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Unpacking Democratic Presidential Candidates' Tax Proposals

By **Harry Gutman** (November 5, 2019, 5:24 PM EST)

Two prominent economists at University of California, Berkeley, recently published a book[1] and op-ed article[2] reviewing the concentration of wealth in the United States and asserting that the top 400 income earners pay an average tax rate that is lower than that paid by all other income classes.[3]

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Their conclusions and policy prescriptions, principally the enactment of an annual wealth tax, have attracted significant political and academic interest, particularly among the Democratic presidential candidates. Sen. Ron Wyden, D-Ore.,the ranking member of the Senate Finance Committee, has also expressed interest.

All their proposals would increase taxes on high-income individuals. On the other hand, the Trump administration has hinted at various times that it is considering unilateral administrative action to relieve the burden of taxation of capital income by indexing the basis of capital assets, thus reducing taxes on high-income individuals.

It is not just purported wealth and income inequality that has attracted attention. Projected federal budget deficits of staggering magnitude have led to calls for reexamination of our tax and spending structure.[4] On the tax side, the focus is on how to increase revenue and, obviously, increasing tax on high-income individuals is a prime target.[5]

Finally, a number of favorable individual income tax provisions enacted in the 2017 tax legislation[6] are scheduled to expire in 2025. How to deal with them will continue to attract legislative attention, if not action.

This article will summarize the most prominent current proposals and discuss the realistic prospects for legislative action.

This article does not specifically address proposals relating to the taxation of corporate business income. However, they have a distributional impact on high net worth individuals. The current consensus of economists is that the corporate tax burden is borne 75% by the owners of capital and 25% by labor.[7] Thus, any corporate income tax increases are indirect tax increases on the owners of corporate shares.

The Current Proposals

A brief summary of the most-mentioned current proposals follows.

Individual Income Tax

Categories (1) through (4) are tax increases. They are ranked in my view of the order of likely passage. Categories (5) and (6) are tax decreases when measured against current law.

1. Increase income tax rates for high-income individuals.

Sen. Bernie Sanders, I-Vt., would add four new individual income tax brackets for high-income individuals with rates of 37%, 43%, 48% and 52%.[8] Former Vice President Joe Biden would increase the top individual income rate to 39.6%

2. *Abolish the tax preference for capital income.*

Gain on the sale of a capital asset and dividends would be taxed at ordinary income rates for taxpayers above certain income levels. This is a popular proposal, endorsed by virtually all the Democratic candidates.[9]

If enacted, it would eliminate a major tax cottage industry devoted to converting ordinary income into capital income. It would also eliminate the need to address carried interests.

Less comprehensive reforms include repealing the special treatment of carried interests and eliminating tax free treatment of certain property exchanges.

3. Eliminate step-up in basis for property transferred at death.[10]

Treating death (and gifts) as income tax recognition events was first recommended by a Treasury Department study published in 1969[11] and was an Obama administration tax proposal in 2016.[12] Providing a carryover-basis regime for property transferred at death was enacted in 1976 and repealed in 1978 without ever having been effective.

Step-up in basis is one of the largest income tax expenditures[13] and disproportionately benefits high net worth individuals. Nonetheless, repeal of step-up has been successfully opposed in the past, principally by the estate planning bar, on the grounds of complexity, the questionable claim that basis information is not available and legitimate questions about which assets are to be subject to the new regime.

Complexity is a function of whether a carryover basis or income recognition is imposed and the interaction of that system with an estate tax regime. In a carryover basis world the goal is to have the same net tax result whether property is sold before or after death. Introduction of an estate tax requires a complex mechanism to achieve that policy goal.

That complexity disappears if death is an income tax realization event. Due to broker reporting rules, lack of basis information is an issue limited principally to nonmarketable assets and does require special rules.

The transition issue raises the question of whether the new regime is applicable only to assets acquired after the effective date of the statute or all assets held at death regardless of the acquisition date. Resolution of this issue requires balancing difficult practical and equity questions.

Both systems need rules to address personal residences, transfers to spouses and personal property. And it is important to note that gifts would be realization events if death is a realization/recognition event. Anti-abuse rules would be required.

4. Tax marketable capital assets annually on an accrual basis (mark-to-market) for high-income taxpayers.

Wyden has released a 32-page document proposing a system that would require taxpayers who meet certain income or asset thresholds for each of the preceding three years to mark all tradable assets to market annually.[14] The income threshold would be $1 million, and the asset threshold would be $10 million for all assets other than household goods.

The first $2 million in value of a primary and secondary personal residence is not included in the $10 million asset threshold and there are other exclusions for family farms and retirement accounts. Nontradable property would be taxed when sold pursuant to a lookback rule that would impose an interest charge on the deferred tax.

The Wyden proposal raises a myriad of questions, not the least of which are transition and anti-abuse rules, as well as the treatment of assets that are not covered by the new regime. Comments on various aspects of the proposed system are specifically requested.

It is important to note that a comprehensive mark-to-market regime would eliminate the step-up in basis problem. However, the problem remains in a hybrid system where some assets held at death have not been marked to market.

5. Make the Tax Cuts and Jobs Act individual tax cuts permanent.

The Tax Cuts and Jobs Act individual tax cuts, 20% tax on pass-through income and the doubled estate tax exemption are due to expire in 2025.[15] These provisions were sunsetted in order for the TCJA to comply with the revenue loss limitations and other procedural requirements imposed by the reconciliation process pursuant to which the act was passed. A major impediment to their extension is the estimated revenue cost of $920 billion.[16]

6. Index the basis of capital assets.

There have been press reports that the Trump administration is considering adopting a regulation authorizing the indexation of basis.[17] The George W. Bush administration is reported to have considered indexing basis administratively but was advised that it did not have the legal authority to implement the plan.

The argument for indexation is that adjusting for inflation assures that real rather than nominal gain will be subject to tax. However, under current law capital gains are already taxed preferentially and one could argue that the capital gains preference is a rough measure to address inflation gain.

The more fundamental question is whether indexation is appropriate when gain is not taxed until it is

realized. In a tax system in which economic income is taxed annually, changes in the value of capital assets would be subject to tax (marked-to-market) annually.

Our tax system departs from this model by deferring the tax on capital assets until they are sold. Thus, when compared to a tax on economic income, holders of capital assets have the benefit of tax deferral. To the extent the inflation rate is roughly equivalent to the interest rate that would be applicable to the deferred income, there is no need to index basis.

Wealth Transfer Taxation

1. Decrease current exemption level.

Sanders would reduce the estate tax exemption to $3.5 million and the gift tax exemption to $1 million.[18] Sen. Cory Booker, D.-N.J., would reduce the transfer tax exclusion to $3.5 million.[19]

2. Increase current rates on large estates.

Sanders would increase rates at all brackets above $3.5 million, with a maximum rate of 77% on estates over $1 billion.[20] Booker would increase the maximum estate tax rate to 65% for estates over $50 million with increase for estates in lower brackets.[21]

3. Replace current tax with an accessions tax that would treat an inheritance as income to the recipient.

Julian Castro would replace the current transfer taxes with an inheritance tax on lifetime inheritances above $2 million.[22]

4. Repeal the wealth transfer taxes.

This is a perennial Republican favorite.[23]

Wealth Taxation

These are the proposals that are directed specifically at wealth inequality.[24] They have provoked the most recent attention, even if the likelihood of passage is remote.

Sen. Elizabeth Warren, D-Mass., would impose an annual tax of 2% on every dollar of net worth in excess of $50 million and a 3% tax on every dollar above $1 billion.

Her advisers estimate the tax would apply to 75,000 households and would raise $2.75 billion over a 10-year period. Sanders proposes a graduated annual tax that starts at 1% for a married couple with $32.5 million and rises to 8% for wealth in excess of $10 billion. It is estimated to apply to 180,000 households and raise $4.35 trillion over ten years.

Questions have arisen about the constitutionality of a wealth tax, the accuracy of the underlying findings with respect to both income and wealth inequality, the economic impact of the tax, the amount of revenue that can be generated and whether it will, in fact, materially affect wealth and income distribution. One can expect continuing discussion of these issues.

What is the takeaway?

The prospects for legislation depend upon the outcome of the 2020 election. As a practical matter, unless the party of the president controls both the U.S. Senate and the House of Representatives, absent a consensually recognized fiscal crisis, it is difficult to see how significant tax legislation can be enacted.

The principal reason lies in the procedural rules that govern the enactment of tax legislation. While the special rules of the Budget Act that create procedural points of order against revenue-losing legislation would not apply to a tax increase bill, the legislation would still be subject to a filibuster in the Senate and 60 votes would be required to bring the legislation to a vote.

The filibuster issue can be avoided by the use of the special reconciliation process — as was done in 1993 to enact the largest absolute tax increase in history when the Senate was composed of 57 Democrats and 43 Republicans. The reconciliation process imposes a time limit on debate in the Senate and thus precludes a filibuster. However, that process requires the passage of a budget resolution authorizing the tax increase.

A budget resolution is the agreement of the House and Senate as to spending and revenue targets. It is not a law — no executive action is needed. Thus, if the Democrats have a majority in both bodies a budget resolution can be enacted and the filibuster avoided.

Perhaps more important as a practical matter, even if there were a Democratic trifecta in the 2020 election, tax legislation would not be enacted until late 2021 at the earliest, with effective dates likely in 2022. Thus, while it will be important to monitor the debate and think about what steps to take, there will be ample time to decide what to do.

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[1] Saez and Zucman, "The Triumph of Injustice," W. W. Norton & Company (2019).

[2] Seaz and Zucman, "How to Tax Our Way Back to Justice", New York Times, Oct. 11, 2019.

[3] See Saez and Zucman, note 1 , op cit. Table 1.2 at p.15. These two economists are among the principal tax advisers to Sen. Elizabeth Warren, D-Mass., and are the architects of her wealth tax proposal discussed below.

[4] See e.g., Gale, "Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future (Oxford University Press, 2019)"; Auerbach and Gale, "Revisiting the Budget Outlook: An update after the Bipartisan Budget Act of 2019", Brookings, Oct. 10, 2019.

[5] Other potential revenue sources, such as increasing the corporate tax rate, reforming social security taxes, a VAT, energy taxes and taxes on financial institutions and transactions are not discussed.

[6] The most significant from a revenue perspective are: individual income tax rates, standard deduction, 20% deduction for qualified business income, child care credit modifications, individual AMT exemption and the estate and gift tax exemption.

[7] See, e.g., Joint Committee on Taxation, "Modeling the Distribution of Taxes on Business Income" (JCX-14-13) Oct. 16, 2013.

[8] "How Bernie pays for his proposals," https://berniesanders.com/issues/how-bernie-pays-for-his proposals/. Eastman, "Unpacking Biden's Tax Plan for Capital Gains, Tax Foundation," July 31, 2019.

[9] Biden, Warren, Booker and Castro support this. Sanders would apply the provision to households with income above $250,000. Biden would apply it to families with income above $1 million. See, Eastman, 'Unpacking Biden's Tax Plan for Capital Gains," Tax Foundation, July 31, 2019.

[10] This is endorsed by Biden, Booker, Sanders, Warren and Castro.

[11] Tax Reform Studies and Proposals, U.S. Department of the Treasury, Joint Publication of the Committee on Ways and Means and Committee on Finance, Feb. 5, 1969, Part 1, 28.

[12] U.S. Department of the Treasury, General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals, February 2016, 155.

[13] The 5-year revenue loss is estimated to be $204 billion. JCX 81-18, Estimates of Federal Tax Expenditure for Fiscal Years 2018-2022, Oct. 4, 2018.

[14] Wyden, Treat Wealth Like Wages, Senate Finance Committee (2019); Castro, People First Economic Plan for Working, Aug. 17, 2019. Warren would apply the mark-to-market regime to the wealthiest 1% of households.

[15] Tax Cuts and Jobs Act, 115 P.L. 97; U.S Department of the Treasury, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2020 Budget Proposal, March 11, 2019.

[16] Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2020 Budget Proposal (JCS-1-19), July 8, 2019.

[17] See, Chamseddine, "Romney Urges Against Using Executive Authority to Index Cap Gains." Tax Notes, Sept. 23, 2019.

[18] S. 309, For the 99.8% Act, Jan. 31, 2019.

[19] S. 3766, American Opportunity Accounts Act, Dec. 18, 2018.

[20] Note 19, op. cit.

[21] Note 20, op. cit.

[22] Castro, People First Economic Plan for Working, Aug. 17,2019, p.5.

[23] See e.g., Thune, "Brady Re-introduces Bill to Repeal Death Tax," June 19,

2013; https://www.thune.senate.gov/public/index.cfm/2013/6/thune-brady-re-introduce-bill-to-repeal-death tax. The current versions are S. 251 and H.R. 218.

[24] See Sullivan, "Economic Analysis: Risking the Wrath of 900 Billionaires," Tax Notes, Oct. 21, 2019.