top quintile on right, lighter blue is Soc. Sec.)
Correlated Disparities

**Race and Gender:**

“Income and wealth were consistently lower over time for older households headed by someone who was a racial minority, single, or hadn’t attended college.” GAO Study at 23

**Longevity:**

“For income, an estimated 52 percent of individuals from households in the bottom quintile of the mid-career earnings distribution were alive in 2014, compared to an estimated 74 percent of individuals from households in the top quintile. The percentages by wealth quintile were similar.” GAO Study at 35
More on the Wealth Gap

• [additional slide(s) expected]
How should the tax system respond to the Income Gap and Wealth Gap?

1. S-Corp/Partnership Labor Income Currently Taxed as Capital Gains
2. Senator Elizabeth Warren’s Wealth Tax Proposal
4. Edward Kleinbard’s Dual Business Enterprise Income Tax (Dual BEIT)
5. Making the Income, Estate and Gift Tax Systems More Progressive
Pass-Through Income as a Significant Driver of Wealth Increase at the Top
THE TWO BASES
Adjusted Gross Income and Wealth
Business Participation by AGI Percentile

The graph illustrates the share of positive income across different AGI percentiles for various types of income:

- **Partnership Income**
- **S-corporation Income**
- **Dividend Income from C-corporations**
- **Sole Proprietorship Income**

The x-axis represents the AGI percentile, while the y-axis shows the share with positive income (%). The graph shows a progressive increase in the share of positive income as the AGI percentile increases, with each income type having a distinct pattern.
Business Income Share by AGI Percentile

![Graph showing business income share by AGI percentile. The x-axis represents AGI percentile, and the y-axis represents the share of income type (%). The graph includes five types of income: sole proprietorship, C-corporation, S-corporation, and partnership income.]
Appropriate Tax Response to Such “Labor Income” Increases
Proposals for Wealth Taxes or MTM of CGs
Democratic Egalitarianism

Democratic egalitarianism says that broad-based growth is the most beneficial for the economy, not growth that goes predominantly to the already wealthy. Policies, accordingly, should tend to redistribute downwards, to the extent possible, to ensure that even those at the bottom have a decent standard of living and to prevent those at the top from acquiring plutocratic control of the institutions of government and the economy.

Consider the post-WWII economy when more women were in the work force with men for the first time and the GI Bill allowed returning vets to get a college education, at the same time that various New Deal programs enhanced the possibility for those in the bottom of the wealth and income distributions to have a decent standard of living.
Senator Warren’s Wealth Tax Proposal

- Tax is a small annual bite of a taxpayer’s net worth above a large exemption: 2% on wealth above $50 million, with an additional 4% (total of 6%) on wealth above $1 billion, estimated to generate $3.75 million over ten years
- Revenues to be invested in human and physical infrastructure that supports the economy
  - Eventual expansion of Medicare to cover all Americans
  - Free public college tuition (similar to the post-WWII GI Bill)
  - Student debt forgiveness
  - Green New Deal physical infrastructure projects (transportation, climate change)
- Anti-evasion provisions included to support implementation
  - Formulaic evaluations of small businesses, unoccupied real estate
  - Increase in IRS enforcement budget
  - 40% ‘exit tax’ on expatriation of net worth about $50 million
  - Minimum audit rate for those subject to the wealth tax
Arguments supporting use of wealth tax

• Wealth tax directly addresses the increasing concentration of wealth and its resulting negative externalities

• Taxing wealth concentration expresses a long-held anti-dynasty American value: the American revolution overthrew monarchical control

• Reducing wealth concentration protects democratic institutions from corruption enabled by the power wealth wields

• The tax revenues are critical for human and physical capital investment

• That public investment is a significant spur to economic growth that builds a sustainable economy
The Wealth Tax proposal is “at risk of being short-circuited by unwarranted contention” of unconstitutionality  

The argument (put forward most strongly by Eric Jensen) is that a tax on wealth is a direct tax and cannot be assessed on each taxpayer’s net worth at a uniform rate because a direct tax must be apportioned across the different states under the Constitution.

- Constitutional Convention attendees did not have a clear idea of what direct taxes were: King asked. Madison’s notes indicate that no one answered.
- Ambiguity about direct taxes served the goal of reaching compromise—was connected with the infamous compromise on counting slaves as 3/5 of a person

This argument relies on a case that invalidated the first income tax statute, Pollock v. Farmers Loan & Trust Co. (SCt 1985). Like many other SCt decisions exemplified by Lochner at dawn of the New Deal era, Pollock was an example of the Supreme Court’s hostility towards progressive economic policies like worker protection and minimum wages.

Although many of the Lochner era cases were later overturned by the Court itself, Pollock was not because the nation did so directly via ratification of the Sixteenth Amendment authorizing a national income tax.

Commentators who argue that a wealth tax is unconstitutional assert that wealth taxes must be considered direct taxes because of dicta continuing to name wealth taxes as direct taxes in later Supreme Court cases even though those cases acknowledge that taxes once thought direct are not because they are not amenable to apportionment.

A wealth tax clearly cannot function as an apportioned direct tax because apportionment forces non-uniform rates—the wealthy in poor states would be assessed tax at absurdly high rates while the wealthy in rich states would be assessed tax at unfairly lower rates.

1 Dawn Johnsen & Walter Dellinger, Yes, a wealth tax would be constitutional, WaPo OpEd (Jan 11, 2020).
The argument for constitutionality of a wealth tax²

• The need for a national tax system was a primary driver of the Constitutional Convention, which gave Congress the power to tax.

• ‘Direct tax’ concept in Constitution rests on Articles of Confederation requisitions that could be reasonably apportioned among the states, yielding uniform rates.

• Wealth was then considered proportionate to population within the states and thus susceptible to being taxed by means of an apportioned requisition.

• The Supreme Court’s 1796 analysis of a carriage tax in *Hylton* saw the error in that analysis. The number of carriages varied from state to state, so *Hylton* recognized that the carriage tax could not reasonably be apportioned and that it therefore could not be a ‘direct’ tax. It was nonetheless within the congressional taxing power. Hence it could be assessed at a uniform rate without apportionment among the states.
  • *Hylton* involved justices who had taken part in the Constitution’s framing—so their interpretation should be given significant weight.
  • Such a tax could not be reasonably apportioned because the differences in the tax base would make the rates paid by each state unfair. One state might have 10 wealthy families with carriages, while another state might have 100 wealthy families with carriages. **Apportionment of a tax on carriages would be unreasonable** in such a circumstance since the state with 10 families with carriages would **pay a much higher rate per carriage** than the state with 100 families with carriages.

• With the change in concentration of wealth, it is clear that any broader type of wealth tax that looks at all assets (rather than just carriages) would also fail to satisfy the definition of a ‘direct’ tax capable of apportionment. The arguments claiming that a wealth tax is a ‘direct’ tax and hence illegitimate as proposed misunderstand what a ‘direct’ tax is.

² See Calvin Johnson, ABA Tax Times (Summer and Fall 2019)
A direct tax is one that can be reasonably apportioned resulting in uniform rates among the states.

Apportionment forces non-uniform rates when the tax base per capita (e.g., carriages, wealth) is uneven among the states.

Accordingly, taxes such as wealth taxes with tax bases that vary among the states cannot be direct taxes because they cannot be apportioned.

*National Federation of Independent Businesses v. Sebelius* (SCt 2012) follows *Hylton* by holding that the Affordable Care Act tax on failure to have or buy insurance is not a direct tax because “apportioning such tax would make little sense”.

**Constitutional Argument in a Nutshell**
Wealth Tax Enactment Faces Other Difficulties

1. Properly determining taxpayer’s net wealth subject to tax by expanding on/improving estate tax valuation rules, including formulaic valuations for harder-to-value items, and information reporting requirements (but still much of base in control of owner with no potential third party reporting)
   - Publicly traded assets
   - Collectibles, luxury goods, yachts, jets
   - Closely held businesses and non-owner occupied real estate
   - Pensions and other financial assets

2. Effectively countering tax evasion (else will raise little in revenues)
   - Warren proposal supports significant anti-evasion measures including (but not limited to)
     - Substantial increases to IRS enforcement budget
     - Minimum audit rate for taxpayers subject to the wealth tax
     - 40% ‘exit tax’ on net worth about the wealth tax threshold for expatriation
     - Systematic third-party reporting using existing tax exchange agreements under the Foreign Account Tax Compliance Act
   - Nonetheless, the wealthy have sophisticated advisers and techniques for secreting their wealth—see, e.g., Michael Forsyte et al, Earning Riches by Exploiting a Poor Nation: Angolan Entrepreneur Builds Shell Empire, NYTimes, 1/20/20 (discussion of Angolan heiress corrupt hiding away of millions in state assets with assistance of professional service firms such as McKinsey and others).

3. Overcoming political and conservative aversion to wealth taxes:
   - Con: Undue power over policy exercised by wealthy donors to political campaigns: extreme wealth works to perpetuate itself, including by making taxing the rich unthinkable
   - Pro: Strong public support for higher taxes on wealthy and corporations runs counter, like the fear of communism in the New Deal era
   - Con: Tendency of media pundits (a consensus chorus of nitpickers and naysayers) to mock significant changes in favor of status quo or middle-of-the-road polices
   - Pro: Willingness of Democratic candidates to take strong positions to counter Trump administration’s adverse treatment of low-income and middle class (2017 tax legislation; 2020 cutback on food stamps that will leave 3.5 million current recipients hungry, etc.)
   - Con: Current conservative SCt Justices might be ideologically prone to rely on Pollock anyway
   - Pro: Chief Justice Roberts’ interest in maintaining the integrity of the Court requires a reasoned opinion on wealth taxes comprehending that direct taxes are only those that are reasonably apportioned

4. Finding consistent sources of funding once wealth taxes successfully reduce the ultra wealthy class (assuming that actually happens)
   - Wealth tax would raise about $250B per year (PWBM analysis)—a small bite annually equalling about 0.24% of US net worth of $114T
   - Actual reduction of ultrawealthy wealth concentration is a panacea, but like sin taxes, the wealth tax does have the goal of reducing the concentration of wealth that makes the significant returns from pennies on the dollar possible at the outset. See, e.g., Megan McCordale, Warren’s wealth tax might sound like nothing. But the numbers aren’t small, WaPo (Nov. 12, 2019).
   - In an ideal world, the significant sums raised from the wealth tax will successfully fund a variety of public investments that, like Post-WWII GI Bill and other progressive programs, created a booming near-egalitarian economy in which most boats were able to rise. That would allow the regular income tax system to take over the primary generation of revenues (assuming a number of the needed reforms to undo the system’s bias towards wealth are accomplished)
Market Myths of Standard Economic Theory overstate criticisms of the Wealth Tax

Underlying much of the objection to a wealth tax is the idea promoted by Mitt Romney in the 2012 election that capitalists and owners are the real “makers” who merit their dominant position in society over the bottom 50% who are the “takers”, even though it is highly unlikely that the most well paid hedge fund managers and CEOs are adding value proportional to their pay.

See, e.g., Steven Rattner’s 11/5/19 NYT OpEd: The Warren Way is the Wrong Way, calling it a ‘terrible prospect’ that would be “highly disruptive” paid for by a “mountain of new taxes” that would expand government (including a department of economic development) and “dismember” “global champions” like banks and tech giants and eliminate “private equity that plays a useful role in driving business efficiency” and require corporations to exercise social responsibility by considering the interests of employees, customers and communities, not just shareholders, by giving workers board seats—all essentially “mucking up the essence of our free enterprise system.”

• Rattner apparently forgets the many ways that current tax policy acts to pick winners and losers of industry—e.g., the many permanent subsidies for the fossil fuel industry, compared to very short-term provisions to aid startup of ‘green’ wind and sun power industries.

• Yet even Rattner acknowledges the need for eliminating the CG preference and the estate tax exemption of all gains (through the basis step-up for heirs), raising the rate on ordinary income, and dealing with carried interest and other tax expenditures for the rich.
Senator Wyden’s Capital Gains Proposal: “Treat Wages Like Wealth” (TWLW)

“Americans who work for a living pay taxes with every paycheck. Meanwhile, those whose income comes from wealth can defer their taxes, often for years. If they pay taxes at all after taking advantage of myriad loopholes, they can pay a lower rate than someone who earns a paycheck.” TWLW at 3.

“[T]he average family worth more than $100 million has never paid tax on more than half of its wealth.” TWLW at 3 (quoting Fed Res. Board (2013)).

Proposal applies to a fraction of the richest 1 percent, is estimated to raise between $1.5 trillion and $2 trillion over 10 years, and will be entirely dedicated to funding Social Security benefits through 2095.
Rationale for TWLW Proposal

1. Unfairness of preferential tax rates for LTCGs in current code that disproportionately benefit wealthy taxpayers with considerable investment income.
   • Current treatment: top rate on LTCG is 20% while top rate on ordinary income is 37% (3.8% Medicare and net investment income taxes would also apply)
     “In 2018, almost 70 percent of all realized capital gains went to the top 1 percent. More than 50 percent of realized gains went to the top 0.1 percent.” (Tax Policy Center 2018)
   • Proposal treatment: CGs and ordinary income taxed at same rate, with ultra-wealthy taxpayers’ gains taxed using an anti-deferral accounting system.

2. Difference in treatment of ordinary and CG income creates opportunities for tax avoidance and wealth accumulation unavailable to most Americans. The wealthy can:
   • Defer taxation by delaying dispositions to avoid realizing STCGs (taxed as ordinary income) or LTCGs
   • Seek to convert capital losses to ordinary losses deductible against higher-taxed wage and business income
   • Structure business arrangements to receive CGs rather than salary income, especially in private equity
   • Borrow against capital assets to maintain luxury lifestyle without actually spending down wealth
   • Retain assets til death when they will pass to heirs with a step-up in basis, resulting in no tax liability ever for the appreciation during decedent’s lifetime.
Components of TWLW Proposal

1. **Eliminates CG Rate Preference**
   a. CGs taxed at same rates as ordinary income
   b. Credit or exemption would protect middle class taxpayers from higher taxes on limited capital income

2. **Anti-Deferral Accounting System Applies to**
   a. Individuals, estates or trusts with >$1M annual income (not counting unrealized gains) or >$10M assets for 3 consecutive years (may include years prior to enactment)
   b. Once applies, continues to apply until the applicable taxpayer fails to satisfy either income or asset test for 3 consecutive years (then can elect not to continue)
   c. Asset values for certain types of assets excluded for determining whether taxpayer is covered, up to stated threshold that would be indexed for inflation
      i. Personal residences up to combined total value of $2M
      ii. Retirement accounts up to $3M
      iii. Family farms up to $5M

3. **Special Rules**
   a. Pass-throughs would apply the rules at the partner or S corporation shareholder level, treating the interest as a nontradable asset
   b. C Corporations would generally not apply anti-deferral accounting to their assets, but anti-abuse rules may be necessary to prevent use of corporations to avoid shareholder tax
   c. Phase I and Transition rules “smooth the change” (otherwise, entrepreneurs like Mark Zuckerberg would owe a significant lump sum tax for appreciation of Facebook stock since inception upon passage)

4. **MTM Taxation of Tradable Assets**
   a. What: Publicly traded stocks, bonds, derivatives, securities are marked to market at the end of each tax year
   b. How: Taxpayers covered by system pay tax on the gain or deduct the losses (subject to certain anti-abuse limitations on losses)

5. **Lookback Charge Method for Non-Tradable Assets**
   a. What: real estate, business interests, collectibles (not household goods, subject to anti-abuse rules)
   b. How: upon realization (other than in transaction currently given preferential treatment, such as sections 351 or 721), tax will be based on a lookback charge intended to tax as though the assets had experienced accrued gains between the time they were acquired and sold, eliminating benefit of deferral of taxation. Lookback charge methods could take form of:
      i. Tax on gain plus interest charge on deferred tax
      ii. Yield-based tax
      iii. Tax on gain plus surtax based on asset’s holding period

6. **Taxation of partially exempt assets in 2c:**
   a. Lookback charge method in 5b applies to personal residences (any number, for aggregate value above the threshold) and to family farm (for value above the threshold)
   b. Neither MTM nor Lookback Charge method applies to values in retirement accounts (IRAs, 401ks, etc.) above threshold—those are taxed under current rules
**TWLW example 2:** Taxpayer meets either income or asset test (or both) in each of the three preceding years, so is an applicable taxpayer in year 4.

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<tr>
<td>3</td>
<td>$ 900,000</td>
<td>$11,000,000</td>
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**TWLW example 3.** Taxpayer becomes applicable taxpayer in year 4 and remains one in years 5 and 6. For year 7, taxpayer can elect whether or not to remain in MTM system.

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Criticisms of MTM of Capital Gains

• Ending deferral amounts to a higher tax bite
• May cause decline in savings
• Decline in savings may cause reduction in productive investments
• Reduction in productive investments may cause decline in GDP, wages, and growth

Kleinbard’s Dual BEIT Proposal
Making the Income, Estate and Gift Tax Systems More Progressive
Questions and Discussion