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## Improving Tax Rules by Means-Testing: Bridging Wealth Inequality and “Ability To Pay”

James M. Puckett

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# IMPROVING TAX RULES BY MEANS-TESTING: BRIDGING WEALTH INEQUALITY AND “ABILITY TO PAY”

JAMES M. PUCKETT\*

## *Abstract*

*The federal income tax can and should do more to address wealth disparities and income inequality. The income tax does not directly count wealth, and the realization rule and basis “step-up” at death exclude substantial amounts of income for the wealthy. The Constitution limits Congress’s ability to tax wealth. Despite these serious challenges, this Article considers how to potentially bridge the gap between wealth and the income tax. For example, asset-based phase-outs in the income tax should pass muster without apportionment, although their bite would necessarily be limited. The Article posits that the public would be more receptive to phase-outs than more progressive tax brackets. Relevant to complexity, the existing literature has identified potential mark-to-market solutions to correct the exclusion of unrealized gains. The design of asset-based phase-outs would be prefigured to some extent by whether these proposals gain traction. The income tax, to be sure, cannot by itself solve the problem of wealth inequality. Principles of tax justice, however, arguably require greater attention to wealth in measuring the taxpayer’s “ability to pay.”*

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### *Introduction*

Amid increases in wealth and income concentration in the United States,<sup>1</sup> the federal income tax still serves as “a grand delusion” of progressivity.<sup>2</sup> The federal income tax can and should do more to respond to wealth and

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1. See THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 294-96, 347-50 (Arthur Goldhammer trans., Harvard Univ. Press 2014) (2013) (noting “explosion” of income inequality and increase in wealth inequality since 1980); Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data*, 131 Q.J. ECON. 519, 520 (2016) (noting that income inequality has “sharply increased in the United States since the late 1970s” and concluding that “US wealth concentration is currently high by international standards and has considerably increased in recent decades”); see also JOSEPH E. STIGLITZ, *THE PRICE OF INEQUALITY: HOW TODAY’S DIVIDED SOCIETY ENDANGERS OUR FUTURE* (2012) (identifying causes and social costs of inequality). Discourse concerning inequality regularly surfaces in the mainstream media, and both Democrats and Republicans “talk the talk.” See, e.g., Jared Bernstein, *Everyone’s Talking About Inequality. Here’s How to Tell if They’re Lip Syncing or Really Singing*, WASH. POST (Apr. 20, 2015), <https://www.washingtonpost.com/posteverything/wp/2015/04/20/everyones-talking-about-inequality-heres-how-to-tell-if-theyre-lip-syncing-or-really-singing/>; David Iaconangelo, *Income Inequality: The Good, the Bad, and How to Tackle It*, CHRISTIAN SCI. MONITOR (Jan. 17, 2017), <http://www.csmonitor.com/World/Global-News/2017/0117/Income-inequality-The-good-the-bad-and-how-to-tackle-it> (noting that after the 2012 election “Republicans in the US have begun to speak the language of inequality”).

2. Cf. JEROME R. HELLERSTEIN, *TAXES, LOOPHOLES AND MORALS* 16 (1963) (indicating that high marginal tax rates are “a grand delusion”).

income inequality—or, at the very least, more plausibly link the tax burden with “ability to pay.”<sup>3</sup> To be sure, there are many angles from which to approach this problem. Although perhaps natural, the separation of wealth from the federal income tax is not inevitable. This Article examines how the gap between wealth and ability to pay could be bridged.

The results of the 2016 election should not silence this timeless conversation.<sup>4</sup> Indeed, House Speaker Paul Ryan proposed progressive-sounding tax cuts for the poor and middle class and called the plan “simpler, fairer, and flatter.”<sup>5</sup> As a candidate, President Trump also called for flatter tax brackets.<sup>6</sup> The election, however, did not clearly evidence an

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3. See *infra* Section II.A. Although it is a malleable concept, “ability to pay” is the principal tax equity norm. See, e.g., 2 JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY* 308 (D. Appleton & Co. 1909) (1848) (“[W]hatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all.”); ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* bk. 5, ch. 2, pt. 2, at 171 (A. Allardice 1822) (1776) (“The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities.”); Edwin R. A. Seligman, *Progressive Taxation in Theory and Practice*, 9 AM. ECON. ASS’N Q. 562, 767-68 (1908) (second edition of the author’s 1894 book) (noting centuries-old roots of ability to pay norm); Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 867-69 (2002) (asserting that ability to pay is generally accepted and citing domestic and foreign sources).

4. No doubt from very different perspectives and offering radically different proposals, during their 2016 campaigns, Donald Trump, former Secretary of State Hillary Clinton, and Senator Bernie Sanders all spoke out about economic inequality. See, e.g., Jon Hartley & Glen Hubbard, *The Economic Ignorance of Trump and Sanders*, NAT’L REV. (Mar. 21, 2016), <http://www.nationalreview.com/article/432986/free-markets-bernie-sanders-donald-trump-oppose-them-blindly> (“The rise of populist candidates — Trump and Sanders, with Clinton increasingly tagging on — arguably mirrors the recent trends, in wealth and income inequality, documented by economists such as Thomas Piketty . . . .”); Felipe Ossa, *The Economist Who Brought You Thomas Piketty Sees ‘Perfect Storm’ of Inequality Ahead*, NEW YORK MAG. (Mar. 24, 2016), <http://nymag.com/daily/intelligencer/2016/03/milanovic-millennial-on-millennial-war-is-next.html> (noting economist Branko Milanovic’s remarks that “even the word *inequality* was not politically acceptable, because it seemed like something wild or socialist” and asserting that this “began to change a few years ago”).

5. *Better Way: Our Vision for a Confident America*, A BETTER WAY (June 24, 2016), 16-17, <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>. As this Article goes to press, the House of Representatives has passed a tax reform bill entitled the Tax Cut and Jobs Act. H.R. 1, 115th Cong. (2017) (as passed by House, Nov. 16, 2017) [hereinafter TCJA]. A comprehensive analysis of the TCJA and the emerging plan in the Senate lies beyond the scope of this Article.

6. See TAX POL’Y CTR., *WHAT IS KNOWN ABOUT DONALD TRUMP’S TAX PLAN* (2017), [http://www.taxpolicycenter.org/sites/default/files/publication/141946/what-is-known-about-donald-trumps-tax-plan\\_1.pdf](http://www.taxpolicycenter.org/sites/default/files/publication/141946/what-is-known-about-donald-trumps-tax-plan_1.pdf); see also Rupert Neate, *Trump’s Tax Plan: Massive Cuts for the*

indifference to economic inequality so much as empower voters dissatisfied with elites and excited about “change.”<sup>7</sup> More generally, tax cuts often follow years with high tax rates, and tax increases often follow years with low tax rates.<sup>8</sup>

Current income tax brackets barely distinguish between the upper-middle class and the rich.<sup>9</sup> Indeed, the tax brackets generally apply a *lower* tax rate

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1% Will Usher ‘Era of Dynastic Wealth’, GUARDIAN (Nov. 23, 2016), <https://www.theguardian.com/us-news/2016/nov/23/trump-tax-plan-cuts-wealthy-low-income-inequality>; Lee Sheppard, *Trump’s Tax Plan*, FORBES (Nov. 13, 2016), <https://www.forbes.com/sites/leesheppard/2016/11/13/trumps-tax-plan/#58bf2e9e1122>. On the other hand, then-candidate Trump proposed repealing the step-up in basis at the death of the taxpayer, albeit coupled with estate tax repeal. See Allyson Versprille, *Trump Plan Repeals Estate Tax, Scraps Capital Gain Benefit*, BLOOMBERG BNA: NEWS (Sept. 20, 2016), <https://www.bna.com/trump-plan-repeals-n57982077269/>.

7. See Nancy Benac & Emily Swanson, *Americans Are Angry at the Government, Desire Change, Exit Polls Show*, PBS (Nov. 9, 2016), <http://www.pbs.org/newshour/rundown/americans-angry-government-desire-change-exit-polls-show/> (noting “simmering discontent of the American electorate” and that four in ten voters were “hungry for change” and overwhelmingly favored Trump); Stephen Fidler, *In the Wake of a Tumultuous Year, the Global Elite Face a World of Uncertainty*, WALL ST. J. (Jan. 17, 2017), <https://www.wsj.com/articles/in-the-wake-of-a-tumultuous-year-the-global-elite-face-a-world-of-uncertainty-1484560809> (noting that unemployment or giving up on seeking employment “combined with anxieties about immigration and terrorism, have encouraged a backlash against mainstream politicians and associated elites”); Beverly Gage, *How ‘Elites’ Became One of the Nastiest Epithets in American Politics*, N.Y. TIMES (Jan. 3, 2017), <https://www.nytimes.com/2017/01/03/magazine/how-elites-became-one-of-the-nastiest-epithets-in-american-politics.html> (asserting that Trump “turn[ed] the 2016 election into a competition between knowledge systems: the tell-it-like-it-is ‘people’ versus the know-it-all ‘elites’”); Virginia Postrel, *Trump Is the Change Voters Wanted*, BLOOMBERG (Nov. 9, 2016), <https://www.bloomberg.com/view/articles/2016-11-09/trump-is-the-change-voters-wanted> (“When exit polls asked what quality in a candidate matters most, a plurality of voters, 39 percent, said ‘can bring change.’ Trump captured 83 percent of those votes.”).

8. See generally William E. Foster, *Partisan Politics and Income Tax Rates*, 2013 MICH. ST. L. REV. 703 (examining historical influences on tax brackets); Tracey M. Roberts, *Brackets: A Historical Perspective*, 108 NW. U. L. REV. 925 (2014) (surveying tax bracket changes and related historical events).

9. For an individual, the 33% bracket begins at income of \$191,651; the 35% bracket applies next to a very thin slice of income beginning at \$416,701; and the top ordinary income rate of 39.6% starts at \$418,401. Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (setting forth inflation adjusted tax items for 2017). If enacted, the TCJA would impose a \$1 million bracket threshold for the 39.6% tax rate for married taxpayers filing jointly. TCJA § 1001(a) (revising I.R.C. § 1). Although it cuts taxes for the wealthy, the bill implicitly acknowledges that tax rates max out at an inappropriately low level of income under current law. As a starting point for discussion, upper-middle class might be defined as the top 20% by income, which translates to earning an income of close to \$200,000 a year. See Richard V. Reeves,

to long-term capital gain income, such gains being predominantly realized by the wealthiest taxpayers.<sup>10</sup> Recent IRS analysis concluded that in 2013, much like prior years, the average income tax rate *declined* from approximately 27% within the top 1% of incomes overall to approximately 24% at the top .001% of incomes.<sup>11</sup> The top 400 taxpayers have sometimes paid an effective rate of less than 20%.<sup>12</sup> Differences between the top tiers are substantial: the top 1% had an average adjusted gross income (AGI) of \$428,713, while the top .001% had an average AGI of over \$45 million.<sup>13</sup>

This regressive pattern serves as a compelling example of a larger problem: the income tax inadequately links the tax burden to taxpayers' ability to pay. Stepping back from the tax brackets, gross income comprises only a technical subset of a taxpayer's increases in wealth from year to year. Thus, even if income were a good enough proxy for ability to pay, the implementation in the Code falls short.<sup>14</sup>

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*The Dangerous Separation of the American Upper Middle Class*, BROOKINGS (Sept. 3, 2015), <http://www.brookings.edu/blogs/social-mobility-memos/posts/2015/09/03-separation-upper-middle-class-reeves>. As Reeves aptly responds to the admitted complexity of defining the term:

Class is of course made up of a subtle, shifting blend of economic, social, education and attitudinal factors. . . . [A]n income-based classification will provide a good starting point, not least because the trends in income inequality are fairly clear: the top fifth is pulling away from the rest of society.

*Id.*

10. Compare I.R.C. § 1(h)(1)(C)-(D) (2012) (imposing 15% and 20% rates on long-term capital gains) with I.R.C. § 1(a)-(d) (2012) (imposing up to 39.6% rate on ordinary income). The Congressional Budget Office has estimated that the capital gains preference costs over \$1 trillion in a ten-year period and that the top 1% enjoy 68% of the tax savings from the preference. CONG. BUDGET OFF., *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM* (2013), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768\\_DistributionTaxExpenditures.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf).

11. See Adrian Dungan, *Individual Income Tax Shares, 2013*, IRS STAT. INCOME BULL., Summer 2016, at 82, 82, <https://www.irs.gov/pub/irs-soi/soi-a-ints-id1609.pdf>. A further breakdown of the average tax rates at the top of the income spectrum shows the very highest tiers paying a lower average rate of tax than the top .1%, which pays the highest tax rate. *Id.* at 89 (the top .001% paid an average rate of 24.12%; the top .01%, an average of 26.21%; the top .1%, an average of 27.91%; the top 1%, an average of 27.08%; the top 2%, an average of 25.86; and the top 3%, an average of 24.78%).

12. See Robertson Williams, *Income and Taxes of the Very Rich*, 136 TAX NOTES 121, 121 (2012).

13. Dungan, *supra* note 11, at 82.

14. See *infra* Section I.B.1. Exacerbating this phenomenon, courts sometimes agree with taxpayers claiming exclusions that lack any apparent statutory basis. See Alice G. Abreu & Richard K. Greenstein, *It's Not a Rule: A Better Way to Understand the Definition of Income*, 13 FLA. TAX REV. 101, 103-04 (2012) (positing that "noneconomic values" underlie

In addition, the Code is largely agnostic about the differences between an investor whose income consists of \$50,000 in taxable interest and a worker whose annual salary is \$50,000. These two taxpayers are not similarly situated. Historically, property ownership was the most important measure of taxpaying capacity.<sup>15</sup> Substantial wealth provides security, flexibility, and an opportunity to exercise power. In addition, wealth serves as a proxy for untaxed income, so long as the realization rule and other deferral mechanisms apply.

Other federal taxes, in their totality, add up to a system that is much less progressive than most would imagine.<sup>16</sup> Some would argue that the estate tax and the corporate tax are already adequate to reduce wealth inequality. As Professor Edward McCaffery crisply puts it, however, “The simple answer is: No, they are not.”<sup>17</sup> Estates now have a multimillion-dollar federal estate tax exemption. And substantial avoidance or underreporting of estate tax liability seems likely.<sup>18</sup> Estate tax reform, or transformation

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a “puzzling gap between what the broad definition that *Glenshaw Glass* would seem to include in the tax base and what is actually included”); Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 345 (2011) (arguing that “income” is most apt as a standard so, for example, “the IRS can weigh equity and efficiency, both of which [might] point to income, but allow administrability to outweigh them”).

15. See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 66, 94 (1959); EUGENE STEUERLE, U.S. TREASURY DEP’T, *EQUITY AND THE TAXATION OF WEALTH TRANSFERS* 5-6 (1980); Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 243, 245 (1946) (citing Cicero and Justinian). That income has become important is no surprise because the economy has diversified so much beyond products of the land. See STEUERLE, *supra*, at 6; see also Buehler, *supra*, at 245-46 (“General property appears to have been regarded as the most satisfactory index of personal ability, but its deficiencies were seen and efforts were exerted to tax wages, salaries, and other receipts from personal services, and to impose commodity taxes that would reach the rich who escaped from property taxation.”).

16. See *infra* Section I.B.2.

17. Edward J. McCaffery, *Taxing Wealth Seriously*, 70 TAX L. REV. 305, 326 (2017).

18. See *id.* (noting that “Sheldon Adelson was able to transfer nearly \$8 billion to his family” tax-free and “hundreds of billions of dollars sit in dynasty trusts . . . forever out of the estate tax’s reach”); cf. Debrah Rahmin Silberstein, *A History of the Death Tax—A Source of Revenue, or a Vehicle for Wealth Redistribution*, 17 PROB. & PROP. 58, 64 (2003) (“The history of the death tax demonstrates that it has greatest political support when the purpose is to raise needed revenue. Often that revenue is for a specific purpose, such as military spending.”). But see Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a “Voluntary” Tax?*, 20 STAN. L. & POL’Y REV. 153, 168 (2009) [hereinafter Caron & Repetti, *Estate Tax Non-Gap*] (finding one-third of largest estates transferred outside family) (“What should one make of the wildly disparate estate tax gap estimates—76.8%, 22.9%, 13%, and 10%? We believe that the lower estate tax gap estimates may be justified[.]”); Paul L. Caron & James R. Repetti, *Revitalizing the Estate Tax: 5 Easy Pieces*,

into an accessions tax,<sup>19</sup> may be harder to achieve than income tax reform because the estate tax is so susceptible to public misinformation.<sup>20</sup> Meanwhile, the incidence of the corporate tax may fall on labor rather than shareholders and likely at an effective rate much lower than the statutory rate.<sup>21</sup>

A wealth tax may appear to be an obvious solution to the problem of wealth inequality. Substantial constitutional questions would arise, however, unless a wealth tax were apportioned among the states based on their respective populations.<sup>22</sup> The burden of an apportioned wealth tax would be arbitrary.<sup>23</sup> And although there is a plausible argument that an unapportioned wealth tax would pass muster, this Article seeks a

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142 TAX NOTES 1231 (2014) [hereinafter Caron & Repetti, *5 Easy Pieces*] (recommending five estate tax reforms to reduce inequality and promote growth).

19. For the distinction between wealth and accessions and the underlying theories for choosing between the two tax bases, see Miranda Perry Fleischer, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*, 57 B.C. L. REV. 913, 918-20 (2016).

20. See Mayling Birney et al., *Public Opinion and the Push to Repeal the Estate Tax*, 59 NAT'L TAX J. 439, 442 (2006) ("Surveys also consistently show that the number of people in favor of repeal [of the estate tax] drops when respondents are given information on exemption levels or how many people pay."); Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1051 (2004) ("The estate tax truly is primarily a tax on the super-rich."); *Misperceptions on Estate Tax Detracting from Worthwhile Revenues for United States*, RUTGERS BUS. SCH. (May 25, 2011), <http://www.business.rutgers.edu/business-insights/misperceptions-estate-tax-detracting-worthwhile-revenues-united-states> ("There's a swathe of misinformation that touts the estate tax as applying broadly and that's not true. The tax actually impacts only 0.1% of the American public but if you asked 100 people, at least 60 of them would say it applies to them.") (quoting Professor Jay Soled).

21. See Rosanne Altshuler et al., *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 371-72 (2010) (suggesting that the corporate tax may only be "mildly" progressive); Richard M. Bird & Eric M. Zolt, *Redistribution Via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627, 1642 (2005) ("Because no one knows the true incidence of the corporate tax, many studies simply present alternative scenarios, with no weighting as to which is more likely to hold in reality."); Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 433 (2012) ("[G]enerations of corporate tax incidence models have failed to reach a clear consensus on this question."); McCaffery, *supra* note 17, at 326 (observing that most economists say the burden falls on labor rather than shareholders); Samuel C. Thompson, Jr., *President's Dividends Plan Undertaxes High-Income Taxpayers*, 98 TAX NOTES 389, 389 (2003) (arguing that high-bracket taxpayers are undertaxed on dividends because of corporate tax preferences, deferral of shareholder level tax on retained earnings, and the availability of step-up in basis at death).

22. See *infra* Section IV.A.

23. See *infra* Section IV.A.



workaround: an income tax which incorporates asset-based phase-outs should not be a “direct tax.”<sup>24</sup>

Beyond the more novel possibility of asset-based phase-outs, this Article explores existing proposals and historical precedents, including prior tax brackets, capital gains tax rate reform, and repealing the exemption of a decedent’s unrealized capital gain. It also explains how the phase-out technique would be entwined to some extent with those other options. Phase-outs, to be clear, would not amount to a renamed “Buffett Rule.”<sup>25</sup>

Achieving fairness in the tax system is an important goal on its own, and fairness also bears on consequences. The government’s ability to collect tax is at stake; the system remains, for many taxpayers, based on voluntary compliance.<sup>26</sup> The likely social costs of inequality also counsel the pursuit of distributive changes in the tax system.<sup>27</sup> Of course, scholars have long disputed whether economic inequality is harmful.<sup>28</sup> However, this Article draws from the substantial evidence that economic inequality is costly.<sup>29</sup>

A natural extension of the distributive question is whether a particular change of tax law should help balance the budget. Although the issue is complicated, many would probably say that the need to make progress toward a balanced budget is obvious and compelling.<sup>30</sup> This Article does

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24. *See infra* Section IV.C.

25. The Buffett Rule seeks to apply a minimum tax rate based on the taxpayer’s realized income. *See* Samuel C. Thompson, Jr., *Beyond the ‘Buffett Rule’: Making the Income Tax More Progressive*, 133 TAX NOTES 705 (2011). Asset-based phase-outs, ideally, would seek to achieve vertical equity even in a mark-to-market system, but could still potentially operate even in a realization-based income tax. *See infra* Section III.C.

26. *See* J. T. Manhire, *Tax Compliance as a Wicked System*, 18 FLA. TAX REV. 235, 244 (2016).

27. *See infra* Section I.A.

28. *Cf.* HENRY C. SIMONS, A POSITIVE PROGRAM FOR LAISSEZ-FAIRE: SOME PROPOSALS FOR A LIBERAL ECONOMIC POLICY 12 (Harry D. Gideonese ed., 1934) (remarking that a “substantial measure of inequality may be unavoidable or essential for motivation; but it should be recognized as evil and tolerated only so far as the dictates of expediency are clear”).

29. *Cf.* PIKETTY, *supra* note, 1 at 16 (“It is long since past the time when we should have put the question of inequality back at the center of economic analysis and begun asking questions first raised in the nineteenth century.”).

30. *The Economic and Fiscal Benefits of Pro-Growth Policies: Hearing Before the H. Budget Comm.*, 114th Cong. 1-2 (2016) (statement of John W. Diamond, Ph.D., Rice University’s Baker Institute for Public Policy) (“The federal debt is projected to increase as a share of GDP from 77 percent in 2017 to 150 percent in 2047. As noted above, demographic changes are driving much of the increase in federal spending with the remaining increase related to rising interest payments on the national debt. The obvious conclusion is that the projected expenditure increases in the United States are unsustainable and fiscal restraint is

not, however, aim to address whether Congress should prioritize balancing the budget over using revenue from wealthy taxpayers to reduce the tax burden on others.

Part I provides a brief background on the social harms of economic inequality and the tax system's limited progressivity. Part II identifies several design challenges facing the concept of linking ability to pay tax with taxpayers' wealth. Part III considers how best to respond to these challenges and cautiously advances asset-based phase-outs as a modest work-around to the constitutional limitations on wealth taxation. Part IV discusses the constitutional requirement of apportioning "direct taxes" and the potential escape hatches from apportionment.

### *I. Economic Inequality and the Tax System*

Since the 1980s, economic inequality in the United States has expanded markedly. Economist Thomas Piketty summarizes the lead up to the current state of income inequality:

The top decile claimed as much as 45–50 percent of national income in the 1910s-1920s before dropping to 30–35 percent by the end of the 1940s. Inequality then stabilized at that level from 1950 to 1970. We subsequently see a rapid rise in inequality in the 1980s, until by 2000 we have returned to a level on the order of 45–50 percent of national income.<sup>31</sup>

Many have argued that economic inequality harms the economy and undermines the potential for a robust and vibrant democracy.<sup>32</sup>

Economic inequality has been trending upward as a result of two overarching mechanisms. First, the government has promoted inequality through shaping the rules of the market.<sup>33</sup> Second, even as the government

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imperative. The United States must reduce the projected level of expenditures and reform its tax system to reduce economic distortions and maximize economic growth.”).

31. PIKETTY, *supra* note 1, at 23.

32. Christina Pazzanese, *The Costs of Inequality: Increasingly, It's the Rich and the Rest*, HARV. GAZETTE (Feb. 8, 2016), <http://news.harvard.edu/gazette/story/2016/02/the-costs-of-inequality-increasingly-its-the-rich-and-the-rest/>.

33. See John Schmitt, *Inequality as Policy: The United States Since 1979*, CTR. FOR ECON. & POL'Y RES. (Oct. 2009), <http://cepr.net/documents/publications/inequality-policy-2009-10.pdf> (“Taken together, these policies – a low and falling minimum wage; the de- or re-regulation of major industries; the corporate-directed liberalization of international capital, product, and labor markets; the privatization of many government services; the decline in unionization; and other closely related policies – are the proximate cause of the rise in inequality.”).

fosters inequality in the pre-tax sense, it does less and less to counteract inequality through the tax and spending systems.<sup>34</sup>

*A. Harms of Economic Inequality*

Elevated levels of economic inequality inhibit economic output and decrease happiness; the rich insulate themselves from the impact, while the poor and middle class bear a disproportionate burden.<sup>35</sup> There is surely no set list of dynamics in this process, but several primary phenomena or patterns can be identified. A recurring theme is that the rich are different from most people in terms of preferences, influence, resources, and ability to use self-help to solve problems.<sup>36</sup>

Political contributions and independent political expenditures are concentrated in a very thin slice of the population.<sup>37</sup> Professor Timothy Kuhner explains just how elite this group is:

In the case of superPACs and dark money groups, where limits are weakest, 200 millionaires and billionaires (0.000063 percent of the population) stand behind roughly 80 percent of all the money spent. In the end, 0.37 percent of the population supplies approximately 70 percent of all money in politics.<sup>38</sup>

Even if spending alone is insufficient to procure a desired outcome, this elite group has long enjoyed greater access to politicians,<sup>39</sup> and legislative agendas tend to mirror their concerns.<sup>40</sup>

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34. STIGLITZ, *supra* note 1, at 77.

35. *Id.* at 83.

36. *Cf.* RICHARD V. REEVES, DREAM HOARDERS 58 (2017) (detailing the ability of the upper middle class to maintain their economic position for their children, and thus perpetuate “a more rigid class structure than many European nations,” through inheritances, legacy preferences in the elite college admissions process, zoning ordinances, and the procurement of valuable internship experiences through previously established connections).

37. David Weakliem & Robert Biggert, *Not Asking for Much: Public Opinion and Redistribution from the Rich*, 12 COMP. SOC. 66, 67 (2013) (“Money provides political advantages even when rights to vote are equal, so affluent people may be able to block or weaken measures that threaten their interests even when those measures are popular with the public.”).

38. TIMOTHY K. KUHNER, CAPITALISM V. DEMOCRACY: MONEY IN POLITICS AND THE FREE MARKET CONSTITUTION 6 (2014) (footnote omitted).

39. *See* G. WILLIAM DOMHOFF, WHO RULES AMERICA? THE TRIUMPH OF THE CORPORATE RICH 54-55 (7th ed. 2014) (noting the Bohemian Grove as a place for political Lakeside Talks between the upper class, corporate rich, and political hopefuls) (“The retreat sometimes provides an occasion for more than fun and merriment. Although business is rarely discussed, except in an informal way in groups of two or three, the retreat provides

Economic inequality leads to instability, which in turn depresses output. Wealth concentration depresses overall demand, leading to unemployment, which often cascades into government intervention to spur private investment through cheap credit.<sup>41</sup> Demands for deregulation increase risk.<sup>42</sup> The bubbles in technology startups and in housing are painful reminders of the phenomenon.<sup>43</sup> Inordinate risk from bubbles pushes down investment, dampening growth.<sup>44</sup> Economist Joseph Stiglitz identifies a peculiar “irony” of this historical pattern: “while inequality gives rise to instability, the instability itself gives rise to more inequality.”<sup>45</sup> Then, because “the rich are better able to bear risk, they reap the reward that society provides for compensating for the greater risk,” notwithstanding that they initiated the policies that imposed the risk and its costs on others.<sup>46</sup>

High inequality produces a myriad of other obstacles to productivity. The more wealth becomes concentrated, the less the government invests in infrastructure, research, and education.<sup>47</sup> From state to state in the United

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members with an opportunity to introduce their friends to politicians and to hear formal noontime speeches, called Lakeside Talks, from political candidates and a wide range of experts.”).

40. See KUHNER, *supra* note 38, at 6; see also DOMHOFF, *supra* note 39, at 162 (“The corporate rich and the power elite build on their structural power, their status power, their storehouse of policy recommendations, and their success in the electoral arena to dominate the federal government on the issues they care about. Lobbyists from corporations, law firms, and trade associations, working through the special-interest process, play a crucial role in shaping government policies on narrow issues of concern to wealthy families, specific corporations, or business sectors.”).

41. STIGLITZ, *supra* note 1, at 84; Michael E. Porter & Jan W. Rivkin, *A Wake-up Call for Tomorrow's Top 1 Percent: Rebuild America's Middle Class*, FORTUNE (Mar. 25, 2015), <http://fortune.com/2015/03/26/a-wake-up-call-for-tomorrows-top-1-percent-rebuild-americas-middle-class/> (“Weak middle-class prospects undermine the consumer spending on which many businesses depend. Workers with marginal or stagnant incomes, and without the skills needed to improve them, are less committed and less productive. And a languishing middle class fosters disgruntled voters who demand policies that redistribute prosperity rather than create it.”).

42. STIGLITZ, *supra* note 1, at 89; Katherine Bentley, Senior Thesis, *The 2008 Financial Crisis: How Deregulation Led to the Crisis*, LAKE FOREST C. PUBLICATIONS, 27 (2015), <http://publications.lakeforest.edu/cgi/viewcontent.cgi?article=1054&context=seniortheses>.

43. STIGLITZ, *supra* note 1, at 87-89; Bentley, *supra* note 42, at 4-11 (noting the significance of the housing bubble as a contributory factor in the 2008 recession).

44. STIGLITZ, *supra* note 1, at 91.

45. *Id.*

46. *Id.*

47. *Id.* at 93; JAN W. RIVKIN ET AL., THE CHALLENGE OF SHARED PROSPERITY 22-23 (Sept. 2015), <http://www.hbs.edu/faculty/Publication%20Files/challenge-of-shared-prosper>

States, as well as in other countries, economic inequality is associated with lower life expectancy, higher crime, increased rates of mental health conditions, and other social problems.<sup>48</sup> This underinvestment occurs “despite evidence that the boost these investments give to the economy far exceeds the average return in the private sector, and is certainly higher than the cost of funds to the government.”<sup>49</sup> Decreased educational attainment inhibits productivity.<sup>50</sup> And reduced economic mobility erodes faith in a core tenet of democracy.<sup>51</sup>

Piketty identifies the ability of a small, top-earning managerial class to effectively “set their own remuneration” as a key driver of inequality.<sup>52</sup> Their compensation, however, lacks “any clear relation to their individual productivity.”<sup>53</sup> Similar to the case of the elite managerial returns, Piketty suggests that the return from capital is oftentimes “unpredictable and arbitrary” and catapulted by the owner’s starting wealth.<sup>54</sup>

In many industries, only a few top performers take most gains.<sup>55</sup> That is not to say that top earners were simply lucky; however, such winner-take-all markets may yield windfalls to those who could not possibly have anticipated their return on effort, while making it difficult for others to enter. If the cost of entry into a venture is considerable, and only a few investors are likely to profit, some potential inventors and competitors will not try.

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ity\_95e150dc-b2fd-417f-8c6d-c33a27fd6cb8.pdf (noting that rising inequality led to “political polarization and paralysis” and in turn “systemic underinvestment in the commons”); Pazzanese, *supra* note 32.

48. See RICHARD WILKINSON & KATE PICKETT, *THE SPIRIT LEVEL: WHY GREATER EQUALITY MAKES SOCIETIES STRONGER* 19-20 (2009).

49. STIGLITZ, *supra* note 1, at 93.

50. *Id.* at 94; J. Bradford DeLong et al., *Sustaining U.S. Economic Growth*, in *AGENDA FOR THE NATION* 17, 30 (Henry J. Aaron et al. eds., 2003) (“The slower growth in the educational attainment of the work force from 1980 to 2000 shaved productivity growth by 0.13 percent a year relative to the average for 1915 to 1980.”).

51. Frederick Solt, *Economic Inequality and Democratic Political Engagement*, 52 *AM. J. POL. SCI.* 48, 48 (2008) (“The analyses demonstrate that economic inequality powerfully depresses political interest, discussion of politics, and participation in elections among all but the most affluent and that this negative effect increases with declining relative income.”)

52. PIKETTY, *supra* note 1, at 24. Piketty finds that similar trends have taken hold globally, though except in Britain, the trend is “less marked.” *Id.*

53. *Id.*

54. *Id.* at 26-27.

55. See generally ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER TAKE ALL SOCIETY* (1995) (arguing that minor differences in performance lead to enormous differences in return, which is an inefficient barrier to entry).

Rent-seeking goes hand in hand with inequality. The problem goes beyond the potential waste of lobbying expenditures. For example, results of rent-seeking include misallocations of resources involving monopolized products (such as pharmaceuticals), misallocations of talent into the financial sector, and inadequate accounting for environmental and other social costs.<sup>56</sup> Inequality fosters rent-seeking because the wealthy can attempt to capture the benefits of rent-seeking while forcing others to bear the burdens.<sup>57</sup>

Finally, subtle effects on productivity and psychological enjoyment may be related to perceptions of inequality.<sup>58</sup> As to productivity, there is evidence that workers who feel unfairly compensated tend to be less productive.<sup>59</sup> Regarding psychological enjoyment, the perceived need to compete—as it turns out, futilely—for status goods leaves less time for family and friends and generally produces unhappiness.<sup>60</sup>

### *B. Flattening of the Federal Tax System*

As discussed below, while economic inequality has escalated, the federal income tax and estate tax have been reduced from their historical levels. The capital gains preference further undermines the progressivity of the federal tax system. Meanwhile, the payroll tax adds a regressive element to the federal tax system. Capital gains preferences and payroll taxes are not new, but at least in the past, highly progressive tax brackets for ordinary income, as well as a more robust estate tax, did more to achieve progressivity in the overall tax system.

#### *1. Federal Income Tax*

The federal income tax has changed from a class tax, targeting only rich Americans at its inception,<sup>61</sup> to a mass tax,<sup>62</sup> drawing in both rich and

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56. STIGLITZ, *supra* note 1, at 95-98.

57. *Id.* at 99 (citing permission and subsidy of offshore drilling as an example of “huge” private rewards with dispersed costs for ordinary Americans).

58. See Elizabeth Tricomi et al., *Neural Evidence for Inequality-Averse Social Preferences*, 463 NATURE 1089 (2010) (citing prior behavioral and anthropological evidence that humans favor reducing inequality and finding “direct neural evidence” of aversion to inequality using functional MRI testing).

59. STIGLITZ, *supra* note 1, at 104.

60. *Id.* at 104-06.

61. The Civil War income tax initially was a flat 10% and exempted average households from taxation with a personal exemption. See W. Elliot Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 29, 34-35 (Joel B. Slemrod ed., 2000). Later, the exemption was reduced

average Americans. From 1913 until 1980, however, income tax brackets penetrated into much higher levels of purchasing power.<sup>63</sup> Today, the brackets level off before \$500,000 of income.<sup>64</sup> As explained below, the earlier top brackets were often much higher, especially if converted into purchasing power in 2017 dollars.<sup>65</sup> Platinum brackets recognized that those with ultra-high incomes are differently situated from the upper middle class or the merely rich.<sup>66</sup> In addition, multimillion-dollar incomes were separately distinguished via the tax brackets at various times.<sup>67</sup>

In 1913, although there were no platinum brackets, the top rate of 7% applied to incomes above \$500,000—well over \$10 million in present value.<sup>68</sup> Platinum brackets appeared as early as 1917, disappeared after World War I, then reappeared in the 1930s.<sup>69</sup> In the late 1930s and early 1940s, top brackets penetrated to around \$80 million in present value.<sup>70</sup> Thus, the federal income tax sharply distinguished among different classes of taxpayers, especially when it transformed into a mass tax during World War II.<sup>71</sup> As late as 1963, a 91% rate of tax applied to incomes over \$1.5 million in present value (\$200,000 in 1963 dollars).<sup>72</sup>

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and a 5% bracket added. Still, the tax only reached a relatively small proportion of households. The tax expired in 1872. The 1894 income tax (ultimately struck down) applied a 2% tax, exempting as before most taxpayers with a personal exemption. Likewise, after ratification of the Sixteenth Amendment, the 1913 income tax exempted most taxpayers. *Id.* at 40-41.

62. *See id.* at 58; Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685, 686 (1988).

63. *See Roberts, supra* note 8, at 936-38; *SOI Tax Stats – Historical Table 23*, IRS (Aug. 11, 2017), <https://www.irs.gov/uac/soi-tax-stats-historical-table-23>.

64. *See* I.R.C. § 1(a)-(d) (2012); Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (providing inflation adjusted tax brackets).

65. After 1941, million-dollar brackets superficially disappeared, but nominal top brackets of \$200,000 to \$400,000 in the following decades represent well over \$1 million when inflated to present value. *See U.S. Federal Income Tax Rates History, 1862-2013 (Nominal and Inflation-Adjusted Brackets)*, TAX FOUND. (Oct. 17, 2013), <http://taxfoundation.org/article/us-federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets> [hereinafter *U.S. Federal Income Tax Rates History*].

66. This Article refers to income tax brackets with a threshold of at least \$1 million as “platinum” brackets.

67. *See U.S. Federal Income Tax Rates History, supra* note 65.

68. *See id.*

69. *Id.*

70. *Id.*

71. *See Brownlee, supra* note 61, at 59.

72. *See U.S. Federal Income Tax Rates History, supra* note 65.

Reagan-era tax cuts sharply reduced the progressivity of the income tax.<sup>73</sup> And, for a few years, the tax became almost flat: in 1988, a 15% bracket at relatively low incomes and a 28% bracket at middle income levels took effect.<sup>74</sup> In 1990, President George H.W. Bush famously broke his anti-tax pledge<sup>75</sup> by approving a 31% bracket beginning at \$82,150 the next year.<sup>76</sup>

President Clinton signed into law two new brackets applying rates of 36% and 39.6%.<sup>77</sup> Temporary tax cuts under President George W. Bush eliminated the top bracket and reduced the remaining rates.<sup>78</sup> The latest compromise, under President Obama, made the lower brackets permanent and revived the 39.6% bracket.<sup>79</sup>

A progressive income tax with a low rate for capital gains has been described as a “ludicrous business of dipping deeply in large incomes with a sieve.”<sup>80</sup> Most taxpayers have little in the way of investment income and essentially see their wages taxed at ordinary rates. In 2010, capital gains and dividends taxed at special rates comprised a mere 1% of the income of

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73. Alice Gresham Bullock, *The Tax Code, the Tax Gap, and Income Inequality: The Middle Class Squeeze*, 53 *HOW. L.J.* 249, 256-57 (2010).

74. *Id.*

75. See Meg Fowler, *From Eisenhower to Obama: What the Wealthiest Americans Pay in Taxes*, ABC NEWS (Jan. 18, 2012), <https://www.yahoo.com/news/eisenhower-obama-wealthiest-americans-pay-taxes-193734550--abc-news.html> (noting the “famed promise of ‘no new taxes’”).

76. See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as amended in scattered sections of 7 U.S.C.); Bruce Bartlett, *Time for a Tax Reform*, FORBES (Apr. 3, 2009), <http://www.forbes.com/2009/04/02/time-tax-reform-opinions-columnists-overdue.html>.

77. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified as amended in scattered sections of 7 U.S.C.).

78. See Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.); Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).

79. See American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (codified as amended in scattered sections of 26 U.S.C.).

80. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 219 (1938); see also Charles J. Cooper et al., *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 *VA. TAX REV.* 631 (1993); Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 *VA. TAX REV.* 477 (2009); Marjorie E. Kornhauser, *The Morality Of Money: American Attitudes Toward Wealth and the Income Tax*, 70 *IND. L.J.* 119 (1994); John W. Lee, III, *The Capital Gains “Sieve” and the “Farce” of Progressivity 1921-1986*, 1 *HASTINGS BUS. L.J.* 1 (2005).



taxpayers with adjusted gross income (AGI) below \$50,000.<sup>81</sup> But upper-middle class taxpayers (and especially the wealthiest taxpayers) make substantial investments in property. The top 1% is different from all other groups in that capital income, such as capital gains, makes up a majority of their income.<sup>82</sup>

Investments in property can benefit from many tax preferences. As explained below, some of the most important are the realization rule, the step-up in basis for heirs who inherit property, and the preferential tax rates applicable to net long-term capital gains. The capital gains preference has been almost a constant in modern tax history.<sup>83</sup> Today, the highest rate on most long-term capital gains is 20%, just under half the highest rate applicable to ordinary income. The recent tax on net investment income adds another 3.8%.<sup>84</sup>

There are legitimate reasons for special treatment of certain capital gains. Among the hodgepodge of rationales that are often cited for the capital gains preference, the most compelling is that it helps neutralize the effects of inflation and bunching of income accrued over many years into one taxable period.<sup>85</sup> The importance of inflation is the understatement of basis and the taxation of nominal gains. Bunching, on the other hand, could possibly push a taxpayer into a higher tax bracket for the year of the gain realization.

Taxing capital gains accurately may also require inflation adjustments to basis.<sup>86</sup> Because the income tax does not index cost basis, the capital gains preference can be rationalized to a limited extent as roughly making good on that failure. But the capital gains preference is poorly tailored to implement that rationale. The preference is triggered after owning an asset for a year and a day and does not depend on the taxpayer having a

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81. See Justin Bryan, *Individual Income Tax Returns, 2010*, IRS STAT. INCOME BULL., Fall 2012, at 5, 10 fig.F, <https://www.irs.gov/pub/irs-soi/12infallbulincome.pdf>.

82. See CONG. BUDGET OFFICE, *THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES*, 2011, at 5 (2014) (finding that labor income made up at least two-thirds of market income for each quintile though the share “falls off significantly for households in the top 1 percent of the distribution”).

83. Before 1921 and from 1988-1991, there was no preference.

84. See Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a)(1), 124 Stat. 1029, 1060-62 (2010) (codified at I.R.C. § 1411).

85. See *Suburban Realty Co. v. United States*, 615 F.2d 171, 186 (5th Cir. 1980) (noting importance of “appreciation in value accrued over a substantial period of time” and “‘bunching’ effect”).

86. See generally Reed Shuldiner, *Indexing the Federal Income Tax*, 48 TAX L. REV. 537 (1993).

significant tax basis.<sup>87</sup> Further complicating reform of the taxation of capital gains is the corporate income tax, the burden of which may be borne by shareholders or shifted to labor.<sup>88</sup>

The realization rule has always been a basic principle of the federal income tax. Although the normative tax base would theoretically include changes in wealth during the year, tax generally is triggered only upon a sale or other disposition of property. This deferral allows investors to radically reduce, or even eliminate, tax on their gains in property. Because the ownership of property is so concentrated, the benefits of deferral are quite regressively distributed. By one estimate, \$2 or \$3 trillion in unrealized gains are excluded from tax.<sup>89</sup>

Although U.S. citizens and corporations pay tax on their worldwide income, there are ample opportunities for the U.S. owners of foreign corporations to avoid U.S. tax on foreign income.<sup>90</sup> In general, the foreign income of foreign corporations beneficially owned by Americans remains outside the U.S. tax net, subject to certain anti-deferral regimes. Consequently, income can generally be deferred until repatriation in the form of a dividend. The received wisdom is that repatriation will not be forthcoming, because owners would hope for a tax holiday reducing or eliminating the tax rate on such income.

Section 1014 of the Internal Revenue Code provides a “step-up”<sup>91</sup> in basis for inherited property. In other words, the decedent’s heirs or devisees take the property with a basis equal to the property’s fair market value.<sup>92</sup> With basis equal to fair market value, if the new owner immediately cashes out, no gain or loss is recognized. Or, if the heir waits until later to sell, only the appreciation in the property after the decedent’s death will be taxed. Thus, neither the decedent nor the heirs pay tax on any appreciation

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87. See I.R.C. §§ 1(h), 1222 (2012).

88. See *supra* note 21 and accompanying text.

89. See ARTHUR B. LAFFER & STEPHEN MOORE, RETURN TO PROSPERITY: HOW AMERICA CAN REGAIN ITS ECONOMIC SUPERPOWER STATUS 183 (2011).

90. See JOINT COMM. TAX’N STAFF, 112TH CONG., BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 2-7 (2011), <https://www.jct.gov/publications.html?func=startdown&id=3793>.

91. Technically, the basis can “step-down” if fair market value is lower.

92. I.R.C. § 1014(a) (2012); see also Richard Schmalbeck et al., *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. (forthcoming 2017) (manuscript at 3).

between the decedent's basis and fair market value at the time of the decedent's death.<sup>93</sup>

Thus, from a historical perspective, today's tax rates are not particularly high, nor do the brackets do much to distinguish the very rich from the rest of the population. The rich are taxed as if they were upper-middle class, but because they may realize the bulk of their income as capital gains, they may effectively be taxed at much lower rates.<sup>94</sup> Moreover, such gains may be deferred or even eliminated if the owner holds the property until death.

## 2. Other Federal Taxes

The payroll tax was enacted in 1935 to fund Social Security benefits.<sup>95</sup> As explained below, despite the appearance of a benefit scheme, it makes sense to conceive of the program as a tax with two strongly regressive design features. First, the payroll tax is a flat rate of 7.65% on the employer and employee with a wage cap currently set at \$127,200.<sup>96</sup> Second, the payroll tax base does not include investment income.<sup>97</sup> This exclusion constitutes another regressive feature because those with wealth to invest have greater ability to pay than those with equal wage income.<sup>98</sup>

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93. There is a misconception that section 1014 is meant to eliminate double taxation. *See, e.g., Janis v. Comm'r*, 469 F.3d 256, 262 (2d Cir. 2006) (noting that the "rule avoids a double tax on the appreciation in the value of the property that occurred prior to death"). Section 1014 can hurt the decedent's heirs when the estate tax applies, if it results in a "step-down." Section 1014 may help the decedent's heirs even when the estate tax does not apply, because the "step-up" is not conditioned on estate tax liability.

94. *See* Joseph D. Henchman & Christopher L. Stephens, *Playing Fair: Distribution, Economic Growth, and Fairness in Federal and State Tax Debates*, 51 HARV. J. ON LEGIS. 89, 101 (2014) ("Warren Buffett, CEO of Berkshire Hathaway . . . famously complained that it was unfair that he pays a lower percentage of his income in federal taxes than his secretary."); McMahon, *supra* note 20, at 1005 ("[I]ncomes of the members of this club [the Fortunate 400] consist largely of capital gains—over 70% of the group's total AGI in each of 1998, 1999, and 2000 was net capital gains.").

95. *See generally* C. EUGENE STEUERLE & JON M. BAKIJA, *RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY: RIGHT AND WRONG APPROACHES TO REFORM* (1994); Wilbur J. Cohen, *The Development of the Social Security Act of 1935: Reflections Some Fifty Years Later*, 68 MINN. L. REV. 379 (1983).

96. *See Contribution and Benefit Base*, SOC. SECURITY ADMIN., <https://www.ssa.gov/oact/cola/cbb.html> (last visited Oct. 10, 2017).

97. A 3.8% surcharge on net investment income for taxpayers with income over \$200,000 was enacted in 2010 to help fund Medicare. *See* Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a)(1), 124 Stat. 1029, 1060-62 (2010) (codified at I.R.C. § 1411).

98. *See* Linda Sugin, *Payroll Taxes, Mythology, and Fairness*, 51 HARV. J. ON LEGIS. 113, 130 n.98 (2014) ("Of course, the low-income investor has wealth, which the low-

Like the income tax, “[t]he payroll tax affects too many people and raises too much revenue to remain outside the core debate about tax fairness.”<sup>99</sup> The fairness debate concerns both the need for fair distinctions between the rich and others as well as unfair distinctions between laborers and investors with the same income. Because of the regressive nature of the payroll tax, “[i]f the tax system’s treatment of retirement savings is analyzed along with the Social Security system, the combined system reveals ‘a far less redistributive, and thus less justice-enhancing, national retirement security program than emerges from looking at Social Security benefits alone.’”<sup>100</sup>

Without embracing a benefits model of taxation, Professor Sugin argues that Social Security differs importantly from a market:

If payroll taxes “buy” retirement security, the price is arbitrary, depending on numerous factors including lifespan, income, and marital status. Early participants in the program received significantly more in retirement benefits than they had paid in taxes. In contrast, Social Security is a bad “investment” for numerous workers today because many individuals retiring now paid more in Social Security taxes than they will receive in retirement benefits. . . . Some groups, like non-working spouses of high-income taxpayers who receive widow benefits have disproportionately benefitted under the scheme. Others, black men in particular, do not live long enough to collect a fair share of benefits compared to taxes paid. . . . [T]he amount of tax that pays for credits . . . differs for high and low-income taxpayers, and has changed over time.<sup>101</sup>

Accordingly, Social Security more resembles a tax than a fee and should not be walled off from broader discussions of tax equity.

Anticipating the potential objection that the fee should simply be recalibrated, Professor Sugin suggests that if the benefits theory of taxation has a place, it is for concrete, determinable benefits.<sup>102</sup> The value of Social Security benefits, however, is arguably too indeterminate to fit the model.<sup>103</sup>

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income wage earner eligible for the credits does not, so the very low-income investor is likely to be substantially better off financially than the very low-income worker.”).

99. *Id.* at 115.

100. *Id.* at 115 n.9 (quoting Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 873 (1987)).

101. *See id.* at 136 (footnotes omitted).

102. *See id.* at 137.

103. *See id.* Professor Sugin outlines the reasons behind the indeterminacy as follows:

The estate tax could theoretically compensate for distributional shortcomings of the income tax and the payroll tax. Estate tax repeal, however, has proven surprisingly popular.<sup>104</sup> Very few families would receive the bulk of the benefits of repeal.<sup>105</sup> Tales of disaster about the breakup of family farms and small businesses, though apocryphal, presumably have led to the unpopularity of the tax.<sup>106</sup>

From 1935 to 1971, the top estate tax rate stood at 70% or 77%.<sup>107</sup> The top bracket threshold was millions higher than the \$1 million top bracket today, even without adjustment for inflation.<sup>108</sup> As late as the 1990s, less

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In the case of Social Security retirement, the “price” for benefits must be paid many years prior to the receipt of benefits. Is the benefit the actual amount of Social Security received over a lifetime, or is the benefit the security of a steady income until death, regardless of the actual amount paid out? These valuation problems arise in determining the right levy for payroll taxes under a benefits tax scheme, and using the tax’s flat rate as a percentage of wages up to a cap is problematic at best.

*Id.*

104. Michael J. Graetz, “Death Tax” Politics, 57 B.C. L. REV. 801, 813 (2016) (“The temporary estate tax repeal in 2010 and that year’s political deal ratify the much broader success of a conservative Republican wing that has been attacking progressive taxation and pushing its anti-tax agenda over the past three decades. Neither the fight over the estate tax, nor the larger debate about progressive taxation, is anywhere close to being over.”); see also Weakliem & Biggert, *supra* note 37, at 69 (“[A] 2008 CBS News/New York Times survey noted that the estate tax applied only to estates of over 3.5 million dollars and followed by asking respondents which statement came closer to their own view: ‘there should be no tax on any estate’ or ‘the estate tax should be eliminated for most people, but kept in place for the very largest estates.’ Opinions were evenly divided, with 44% in favor of complete elimination and 47% in favor of keeping it for the largest estates; only 4% volunteered that the tax should be kept as it is or applied more widely.”).

105. See Darien B. Jacobson et al., *The Estate Tax: Ninety Years and Counting*, IRS STAT. INCOME BULL., Summer 2007, at 118, 124-25, 128, <https://www.irs.gov/pub/irs-soi/ninetyestate.pdf> (providing brief history of estate tax and graphing the “small fraction of estates” that have paid the tax).

106. See Glenn Kessler, *Is the Estate Tax Killing Small Farms and Businesses?*, WASH. POST (Apr. 14, 2015), <https://www.washingtonpost.com/news/fact-checker/wp/2015/04/14/the-facts-about-the-estate-tax-and-farmers/>; *Misperceptions on Estate Tax Detracting from Worthwhile Revenues for United States*, RUTGERS BUS. SCH. (May 25, 2011), <http://www.business.rutgers.edu/business-insights/misperceptions-estate-tax-detracting-worthwhile-revenues-united-states/> (“People often complain that family businesses or family farms have to be sold to meet the estate tax, but in 2001 when Congress held hearings on repealing the tax, they were hard pressed to find any farms or businesses that were forced to liquidate because of it.”) (quoting Professor Jay Soled).

107. See Jacobson et al., *supra* note 105, at 122.

108. See *id.* at 122, 124.

staggering estates were subject to the estate tax, and the rate maxed out at 55%. The exemption amount stood at \$675,000 before the Bush tax cuts.<sup>109</sup> Currently only multimillion-dollar estates are subject to the tax and at a rate of 40%.<sup>110</sup> With an exemption amount of over \$5 million (over \$10 million for a married couple), very few estates are subject to the tax. Whether the estate tax results in substantial revenue collection from those to whom it would seem likely to apply is another question. It is no secret that the rich often engage in aggressive estate tax planning.<sup>111</sup> Some argue that the rules effectively require taxpayers to bear a significant amount of economic risk to achieve aggressive estate tax planning goals.<sup>112</sup>

In sum, although the models and estimates vary, the federal tax system is much less progressive than most would imagine.<sup>113</sup> Although this Article does not attempt to specify the ideal level of progressivity in the system, it proceeds on the assumption that substantially more progressivity is desirable.

## *II. Challenges of Linking Wealth Inequality with “Ability to Pay” Income Tax*

A host of substantial challenges, ranging from theoretical to practical, stand between wealth and the income tax. This Part first seeks to identify the tax justice theories that would bring legitimacy to progressive income taxation, wealth taxation, and by extension addressing wealth in the income tax. This preliminary step seems in order given the conceptual disconnect between wealth and income and the growing scholarly movement to address tax equity.<sup>114</sup> After grappling with these theoretical problems, the

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109. *See id.* at 122.

110. I.R.C. §§ 2001, 2010 (2012).

111. *See* Caron & Repetti, *Estate Tax Non-Gap*, *supra* note 18, at 154; *see also supra* note 18 and accompanying text.

112. *See* Caron & Repetti, *Estate Tax Non-Gap*, *supra* note 18, at 162.

113. *See* JANE G. GRAVELLE ET AL., CONG. RESEARCH SERV., RL32693, DISTRIBUTION OF THE TAX BURDEN ACROSS INDIVIDUALS: AN OVERVIEW (2010); *Average Effective Federal Tax Rates – All Tax Units, by Expanded Cash Income Level, 2016*, TAX POL’Y CTR. (Mar. 17, 2017), <http://www.taxpolicycenter.org/model-estimates/baseline-average-effective-tax-rates-march-2017/t17-0039-average-effective-federal>.

114. *See, e.g.*, James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1131 (2008) (“Tax policy has ignored the necessity of first identifying equity goals appropriate for a just government and then designing a tax system to help achieve those goals.”); Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229, 231 (2011) (arguing for “a nuanced, philosophical

discussion anticipates concerns relating to public support for the policy change, potential economic distortions that might follow, and administrative difficulties.

*A. The Protean Nature of “Ability to Pay”*

As indicated in the introduction,<sup>115</sup> this Article has highlighted ability to pay because of its longstanding importance as a tax policy norm.<sup>116</sup> Even those who discount it feel compelled to engage with it.<sup>117</sup> Ability to pay falls under a broader principle of fair sacrifice. The benefit principle could be characterized as perhaps the chief rival theory of tax justice at this time.<sup>118</sup> There are, to be sure, other theories of tax justice, such as libertarianism, liberal egalitarianism, and social welfarism.<sup>119</sup>

This Article will not dwell long on the benefits principle, however, given that the weight of scholarship has moved on in favor other theories. As Professor Deborah Schenk writes, “[t]he benefits principle posits that government expenses should be allocated in proportion to the benefits

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understanding of fairness that incorporates the role of taxation into a broader conception of a just society”).

115. See *supra* note 3 and accompanying text.

116. See Sugin, *supra* note 114, at 248 (“Proponents of equality in taxation must consider how best to incorporate the complexities of measuring valuation and productivity into the standard analyses of ability to pay and equal sacrifice.”). This shorthand is also standard fare in textbooks. See, e.g., JOHN A. MILLER & JEFFERY A. MAINE, *THE FUNDAMENTALS OF FEDERAL TAXATION* 3 (3d ed. 2013) (“[A] system should levy taxes commensurately with one’s ability to pay those taxes. It is generally thought that incomes taxes and consumption taxes are best on this count.”).

117. See Buehler, *supra* note 15, at 244 (recounting Buehler’s participation in a National Tax Association “round table of economists, tax administrators, and others,” some of whom “denounced” the phrase, and that “after heated controversy it was apparent that ability to pay still possessed much vigor, that it had many ardent supporters, and that it was not yet ready for burial”); Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263, 310-11 (2000); Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 459 n.173 (2000).

118. See Rakowski, *supra* note 117, at 310 (“The chief rival (or back-up) to the benefit principle as a standard for apportioning the cost of public goods has been the *fair sacrifice principle*.”); Repetti, *supra* note 114, at 1133-34 (describing benefits principles and ability to pay); Schenk, *supra* note 117, at 458 (“Rejection of the benefits principle as a means of allocating the cost of public goods usually leads to consideration of fair sacrifice principles.”).

119. See Barbara H. Fried, *Compared to What? Taxing Brute Luck and Other Second-Best Problems*, 53 TAX L. REV. 377, 379 (2000); Repetti, *supra* note 114, at 1134; Sugin, *supra* note 114, at 239.

received.”<sup>120</sup> Professor Schenk then identifies difficult computational questions that “make[] it clear that this is not a workable approach.”<sup>121</sup> That being said, the benefits principle is usually taken to counsel in favor of a head tax rather than a progressive tax system of any kind.<sup>122</sup>

Even the opponents of wealth taxation concede that the application of benefits principles is “difficult” and “our intuitions . . . offer only shaky guidance.”<sup>123</sup> Professor Rakowski presents (and rejects) two plausible benefits rationales for wealth taxation. First, “*insofar as* the state’s protective benefits are limited to worldly goods, one might think that it makes sense for the tax to vary with the value of those goods, just as the cost of insuring them does.”<sup>124</sup> Second, “the rich evidently benefit most from economic activity in quantitative material terms and that, speaking very generally, economic flourishing depends on a nation’s security and its suppression of criminal activity.”<sup>125</sup> In sum, reasonable minds could differ about how to apply benefits principles to wealth taxation, given the apparent difficulty of apportionment of costs.

It is probably fair to say that ability to pay, along with other fair sacrifice principles, has dominated other plausible tax justice norms.<sup>126</sup> Yet this leads to difficult questions concerning what these principles mean. Fair sacrifice principles standing alone do not point to a specific tax base.<sup>127</sup> More generally, “the burden of supplying public goods should be allocated among citizens based not on what each receives, but rather on what constitutes a fair contribution.”<sup>128</sup>

Economist Nicholas Kaldor is often cited for the proposition that “[o]nly a combination of income and property taxes can give an approximation to taxation in accordance with ability to pay.”<sup>129</sup> Other scholars have elaborated on the notion that wealth affords benefits in addition to future consumption:

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120. Schenk, *supra* note 117, at 458.

121. *Id.*

122. Rakowski, *supra* note 117, at 304; Schenk, *supra* note 117, at 458.

123. Rakowski, *supra* note 117, at 303.

124. *Id.* at 306.

125. *Id.* at 308.

126. *See supra* notes 3, 117, and accompanying text.

127. *See* Schenk, *supra* note 117, at 458.

128. *Id.*

129. *See* Rakowski, *supra* note 117, at 365 (alteration in original) (quoting NICHOLAS KALDOR, INDIAN TAX REFORM: REPORT OF A SURVEY (1956), *reprinted in* NICHOLAS KALDOR, REPORTS ON TAXATION II, at 31, 58 (1980)).



[W]ealth confers political power, social power, peace of mind, independence, security and, at least in early 21st century United States, great prestige. The power to direct investment of savings to private, rather than public ends, is a further benefit. For some, wealth may not even represent future consumption; accumulation may be an end in itself.<sup>130</sup>

Professor Repetti echoes these themes, albeit in setting forth a different theory of tax justice that supports wealth taxation: “Persons with greater wealth have more to invest and thus can exercise greater control. . . . [T]he selection of investments can exert great influence.”<sup>131</sup>

The typical fairness objections to wealth taxation include that it would be unfair to savers or would unfairly exclude human capital.<sup>132</sup> Professor Schenk persuasively argues that allowing “time preferences” to override the choice of tax base is putting the “cart before the horse.”<sup>133</sup> Professor Schenk also offers a rejoinder to the human capital objection: that including such capital would represent “a significant loss of freedom” and that “it is difficult, if not impossible, to measure human capital accurately.”<sup>134</sup> Human capital exclusion from wealth could also make sense as a rough adjustment in keeping with the perspective of Professors Lily Kahng and Mary Louise Fellows. In their view, workers are systematically denied deductions for expenses that contribute to intellectual capital or the production of income and should be at least in part recoverable.<sup>135</sup>

Scholars generally invoke the diminishing marginal utility of money to justify a progressive tax system.<sup>136</sup> In addition, some have argued that winner-take-all markets buttress this case.<sup>137</sup> However, assumptions about

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130. Schenk, *supra* note 117, at 463-65 (footnotes omitted).

131. See Repetti, *supra* note 114, at 1162.

132. See Rakowski, *supra* note 117, at 365-66; Schenk, *supra* note 117, at 465.

133. Schenk, *supra* note 117, at 461-62.

134. *Id.* at 466.

135. See generally Mary Louise Fellows & Lily Kahng, *Costly Mistakes: Undertaxed Business Owners and Overtaxed Workers*, 81 GEO. WASH. L. REV. 329 (2013); Lily Kahng, *Who Owns Human Capital?*, 94 WASH. U. L. REV. 607 (2017).

136. See generally Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904 (2011) (explaining and critiquing this analytical move).

137. See Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 79 (1998) (“When income is distributed in the manner typical of winner-take-all markets, even conservative assumptions about the rate at which the marginal utility of money declines make it simple to show that a system of progressive taxation can result in greater aggregate utility, and therefore greater

declining utility may be overstated or inaccurate.<sup>138</sup> It may be more intellectually honest to stipulate that egalitarian theories of justice or other rationales for redistribution underlie the choice of a progressive tax system.<sup>139</sup>

Thus, ability to pay, at a superficial level, relates to the available resources of the taxpayer, but, at a deeper level, it is a heuristic for a milieu of policy considerations behind the implementation of a progressive income tax.<sup>140</sup> Redistributive “theories fall into two groups: those that equalize opportunity or resources and those that equalize welfare or outcomes.”<sup>141</sup> Moreover, any plausible theory of distributive justice must account for the importance of luck, talent, and beginning inequality.<sup>142</sup> And all these considerations could be addressed by some form of taxing wealth.<sup>143</sup>

Professor Repetti distinguishes ability to pay and argues that “the underlying goal of distributive justice in a democracy is to establish conditions that will provide equal opportunity for all to participate, [so] the government’s tax system should be designed to impose a burden on the taxpayer’s ability to exert disproportionate influence on the political process.”<sup>144</sup> Another potential refinement of ability to pay is Professor Deborah Geier’s concept of “income available for discretionary use.”<sup>145</sup>

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efficiency, than a system of proportional taxation. In other words, the old equity/efficiency trade-off need not be made. We can have both.”)

138. See Lawsky, *supra* note 136, at 914.

139. See Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 519–20 (1952); Michael A. Livingston, *Blum and Kalven at 50: Progressive Taxation, “Globalization,” and the New Millennium*, 4 FLA. TAX REV. 731, 745–46 (2000) (“The alternate arguments—diminishing marginal utility of money, the benefit theory and the breakup of large concentrations of wealth—were dubious even in Blum and Kalven’s day, and intermediate developments have if anything weakened these further. . . . There is no escaping the redistributive or fairness issue.”).

140. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 30 (4th ed. 2002); LAURIE L. MALMAN ET AL., *THE INDIVIDUAL INCOME TAX BASE: CASES, PROBLEMS, AND POLICIES IN FEDERAL TAXATION* 12–13 (2002); Blum & Kalven, *supra* note 139, at 519–20.

141. Schenk, *supra* note 117, at 471.

142. See GRAETZ & SCHENK, *supra* note 140, at 33.

143. See Schenk, *supra* note 117, at 471–72.

144. Repetti, *supra* note 114, at 1160.

145. Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765, 765 (2006).

Either of these perspectives, however, would appear to accommodate wealth taxation quite comfortably.<sup>146</sup>

*B. Public Opinion on Economic Inequality and Taxation*

Tax reform need not be chained to popular conceptions of ideal tax policy, but public opinion is relevant as a source of inspiration and a gauge of the relative plausibility of policy options and the likely critiques that will resonate politically. Recent work exploring American opinions on inequality and taxation find a complicated set of beliefs. These attitudes would seem to offer both pitfalls and opportunities for progressive tax reform.

In *The Undeserving Rich*, Professor Leslie McCall examines public opinion data from the General Social Survey (GSS) and the National Election Studies, as well as from historical and theoretical sources, to explain American attitudes about inequality and redistribution.<sup>147</sup> Importantly, Americans have consistently shown strong concern about economic inequality as well as the relationship between inequality and opportunity.<sup>148</sup> Professor McCall notes that prior work has generated overly simplistic conclusions about Americans' views of inequality—these could be labeled tolerance, ambivalence, or ignorance.<sup>149</sup>

None of these prior perspectives would seem to offer particularly helpful prescriptions for proponents of progressive income taxation. The “tolerance” and “ignorance” accounts might foreshadow futility or a herculean effort to reduce bias. If “ambivalence” is the correct story, it most likely leaves space for elites to shape the course.<sup>150</sup>

Professor McCall's examination, in contrast, finds that Americans have consistently been concerned about economic inequality and want the government to do more to solve the problem.<sup>151</sup> Although it may be more of an exception than the rule, the perception of inequitable market rewards for labor seems to nudge the population toward intolerance of inequality and

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146. *See id.* at 768, 824 (including “large gratuitous receipts” in the tax base and contemplating a wealth tax); Repetti, *supra* note 114, at 1162 (suggesting wealth and/or income as the tax base to burden a person's ability to exert political influence).

147. LESLIE MCCALL, *THE UNDESERVING RICH* 13-18 (2013).

148. *Id.* at 37 (“Americans are skeptical of the availability of true equality of opportunity and disapprove of existing levels of inequality . . .”).

149. *Id.* at 28-50.

150. *Id.* at 217 (positing that policy ambivalence represents confusion rather than ignorance or hostility and a “need for public elites to lead the way”).

151. *Id.* at 189 (“Americans do increasingly object to inequality, and those who do so also believe government should act to redress it . . .”).

indirectly toward a desire for redistributive policies. Regardless of that tendency, a clear majority of the population has long answered that those with high incomes should pay a larger or much larger share of their incomes in taxes.<sup>152</sup> This pairs oddly with results since 1992, indicating less than a majority answered that taxes for those with high incomes are too low or much too low.<sup>153</sup>

According to Professor McCall's account, prior research had also failed to connect beliefs about inequality to beliefs about opportunity. Professor McCall's nuanced findings portray an America that is concerned about inequality and how it connects with equality of opportunity. Although Americans consistently show that they believe strongly in "bootstraps" opportunity, this does not seem to correlate with their attitude toward economic inequality. Unlike in Europe, luck does not seem to enter much into the equation in American attitudes toward economic inequality.<sup>154</sup> The American view of equality of opportunity, however, appears somewhat paradoxically linked with whether equitable outcomes flow from those opportunities.<sup>155</sup>

Even if Americans are concerned about inequality, and even if they believe that it harms equal opportunity, this might not lead to support for strongly redistributive tax policy.<sup>156</sup> These beliefs could be compatible with regulation of compensation or other nontax solutions.<sup>157</sup> Dramatic changes to top tax rates would appear at odds with prevailing attitudes.

Combining Professor McCall's insights with a more anecdotal approach yields relatively greater hope for progressive tax reform that can be packaged as closing loopholes or forcing the rich to pay their fair share

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152. *Id.* at 198.

153. *Id.*

154. *Id.* at 30 ("Americans have been indoctrinated by economic and political elites to believe that effort is fairly rewarded and government redistribution is unnecessary. Europeans have been swayed by powerful socialist and labor movements to believe that luck determines the class into which one is born and likely to stay, necessitating a compensatory system of social support."). *But see* Weakliem & Biggert, *supra* note 37, at 85 ("The most recent question, from a 2008 Pew survey, finds that more people ascribe wealth to social background than to 'hard work, ambition, or education.'").

155. MCCALL, *supra* note 147, at 37 ("Americans are skeptical of the availability of true equality of opportunity and disapprove of existing levels of inequality, yet support for the free market in principle is strong. The rich deserve to be well compensated for their hard work and contributions to society, yet many of them are overpaid.").

156. *Id.* at 189.

157. *Id.* ("The evidence suggests that Americans may be unsure or uninformed about how to address rising inequality and thus are swayed by contemporaneous debates and portrayals of the issue in the media.").

relative to a current baseline. As Vanessa Williamson chronicles in *Read My Lips*, survey respondents consistently believe that the rich do not pay their fair share and inappropriately take advantage of loopholes.<sup>158</sup> The respondents tend to equate loopholes with deductions.<sup>159</sup> There seems to be no necessary contradiction between these anecdotes and the GSS respondents—the GSS question could be perceived as more of a question about the law whereas a free response opportunity allows respondents to explore the compliance reality. Perhaps the underlying rationale behind the GSS data mined by Professor McCall is that if the rich paid taxes at an effective rate close to that in the tax tables, then their tax burden would not be too low.

This important work on American opinions toward tax and inequality does not suggest that the most aggressive and salient income tax measures to combat inequality—such as radically increased tax rates for the rich—are nonstarters. Yet they do suggest support for measures that would bring the effective tax rate for rich individuals closer to the rates suggested by the tax tables. That may not mean just closing “loopholes. The public may much more readily support mark-to-market or ending step-up at death than more progressive tax brackets.

This is not to say that even closing loopholes—or securing similar tax law changes—would be easy politically. It also does not mean that changes to the top tax bracket are out of the question. It may become even more feasible if American attitudes about the role of luck toward economic inequality were to become more like those in Europe. Given the difficulty of securing tax reform of any kind, to say nothing of progressive tax changes, it seems beneficial to explore changes that do not involve the top tax bracket. Moreover, some of these changes could dramatically increase the tax paid by the wealthy.

It is, to be sure, a jump from “closing loopholes” to the pursuit of asset-based phase-outs set forth in Section III.C. Survey respondents would not

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158. VANESSA S. WILLIAMSON, *READ MY LIPS* 130-31 (2017) (“In 2011, when the Pew Research Center asked Americans what bothered them most about taxes, 57 percent said ‘the feeling that some wealthy people get away not paying their fair share’ . . . . This belief, my interviews reveal, is reinforced by an income-tax filing process that encourages people to imagine that the wealthy are getting a special deal, and in particular, to see loopholes (rather than historically low top marginal rates) as the reason why rich people can avoid paying much in taxes.”); see also *Kaiser Health Tracking Poll*, KAISER FAMILY FOUND., (Jul. 2011), <https://kaiserfamilyfoundation.files.wordpress.com/2013/01/8209-f.pdf> (showing that a majority of those polled believed that “[c]losing tax loopholes for wealthy Americans” would reduce the federal budget deficit).

159. WILLIAMSON, *supra* note 158, at 132-33.

necessarily support or understand this concept. To my knowledge, there have been no studies on American opinions towards tax phase-outs. Clear public opposition towards means-testing of Social Security and Medicare are distinguishable because of the prevailing benefit program logic with respect to those programs.<sup>160</sup>

In sum, means-testing or phase-outs, as a framing device, could be helpful in presenting progressive tax policies. Means-testing has become a familiar conservative refrain with respect to even the most popular government entitlements, Social Security and Medicare. Means-testing may be the frame that goes precisely between the extreme of doing nothing—i.e., relying on the market to fix salaries—and measures that single out the rich for perceived “penalties” such as platinum tax brackets.

### *C. Phase-Outs and Cliffs Create Tax Rate Bubbles*

The scholarly reception to phase-outs ranges from firm opposition at worst<sup>161</sup> to cautious intrigue at best.<sup>162</sup> Proponents of phase-outs point to the

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160. See Jeffrey M. Jones, *Americans Look to Wealthy to Help Save Social Security*, GALLUP (Jul. 29, 2010), <http://www.gallup.com/poll/141611/americans-look-wealthy-help-save-social-security.aspx>; see also Rick Blizzard, *Who Supports Medicare Means Testing?*, GALLUP (Nov. 18, 2003), <http://www.gallup.com/poll/9733/who-supports-medicare-means-testing.aspx> (“But despite the divisive nature of public opinion on Medicare means testing, it is easy to understand why legislators continue to revisit it. What will be the cost of providing the same Medicare access for all seniors? The aging baby boomer generation will soon be eligible for Medicare, and as life expectancy increases, this group will be collecting Medicare longer. This bubble will dramatically increase the overall cost of Medicare.”).

161. See generally Glenn E. Coven, *Congress as Indian-Giver: “Phasing-Out” Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505 (1987); Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1898-1901 (1994); Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405 (1997).

162. See Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Tax Gap*, 65 ALA. L. REV. 139, 161 (2013) (“[T]o promote vertical equity and to prevent the government from losing too much revenue, the [proposed] exclusion should phase out as a shareholder’s income increases.”); Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 731-32 (2003) (“Ultimately, however, phaseouts can be an effective means to enhance vertical equity at a relatively low revenue cost.”); David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 334 (2015) (stating that phase-outs “permit precise income-based allocations. . . . focus[ing] the subsidy where it does the most good” with the “main disadvantage [being] that phase-outs and cliffs increase effective marginal rates”).

ability to target benefits to those who need them, a distributive advantage in improving vertical equity.<sup>163</sup>

The principal trade-off of a phase-out is an effective marginal rate “bubble.” This means that the marginal tax cost of additional income temporarily rises above the rate specified in the tax brackets due to a tax benefit being clawed back, before falling back in line with the brackets once the phase-out is complete.<sup>164</sup> Phase-outs of tax benefits are often, as Professor McCaffery puts it, “in fact changes in the rates because there is a straight-forward relationship between rates and base-definition.”<sup>165</sup> Turning this on its head, Professor McCaffery cautions that phase-outs may be “rather incoherent if one attempted to defend them as matters of base definition.”<sup>166</sup> All other things being equal, it would seem undesirable for “marginal rates to bounce up and down for no apparent reason.”<sup>167</sup>

While policymakers and scholars typically cite cost savings,<sup>168</sup> others have been sharply critical of the cost savings logic. As Professor Shaviro has argued, “Eliminating the phaseout on a revenue-neutral basis would simply mean that some taxpayers’ marginal tax rates would drop while others’ would increase, permitting implementation of a rate structure that might make more sense overall.”<sup>169</sup> And as Professor McCaffery states:

In the case of the phase-outs and the like, Congress is legislating that people at certain income ranges should pay a higher percentage of their incomes in taxes, without regard to the sources of that income. That is, there is no principled decision that certain kinds of “income,” or uses thereof, should be favored or not, only that certain *levels* of income should bear higher burdens—this is essentially a decision about tax *rates*. This point

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163. See Brunson, *supra* note 162, at 180-81 (proposing phase-out of a proposed tax rule in the interest of vertical equity and limiting revenue loss); Donaldson, *supra* note 162, at 724, 731-32; Schizer, *supra* note 162, at 334 (“Phase-outs and cliffs offer a familiar trade-off between programmatic benefits and distribution, on one hand, and excess burden, on the other. These limits permit precise income-based allocations. This can focus the subsidy where it does the most good, especially when subsidies generate private benefits.”).

164. Cf. Shaviro, *supra* note 161, at 409 (criticizing this effect).

165. McCaffery, *supra* note 161, at 1900.

166. *Id.* at 1900-01 (citing the dependency deduction and “increased marriage penalties among the wealthy . . . [that] also have the unfortunate effect of aggravating a bias against secondary earners”).

167. See Shaviro, *supra* note 161, at 409.

168. See, e.g., Brunson, *supra* note 162, at 181.

169. Shaviro, *supra* note 161, at 409.

is most obviously seen in the case of the surcharge or “bubble.”<sup>170</sup>

Moreover, phase-outs increase the complexity of the tax system. By Professor Donaldson’s count some years ago, the Code contained nearly twenty phase-out provisions.<sup>171</sup> Professor Donaldson, however, argued against rejecting phase-outs solely because of complexity at the same time as he criticized the “deceitful” use of phase-outs, particularly in the 1986 tax reform packaged as a tax cut.<sup>172</sup> Indeed, phase-outs can seem like “gimmicks” if their true purpose is simply an across-the-board tax rate increase.<sup>173</sup>

On balance, the considerations weighing against phase-outs merit thoughtful consideration, even for one who cares deeply about the distributive potential for phase-outs. But phase-outs are not monolithic. Asset-based phase-outs raise distinct concerns and potential benefits.<sup>174</sup>

#### *D. Potential Distortions from High Marginal Tax Rates*

Some may accept the premise that economic inequality is costly yet contest that increasing taxes on the wealthy would be a wise solution. An important theme of the tax literature involves balancing the perceived utility gains from redistribution with the potential losses from distortions that may be caused by high marginal tax rates. This “optimal tax” literature is often cited for the proposition that high marginal rates at high incomes will reduce total welfare because taxpayers may substitute leisure if work provides less of a reward. This “substitution effect” is the possibility that opponents of high marginal tax rates point to, while omitting an offsetting income effect.

The received wisdom was that an optimal tax would only reach labor and at a relatively low rate; a fixed cash grant would generate modestly increasing average tax rates.<sup>175</sup> There is another related debate about whether a (progressive) consumption tax should replace, or at least

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170. McCaffery, *supra* note 161, at 1900.

171. See Donaldson, *supra* note 162, at 722 n.376.

172. *Id.* at 731-32.

173. See *id.* at 725 n.395 (citing Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 92 TAX NOTES 1415, 1433-34 (2001); see also McCaffery, *supra* note 161, at 1899.

174. See *infra* Section III.C.

175. McMahan, *supra* note 20, at 1077-78; Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 547 (2013).



supplement, the income tax.<sup>176</sup> Scholars have, however, disputed or varied the assumptions of the optimal tax literature, as well as the implications of those assumptions.<sup>177</sup> For example, the income effect would suggest that taxpayers will compensate for the tax cost by exerting more effort to achieve a higher pre-tax income.<sup>178</sup>

In short, theory does not clearly ordain that higher tax rates would be too distortionary or that capital should be tax-exempt. Renowned economists have argued that the realistic implications of the optimal tax literature include relatively high marginal rates (at least at high incomes) and taxing capital.<sup>179</sup>

A related controversy involves the extent to which the income tax can impose a burden on the return to capital with taxpayers able to make portfolio adjustments. Some have argued that portfolio adjustments would allow most of the return to escape from tax, while others have disputed the underlying assumptions and implications.<sup>180</sup> Even assuming that the income tax does substantially burden the return to capital, an important consideration is the potential for “lock-in” of investments during periods of

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176. See Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); George K. Yin, *Accommodating the “Low-Income” in a Cash-Flow or Consumed Income Tax World*, 2 FLA. TAX REV. 445 (1995).

177. See Chris William Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867, 868-70, 869 n.9 (2010) (reviewing literature critiquing the assumptions of the tax substitution argument before “meet[ing] the argument on its own turf” and rejecting it).

178. See James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 858-59 (2001) (noting that “it is difficult to predict a priori” whether the income effect or substitution effect will predominate).

179. See Daniel Shaviro, *The Mapmaker’s Dilemma in Evaluating High-End Inequality*, 71 U. MIAMI L. REV. 83, 149-50 (2016) (“It is fair to say that the above quasi-consensus, even insofar as it ever held true, no longer does. For example, in recent years, three prominent and indeed ‘A-list’ economists—Nobelist Peter Diamond, possible future Nobelist Emmanuel Saez, and Thomas Piketty—have written . . . that marginal tax rates should be steeply graduated, and indeed should probably exceed 70% at the top of the U.S. income distribution [and] that capital income and inheritances should be taxed, with optimal high-end tax rates in a well-designed estate tax possibly exceeding 50%.”).

180. Compare Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 23 (1996) (explaining the theory that the income tax burdens the risk-free and inframarginal return of a taxpayer’s portfolio “in a manner directly related to their borrowing rate”), with James R. Repetti, *supra* note 114, at 1169-75 (probing assumptions of the theory and concluding that “strong evidence suggests that an annual income tax that limits the deductibility of investment losses burdens high-income taxpayers even though they receive the bulk of their income from investments”).

high capital gains tax rates. Although mark-to-market accounting should solve that problem, under the current system, the lock-in effect of capital gains rates (exacerbated by the potential for step-up in basis at death) presents a substantial roadblock to radically increasing revenue from capital gains.<sup>181</sup>

Empirical studies have examined what real-world relationship, if any, exists among inequality, tax rates, and growth. As Professors Caron and Repetti report, “all nineteen of the published studies that have examined the relationship of high concentrations of income to economic growth at the beginning of a period that extends fifteen years or longer have found that high income concentration correlates with poor economic growth.”<sup>182</sup> This finding may obfuscate other causal relationships. For example, critics of high tax rates would assert that high inequality leads to high taxes and that high taxes in turn lead to low investment.<sup>183</sup> Indeed, one study might be construed to support that claim, to the extent that it concluded that low capital investment led to low growth.<sup>184</sup> Other studies that included tax rates as part of their model rejected the notion that high tax rates reduced growth.<sup>185</sup>

Inherited wealth may be a particularly harmful source of inequality. One study found that gross domestic product is negatively correlated with inherited wealth and positively correlated with self-made wealth.<sup>186</sup> The authors posited ways in which entrenched heirs may engage in anticompetitive behavior.<sup>187</sup>

Whatever the empirical support refuting the harms of high tax rates, this issue is bound to remain contested. To the extent that the relationship

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181. See David Kamin, *How to Tax the Rich*, 146 TAX NOTES 119, 123 (2015).

182. Paul L. Caron & James R. Repetti, *Occupy The Tax Code: Using the Estate Tax to Reduce Inequality and Spur Economic Growth*, 40 PEPP. L. REV. 1255, 1268 (2013).

183. See *id.* at 1264.

184. See Alberto Alesina & Dani Rodrik, *Distribution, Political Conflict, and Economic Growth: A Simple Theory and Some Empirical Evidence*, in POLITICAL ECONOMY, GROWTH AND BUSINESS CYCLES 23 (Alex Cukierman et al. eds., 1992).

185. See Charles B. Garrison & Feng-Yao Lee, *Taxation, Aggregate Activity and Economic Growth: Further Cross-Country Evidence on Some Supply-Side Hypotheses*, 32 ECON. INQUIRY 172, 172 (1992) (sixty-three-country study); Roberto Perotti, *Growth, Income Distribution and Democracy: What the Data Say*, 1 J. ECON. GROWTH 149, 151 (1996).

186. Randall K. Morck et al., *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease?*, in CONCENTRATED CORPORATE OWNERSHIP 319 (Randall K. Morck ed., 2000).

187. *Id.* at 362.

between taxes, inequality, and growth takes a long time to play out, critics will somewhat reasonably allege that the results could have been impacted by other factors.<sup>188</sup> The notion, however, that the reduction of inequality via the tax system spurs economic growth finds substantial theoretical and empirical support.

*E. Valuation of Property*

Taxpayers would have an incentive to undervalue their assets for wealth tax purposes and would generally benefit from an informational advantage compared to the government. The potential for abuse is especially acute if the assets are not publicly traded. Given the likelihood of a low tax rate and the likelihood that taxpayers will engage in creative planning or win valuation disputes,<sup>189</sup> one would naturally ask if only publicly traded property should be included in the tax base.

The limitation of a wealth tax to publicly traded property would, in turn, generate two additional problems. First, apportionment of debt could be complicated, particularly if certain assets are excluded.<sup>190</sup> Second, taxpayers might radically alter their investments to shift toward private equity rather than publicly traded property. Professor Schenk, however, suggests that private equity is not an adequate substitute,<sup>191</sup> indicating that efficiency losses from portfolio adjustments should be minor.

Asset-testing should not be reflexively rejected because potential valuation difficulties. A comparative approach would likely find non-U.S. experience helpful to build on. A significant minority of European nations levy (or have levied) general wealth taxes.<sup>192</sup> In a few Muslim-majority nations, mandatory *zakat* functions as a tax rather than a voluntary contribution.<sup>193</sup> At the time of Professor Lehner's survey, wealth tax rates in

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188. Cf. Caron & Repetti, *supra* note 182, at 1273 (noting that shorter term studies on inequality and growth may be defective because "the relationship is not a short-term relationship," while "long-term studies suggest that other forces may be involved").

189. Cf. Caron & Repetti, *5 Easy Pieces*, *supra* note 18 (describing success of minority discounts, *Crummey* trusts, and Grantor Retained Annuity Trust transactions in reducing estate tax).

190. Cf. Schenk, *supra* note 117, at 452-53.

191. See Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 529-30 (2004).

192. See Moris Lehner, *The European Experience with a Wealth Tax: A Comparative Discussion*, 53 TAX L. REV. 615, 619 (2000).

193. See Russell Powell, *Zakat: Drawing Insights for Legal Theory and Economic Policy from Islamic Jurisprudence*, 7 PITT. TAX REV. 43, 43-44 (2009) ("Zakat (sometimes transliterated as *zakah* in English) is the obligation of almsgiving within Islam. It is the Third

Europe were quite low and generally close to 1% of net wealth.<sup>194</sup> Similarly, although *zakat* rates vary, a default of 2.5% applies.<sup>195</sup> Even while rejecting wealth taxes on grounds of tax justice, Professor Rakowski states:

I am less pessimistic, partly because the experience of European countries with wealth taxes seems to show that they can be administered tolerably well and partly because it seems doubtful that low-level wealth taxes would have much effect on people's work ethic or frugality or alter significantly the mix of assets they hold.<sup>196</sup>

A method of minimizing valuation costs that has been suggested in the mark-to-market context is to levy a retrospective tax upon the disposition of an asset, using a deemed rate of return to approximate the taxpayer's asset values in prior years.<sup>197</sup> It is not apparent that this could be applied to annual wealth taxation or asset-based phase-outs in an administrable way. Another approach could be to use cliffs, especially if only extremely high wealth taxpayers were targeted. There are, to be sure, difficult administrative issues to be confronted in taxing wealth. But the number of countries that have maintained a wealth tax suggests that the idea should not be discarded out of hand.

### III. Potential Income Tax Responses

At the outset, it should be noted that the tax policy options described below are responses rather than perfect solutions to the problems of wealth and income inequality. Multiple approaches, some non-tax, will likely be necessary to reduce inequality.<sup>198</sup> This Article also acknowledges that significant design challenges must be addressed in incorporating taxpayer

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Pillar of Islam and is a requirement for all believers. In the early development of the Islamic community, *zakat* was collected as a tax by the state, and the funds were distributed to defined needy groups.") (footnotes omitted).

194. See generally Lehner, *supra* note 192.

195. See Powell, *supra* note 193, at 51.

196. Rakowski, *supra* note 117, at 271-72.

197. See Schenk, *supra* note 117, at 448.

198. Cf. Repetti, *supra* note 114, at 1160 ("A tax system, by itself, will never achieve absolutely equal access to the political process. Doing so would require confiscatory rates above a certain level of income, which are likely to harm productivity and be politically unacceptable. But the tax system can augment other approaches to achieving equal access to the political process, such as campaign finance reform.").

wealth into the income tax.<sup>199</sup> But there are reasons not to abandon an income-tax-based solution lightly.

First, the income tax is the most salient and familiar tax for most Americans and is the predominant federal revenue source. The perceived fairness of the tax is critical to the success of the voluntary compliance regime. Even if ability to pay is malleable, its resilience and timelessness as a tax equity norm counsels sustained consideration of how to implement it in the income tax. Second, even if other portions of the tax system (for example, the estate tax) do something about wealth inequality more directly, different taxes have different strengths and weaknesses. Thus, it is presumably advantageous for multiple taxes to address the problem of wealth inequality.<sup>200</sup>

Broadly framed, three potential income tax responses are considered below: mark-to-market accounting for assets, bringing back platinum brackets, and rethinking and expanding phase-outs. Each of these three options offers its own mix of advantages and disadvantages.

The familiar options are important, but do not address the problem of wealth inequality so much as the problem of income measurement. Mark-to-market accounting and the tax brackets do not address the situation where taxpayers have equal income but different wealth. To address that potential difference among taxpayers, there would need to be some further step taken to deny tax benefits to individuals with high wealth relative to income. Without mark-to-market accounting, it may be helpful to use penetrative brackets or wealth-based phase-outs as an imperfect substitute for taxing unrealized gains.

#### *A. Mark-to-Market*

Even though the public unduly focuses on the benefits to the wealthy from deduction loopholes,<sup>201</sup> they are correct in spirit. The realization rule structurally embeds undertaxation of investment income by deferring taxation until a sale, exchange, or other disposition of property. The realization rule also works in tandem with the step-up in basis for inherited property,<sup>202</sup> which effectively exempts the decedent's unrealized

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199. *See supra* Part II.

200. *See generally* David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 357 (2015) (“Because all plausible forms of tax measurement are imperfect, it often will be better for governments to utilize multiple forms of tax measurement.”).

201. *See supra* notes 158-59 and accompanying text.

202. I.R.C. § 1014(a) (2012).

appreciation for the heirs. Ironically, these broad rules, which do not necessarily require any expert gamesmanship, are probably not what average citizens have in mind when they criticize loopholes for the wealthy.

The realization rule may amount to trillions of dollars in tax base erosion.<sup>203</sup> Accordingly, it is critical to do something about this problem if the goal is to address differences in wealth within the income tax.<sup>204</sup> As noted above, reforming the realization rule would not really draw distinctions between taxpayers based on their wealth, but it would correct the measurement of income. And without correct income measurement, it would not be clear that truly like taxpayers were being compared if, for example, an asset-based phase-out were adopted.<sup>205</sup>

A mark-to-market tax on property would face administrative challenges, especially with respect to real estate and intangibles. One option would be to embrace the complications because of the importance of doing something about unreported income and the lock-in effect. Moreover, valuation complications can be mitigated by imposing a deferral penalty if the system only applies to easily valued assets.<sup>206</sup> If the penalty were insufficient, however, the lock-in effect would remain.<sup>207</sup>

Although realization and the step-up at death create a powerful effect together, they do not necessarily have to be repealed together. And one would expect section 1014 to fall more easily than the realization rule. Carryover basis—the least transformational alternative to section 1014—would not add much complexity to the tax system. Although section 1014 arguably once had merit for administrative reasons—that it would be difficult to know the decedent’s basis long after his or her death—modern

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203. See generally David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 109 TAX NOTES 1047 (2005).

204. Analysis of the constitutional issues for mark-to-market taxation lies beyond the scope of this Article. It bears mentioning, however, that a more limited mark-to-market regime for dealers in securities has existed for some time. See I.R.C. § 475. This provision has been upheld by the lower federal courts though has never been reviewed by the Supreme Court. See Miller, *supra* note 203, at 1053.

205. See *infra* Section III.C.

206. See David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 100 (1999) (“[T]o have the same effective tax rates, the mark-to-market base must have a lower nominal rate than the realization base.”).

207. Cf. Kamin, *supra* note 181, at 123 n.29 (stating that “[s]uch an approach might help to minimize . . . although certainly not eliminate” planning around the choice of systems).

technology has all but eliminated the need for this unfair and distortionary provision.<sup>208</sup>

In addition, the abolition of section 1014 should enhance efficiency. One of the problems with the realization rule is that it arguably causes taxpayers to retain investments to avoid realizing gain. Neutralizing this lock-in effect is one of the arguments in favor of a capital gains preference. However, the section 1014 exclusion is incoherent vis-à-vis the lock-in rationale. If taxpayers are able to reap the ultimate capital gains preference—complete exemption of all unrealized appreciation via step-up in basis at death—by holding assets for as long as they can, then they have the ultimate lock-in incentive.<sup>209</sup>

Another alternative to carry-over basis is taxation of unrealized gains at the decedent's death. This would completely remove the problem of record keeping for decades and over several taxpayers' lifetimes. It would also be a more effective option to reduce the lock-in effect. Deemed realization at death would not represent additional complexity for taxpayers who already must value their assets in anticipation of the estate tax, though it could conceivably extend that complexity to those who are nowhere near the threshold for estate tax liability.

In sum, repealing the realization rule—or at least section 1014—is critically important to measuring income correctly. Even if these technicalities are nothing like what the public has in mind, this sort of tax reform should tap into public desire to combat loopholes without necessarily raising tax rates. These reform options—even the less dramatic ones—would also appear to offer important efficiency advantages.

The chief drawback is complexity, which falls into two different versions. First, it may prove easy to overstate the reporting burden for the average taxpayer and difficult to counteract misinformation. Although a

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208. Schmalbeck et al., *supra* note 92, manuscript at 23-24) (“In sum, in virtually every sphere, technological advancements are making tax basis identification viable, even after a taxpayer’s death. With respect to the vast majority of valuable assets that a decedent owns (e.g., stock and bond investments and business real estate and equipment), tax basis records are readily accessible. Admittedly, some of the decedent’s assets (e.g., jewelry and title to a residential home) could prove challenging with respect to making accurate tax basis identifications. Insofar as these latter assets are concerned, it is important to recognize that, in many instances, they generally do not comprise the mainstay of a taxpayer’s net worth.”).

209. Admittedly, in terms of lock-in, one could also hope for heirs and their descendants to hold on to their inheritance and borrow to fund any consumption. But with no complete exemption at death available, and the risk that the tax system will probably at some point increase the tax on gains, the benefit of amassing more and more unrealized gains would be dubious.

cliff (for example, limiting the new rules to taxpayers with \$1 million in assets) should counteract that sort of objection, it would be an overreaction and would create strong incentives to plan around the cliff. Second, the difficulty for the public in understanding these rules probably limits their effectiveness in fostering the perception of fairness of the tax system.

It bears repeating that, as important as these measures are in identifying the correct amount of income, they do not do anything to distinguish between taxpayers with equal incomes and different amounts of wealth. For that, this Article suggests looking to a new kind of phase-out, as described in Section III.C.

#### B. “Platinum” Tax Brackets

Higher top marginal tax rates, as well as more penetrative brackets, are worth considering as an indirect means of addressing wealth inequality. As explained in more detail in Section I.B.1, U.S. federal tax history includes both statutory elements.<sup>210</sup> A top bracket of 70% applied throughout the 1970s. In the 1980s, the highest bracket was lowered to 28%, and in the next three decades seesawed until resting at the top marginal rate of 39.6% under current law.

In terms of linking wealth inequality to the income tax, the case in favor of bringing back platinum brackets is less clear than the case for some form of mark-to-market taxation (whether it be wholesale or simply a revision of section 1014). First, although platinum brackets would be salient and easy to understand, and although platinum brackets clearly would not add any compliance burden for the average taxpayer, the public may not agree that the addition of such brackets improves the fairness of the tax system. If, as discussed in Section II.B, the public is focused on closing loopholes, the reception may be neutral or chilly.

Second, the economic trade-offs are more debatable than those of mark-to-market taxation. Although the theoretical case is ambiguous between substitution and income effects, the economics literature provides substantial support that tax rates for ordinary income could be raised significantly without producing an overwhelming countervailing response.<sup>211</sup> In contrast, as Professor David Kamin puts it, “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.”<sup>212</sup> Thus, a mark-to-market system may be a wise prerequisite to seriously considering either

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210. *See supra* notes 61-79 and accompanying text.

211. *See supra* Section II.D.

212. Kamin, *supra* note 181, at 120.



substantially higher capital gains rates or a “Buffett” rule imposing a substantially higher minimum effective rate.<sup>213</sup>

Third, platinum brackets do not test for wealth. However, high income serves as a useful proxy for wealth. And assuming retention of the realization rule, platinum brackets could be thought of as a surtax for unrealized appreciation, using high income as a proxy for unrealized appreciation.

### C. Phase-Out Provisions

The income tax already includes phase-outs, usually by reference to the taxpayer’s AGI or a slightly modified version thereof. For example, miscellaneous itemized deductions are cut by the 2% of AGI floor.<sup>214</sup> Personal exemptions begin to phase out after approximately \$300,000 of income for a married couple.<sup>215</sup> Floors on casualty losses and medical expenses increase with AGI.<sup>216</sup>

With the caveat that several problems arise upon closer inspection, it seems intuitively promising to consider phase-outs that would take into account wealth—and to consider phasing out a wider array of tax benefits. This possibility has received very little attention in the existing literature.<sup>217</sup> Phase-outs are especially worthy of consideration given the popular ambivalence toward more straightforward increases to the top tax rates. For example, the benefit of the income tax brackets below the top 39.6% bracket could be phased out.<sup>218</sup> Without proposing a set of phase-out provisions, this discussion seeks to identify the most promising spaces for phase-outs to address wealth inequality.

Phase-outs are worth further exploration for at least two reasons. First, if the public is resistant to high top tax rates, phase-outs may be easier to enact. Moreover, even if phase-outs taken together add to the complexity of the tax system, and even if income-based phase-outs could be translated into more sensible brackets without bubbles,<sup>219</sup> the phase-out frame

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213. For an explanation of, as well as a more progressive amendment to, the Buffett rule, see Thompson, *supra* note 25.

214. I.R.C. § 62(a) (2012).

215. See I.R.C. § 151(d)(3) (2012); Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

216. I.R.C. §§ 165(h)(2), 213(a) (2012).

217. Lee Anne Fennell’s work on the importance of willpower to economic success recognizes that some tax benefits should be phased out for the wealthy. See Lee Anne Fennell, *Willpower Taxes*, 99 GEO. L.J. 1371, 1427-29 (2011).

218. Cf. I.R.C. § 11 (2012) (imposing a bubble in the corporate tax to claw back the benefit of the lower rate brackets).

219. See *supra* notes 164-170 and accompanying text.

explicitly tailors benefits to need. This is important not just in terms of feasibility but also as an expressive function that may add to the perceived fairness of the system. Second, in an income tax that accurately measures income, an asset-based phase-out may well be the only way to draw distinctions between equal income taxpayers with different wealth. Clearly, the tax system is far from that ideal. But many familiar options that are motivated by the problem of wealth inequality ultimately relate to income measurement rather than wealth inequality among those with the same income.

The central critique levied against phase-outs is that there is no necessity to use phase-outs to control budget impact. Despite the potential allure of tailoring benefits to recipients with greater need, ultimately one must engage with whether the marginal tax rate bubbles that phase-outs effectively create are superior to an alternative schedule without a bubble. That case is difficult, although clearly it has persuaded some tax scholars to argue for income-based phase-outs.<sup>220</sup>

Though asset-based phase-outs would still create bubbles, such phase-outs could not simply be redesigned as income tax bracket adjustments. This assumes that it would be unconstitutional to deem a small percentage of the taxpayer's wealth to be income.<sup>221</sup> Even if the overwhelmingly likely effect of a phase-out is to broaden the tax base, an addition to taxable income on account of mere ownership of property would likely be held a "direct tax."<sup>222</sup>

To recap and refine the foregoing, there are at least three potentially promising functions that an asset-based phase-out in the income tax could further. First, such a provision could serve as a proxy for a wealth tax, though, because the well of income tax benefits runs to a limited depth, this proxy tax would necessarily be quite limited compared to a true wealth tax. Second, it could accomplish a rough tax on unrealized appreciation. Third, even in a mark-to-market income tax, the provision could seek to achieve vertical equity, distinguishing between taxpayers with the same income and different wealth.

Income tests could accomplish the first two functions reasonably well. The rationale would be that high income serves as a reasonable proxy for wealth. Asset-testing could aim to achieve better tailoring at the cost of complexity. There is a relatively limited value, however, in the tax benefits

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220. See *supra* note 162 and accompanying text.

221. See *infra* Section IV.C.

222. See *infra* notes 273-281 and accompanying text.

that could sensibly be put on the table for phase-outs, in relation to the substantial administrative costs of asset-testing. Raising the top tax rates, in contrast, could raise more revenue with fewer administrative costs. Thus, in the absence of preexisting mark-to-market rules, it would seem unduly complex to use asset-tested phase-outs to impose a substitute wealth tax or a substitute tax on unrealized appreciation. A cliff, rather than a phase-out, would likely be the only plausible option without mark-to-market.

Importantly, these two potential functions of phase-outs would not address vertical equity within an ideal income tax. These functions involve horizontal equity or a surrogate wealth tax. The space to address both wealth inequality and vertical equity is narrow and primarily lies at moderate incomes. That is largely because the bite would be nominal for those with extremely high wealth.

To return to the example from the introduction, one might differentiate between an investor whose income consists of \$50,000 of interest on a million-dollar bond and a worker with a \$50,000 salary. An asset test might, for example, deny the standard deduction, personal exemption, lower-rate tax brackets, or personal expense deductions to the investor. At higher incomes, the standard deduction and personal exemption would be useless, so the system would have to look to different attributes, such as itemized deductions or the tax brackets, to make a difference. Assuming that business deductions and capital gains brackets (unless assets were already marked to market) are off the table, the maximum possible distinction that could be made will be limited, particularly in an era with relatively low marginal tax rates.

As an illustration of what could be accomplished, suppose Tara, an unmarried taxpayer, has inherited land with a fair market value of \$6 million and an AGI of \$500,000 from business operations. Assume, for simplicity, that there is no appreciation from year to year. The six lower-rate tax brackets grant Tara a considerable tax benefit. Channeling Tara's AGI through the lower-rate brackets represents a tax benefit worth approximately \$44,000.<sup>223</sup>

This does not necessarily mean that all of the tax benefit to Tara must be phased out. Nor does it tell us at what threshold of assets to begin the phase-out—or whether to use a cliff instead for simplicity. As an example, suppose the goal is to phase out the lower-rate brackets starting at \$2

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223. This assumes 2017 tax brackets. *See* Rev. Proc. 2016-55, 2016-45 I.R.B. 707. The calculation multiplies the difference between the top tax bracket (39.6%) and each of the six lower brackets (10%, 15%, 25%, 28%, 33%, and 35%) by the amount of income that would otherwise be taxed in such lower bracket.

million in assets and to complete the phase-out by \$5 million of assets. That leaves a phase-out range of \$3 million and an income tax bracket range of \$418,400. Accordingly, one option is to start at the top and lower the beginning of the 39.6% bracket by approximately 14 cents per dollar of assets in excess of \$2 million. A distinct option, given that tax rates rise faster at lower incomes, would be to start from the bottom and push income into higher brackets.

The \$2 million figure for Tara's wealth is useful in another sense. It represents a net wealth at which losing approximately \$40,000 in tax benefits approximates a relatively high-rate wealth tax. Wealth taxes normally apply a rate of less than 2%, and \$40,000 represents 2% of \$2 million. Although the potential sources for phase-outs go beyond the brackets, and brackets may be amended, this is a useful starting point for analysis. Meanwhile, if the phase-out is capped at approximately \$40,000 in tax benefits, the impact would necessarily decline in proportion to wealth as wealth increases. A \$40,000 penalty for a taxpayer with wealth of \$20 million would amount to a very minor wealth tax of 0.2%. Hence the prior caveat that the bite would be limited and the distinction would matter most for the merely wealthy as opposed to the super-rich.

Given this phenomenon, a cliff's simplicity benefits could be attractive. A \$2 million cliff could mitigate complexity because the valuation question would be limited to identifying onto which side of the threshold the taxpayer falls rather than identifying a precise value. But cliffs could lead to excessive distortions related to planning around the threshold. Professor Lee Anne Fennell has suggested that modestly randomized cliffs may minimize those distortions with low administrative costs.<sup>224</sup>

This framework, to be sure, leaves important questions for further consideration. Would a cliff be likely to generate considerable distortions? How many taxpayers would be clustered close to the cliff?<sup>225</sup> What assets, if any, should be excluded for purposes of a cliff or phase-out? Should the typical framework of marriage bonuses and penalties apply? Should a cliff or phase-out be adjusted for regional or local differences in cost of living? Each of these issues should be considered further before implementation of asset-based phase-outs.

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224. See Fennell, *supra* note 217, at 1428.

225. IRS data suggests that fewer than three million taxpayers have net worth in excess of \$2 million. See *All Top Wealthholders by Size of Net Worth: Table 1 – Personal Wealth 2007*, IRS STAT. OF INCOME DIV. (Aug. 8, 2017), <https://www.irs.gov/uac/soi-tax-stats-all-top-wealthholders-by-size-of-net-worth> (click on “2007” hyperlink).

#### IV. Constitutional Limitations

A wealth tax would address the problem of wealth inequality more immediately and directly than either the income tax or the estate tax.<sup>226</sup> Notwithstanding those advantages, wealth taxation—and even potentially income tax phase-outs involving asset tests—would present the question of whether the Constitution requires apportionment of the tax.<sup>227</sup> As discussed below, an apportionment requirement would effectively block the tax, because an apportioned tax would be arbitrary and unfair.<sup>228</sup>

##### A. Apportionment Rule for Direct Taxes

The Constitution grants Congress the power to “lay and collect Taxes, Duties, Imposts, and Excises,”<sup>229</sup> provided that “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.”<sup>230</sup> The Constitution further provides that “direct Taxes shall be apportioned among the several States . . . according to their respective Numbers.”<sup>231</sup>

The meaning of “direct tax” appears to have been unclear from the beginning.<sup>232</sup> As a rough gloss, such a tax is “not contingent on anything but being or existence.”<sup>233</sup> Among the likely original purposes for the apportionment rule are protecting large states with low population, protecting states in which slavery was legal, and avoiding crowding out states from levying poll taxes and land taxes.<sup>234</sup>

226. See Daniel Altman, *To Reduce Inequality, Tax Wealth, Not Income*, N.Y. TIMES (Nov. 18, 2012), <http://www.nytimes.com/2012/11/19/opinion/to-reduce-inequality-tax-wealth-not-income.html> (“Wealth inequality has worsened for two decades and is now at an extreme level. Replacing the income, estate and gift taxes with a progressive wealth tax would do much more to reduce it than any other tax plan being considered in Washington.”).

227. See U.S. CONST. art. I, § 9, cl. 4.

228. There are examples of early apportioned taxes to fund wars, and the Civil War income tax was enacted after discussion of a potential property tax. See Brownlee, *supra* note 61, at 15.

229. U.S. CONST. art. I, § 8, cl. 1.

230. U.S. CONST. art. I, § 9, cl. 4.

231. U.S. CONST. art. I, § 2, cl. 3.

232. See *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, 563 (1895) (citing notes of James Madison), *confirmed and expanded*, 158 U.S. 601 (1895); *Springer v. United States*, 102 U.S. 586, 597 (1880) (citing Alexander Hamilton’s briefs); *Hylton v. United States*, 3 U.S. (3 Dall.) 171, 176 (1796) (Patterson, J., concurring) (“no clear and precise idea”); JASPER L. CUMMINGS, JR., *THE SUPREME COURT, FEDERAL TAXATION, AND THE CONSTITUTION* 352 (2013).

233. CUMMINGS, *supra* note 232, at 344.

234. *Id.* at 360-63.

Apportionment of a wealth tax would be an unworkable “fiasco” in that a state’s share of the total tax liability would be “arrived at *without regard to the actual wealth held by the taxpayers in each state*”:

Take two states close to one another in size. Maryland, in the 2010 census, had 5,773,552 people, or 1.87% of the population, while Missouri had 5,988,927 people, or 1.93% of the nation. . . . Maryland in 2010 was a much wealthier state than Missouri. Incomes were higher in Maryland, with \$34,849 per capita, as against \$24,724 in Missouri . . . .

. . . Yet according to the constitutionally required formula, Missourians collectively will have to pay about the same, or a little more, in federal wealth tax, than Marylanders.<sup>235</sup>

Such a system would impose a fundamentally unfair burden on states, and by extension taxpayers, where there is high population relative to wealth. The following subsections examine the triggers for the apportionment requirement.

#### *B. Scope of the Apportionment Rule*

As Justice Chase recognized in the seminal case of *Hylton v. United States*,<sup>236</sup> apportionment and uniformity<sup>237</sup> are a dichotomy<sup>238</sup>—a direct tax that must be apportioned will apply different rates to the same base:

For example: Suppose two States, equal in census, to pay 80,000 dollars each, by a tax on carriages, of 8 dollars on every carriage; and in one State there are 100 carriages, and in the other 1000. The owners of carriages in one State, would pay ten times the tax of owners in the other. A. in one State, would pay for his

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235. Matthew J. Franck, *The Constitutional Fiasco of a Wealth Tax*, NAT’L REV. (Nov. 19, 2012) <http://www.nationalreview.com/bench-memos/333660/constitutional-fiasco-wealth-tax-matthew-j-franck>.

236. 3 U.S. (3 Dall.) 171 (1796).

237. See U.S. CONST. art. I, § 8, cl. 1 (requiring duties, imposts, and excises to be uniform). Cummings suggests that the Court “mostly employed the term indirect as a simplistic label for imposts, duties, and excises.” CUMMINGS, *supra* note 232, at 340 (positing that the Court assumed such taxes could not be direct because of constitutional requirement of uniformity).

238. *Hylton*, 3 U.S. at 173 (observing that Congress “were to observe *two* rules in imposing [them], namely, the rule of *uniformity*, when they laid *duties, imposts, or excises*; and the rule of *apportionment*, according to the *census*, when they laid any *direct tax*”); see also CUMMINGS, *supra* note 232, at 342.

carriage 8 dollars, but B. in the other state, would pay for his carriage, 80 dollars.<sup>239</sup>

Justice Chase observed that the rate differential would lead to “great inequality and injustice.”<sup>240</sup>

Justice Chase then extended this observation to a general principle that it would be “unreasonable” to infer that the Constitution would require Congress to adopt the apportionment method when its application would be unjust.<sup>241</sup> To avoid arbitrary variation in tax rates, the Court held that the carriage tax was constitutional without apportionment.<sup>242</sup> The same injustice would seemingly follow, however, if Congress taxed land via the apportionment method. Yet Justice Chase posited in dictum that the only taxes contemplated by the “direct tax” language are “a capitation, or poll tax” and “a tax on LAND.”<sup>243</sup> In sum, the Court’s first foray into defining “direct tax” suggests that the concept should be extremely narrow to limit unjust outcomes.

Professor Joseph Dodge offers two insights that buttress the *Hylton* logic. First, population was viewed as a proxy for land wealth, which would tend to limit the variation in effective tax rates on an apportioned land tax.<sup>244</sup> Second, if apportionment was included to satisfy Southern interests, a narrow construction would further that purpose more than a broad construction:

*Apportionment according to population requires that poorer per-capita (i.e., Southern) states be discriminated against. This effect would have been compounded by the fact that slaves counted as three-fifths, resulting in an increase in the quotas of the slave states without any accompanying increase in any likely tax base (except a property tax in which slaves were counted). In sum, the regional-oppression rationale for apportionment*

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239. *Hylton*, 3 U.S. at 174.

240. *Id.*

241. *Id.*

242. *Id.* at 183.

243. *Id.* at 175 (capitalization in original). The opinions of Justices Paterson and Iredell agree on this limited scope. *See id.* at 177 (Paterson, J.); *id.* at 183 (Iredell, J.). Justice Wilson’s crisp opinion concurs that the tax is constitutional without further explanation. *Id.* at 183-84 (Wilson, J.).

244. *See* Joseph M. Dodge, *What Federal Taxes Are Subject to the Rule of Apportionment Under the Constitution?*, 11 U. PA. J. CONST. L. 839, 921, 924 (2009).

actually favors a *narrow* concept of “direct tax” that is *limited* to taxes on real estate, plus capitation taxes and requisitions.<sup>245</sup>

Professor Dodge nevertheless concludes that “direct tax” should encompass ad valorem taxes on any property except intangibles.<sup>246</sup>

Professor Dodge’s central thesis is that some coherent principle must account for the accepted and uncontroversial categories of requisitions, head taxes, and land taxes, all of which require apportionment.<sup>247</sup> Professor Dodge observes that “[a]pportionment *among states requires that any item subject to the tax have a definite geographical location in a state*, because the tax rate for a state is the state’s quota divided by the value (or quantity) of the subject of the tax within the state.”<sup>248</sup>

The practical necessity of a physical situs for apportionment persuasively explains why the original meaning of “direct tax” may have excluded a tax on intangibles from the apportionment rule. But if one utilizes a formalist approach (limited to capitations, requisitions, and land taxes), a tax on tangible personal property should not be construed as a direct tax simply because it is (functionally) capable of being apportioned.<sup>249</sup>

After a long period without hearing direct tax cases, the Supreme Court arguably applied a deferential, formalistic approach in cases after the Civil War.<sup>250</sup> As Jasper Cummings explains:

Up to 1895 the Court identified direct taxes based on the form in which Congress had chosen to cast the tax: if Congress did not apportion a tax, and particularly if Congress called it an excise tax, the Court uniformly ruled it was not a direct tax that had to be apportioned.<sup>251</sup>

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245. *Id.* at 893 (footnote omitted).

246. *Id.* at 843, 922.

247. *See id.*

248. *Id.* at 922.

249. *Cf. Hylton v. United States*, 3 U.S. (3 Dall.) 171, 178 (1796); Dodge, *supra* note 244, at 924 (noting that formalism “has its upside in the present context”).

250. *See Springer v. United States*, 102 U.S. 586, 602 (1880) (noting Civil War income tax not a direct tax); *Pac. Ins. Co. v. Soule*, 74 U.S. (7 Wall.) 433, 446 (1869) (holding that a tax on insurance company premiums not a direct tax); *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533, 549 (1869). Importantly, cases decided after *Pollock* seem to follow *Hylton*’s rationale. *See infra*.

251. CUMMINGS, *supra* note 232, at 67. Cummings posits two explanations for the Supreme Court’s reticence to strike down taxes on substance over form grounds: a kind of tax exceptionalism in deferring to Congress on tax matters, and that “perhaps the Court wearied of contending with economic distinctions that were basically irresolvable.” *Id.* at 70.



Even after 1895, the Supreme Court only once struck down a tax as a direct tax and otherwise distinguished taxes burdening capital, generally concluding that they could qualify as excises. Thus, there appears to be at least a plausible argument that Congress may enact a wealth tax on personal property even if a land tax must be apportioned.<sup>252</sup>

### C. Potential Loopholes and Pitfalls

The invalidation of the 1894 federal income tax as an unapportioned direct tax is hard to square with the narrow scope articulated in *Hylton*.<sup>253</sup> Moreover, income taxes had been enacted and collected during the Civil War era and were upheld in *Springer v. United States*.<sup>254</sup> The last Civil War era income tax expired in 1871.<sup>255</sup> In 1894, Congress enacted a new income tax, which was promptly challenged as unconstitutional.<sup>256</sup> The Supreme Court in *Pollock v. Farmers' Loan & Trust Co.* held that the income tax was a direct tax that was unconstitutional for want of apportionment.<sup>257</sup> The Court essentially looked through rental income to the source, the land, "unable to perceive any ground for the alleged distinction."<sup>258</sup>

The Sixteenth Amendment neutralized the *Pollock* Court's look-through logic with respect to income and freed Congress to enact an income tax in

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Cummings notes, "When Congress episodically chose during the 1800s to collect taxes from persons based on the value of property they owned, it apportioned the total tax revenue desired among the states, according to the census." *Id.* at 339.

252. Scholarship in this area is diverse. *See, e.g.*, Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 42-43 (1999) (apportionment repealed by Thirteenth Amendment); Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes,"* 33 ARIZ. ST. L.J. 1057, 1091-107 (2001) (defending tax shifting analysis and extending to consumption tax); Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 CONST. COMMENT. 295, 297-99 (2004) (arguing that apportionment applies only if equitable, primarily reducing the scope to universal capitations and requisitions); Schenk, *supra* note 117, at 441-42 (suggesting that recharacterization as an income tax can save a broad-based wealth tax).

253. *Cf.* CUMMINGS, *supra* note 232, at 344 ("The foregoing generalities forecast the difficult questions: what about taxes that appeared to be imposed on the ownership of property other than land, and what about taxes that fell indirectly on land; are excises on the use of property in a certain way direct or indirect?").

254. 102 U.S. 586 (1880).

255. Sheldon D. Pollack, *The First National Income Tax, 1861-1872*, 67 TAX LAW. 311, 330 (2014) (noting debate in favor of an extension but that allowing the tax to expire was "the path of least resistance").

256. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 433 (1895), *confirmed and expanded*, 158 U.S. 601 (1895).

257. *Id.* at 583.

258. *Id.* at 580-81.

1913. The Sixteenth Amendment did not, however, abolish other constitutional tax requirements.<sup>259</sup> Cummings argues that “the abandonment of lookthrough was limited . . . presumably leaving any other federal tax that was not an income tax subject to being found to be a tax on property ownership.”<sup>260</sup>

The Court had reasoned that direct taxes cannot be shifted, and because a tax on income from land cannot be shifted, such a tax is direct.<sup>261</sup> This test did not follow from *Hylton* and failed to account for the high likelihood of shifting taxes on land to tenants.<sup>262</sup> *Pollock*, upon rehearing, extended the scope of “direct tax” to a tax on “invested personal property” or the income from such property.<sup>263</sup>

Not long after the Court decided *Pollock*, it undermined the underlying logic of the opinion. In 1900, the Court rejected the tax shifting rationale in deciding that an estate tax was not a direct tax.<sup>264</sup> In 1904, the Court upheld a gross receipts tax on sugar refiners.<sup>265</sup> And in 1911, the Court distinguished the corporate income tax as an excise tax,<sup>266</sup> arguably using a “form over substance” approach.<sup>267</sup> However, in *Eisner v. Macomber*,<sup>268</sup> the Court held that “to tax without apportionment a stockholder’s interest in

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259. See CUMMINGS, *supra* note 232, at 393 (citing *Brushaber v. Union Pac. R. Co.*, 240 U.S. 1, 12, 18-19 (1916); *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916) (“dealing solely with the restriction imposed by the Sixteenth Amendment on . . . putting it in the class of direct, to which it would not otherwise belong, in order to subject it to the regulation of apportionment”)).

260. *Id.*

261. *Pollock*, 157 U.S. at 558 (“Ordinarily all taxes paid primarily by persons who can shift the burden upon some one else, or who are under no legal compulsion to pay them, are considered indirect taxes; but a tax upon property holders in respect of their estates, whether real or personal, or of the income yielded by such estates, and the payment of which cannot be avoided, are direct taxes.”).

262. See CUMMINGS, *supra* note 232, at 71. Surprisingly, a consumer sales tax presumably is not a direct tax, even though its burden could be difficult to shift. *Id.* Chief Justice Fuller, author of the majority opinion in *Pollock*, has been described as “the prime example of that luckiest of all persons known to the law—the innocent third party without notice.” *Id.* at 73 (citing BERNARD SCHWARTZ, A HISTORY OF THE SUPREME COURT 175 (1993)).

263. *Pollock*, 158 U.S. at 628-29.

264. *Knowlton v. Moore*, 178 U.S. 41, 88 (1900); see also CUMMINGS, *supra* note 232, at 379.

265. *Spreckels Sugar Ref. Co. v. McClain*, 192 U.S. 397 (1904).

266. *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

267. See CUMMINGS, *supra* note 232, at 68.

268. 252 U.S. 189, 218 (1920).

accumulated earnings prior to dividend” declaration was “overruled” by *Pollock*.

Most recently, in 2012 the Court, citing *Hylton*, *Pollock*, and *Macomber*, grappled with the meaning of “direct tax” in upholding the shared responsibility payment,<sup>269</sup> triggered by meeting an income threshold and failing to obtain health insurance.<sup>270</sup> But the significance of a hat tip to *Pollock* and *Macomber* should not be overstated.

To conclude that the shared responsibility payment is “plainly not a tax on the ownership of land or personal property” is hardly a ratification of the underlying logic of the expansionist cases.<sup>271</sup> Moreover, this conclusion, far from embracing that logic, seems to undermine it. Arguably, the Court took care to apply the requirement that was misapplied in *Pollock*, that the payment “cannot be avoided.”<sup>272</sup>

Professor Erik Jensen argues to the contrary: that despite the “sloppy” opinion, it is “hard to read” the opinion other than to imply that taxes on income from property are “direct.”<sup>273</sup> Professor Jensen concedes that “some unapportioned federal taxes on property might be shoehorned into the ‘taxes on income’ box.”<sup>274</sup> Specifically, the Court in *NFIB* contemplated the example of a penalty on houses without energy efficient windows, adjusted for income, filing status, and reported on a tax return.<sup>275</sup> The opinion finds no fault in this hypothetical, clearly concluding that the penalty constitutes a “tax,” but failing to specify whether it is a tax on income or otherwise direct.<sup>276</sup>

To trigger apportionment for an income tax provision, a court would have to distinguish the shared responsibility payment, which was held not to be a direct tax. It would also need to differentiate an income tax penalty from the income tax penalty for windows clearly contemplated as a valid tax in *NFIB*. The underlying rationale is a mystery, but the facts of the case and the hypothetical suggest that the Court would be reluctant to strike down income taxes that distinguish between taxpayers because of their personal characteristics or property. An asset-based phase-out would seem

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269. See I.R.C. § 5000A(b) (2012).

270. Nat’l Fed’n of Indep. Bus. v. Sebelius, 567 U.S. 519, 570-71 (2012).

271. *Id.* at 571.

272. See *Pollock*, 157 U.S. at 558, 628-29; CUMMINGS, *supra* note 232, at 71.

273. Erik M. Jensen, *Did the Sixteenth Amendment Ever Matter? Does It Today?*, 108 NW. U. L. REV. 799, 818-19 (2014).

274. *Id.* at 821.

275. *NFIB*, 567 U.S. at 569.

276. *Id.*; Jensen, *supra* note 273, at 822.

to be analogous to the drafty windows tax penalty from *NFIB*. Notably, the shared responsibility payment and the hypothetical window surtax are avoidable if the taxpayer has no income.

Professor Schenk's insight that an ex ante wealth tax can be a proxy for a low-rate income tax<sup>277</sup> is analytically appealing. But this essentially turns *Pollock*'s "look-through" on its head, by looking through a mass of wealth to approximate the income. This logic seems vulnerable. Although Professor Schenk's motivation is, in part, to anticipate portfolio adjustments that would reduce the tax burden,<sup>278</sup> a court would probably ask why not mark-to-market? Perhaps the fatal flaw of distinguishing income from wealth, in the absence of any discernible cash flows or appreciation, is that the tax would be automatic and inescapable. Although asset-based phase-outs may be practically inescapable and would increase a taxpayer's effective rate of tax, the implicit no-income escape hatch represents a substantive difference from a direct tax.

In sum, it is unlikely that a federal wealth tax may reach land. Even Justice Chase's opinion in *Hylton*, applying a rule of reason, presupposed that a land tax would be a direct tax.<sup>279</sup> It is perhaps more plausible that the Court would overrule *Pollock* and uphold an unapportioned federal wealth tax on personal property.<sup>280</sup> In contrast, an income tax with asset-based phase-out provisions seems unlikely to trigger apportionment, given the latest gloss on "direct tax" in *NFIB*.<sup>281</sup>

### V. Conclusion

This Article has explored how the federal tax system has slumped while wealth and income inequality have intensified. It has drawn from a number of perspectives, including theories of tax justice, research on public opinion, and economic perspectives, to legitimize a wealth-based response in the income tax. Although a wealth tax could be a more powerful antidote, the Article seeks a work-around in light of the limitations of the Constitution's apportionment rule and avoids relying on the estate tax.

In the wake of the election of 2016, it remains imperative to envision new responses to inequality through the tax system. This Article has taken

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277. See Schenk, *supra* note 117, at 441 ("To pass constitutional muster, the wealth tax proposed here easily could be reframed as an income tax with a base equal to the risk-free return to certain assets.").

278. *Id.* at 436-41.

279. See *supra* notes 236-243 and accompanying text.

280. See *supra* notes 261-263 and accompanying text.

281. See *supra* notes 269-276 and accompanying text.

initial steps toward designing wealth-based phase-outs in the income tax. Although the effect of such phase-out provisions would be modest, asset-based phase-outs in the income tax should be able to pass muster under the Constitution without apportionment. Moreover, phase-outs would appear to be more consistent with the limitations of current public opinion than estate tax reform.

Trump-style populism seems unlikely to result in sharply progressive tax policy, particularly in terms of the top income tax rate or the estate tax. Moreover, the House tax reform bill is contrary to then-candidate Trump's calls during the campaign of 2016 for curtailing the step-up in basis at death and deferral of foreign income.<sup>282</sup> It is possible, however, that the million-dollar income bracket implementing a tax cut under the House bill<sup>283</sup> will someday be cited and repurposed to implement more progressive tax rates.

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282. *See supra* note 4 and accompanying text. The TCJA, however, proposes to terminate the estate tax after 2024 without ending the step-up in basis. TCJA §§ 1601-1602. It would also provide an exemption for the foreign-source portion of dividends from foreign corporations to certain U.S. corporate shareholders. TCJA §§ 4001. As this Article goes to press, President Trump has expressed support for the TCJA without addressing these provisions that are seemingly at odds with his prior statements. *See* Press Release, The White House, Office of the Press Sec'y, Statement from the President on the Tax Cuts and Jobs Act (Nov. 2, 2017), <https://www.whitehouse.gov/the-press-office/2017/11/02/statement-president-tax-cuts-and-jobs-act>.

283. TCJA § 1001(a).