Democrats' Emerging Tax Idea: Look Beyond Income, Target Wealth

Richard Rubin

The income tax is the Swiss Army Knife of the U.S. tax system, an all-purpose policy tool for raising revenue, rewarding and punishing activities and redistributing money between rich and poor.

The system could change fundamentally if Democrats win the White House and Congress. The party's presidential candidates, legislators and advisers share a conviction that today's income tax is inadequate for an economy where a growing share of rewards flows to a sliver of households.

For the richest Americans, Democrats want to shift toward taxing their wealth, instead of just their salaries and the income their assets generate. The personal income tax indirectly touches wealth, but only when assets are sold and become income.

At the end of 2017, U.S. households had $3.8 trillion in unrealized gains in stocks and investment funds, plus more in real estate, private businesses and artwork, according to the Economic Innovation Group, a nonprofit focused on bringing investment to low-income areas. Most of the value of estates over $100 million consists of unrealized gains, said a 2013 Federal Reserve study. Much has never been touched by individual income taxes and may never be.

Democrats are eager to tap that mountain of wealth to finance priorities such as expanding health-insurance coverage, combating climate change and aiding low-income households. Their ideas range from new rules on inherited assets, to a plan by Sen. Ron Wyden for annual taxes on unrealized gains, to a proposal from Sen. Elizabeth Warren to tax wealth itself. These come atop more conventional proposals to raise income taxes and expand estate taxes.

"The whole tax system is stacked in favor of the tax-avoidance crowd," said Mr. Wyden, who would lead the tax-writing Finance Committee if Democrats retook the Senate. "When you stand up and you say, hey look, you've got one system for a cop and a nurse and another for highfliers to pay what they want to, when they want to, everybody nods."

The Democratic debate on taxing wealth is one facet of a bigger, often contentious discussion. Experts across the political spectrum agree income inequality widened in recent decades, and wealth inequality even more. There is little agreement on what, if anything, the government should do about it.

Many on the right believe narrowing the gap between the rich and middle class matters less than raising the incomes of the middle class. That, they say, calls for measures to boost investment and educational opportunity. Many conservatives argue that taxes targeted at the rich could hinder investment in ways that would hurt everyone's wages and discourage the creation of wealth in the first place.

New taxes on wealth would complicate tax administration and bring unknown economic consequences. "It would be incredibly disruptive to markets," said Sen. John Thune (R., S.D.). "People would start looking for how to game it and ways to shield and shelter."

Liberals, by contrast, see extreme inequality as morally wrong and socially divisive, and regard the current system, which taxes income generated by wealth more lightly than wages, as especially objectionable and a contributor to wealth gaps between blacks and whites.

While the current income tax is already progressive—rates are higher for people whose income is higher—Democrats say progressivity breaks down at the very top because reduced corporate taxes, preferential rates for capital gains and a narrowed estate tax are especially favorable to the wealthiest Americans. If Democrats gain unified control of government in 2021, rich households, including heirs living off inheritances and company founders compensated with stock, will be in the crosshairs.

The U.S. has taxed capital gains since introducing the modern income tax in 1913, when the country decided tariffs and excise taxes were insufficient and unreliable.

Since then, Congress has mostly kept lower tax rates on capital gains for three main reasons: to offset inflation's effects, encourage investment and discourage people from holding onto assets for tax reasons.

The problem, Democrats say, is that capital gains are taxed only when gains are realized through a sale and become income. An investor who buys $10 million in stock that pays no dividend and watches it grow to $50 million doesn't pay income tax on that appreciation unless the stock is sold.

If that investor dies before selling, the unrealized gains get wiped out, for income-tax purposes. The heirs treat the assets' cost basis as $50 million, not $10 million; they face no income tax on the $40 million of capital gains if they sell, although an estate tax may be due. This long-standing elimination of unrealized gains at death, for tax purposes, is called "stepped-up basis."

It means the optimal tax strategy for the very rich, fine-tuned and promoted by the wealth-planning industry, is straightforward: Hold assets until death, borrow against them for living expenses and barely pay income taxes.

Democrats are attacking the foundations of that strategy. They talked for years about raising taxes on high-income investors, citing Warren Buffett 's claim of paying a lower tax rate than his secretary. They've succeeded in raising the top capital gains rate from 15% under President George W. Bush to 20%, plus the 3.8% tax on investment income added to fund the Affordable Care Act. The top ordinary-income rate is 37%.

Just raising capital-gains tax rates further wouldn't require the likes of Mr. Buffett to report more of their growing wealth on their returns, make them more willing to sell assets or raise much revenue. In fact, if the capital-gains rate went above 28.5% without other changes, investors would delay so many sales that federal revenue would drop, according to the Tax Policy Center, a research group.

That would be a rare instance of the U.S. being on the wrong side of the Laffer Curve, named for economist Arthur Laffer, who projected that government revenue drops if

tax rates get high enough.

Republicans see the same money accumulating and want to deploy it by not taxing it. Their goal, rather than generating money for expanded government programs, is to incentivize the private holders of capital to realize the gains and spur economic growth. The 2017 tax law created opportunity zones, which offer deferral and rate discounts for reinvesting capital gains in low-income areas. GOP lawmakers are pushing the Trump administration to consider the idea of indexing capital gains to inflation, reducing taxes on sales of long-held appreciated assets.

Still, some conservatives are moving closer to Democratic positions. In June, the Peterson Foundation, which favors budget-deficit reduction, invited plans from others, and three conservative groups proposed limiting or repealing stepped-up basis.

The Manhattan Institute's Brian Riedl said it was the sort of concession conservatives would be willing to make "in exchange for tax reform or a grand deal" to curb entitlement spending.

In campaigns, Congress and academia, Democrats are shaping tax plans for 2021, when they hope to have narrow majorities. There are three main options.

The Biden Plan

President Obama left office with a list of ideas for taxing the rich that might have raised nearly $1 trillion over a decade. The most important was taxing capital gains at death.

The idea was too radical for a serious look from Congress at the time. Now, to a Democratic base that has moved left, it looks almost moderate.

Former Vice President Joe Biden, the candidate most prominently picking up where Mr. Obama left off, has proposed repealing stepped-up basis. Taxing unrealized gains at death could let Congress raise the capital gains rate to 50% before revenue from it would start to drop, according to the Tax Policy Center, because investors would no longer delay sales in hopes of a zero tax bill when they die.

And indeed, Mr. Biden has proposed doubling the income-tax rate to 40% on capital gains for taxpayers with incomes of $1 million or more.

But for Democrats, repealing stepped-up basis has drawbacks. Much of the money wouldn't come in for years, until people died. The Treasury Department estimated a plan Mr. Obama put out in 2016 would generate $235 billion over a decade, less than 10% of what advisers to Sen. Warren's campaign say her tax plan would raise.

That lag raises another risk. Wealthy taxpayers would have incentives to get Congress to reverse the tax before their heirs face it.



Former Vice President Joe Biden has proposed repealing "stepped-up basis" and taxing capital gains at death. Photo: Kevin E. Schmidt/Quad-City Times/Zuma Press

Mr. Obama's administration never seriously explored a wealth tax or a tax on accrued but unrealized gains, said Lily Batchelder, who helped devise his policies.

"If someone's goal is to raise trillions of dollars from the very wealthy, then it becomes necessary to think about these more ambitious proposals," she said.

The Wyden Plan

Instead of attacking favorable treatment of inherited assets, Mr. Wyden goes after the other main principle of capital-gains taxation—that gains must be realized before taxes are imposed.

The Oregon senator is designing a "mark-to-market" system. Annual increases in the value of people's assets would be taxed as income, even if the assets aren't sold. Someone who owned stock that was worth $400 million on Jan. 1 but $500 million on Dec. 31 would add $100 million to income on his or her tax return.

The tax would diminish the case for a preferential capital-gains rate, since people couldn't get any benefit from deferring asset sales. Mr. Wyden would raise the rate to ordinary-income levels. Presidential candidate Julián Castro also just endorsed a mark-to-market system.

For the government, money would start flowing in immediately. The tax would hit every year, not just when an asset-holder died. Mr. Wyden would apply this regime to just the top 0.3% of taxpayers, said spokeswoman Ashley Schapitl. Mr. Castro's tax

would apply to the top 0.1%.



Democratic Sen. Ron Wyden of Oregon, center, would tax annual increases in the value of assets, whether or not they were sold. Photo: jim lo scalzo/EPA/Shutterstock

There are serious challenges. Revenue could be volatile as markets rise and fall. Also, the IRS would determine asset increases annually, requiring baseline values and ways to measure change. That's easy for stocks and bonds but far more complicated for private businesses or artwork.

The rules would have to address how to treat assets that lose instead of gain value in a year, and how taxpayers would raise cash to pay taxes on assets they didn't sell. Under Mr. Castro's proposal, losses could be used to offset other taxes or carried forward to future years.

Mr. Wyden would include exemptions for primary residences and 401(k) plans. For assets that aren't publicly traded, Mr. Castro would impose taxes only upon a sale, plus a charge applied to limit the benefits of tax deferral.

"We're obviously going to spend a lot of time working this through because when you're talking about an issue this important, this substantial, it's important to get it right," Mr. Wyden said.

The Warren Plan

The most ambitious plan comes from Sen. Warren of Massachusetts, whose annual wealth tax would fund spending proposals such as universal child care and student-loan forgiveness.

The ultra-rich would pay whether they make money or not, whether they sell assets or not and whether their assets are growing or shrinking.

Ms. Warren, who draws cheers at campaign events when she mentions the tax, would impose a 2% tax each year on individuals' assets above $50 million and a further 1% on assets above $1 billion. Fellow candidate Beto O'Rourke has also backed a wealth tax, and it is one of Vermont Sen. Bernie Sanders ' options for financing Medicare-for-All.

Ms. Warren's plan appeals to some Democrats because it would raise a lot of money from a tiny number of people. According to economists working with her campaign, it would generate $2.75 trillion over a decade from 75,000 households. That would be roughly a 6% boost in federal revenue from under 0.1% of households.

For Democrats, the Warren plan has advantages: Money would come only from the very wealthiest. The IRS could focus enforcement on very few people. Revenue would come quickly.

"Look at Mark Zuckerberg, " said Gabriel Zucman, an economist at the University of California, Berkeley, who advised Ms. Warren, speaking of the Facebook Inc. founder. "Are you going to wait 50 years before you start taxing him through the estate tax?"



Sen. Elizabeth Warren (D., Mass.), seen at the Iowa State Fair, would impose a wealth tax on the very rich. Photo: brian snyder/Reuters

In the real world, a wealth tax would emerge from Congress riddled with gaps that the tax-planning industry would exploit, said Jason Oh, a law professor at the University of California, Los Angeles. For example, if private foundations were exempted, the wealthy might shift assets into them.

"We've never seen in the history of taxation a pristine tax of any form," Mr. Oh said. "People who want to pursue a wealth tax for the revenue may be a little disappointed when we see the estimates roll in."

European countries tried—and largely abandoned—wealth taxes. They struggled because rich people could switch countries and because some assets were exempt. Mr. Zucman said Ms. Warren's tax would escape the latter problem by hitting every kind of asset, from artwork to stock to privately held businesses to real estate.

While he and fellow economist Emmanuel Saez assume 15% of the tax owed would be avoided, former Treasury Secretary Larry Summers and University of Pennsylvania law professor Natasha Sarin wrote a paper estimating the plan would raise less than half what Mr. Zucman projects, based on how much wealth escapes the estate tax.

A paper by economists Matthew Smith of the Treasury Department, Eric Zwick of the University of Chicago and Owen Zidar of Princeton University contends top-end wealth is overstated. Acccording to their preliminary estimate, the top 0.1% have 15% of national wealth, instead of the 20% estimated by Mr. Zucman. Their findings imply that Ms. Warren's tax might raise about half of what's promised.

For an investment yielding a steady 1.5% return, a 2% wealth levy would be equivalent to an income-tax rate above 100% and cause the asset to shrink. That leads to the criticism that wealth taxes could push people to seek higher returns, possibly discouraging productive investment and adding risk to the financial system.

"You hear 1%, 2%, doesn't sound that much. Paying 1%, 2% on an asset you have every single year, that can add up," said Ben Ritz of the Progressive Policy Institute, a centrist Democratic-affiliated think tank. "You're basically having the asset shed money over time."



Sen. John Thune (R., S.D.) said wealth taxes would complicate tax administration and people would try to game them. Photo: Stefani Reynolds/CNP/Zuma Press

To audit 30% of wealthy taxpayers, as Mr. Zucman recommends, would involve tens of thousands of complex investigations, a challenge even if the IRS were beefed up as Ms. Warren proposes. The agency already struggles with similar calculations for estate taxes, engaging in long battles over valuing such things as fractional shares of family businesses. Under the wealth tax, those once-per-lifetime audits would become annual affairs.

The wealth tax also has an extra asterisk: it would be challenged as unconstitutional.

The Constitution says any direct tax must be structured so each state contributes a share of it equal to the state's share of the population. A state such as Connecticut has far more multimillionaires per capita than many others, so its share of the wealth tax would far exceed its share of the U.S. population. How Ms. Warren's wealth tax might be categorized or affected is an unsettled area of law relying on century-old Supreme Court precedents.

Still, the wealth tax polls well, and Democratic candidates are eager to draw a contrast with President Trump, a tax-cutting billionaire.

Republicans will push back. Rep. Tom Reed (R., N.Y.) says tax increases aimed at the top would reach the middle class. "It easily goes down the slippery slope," he said. "If it's the 1%, it's the top 20%." he said.

Write to Richard Rubin at richard.rubin@wsj.com

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