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## Comparing Capital Income and Wealth Taxes

Ari Glogower

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# Comparing Capital Income and Wealth Taxes

Ari Glogower\*

## *Abstract*

*As part of the Pepperdine Law Review Symposium The Impact of the 2017 Tax Act on Income and Wealth Inequality: Lessons for 2020 and Beyond, this Essay compares two reform directions to rebuild the progressive tax system: an improved capital income tax—which would eliminate the benefit from deferring gains until a sale—or a wealth tax.*

*The Essay first introduces the concept of a “rate-equivalent” wealth or capital income tax as a way to assess reform alternatives consistently and to identify the assumptions as to how the reforms would be structured. For any chosen capital income tax (or wealth tax) reform, the rate-equivalent wealth tax (or capital income tax) is the tax yielding the same tax liability for a taxpayer earning a specified investment return rate. The Essay then illustrates how this concept can help illuminate the assumptions behind comparisons of wealth tax and capital income tax reforms in the literature.*

*Some views in the literature suggest that policymakers should favor an improved capital income tax because the two reforms can have comparable economic effects, while a capital income tax is more desirable in other respects.*

*The Essay surveys the literature evaluating three aspects of these reforms—their economic effects, administrability and avoidance opportunities, and constitutionality—and offers additional perspective on how in each area the distinctions between the two reforms are often narrower than they are sometimes assumed to be in the literature. In many cases the analysis of these reforms will also depend on the particular manner in which*

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*each reform is structured or the baseline against which the reform is measured. For this reason, policymakers should not reach categorical conclusions that one reform direction is intrinsically more desirable than the other.*

*The Essay concludes by considering one respect in which an improved capital income tax or a wealth tax can unambiguously differ: as different measures for comparing taxpayers in a progressive tax system. This distinction, however, will depend on the normative choice as to how inequality should be measured and mitigated by the tax system. For example, the choice between a capital income tax and a wealth tax could have different consequences, depending upon whether one assumes that the progressive tax system should mitigate differences in utility, income, wealth, or a combination thereof.*

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## I. INTRODUCTION

As part of this Symposium on *The Impact of the 2017 Tax Act on Income and Wealth Inequality: Lessons for 2020 and Beyond*, this Essay compares two reform directions to rebuild the progressive tax system: an improved capital income tax that eliminates the benefit from deferring gains until a realization event, or a wealth tax.

The 2017 tax legislation<sup>1</sup> introduced structural changes that primarily benefitted the wealthiest taxpayers and reduced the progressivity of the tax system.<sup>2</sup> The legislation also exploited and compounded design problems in the current income tax system which inhibit the fair and efficient taxation of investment income,<sup>3</sup> so that its regressive changes could entrench a less progressive tax system over time.<sup>4</sup> An improved capital income tax and a wealth tax represent the two most promising reform directions to reverse these trends and to restore fairness to the tax system.<sup>5</sup>

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1. Pub. L. No. 115-97, 131 Stat. 2054 (2017).

2. Among its most prominent changes, the legislation nearly halved the corporate tax rate and introduced a new deduction for income earned through “pass-through businesses.” *Id.* at § 13001 (codified at I.R.C. § 11 (2017)) (reduction in the corporate tax rate); § 11001 (codified at I.R.C. § 199A (2017)) (new pass-through business deduction). For discussion of these changes and their effects, see David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1445, 1459–61 (2019). The legislation delivered its greatest benefits to higher income taxpayers, in both absolute and relative terms. *Id.* at 1445–58. One contemporary study estimated that taxpayers in the bottom income quintile would receive a tax cut equivalent to only 0.4% of their after-tax income, or approximately \$60. TAX POLICY CENTER STAFF, DISTRIBUTIONAL ANALYSIS OF THE CONFERENCE AGREEMENT FOR THE TAX CUTS AND JOBS ACT 3–4 (2017), [https://www.taxpolicycenter.org/sites/default/files/publication/150816/2001641\\_distributonal\\_analysis\\_of\\_the\\_conference\\_agreement\\_for\\_the\\_tax\\_cuts\\_and\\_jobs\\_act\\_0.pdf](https://www.taxpolicycenter.org/sites/default/files/publication/150816/2001641_distributonal_analysis_of_the_conference_agreement_for_the_tax_cuts_and_jobs_act_0.pdf). This study estimated that taxpayers in the top income percentile would receive a tax cut equivalent to 3.4% of their after-tax income, or approximately \$51,000. *Id.* at 3. U.S. Treasury researchers estimated that 72% of the total savings from the new Section 199A pass-through deduction accrue to the top 5% of taxpayers. LUCAS GOODMAN, KATHERINE LIM, BRUCE SACERDOTE & ANDREW WHITTEN, U.S. TREASURY OFFICE OF TAX ANALYSIS, SIMULATING THE 199A DEDUCTION FOR PASS-THROUGH OWNERS 13 (2019). The changes in the 2017 legislation compounded the trend of declining overall progressivity in the tax system. See, e.g., CONG. BUDGET OFFICE, PROJECTED CHANGES IN THE DISTRIBUTION OF HOUSEHOLD INCOME, 2016 TO 2021, at 12–16, 17–19 (2019) (finding that growth in household income, after taxes and transfers, has increased much more quickly at the top of the income distribution in recent years, in part because of the declining progressivity of the tax system).

3. See *infra* Section II.A. (describing how the current rules for taxing capital income inhibit progressive taxation).

4. See Ari Glogower & David Kamin, *The Progressivity Ratchet*, 104 MINN. L. REV. 1499, 1550–75 (2019) (describing how, absent structural reforms, lower taxes on corporations and pass-through businesses can inhibit progressive taxation throughout the tax system).

5. See generally David Kamin, *How Far to Go in Reforming Taxation of Wealth: Revenue and*

Although an improved capital income tax and a wealth tax could have similar economic effects,<sup>6</sup> the two reforms would be structured differently and would tax different bases.<sup>7</sup> The Essay first introduces the concept of a “rate-equivalent” wealth or capital income tax as a way to assess reform alternatives consistently and to identify the assumptions underlying any comparison as to how the reforms would be structured.<sup>8</sup> For any chosen capital income tax (or wealth tax) reform, the rate-equivalent wealth tax (or capital income tax) is the reform alternative yielding the same tax liability for a taxpayer earning a specified investment return rate.<sup>9</sup> The Essay then illustrates how this concept can help illuminate the assumptions behind comparisons of wealth tax and capital income tax reforms in the literature.<sup>10</sup>

The Essay then considers comparisons of the two reforms.<sup>11</sup> One general line of reasoning in the literature as to which reform is more desirable may be characterized as follows: The economic objectives of a net wealth tax can be achieved through an improved capital income tax. At the same time, a wealth tax would face other possible problems, such as potential challenges of administrability and constitutionality.<sup>12</sup> Even more abstractly, this argument may be characterized as follows: A wealth tax and a capital income tax are similar in critical respects, but a wealth tax is detrimental in other respects; therefore, policymakers should favor the latter.

This Essay argues, however, that this argument can just as easily run in the opposite direction: The areas of overlap and difference between an improved capital income tax and a wealth tax can also indicate the relative

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*Tax Avoidance*, 168 TAX NOTES FED. 1225, 1225–34 (2020) (describing a wealth tax and a capital income tax reform as two fundamental reform options to raise revenue and address economic inequality, which are likely to be more effective than more modest incremental reforms).

6. *See infra* Section III.A.

7. *See infra* Sections II.B., II.C.

8. *See infra* Section III.A.

9. *See infra* Section III.A.

10. *See infra* notes 62–71 and accompanying text.

11. Of course, policymakers need not consider these two reforms as mutually exclusive and may instead consider methods to coordinate the taxation of both capital income and wealth. *See generally* Ari Glogower, *Taxing Inequality*, 93 N.Y.U. L. REV. 1421 (2018) (describing the role of both income and wealth in a progressive tax system and how the two measures may be integrated in a single tax instrument).

12. *See, e.g.*, Alan S. Blinder, *Wealth Tax Is a Decent Idea, Though Probably Unconstitutional*, WALL STREET J. (Dec. 5, 2019, 7:11 PM), <https://www.wsj.com/articles/wealth-tax-is-a-decent-idea-though-probably-unconstitutional-11575591063> (arguing that capital income tax reforms can achieve similar economic effects as would a wealth tax with less constitutional risk).

desirability of a wealth tax, rather than just the advantages of a capital income tax.<sup>13</sup> Furthermore, the same design challenges in implementing a wealth tax can also pose challenges to capital income tax reforms, depending on how the capital income tax reform is structured.<sup>14</sup>

The Essay surveys the literature evaluating three aspects of these reforms—their economic effects, administrability and avoidance opportunities, and constitutionality—and offers additional perspective on how, in each area, the distinctions between the two reforms are often narrower than they are sometimes assumed to be in the literature.<sup>15</sup> In many cases, the analysis of these reforms will also depend on the particular manner in which each reform is structured or the baseline against which the reform is measured.

Because of these similarities, policymakers should not reach categorical conclusions that one reform direction is intrinsically more desirable than the other. While policymakers should take seriously the challenges in

13. See *infra* Part IV.

14. See *infra* Section III.B.

15. See *infra* Part III. This brief Essay highlights certain salient considerations in the choice between a wealth tax and capital income tax reforms but does not offer a comprehensive analysis of every policy aspect of these instruments or the choice between them. For recent works on the distinctions between capital income and wealth taxes, see generally ORG. FOR ECON. CO-OPERATION & DEV., Tax Policy Studies No. 26, *THE ROLE AND DESIGN OF NET WEALTH TAXES IN THE OECD* (2018) [hereinafter OECD] (assessing net wealth taxes, personal capital income taxes, and wealth transfer taxes); Lily Batchelder & David Kamin, *Policy Options for Taxing the Rich*, in *MAINTAINING THE STRENGTH OF AMERICAN CAPITALISM* 200–234 (Melissa S. Kearney & Amy Ganz eds., 2019), <https://www.economicstrategygroup.org/publication/maintaining-the-strength-of-american-capitalism/> (discussing four tax proposals that would tax the wealthy in order to increase revenue); Miranda Perry Fleischer, *Not So Fast: The Hidden Difficulties of Taxing Wealth*, 58 *NOMOS WEALTH VOLUME* 261, 284–85 (2017) (describing design challenges with a wealth tax); David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 *N.C. L. REV.* \_\_\_ (forthcoming 2021); Ari Glogower, *Taxing Capital Appreciation*, 70 *TAX L. REV.* 11, 128–42 (2016) (describing reform options for a capital income tax); Daniel Hemel, *Taxing Wealth in an Uncertain World*, 70 *NAT'L TAX L. REV.* 128–42 (2016) (describing different potential obstacles to either a wealth tax or capital income tax reform); Kamin, *supra* note 5 (comparing the revenue raising potential of a wealth tax and capital income tax reform with more modest incremental reforms); Greg Leiserson, *Taxing Wealth*, in *TACKLING THE TAX CODE: EFFICIENT AND EQUITABLE WAYS TO RAISE REVENUE* 89–147 (Jay Shambaugh & Ryan Nunn eds., 2020) (detailing four proposals that would strengthen the tax base of and increase the tax rate on the wealthy); Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 *HOWARD L.J.* 319, 321–35 (2010) (describing the benefits of a wealth tax over an income tax as a method for redistribution); Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation*, *BROOKINGS PAPERS ON ECON. ACTIVITY*, at 437, 438, 469–85 (2019) (describing the progressive effects of a wealth tax); Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 *TAX L. REV.* 423 (2000) (proposing a tax on wealth through a capital income tax reform); David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 *TAX L. REV.* 499, 500–31 (2000) (proposing and evaluating a wealth tax).

implementing either reform, it would also be a mistake to overstate these challenges or to presume they are categorically unique to one reform or the other.

The Essay concludes by considering one respect in which an improved capital income tax or a wealth tax can unambiguously differ: as different measures for comparing taxpayers in a progressive tax system.<sup>16</sup> From this perspective, a wealth tax may yield unique advantages over a capital income tax, as a different measure of a taxpayer's economic circumstances. This distinction, however, will depend in turn on normative choice as to the measure of inequality that the progressive tax base should ameliorate. For example, the choice between a capital income tax and a wealth tax will have different consequences, depending upon whether one assumes that the progressive tax system should ameliorate differences in utility, income, wealth, or a combination thereof.<sup>17</sup>

The remainder of the Essay proceeds as follows. Part II briefly reviews the current rules for taxing capital income, the problems with these rules, and the alternative possible directions of an improved capital income tax or a wealth tax. Part III introduces the concept of rate-equivalent capital income or wealth taxes, describes different aspects of the similarities and differences between the two possible reform directions, and explains why both face similar challenges and considerations. This Part also explains how the analysis may depend more on the particular structure of these reforms than on their formal labels. Part IV then considers the differences between a capital income tax and a wealth tax as different measures for comparing taxpayers in a progressive tax system.

## II. THE DESIGN OF CAPITAL INCOME AND WEALTH TAXES

### A. *Current Law*

The federal income tax base notionally includes “all income from whatever source derived,”<sup>18</sup> including capital income earned in the form of

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16. *See infra* Part IV.

17. *See infra* Section IV.B.

18. I.R.C. § 61(a) (2017). The Code also explicitly excludes certain items from income, in I.R.C. §§ 101–140.



business income,<sup>19</sup> capital gains,<sup>20</sup> interest,<sup>21</sup> dividends,<sup>22</sup> or otherwise.<sup>23</sup> In practice, however, the realization rule—which defers tax on capital gains until the time of a sale or exchange<sup>24</sup>—allows taxpayers to avoid or reduce the tax owed on certain forms of capital income by holding assets for longer and delaying a realization event.<sup>25</sup> The tax avoidance opportunities allowed by the realization rule, in turn, reduce the amount of revenue raised at the current preferential rates on capital income<sup>26</sup> and limit the revenue-raising potential from further rate increases.<sup>27</sup> For these reasons, Professor Bill Andrews famously referred to the realization rule as the “Achilles’ Heel” of the income tax.<sup>28</sup>

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19. I.R.C. § 61(a)(2).

20. See I.R.C. § 61(a)(3).

21. I.R.C. § 61(a)(4).

22. I.R.C. § 61(a)(7).

23. See I.R.C. § 61(a). For example, some capital income may be taxed as mischaracterized labor income. See Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 181 (2011) (describing the practical challenges in distinguishing between capital and labor income, and why this challenge offers an additional argument for positive taxation of capital).

24. I.R.C. § 1001.

25. Glogower, *supra* note 15, at 114–26 (describing the realization rule and its consequences for the tax system); see generally Edward J. McCaffery, *Proceedings: Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association*, 93 NAT’L TAX ASS’N 268, 271 (2000) (describing how taxpayers can use the realization rule to avoid paying taxes on capital income).

26. Long-term capital gains and qualified dividends are currently taxed at top marginal rates of 23.8%. See I.R.C. §§ 1(h), 1411.

27. See Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 350–53 (1993); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 392 (2004) (explaining how the realization rule limits the revenue raising potential from higher capital gains rates). All conventional estimates find, however, that the revenue-maximizing rate on capital gains is significantly higher than the top rates under current law. See Batchelder & Kamin, *supra* note 15, at 211–12 (reviewing estimates of the revenue maximizing rates under current law and in connection with incremental reforms).

28. William D. Andrews, *The Achilles’ Heel of the Comprehensive Income Tax*, in NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, at 278 (Charles E. Walker & Mark A. Bloomfield eds., 1983). Andrews describes the problems of the current realization-based income tax system, and how they could imply alternative reform directions, including reforms to address the current problems with income taxation or a switch to alternative tax bases. *Id.* Andrews advocated for a shift to a consumption tax combined with a “strengthened estate and gift tax” but acknowledged the alternative possibility of income tax reforms. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1148 (1974) (“[S]ome of our existing problems could probably be ameliorated by fuller reflection of real accretion, but no practical solution in this direction offers anything approaching the simple practicality of a consumption-type or cash flow personal income tax.”); *id.* at 1172–73 (describing the advantages of pairing a consumption tax with a more robust

Because of the realization rule, Congress cannot fairly and efficiently tax capital income by simply increasing the marginal rates under current law. Scholars and policymakers have consequently recognized that more effectively taxing capital income will also require reforms to the definition of the taxable base, rather than changes in the rates alone.<sup>29</sup>

### B. *An Improved Capital Income Tax*

Scholars and policymakers have proposed a variety of options to reform the definition of the capital income tax base in order to overcome the obstacles posed by the realization rule and thereby more fairly and efficiently tax capital income.<sup>30</sup> These various “accrual taxation” methods would instead account for annual changes in asset values, so that taxpayers would not be able to reduce their tax liabilities by holding assets for longer and avoiding a realization event.<sup>31</sup>

Some methods would tax annual changes in asset values prospectively, based on the expectation appreciation or “growth path” of each asset. Prospective taxation could be based on general expectation of the growth paths for all assets or for specific categories of assets, or on the specific expectations of the growth path for each individual asset. For example, one generalized prospective method would impute an assumed return each year to the taxpayer’s original cost basis in the asset, as adjusted for the presumed return in prior years.<sup>32</sup> Alternatively, this same method can be modified to

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estate and gift tax).

29. For proposals combining both reforms to the taxation of individual capital income with adjustments to the rates on both corporate and individual income, see Harry Grubert & Rosanne Altshuler, *Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent*, 69 NAT’L TAX J. 643, 658–62 (2016); ERIC TODER & ALAN D. VIARD, URBAN-BROOKINGS TAX POLICY CTR., A PROPOSAL TO REFORM THE TAXATION OF CORPORATE INCOME (2016), <https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000817-a-proposal-to-reform-the-taxation-of-corporate-income.pdf>.

30. Others have proposed more modest incremental reforms to reduce, but not eliminate, the benefits for capital income. See, e.g., NATASHA SARIN, LAWRENCE H. SUMMERS & JOE KUPFERBERG, TAX REFORM FOR PROGRESSIVITY: A PRAGMATIC APPROACH (The Hamilton Project ed., 2020) (proposing incremental changes to the tax system including taxing capital gains at higher rates and eliminating the basis step up at death under section 1014 while objecting to more “radical proposals, like wealth taxation and mark-to-market reforms”).

31. The categorization of different methods of accrual taxation in this section is based on the categorizations in Glogower, *supra* note 15, at 113, and in Alvin C. Warren, Jr., *U.S. Income Taxation of New Financial Products*, 88 J. PUB. ECON. 899, 914–20 (2004).

32. See Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A*

utilize general rates of appreciation each year for assets in certain classes.<sup>33</sup> For some investments, a prospective method could tax the specific expected value of each asset over the investment period.<sup>34</sup> In all of these cases, the total gain or loss can be corrected upon a subsequent realization event, so that the taxpayer is only taxed over time on the total gain or loss experienced.<sup>35</sup>

Other methods would tax annual changes in asset values each year, based on the observed changes in values in that year, regardless of the presence or absence of a realization event. For example, a “mark-to-market” system would tax asset gain or loss each period, based on the asset’s change in value in the period.<sup>36</sup> Current law already requires mark-to-market taxation in specific circumstances.<sup>37</sup> A general mark-to-market system, in contrast, would tax a broader range of assets, for a broader class of taxpayers.<sup>38</sup>

Retrospective methods, in contrast, would wait until the time of a realization event—as under current law—but then retroactively impute a portion of the income (or loss) realized to prior years. These methods could also be implemented generally for all assets, or specifically for particular assets or asset classes. An annual rate of return could be imputed based on the difference between the original cost, the value at the time of realization, and the duration of the holding period.<sup>39</sup> A retrospective method would not necessarily need to account for the asset’s original basis. For example, one method would simply observe the price realization upon a sale or disposition

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“Revolutionary” Approach to Ownership, 47 TAX L. REV. 725, 733–40 (1992); Schenk, *supra* note 15, at 446–48.

33. See Glogower, *supra* note 15, at 159 n.266.

34. See generally Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 283–330 (1992).

35. For example, if a taxpayer is “overtaxed” as a result of the imputed return to basis exceeding the asset’s actual appreciation, the taxpayer will realize a corresponding loss upon the sale of the asset. Cunningham & Schenk, *supra* note 32, at 736–37.

36. See generally, e.g., Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Supplier Integration Proposal*, 50 TAX L. REV. 265 (1994); David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 121 TAX NOTES 213 (2008); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95 (1999).

37. See, e.g., I.R.C. § 475 (mark-to-market method for securities dealers); § 1256 (mark-to-market method for certain derivatives investments).

38. See, e.g., Miller, *supra* note 36.

39. See generally Cynthia Blum, *New Role for the Treasury: Charging Interest on Tax Deferral Loans*, 25 HARV. J. ON LEGIS. 1 (1998); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722 (1990); Christopher H. Hanna, *The Virtual Reality of Eliminating Tax Deferral*, 12 AM. J. TAX POL’Y 449 (1995); Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45 (1996).

and impute a return to prior years, without regard to the asset's cost.<sup>40</sup> Proposals for retrospective methods typically also treat the taxpayer's death as a realization event, to prevent the deferral of gains indefinitely across generations.<sup>41</sup>

Certain methods may be more or less amenable for certain assets or asset classes. For example, the prospective expected value method would be feasible for investments with a reasonably predictable investment period and settlement value.<sup>42</sup> Similarly, a mark-to-market system would be easiest to implement for regularly traded securities with observable and relatively reliable prices but would be more difficult for nontraded assets.<sup>43</sup>

Finally, policymakers can implement a combination of methods to account for the different characteristics of certain asset classes and to take advantage of the legal and administrative infrastructure of the current tax system. For example, a system of mark-to-market for regularly traded assets can be combined with a method of retrospective taxation for irregularly traded assets.<sup>44</sup> Similarly, a prospective method that taxes an imputed return to basis can also be combined with a tax on any additional gain or loss upon realization, either through the current realization rule system (which would tax all the excess gain or loss in the year of realization)<sup>45</sup> or through a retrospective method (which would impute a portion of the excess gain or loss to prior years).<sup>46</sup>

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40. See generally Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991). Professor Auerbach's proposal can be understood as one application of a generalized approach that would prospectively tax an imputed return to basis until a specified "gain reference date" at which point the basis would be adjusted to account for the growth path suggested by the final realization price. See David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 769-777 (1995) (describing Professor Auerbach's approach as a special case of this method where the gain reference date is upon acquisition).

41. See Glogower, *supra* note 15, at 153; Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 6 (1992).

42. For an example of how this method is applied in current law, see the original issue discount rules in I.R.C. §§ 1272-1275 (imputing annual interest income for bonds purchased at a discount to the face value).

43. Glogower, *supra* note 15, at 129.

44. See, e.g., *id.* at 142-62 (the "deferred tax accounting" method); see also RON WYDEN, SENATE FIN. COMM., TREAT WEALTH LIKE WAGES 10-22 (2019), <https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf> (recent proposal for a similar hybrid system).

45. See *supra* note 36 and accompanying text.

46. Glogower, *supra* note 15, at 159-60 n.266 (suggesting that prospective taxation of an imputed

### C. A Wealth Tax

In recent years, policymakers have proposed a wealth tax as an alternative direction for the progressive tax system.<sup>47</sup> In principle, a wealth tax is conceptually simpler than a capital income tax. Unlike a capital income tax, which taxes a flow of income during the taxing period, a wealth tax would instead tax the stock of a taxpayer's wealth, as observed at a moment during the taxing period.<sup>48</sup> The wealth tax base is typically determined based on the value of the taxpayer's assets at the time of observation,<sup>49</sup> but in principle could also be determined based on the taxpayer's "cost" or basis in the assets. A broad-based wealth tax would account for a broad range of a taxpayer's assets, whereas a narrower wealth tax base would only account for certain assets, that may be easier to value each taxing period.<sup>50</sup> The base of a wealth tax would also necessarily be calculated net of a taxpayer's debt.<sup>51</sup>

A federal wealth tax would be largely unprecedented in the United States,<sup>52</sup> but variants of a wealth tax are more common in other countries as well as in subfederal taxing jurisdictions. The real property tax common in

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return to basis can be combined with retrospective taxation of residual gains or losses upon realization).

47. These recent proposals have focused in particular on taxing high-end wealth. See Elizabeth Warren, Senator, *Ultra-Millionaire Tax*, WARREN DEMOCRATS <https://elizabethwarren.com/plans/ultra-millionaire-tax> (proposing a wealth tax with rates of 2% and 6% on net wealth above \$50 million); Bernie Sanders, Senator, *Tax on Extreme Wealth*, BERNIE SANDERS, <https://berniesanders.com/issues/tax-extreme-wealth/> (proposing a wealth tax with rates ranging from 2% to 8% on net wealth above \$32 million). For prior wealth tax proposals in the literature, see BRUCE ACKERMAN & ANNE ALSTOTT, *THE STAKEHOLDER SOCIETY* 94–112 (1999); THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 515–18, 524–30 (Arthur Goldhammer trans., 2014); Moran, *supra* note 15, at 329–35; Shakow & Shuldiner, *supra* note 15.

48. See OECD, *supra* note 15, at 16, 48. A taxpayer's wealth stock can also be determined as an average of multiple observations during the taxing period. See Shakow & Shuldiner, *supra* note 15, at 511 n.23.

49. See, e.g., Warren, *supra* note 47; Sanders, *supra* note 47.

50. For example, local property taxes can be understood as subfederal wealth taxes on a narrowly defined tax base, with revenues typically designated to particular uses.

51. See Shakow & Shuldiner, *supra* note 15, at 537. Reducing a broad wealth tax base by a taxpayer's liabilities is necessary to avoid unduly burdening a taxpayer with both highly valued assets and large corresponding liabilities. See *id.* Netting out debt may not be necessary or desirable for a narrower wealth tax base, such as a local property tax. See *id.*

52. During the Federal period, Congress did impose short-lived federal real estate taxes. See Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 24 (1999); Nicholas R. Parrillo, *A Critical Assessment of the Originalist Case Against Administrative Regulatory Power: New Evidence from the Federal Tax on Private Real Estate in the 1790s*, 130 YALE L.J. (forthcoming 2021) (describing the administration of the 1798 tax on real estate).

many local taxing jurisdictions<sup>53</sup> can be understood as a narrow form of a wealth tax, with a limited category of assets subject to tax and often with dedicated uses for the revenues raised.<sup>54</sup> Similarly, a number of foreign jurisdictions have experimented with wealth taxes, with some realizing greater success than others.<sup>55</sup> For one example, Swiss citizens pay a wealth tax that varies by canton and raises revenue roughly equal to approximately 1% of the country's GDP.<sup>56</sup>

### III. COMPARING CAPITAL INCOME AND WEALTH TAXES

Comparing the economic effects of capital income taxes and wealth taxes first requires a consistent way to translate between the two reforms. This Part introduces the concept of rate-equivalent capital income and wealth taxes and illustrates how it can illuminate the assumptions behind comparisons of wealth tax and capital income tax reforms in the literature. This Part also examines the economic effects, administrability, and constitutionality of wealth tax and capital income tax reforms. This discussion illustrates how, in many cases, the differences between a capital income reform or a wealth tax may be narrower than they might appear. Furthermore, this discussion illustrates how in many cases the choice of how the reform is structured or the baseline against which the reform is measured may be more consequential than any innate differences between capital income and wealth taxes as formally distinct categories.

#### A. *Economic Effects and Rate-Equivalent Reforms*

The literature observes that, in certain circumstances, a wealth tax and a capital income tax can have equivalent economic effects to individual taxpayers.<sup>57</sup> By manipulating the definition of the taxable base, a wealth tax

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53. See TAX POLICY CTR., TAX POLICY CENTER BRIEFING BOOK (last updated May 2020), <https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-property-taxes-work>.

54. See Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717, 744 n.199 (2020).

55. See OECD, *supra* note 15, at 16 (describing a decrease in the number of OECD countries using wealth taxes from 1990 to 2017).

56. *Id.* at 18, 78. For a discussion of differences in the design of wealth taxes in Switzerland and other countries, see *id.* at 76–95.

57. See, e.g., *id.* at 48–49; see also *id.* at 99 (describing a wealth tax as equivalent to a “proportional tax on a presumptive return”). Capital income taxes and wealth taxes can also have different economic effects in other scenarios that are not the focus of this Essay, and which may also depend on the

can be reconfigured as a tax on an assumed return to the taxpayer's assets, which resembles a capital income tax. This Essay refers to such a wealth tax yielding the same tax liability as under a capital income tax, for any fixed rate of investment return, as the "rate-equivalent wealth tax" and its converse as the "rate-equivalent capital income tax." The Essay refers to the fixed rate of investment return used for purposes of setting the rate equivalency among the two taxes as the "reference investment return rate"

For a simple example, assume *Wealth Holder 1* has \$10,000 of wealth which earns a 10% risk-free investment return each year, for a total annual return of \$1,000. A tax liability of \$100 could be generated by either a 10% tax on *Wealth Holder 1*'s \$1,000 investment return under an annual capital income tax,<sup>58</sup> or a 1% tax on *Wealth Holder 1*'s \$10,000 of assets at the beginning of the period under a wealth tax.<sup>59</sup> In this case, the economic effect of the two rate-equivalent instruments would also not vary over time. For example, under either instrument *Wealth Holder 1* would have an ending wealth balance of \$23,673.64 after a period of ten years and would pay a total tax of \$1,519.25.

Of course, not all taxpayers and investments yield the same return. The literature also describes the basic result that a capital income tax and its rate-equivalent wealth tax would yield different tax liabilities in the case of a taxpayer who earned a lower or a higher return than the reference investment return rate.<sup>60</sup> A wealth tax would impose a relatively higher burden on low-yield investments, whereas an accrual capital income tax would impose a relatively higher burden on higher-yield investments.

For example, assume that *Wealth Holder 2* and *Wealth Holder 3* also each have \$10,000 of wealth at the beginning of the taxing period, but *Wealth Holder 2* earns no investment return and *Wealth Holder 3* earns a 20% investment return.<sup>61</sup> Also assume that the reference investment return rate is

particular design of each tax instrument. For a discussion of the taxation of returns to risk under either instrument, see Shakow & Shuldiner, *supra* note 15, at 517–20 (discussing the taxation of returns to risk under either instrument).

58. This illustration assumes that the annual capital income tax could accurately measure and tax capital income earned each year.

59. The tax liability due under the single-period capital income tax will be calculated as  $Prt_1$  where  $P$  is the wealth principal,  $r$  is annual investment return, and  $t_1$  is the capital income tax rate. The liability due under the single-period wealth tax will be calculated as  $Pt_2$  where  $t_2$  is the wealth tax rate. The two instruments will yield an equivalent tax liability where  $rt_1 = t_2$ .

60. See, e.g., OECD, *supra* note 15, at 49; Leiserson, *supra* note 15, at 127.

61. For example, this higher return could result from economic rents or mischaracterized labor

still *Wealth Holder 1*'s 10% investment return, and the capital income tax rate is 10% and the rate-equivalent wealth tax rate is 1%.

A wealth tax imposes a greater burden on lower-yielding assets, as compared to its rate-equivalent capital income tax. In this case, *Wealth Holder 2* would owe no tax at all under the capital income tax and would still have the \$1,000 balance at the end of the ten-year period. Under a wealth tax, however, *Wealth Holder 2* would still pay tax each year under a wealth tax, for a total tax of \$956.18 and an ending balance of \$9,043.82 at the end of the period. Conversely, a wealth tax will impose a lower burden on higher yielding assets. For example, *Wealth Holder 3*—with an investment return above *Wealth Holder 1*'s 10% reference investment return rate—would pay \$4,704 under the capital income tax and have an ending balance of \$52,338.36, and would pay only \$2,470.89 under the rate-equivalent wealth tax and would have a higher ending balance of \$56,946.84.

These simple examples illustrate the central importance of the choice of the investment return reference rate when comparing the individual-level economic effects of wealth taxes and capital income taxes. More generally, the use of the rate-equivalent tax and investment return reference rate concepts can help bring consistency and specificity to comparisons of the two reforms.

The concept of rate-equivalent taxes can illuminate the assumptions behind comparisons of wealth tax and capital income tax reforms in the literature. For example, economist Jason Furman compares a hypothetical capital income tax and wealth tax to argue that the former would be more efficient and equitable than a wealth tax.<sup>62</sup> His example considers the varying effects of a 2% wealth tax and a 40% mark-to-market capital income tax for two different taxpayers: an investor in risk-free Treasuries that yield a 2% annual return, and an entrepreneur earning a 50% annual return predominantly comprised of supernormal returns (which could be economic rents or mischaracterized labor).<sup>63</sup> Furman suggests that a capital income tax would be preferable, since a wealth tax would both overburden the investor in

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income. See *supra* note 23. For a discussion of the different possible components of investment returns, see Ari Glogower & David Kamin, *Missing the Mark: Evaluating the New Tax Preferences for Business Income*, 71 NAT'L TAX J. 789, 791 (2018).

62. Jason Furman, Harvard Kennedy School Professor of the Practice of Economic Policy, Keynote Address at the Tax Policy Center Conference: Should the Tax System be Used to Reduce Wealth Inequality in the United States? 10–11 (Jan. 16, 2020) (slides available at [https://www.taxpolicycenter.org/sites/default/files/furman\\_presentation\\_0.pdf](https://www.taxpolicycenter.org/sites/default/files/furman_presentation_0.pdf)).

63. *Id.*



Treasuries and under-tax the entrepreneur.<sup>64</sup>

The concept of rate-equivalent capital income and wealth taxes helps to specify the assumptions underlying this example and the basis by which it compares the two possible tax instruments. In this case, comparing a 2% wealth tax and a 40% capital income tax implies a reference investment return rate of 5%,<sup>65</sup> which exceeds the Treasury investor's return but is substantially lower than the entrepreneur's presumed return.

Choosing a lower reference investment return rate in setting the relative wealth and capital income tax rates in this example, in contrast, would reduce the degree by which the wealth tax overburdened the investor in Treasuries. Of course, a lower reference investment return rate, however, could compound the entrepreneur's favorable treatment under the wealth tax. Three additional considerations, however, could minimize the disparity between the entrepreneur's treatment under a capital income tax or a wealth tax. First, while entrepreneurs can certainly amass large fortunes and earn supernormal rents over a period of years,<sup>66</sup> an individual is less likely to experience the same compounded supernormal returns year over year for an extended period of time.<sup>67</sup> After this period, the variance between a capital income tax and its rate-equivalent capital income tax would narrow, if the normal return

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64. Others have argued that the effect of a wealth tax in imposing a relatively higher burden on lower returns may also be beneficial by encouraging productive investment of capital and incentivizing entrepreneurship. See, e.g., OECD, *supra* note 15, at 54–55; Fatih Guvenen, Gueorgui Kambourov, Burhan Kuruscu, Sergio Ocampo & Daphne Chen, *Use It or Lose It: Efficiency Gains from Wealth Taxation 1* (Sept. 6, 2019) (unpublished manuscript) (on file with Washington Center for Equitable Growth), <https://equitablegrowth.org/working-papers/use-it-or-lose-it-efficiency-gains-from-wealth-taxation/>; see also *infra* note 77 and accompanying text. Others argue, however, that a wealth tax would not be the most efficient method of encouraging entrepreneurship or productive investment of capital. See, e.g., Garret Watson, *Proponents of Wealth Taxation Must Consider Its Impact on Innovation*, TAX FOUND. (Nov. 12, 2019), <https://taxfoundation.org/wealth-tax-economic-impact/> (arguing that a wealth tax is “a poorly targeted method to encourage greater innovation” since “owners of wealth will be motivated to seek higher returns wherever they find them . . . not solely through engaging in innovative activity”).

65. See *supra* note 59 (using the formula,  $2\% \div 40\% = 5\%$ ).

66. See Colin Beresford, *Elon Musk's Net Worth Has Skyrocketed Over \$100 Billion*, CAR & DRIVER (Sept. 1, 2020), <https://www.caranddriver.com/news/a33860968/elon-musk-net-worth100-billion/> (discussing how Tesla CEO Elon Musk's estimated net worth increased by more than 400% between August 2019 and August 2020, alongside a rise in Tesla's stock). This rapid appreciation could reflect a combination of a return to labor income, normal business returns, supernormal returns resulting from the business activities and market position, and a pure windfall from investor speculation.

67. That is, even if these higher returns reflect disguised labor, they would not be likely to compound indefinitely over a long period.

constitutes a greater proportion of the individual's total investment return.

The example also presumes a constant positive investment return for both taxpayers. Unlike a typical capital gains tax, a wealth tax would also generate a positive net tax liability even in a year when the entrepreneur experiences no gains, or even losses.<sup>68</sup> As a result, the disparity between a wealth tax and a capital income tax could narrow in the case of an entrepreneur who experiences periods of both losses and gains. Finally, a wealth tax can be structured with a varying rate schedule, which imposes higher rates on the largest fortunes.<sup>69</sup> In this case, a higher wealth tax rate on large fortunes would also imply a higher investment return reference rate,<sup>70</sup> which would similarly minimize the disparity between the entrepreneur's treatment under a capital income tax or a wealth tax.<sup>71</sup>

*Macroeconomic Effects.* Beyond these individual-level consequences, discussions of a wealth tax often focus on its anticipated macroeconomic effects.<sup>72</sup> Objections to a wealth tax frequently suggest that it would have adverse or even disastrous consequences for economic growth. For example, Treasury Secretary Steven Mnuchin argued that under a wealth tax “[y]ou’re going to completely disincentivize capital investment, which is going to be very, very bad for economic growth.”<sup>73</sup> In this case as well, however, the assessment of a wealth tax will depend on whether the alternative baseline would be current law or an improved capital income tax, and upon the particular design features chosen for either the wealth tax or a capital income tax reform.

Some studies anticipate significant adverse economic effects from a wealth tax. For example, the Penn-Wharton Budget Model estimates that Senator Warren's wealth tax proposal<sup>74</sup> would reduce total GDP by 1.1–2.1% by 2050, depending on the uses of the wealth tax revenues.<sup>75</sup> Other studies

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68. See *supra* note 48 and accompanying text.

69. See, e.g., *supra* note 47.

70. For example, increasing the wealth tax rate from 2% to 8% in the example *supra* note 65 and accompanying text would imply increasing the investment return reference rate from 5% to 20%.

71. Of course, in this case, the higher wealth tax rate would also impose an even greater burden on a taxpayer with wealth above the threshold but with lower-yield investments such as Treasuries.

72. See, e.g., Alan Rappeport & Thomas Kaplan, *Democrats' Plans to Tax Wealth Would Reshape U.S. Economy*, N.Y. TIMES (Oct. 2, 2019), <https://www.nytimes.com/2019/10/01/us/politics/sanders-warren-wealthtax.html>.

73. *Id.*

74. See Warren, *supra* note 47.

75. PENN WHARTON BUDGET MODEL, UNIV. OF PENN., SENATOR ELIZABETH WARREN'S

have reached different conclusions by highlighting the pro-growth potential of a wealth tax. For example, economists Emmanuel Saez and Gabriel Zucman argue that a wealth tax would increase savings by lower- and middle-income taxpayers or by the government sector (depending on the use of the tax revenue) which would counter any reduction in capital stock resulting from the tax.<sup>76</sup> They also argue that a wealth tax could have a positive impact on entrepreneurial innovation, by imposing a proportionally larger burden on large and established businesses.<sup>77</sup>

These varying estimates of how a wealth tax would affect economic growth depend upon a number of key assumptions. Adjusting these assumptions can have significant effects on a wealth tax's expected economic effects. First, to the extent that a wealth tax is modeled in an open economy, a reduction in U.S. capital stock would be replaced by foreign investment.<sup>78</sup> The PWBM estimates that the U.S. economy is 40% open,<sup>79</sup> and conventional estimates range from approximately 30% to above 60%.<sup>80</sup> Second, the economic effects of a wealth tax will depend on assumptions as to both the use of the tax revenues and the return to public investment. For example, the PWBM bases its modeling upon an assumption that the revenues will be used for deficit reduction or for public investments generating a 12% return, but

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WEALTH TAX: BUDGETARY AND ECONOMIC EFFECTS 3–5 (Dec. 12, 2019), <https://budgetmodel.wharton.upenn.edu/issues/2019/12/12/senator-elizabeth-warrens-wealth-tax-projected-budgetary-and-economic-effects> [hereinafter PWBM] (estimating economic effects using alternative scenarios where the tax revenues are used to reduce the deficit, fund nonproductive investments, or fund productive investments); *see also* JOHN W. DIAMOND & GEORGE R. ZODROW, THE ECONOMIC EFFECTS OF WEALTH TAXES 21 tbl. 1 (CTR. FOR FREEDOM AND PROSPERITY 2020), [https://www.freedomandprosperity.org/files/White%20Paper/Diamond-Zodrow\\_Economic\\_Effects\\_of\\_Wealth\\_Taxes.pdf](https://www.freedomandprosperity.org/files/White%20Paper/Diamond-Zodrow_Economic_Effects_of_Wealth_Taxes.pdf) (estimating an even larger 2.7% decline in GDP from Senator Warren's proposal). This model assumes all wealth tax revenues are used to finance transfer payments rather than to reduce the deficit or for other public investments, and that these transfers do not themselves generate significant economic growth. *Id.* at 23.

76. Saez & Zucman, *supra* note 15, at 438.

77. *Id.* at 439. Of course, under a wealth tax emerging businesses will also face a lower ex ante after-tax financial payoff if they succeed. *Id.* Saez and Zucman argue, however, that large, established businesses can also use their financial resources to protect their dominant position, and a wealth tax could mitigate this effect. *Id.*

78. *See id.* at 37–38 (arguing in general the U.S. does operate as an open economy).

79. *See generally* PWBM, *supra* note 75, at 13 (assuming the U.S. economy is 40% open); *see also* DIAMOND & ZODROW, *supra* note 75, at 9 (using an estimate of 43%).

80. *See* ALAN D. VIARD, WEALTH TAXATION: AN OVERVIEW OF THE ISSUES 180 (THE ASPEN INST. 2019), <https://www.aei.org/wp-content/uploads/2019/11/Wealth-Taxation-An-Overview-of-the-Issues-Revised-Nov-9-2019.pdf?x88519> (discussing the biggest concerns of the Warren-Sanders wealth tax).

also finds that the sign of the wealth tax's economic effects would flip, and the wealth tax would increase GDP if the revenues raised funded public investments with a return of 15% or more.<sup>81</sup>

In this case as well, the anticipated macroeconomic effects of a wealth tax should be evaluated in the context of possible alternatives, including the baseline of current law and a rate-equivalent capital income tax reform. Of course, a capital income tax can also have the effect of burdening domestic savings and can also generate revenue to fund productive public investments or to increase savings by lower-income taxpayers.<sup>82</sup> In this respect, the general objections to a wealth tax as “very bad for economic growth”<sup>83</sup> might just as easily be levied against an improved capital income tax.<sup>84</sup> In either case, the anticipated effects will depend upon the particular design of the instruments, the rates adopted under either instrument, and the uses of the revenues generated. Furthermore, policymakers could compare the economic effects of reform alternatives consistently by comparing the effects of a wealth tax with those of its rate-equivalent capital income tax, with more fine-grained comparisons made by evaluating the effects for different reference investment returns rates and progressive rate schedules.<sup>85</sup> As described above, when compared to its rate-equivalent capital income tax, a wealth tax may in fact

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81. PWBM, *supra* note 75, at 9, 13 n.7. Other studies suggest that public investment could yield even higher returns, which could correspondingly increase the positive economic effects from a wealth tax. *See, e.g.*, JOSH BIVENS, PUBLIC INVESTMENT: THE NEXT ‘NEW’ THING FOR POWERING ECONOMIC GROWTH 2 (Econ. Pol’y Inst., 2012) (arguing that rates of return on certain public investments can reach 15% to 30%). Diamond and Zodrow’s model, in contrast, assumes that the revenues are used for transfers that do not generate any public investment return. DIAMOND & ZODROW, *supra* note 75, at 23. They note that the economic effects of a wealth tax would be “less negative” if the revenues were used to fund public investments with a positive return. *Id.*; *c.f.* Leiseron, *supra* note 15, at 125 (describing possible spillover benefits from public spending funded by a wealth tax).

82. *See, e.g.*, Eric Toder & Kim Rueben, *Should We Eliminate Taxation of Capital Income*, in TAXING CAPITAL INCOME 89, 127–29 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle, eds., 2007) (describing empirical studies on the effect of capital income taxes on private savings).

83. *See supra* note 72 and accompanying text.

84. For arguments that a moderate capital income tax would also not significantly reduce investment and economic growth, see CHRIS WILLIAM SANCHIRICO, DO CAPITAL INCOME TAXES HINDER GROWTH?, Penn. WHARTON PUB. POL’Y INITIATIVE 2 (2013), <http://ssrn.com/abstract=2222843> (describing uncertainty in both theoretical models and empirical studies on the effects of capital income taxation on savings, the potential compensating effects of foreign investment, and the potential adverse economic effects of labor income taxes and increased government borrowing).

85. *See supra* note 71 and accompanying text (noting progressive rate schedules could also imply different reference return rates for taxpayers at varying wealth and income levels).

encourage greater economic investment and growth.<sup>86</sup>

Finally, even if a wealth tax or capital income tax reform did in fact result in some reduction in economic growth, these economic effects could be justified on account of the distributive benefits from these reforms. For example, even objections to a wealth tax based on anticipated adverse economic effects concede that lower-income taxpayers could still receive a significant net benefit from a wealth tax, depending again on the use of the funds.<sup>87</sup> In this case the redistributive benefits to lower-income taxpayers from either a wealth tax or an improved capital income tax could outweigh economic costs borne by other taxpayers.

### B. Administration and Avoidance

Objections to a wealth tax also often highlight the administrative challenges and avoidance opportunities<sup>88</sup> it would present.<sup>89</sup> In this case as well, however, an improved capital income tax could face many of these same obstacles. At the same time, policymakers would be able to address these concerns, often through similar anti-avoidance measures. Furthermore, possible imperfections in the implementation of either a wealth tax or an improved capital income tax should be evaluated in the context of the much more serious failings of the current income tax to accurately measure and tax income.<sup>90</sup> That is, the current income tax also encounters many of these same tax avoidance opportunities, which it only avoids in part through concessions that significantly undermine its efficacy and revenue-raising potential.

*Valuation.* Objections to a wealth tax often point to the challenge in valuing non-traded assets—such as real estate, art, and interests in closely held businesses—and both the administrative difficulties and avoidance

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86. See *supra* note 64 and accompanying text.

87. See, e.g., DIAMOND & ZODROW, *supra* note 75 (finding that wealth would increase for the lowest earning 30% of taxpayers even under their model anticipating a significant reduction in GDP resulting from the wealth tax).

88. For purposes of this Essay, avoidance refers to tax reduction strategies or opportunities that arise from the tax rules, which may be contrasted with evasion in clear violation of the law.

89. See, e.g., Lawrence H. Summers & Natasha Sarin, Opinion, *A 'Wealth Tax' Presents A Revenue Estimation Puzzle*, THE WASH. POST (Apr. 4, 2019), <https://www.washingtonpost.com/opinions/2019/04/04/wealth-tax-presents-revenue-estimation-puzzle/> (presuming that a wealth tax would be susceptible to many of the same tax avoidance strategies as the current estate tax).

90. See *supra* Section II.A.

opportunities this challenge would present.<sup>91</sup> The valuation of liquid or non-traded assets poses similar challenges for both a wealth tax and an improved capital income tax, depending how the latter is structured.<sup>92</sup> In particular, both a mark-to-market and a retrospective capital income tax that treat the taxpayer's death as a realization event<sup>93</sup> would face a similar challenge in valuing illiquid or irregularly traded assets. In addition to the administrative challenge, valuation difficulties may also enable avoidance by taxpayers, who would have an incentive to understate the value of assets to minimize their current tax liabilities.<sup>94</sup>

The same possible solutions to valuation challenges could be implemented in either a wealth tax or an improved capital income tax. For example, both instruments could use a retrospective system for hard-to-value assets—that defers observation of asset values until a realization event—to both alleviate administrative burdens and reduce taxpayers' opportunity to benefit by strategically underreporting asset values.<sup>95</sup> Under either instrument, an interest charge could be retroactively imposed with respect to tax liabilities attributable to prior tax periods, to counteract the incentive to

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91. See, e.g., Robert Frank, *The Problem with a Wealth Tax*, WALL ST. J. (Jan 11, 2012), <https://www.wsj.com/articles/BL-WHB-4976> (arguing that a wealth tax, in contrast to an income tax, has a “fatal flaw: valuation” and that “[d]etermining a rich person’s precise net worth is difficult even for the wealthy themselves, let alone the government”).

92. See, e.g., Glogower, *supra* note 15, at 128–29 (describing similar avoidance opportunities under an accrual capital income tax). In some cases, a taxpayer can achieve the same tax savings by undervaluing assets by the same amount under either a wealth tax or an accrual capital income tax. See Hemel, *supra* note 15, at 766.

93. See *supra* note 41 and accompanying text. Of course, a retrospective capital income tax that treats the taxpayer's death at a realization event would only require unsold assets to be valued on this one occasion. As described *infra* notes 99–101, the need for more frequent valuations could in fact make these valuations more easy to administer, rather than more difficult.

94. For a comparison of valuation challenges under the current estate tax and a wealth tax, see Jason Oh & Eric Zolt, *Wealth Tax Design: Lessons From Estate Tax Avoidance* 21 (Univ. Cal. L.A. Sch. Law, Law-Econ. Research Paper No. 20-01, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3526515](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3526515). A wealth tax would also impose a lower rate of tax on a broader base, as compared with a capital income tax. For this reason, under a wealth tax a taxpayer would realize less benefit from understating the amount of their wealth by a fixed dollar amount, as compared to the benefit they would receive by understating their capital income by the same amount under a capital income tax. As a result, in some circumstances a taxpayer may have less incentive to understate their taxable base under a wealth tax.

95. For examples of a retrospective system for a capital income tax, see, e.g., the methods proposed in Glogower, *supra* note 15, at 146–47, and WYDEN *supra* note 44. For discussion of a retrospective system for a wealth tax, see Leiserson, *supra* note 15, at 105–07 (describing and evaluating a “realization-based wealth tax.”).

defer a realization event.<sup>96</sup> The interest charge could also discourage taxpayers from deferring realization under either instrument in the hope that lower tax rates or different tax rules will be introduced in subsequent years.<sup>97</sup>

Finally, either an improved capital income tax or a wealth tax would generate new data which could, in turn, facilitate enforcement, enable more accurate valuations, and discourage avoidance through underreporting asset values.<sup>98</sup> Either instrument could yield new data on the annual fluctuations in asset values which are not observed or recorded under the current tax system.<sup>99</sup> A wealth tax or an improved income tax which observes annual changes in asset values could yield significant new data each year, but even a realization-based reform could still encourage more realizations by reducing the benefit to avoiding realization, which could in turn also yield more data on asset valuations.<sup>100</sup>

These data would in turn enable the IRS to more easily detect reporting outliers or systemically low asset valuations. Although some arguments in the literature assume that tax avoidance would increase over time under a wealth tax, the benefits of increased data collection suggest why the opposite effects may occur, and some of the most prominent tax avoidance opportunities may in fact diminish over time.<sup>101</sup>

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96. See Glogower, *supra* note 15, at 154–55. Alternatively, either instrument could also allow or require estimated tax payments each year, as an alternative to the interest charge. See *id.* at 143–46 (describing a prepayment option for a capital income tax); Leiserson, *supra* note 15, at 106 (estimated tax payment for a realization-based wealth tax).

97. For a discussion of how the expectation of future rate reductions can encourage taxpayers to defer realization, see David Kamin & Jason S. Oh, *The Effects of Capital Gains Rate Uncertainty on Realization* (Univ. Cal. L.A. Sch. Law, Law-Econ. Research Paper No. 19-06 (2019), [https://papers.ssm.com/sol3/papers.cfm?abstract\\_id=3365305](https://papers.ssm.com/sol3/papers.cfm?abstract_id=3365305)).

98. Some forms of an improved capital income tax could offer built-in protections against underreporting asset values. See Hemel, *supra* note 15, at 766 (arguing that “a mark-to-market income tax incorporates a backstop against undervaluation: the tax benefit from undervaluation is recaptured at the time of an arm’s-length sale”). A wealth tax which observes asset values every year could also include adjustments to account for undervaluation by the taxpayer in prior years. In this case, a taxpayer seeking to avoid a wealth tax liability would also have to continue to underreport the asset’s value year after year, and the IRS would have multiple opportunities to enforce accurate valuation. Certain capital income tax reforms, such as a broad mark-to-market system, could also correct in subsequent years for undervaluation in prior years.

99. Glogower, *supra* note 15, at 165–66.

100. That is, even if policymakers preserve a realization-based system for hard-to-value assets under either a wealth tax or a capital income tax, as described *supra* notes 95–96 and accompanying text, an accompanying interest charge would discourage taxpayers from deferring realization events. As a result, even such a system could yield data resulting from more frequent realization events.

101. See, e.g., PWBM, *supra* note 75, at 11 (assuming that tax avoidance of a wealth tax increases

*Debt Abuse.* Other objections to a wealth tax argue that taxpayers could reduce their wealth tax base by inflating their debt reported for tax purposes.<sup>102</sup> In this case as well, however, the strategic use of debt could present similar tax avoidance opportunities under current law and under an improved capital income tax. For example, under current law taxpayers can use acquisition debt to inflate their cost-basis in assets in order to benefit from cost recovery deductions, even if the taxpayer does not bear an economic liability from the debt.<sup>103</sup> Both courts and the IRS have developed strategies to combat such abuse, such as inquiries into whether the debt has real economic substance or should be ignored for tax purposes.<sup>104</sup>

The current income tax also backstops these anti-abuse rules with provisions limiting the amount of losses an individual can claim from business activities. For example, the “at-risk” rules limit the amount of deductible losses from a business activity to a measure of the taxpayer’s net economic investment,<sup>105</sup> and the passive activity rules limit deductible losses from businesses in which the taxpayer does not actively participate.<sup>106</sup> Similarly, the partnership tax rules prevent partners from claiming basis with respect to debt for which the partner does not bear the economic risk of loss.<sup>107</sup>

Variations of these same rules can also prevent the strategic use of debt to reduce tax liabilities under a wealth tax. For example, the ability to net out liabilities under a wealth tax could require similar inquiries into whether the debt has real economic substance, or whether the taxpayer bears an economic risk of loss with respect to the liability. More generally, these same general problems manifest similarly under current law, and present similar challenges and possible solutions under a wealth tax or an improved capital income tax.

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significantly over the first five years of implementation and citing evidence that avoidance responses “grow for a few years before plateauing”). This approach assumes, in effect, that taxpayers are likely to grow more proficient over time at avoiding taxes, but that the IRS would not be likely to grow more proficient over time at preventing such avoidance.

102. See, e.g., Chris Edwards, *Taxing Wealth and Capital Income*, 85 TAX & BUDGET BULL. CATO INST. 1, 2 (August 1, 2019) (arguing that a wealth tax will encourage taxpayers to “underreport assets and overreport debt”).

103. See, e.g., *Comm’r v. Tufts*, 461 U.S. 300, 309 (1983) (affirming that nonrecourse liabilities are also included in both a taxpayer’s basis and “the amount realized upon disposition”).

104. See, e.g., *Estate of Franklin v. Comm’r*, 544 F.2d 1045, 1046 (9th Cir. 1976); see also Mitchell M. Gans, *Re-Examining The Sham Doctrine: When Should An Overpayment Be Reflected In Basis?*, 30 BUFF. L. REV. 95, 105 (1981).

105. I.R.C. § 465 (2018).

106. I.R.C. § 469 (2018).

107. Treas. Reg. §§ 1.752-1, 1.752-2, 1.752-3 (2019).



The potential tax savings from using debt would vary in the case of a wealth tax, which could affect the relative incentives for taxpayers to engage in aggressive tax planning using debt under the different tax instruments. In the case of an income tax, the taxpayer could only achieve a timing benefit from increasing tax basis with debt, unless the taxpayer used other strategies to avoid the realization of additional income when the debt is transferred or cancelled.<sup>108</sup> In some cases, however, the advantages of using debt to create basis may be even greater under a capital income tax than they would be under a wealth tax. Under an income tax, in many cases taxpayers can carry net losses backwards or forwards to other taxable years.<sup>109</sup> Under a wealth tax, in contrast, debt could only be used to reduce the net wealth value in the current year, and would not benefit a taxpayer who does not have a positive base of wealth in that year.<sup>110</sup>

### C. Constitutionality

Some objections to a wealth tax argue that an improved capital income tax would be more likely to be found constitutional than would a wealth tax, notwithstanding their similar economic effects.<sup>111</sup> Under this logic, Congress could achieve comparable economic results through a capital income tax to those it could achieve through a wealth tax, with less risk that the reform could be ruled unconstitutional.<sup>112</sup>

There may not be such a clear and simple divide, however, in evaluating the constitutionality of a wealth tax and an improved capital income tax,

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108. See, e.g., *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983).

109. See, e.g., I.R.C. § 172 (deduction for net operating loss carryovers and carrybacks); § 1211 (capital loss carrybacks and carryovers); § 1256 (mark-to-market method for certain derivatives investments).

110. Debt resulting in a negative wealth tax liability could still benefit the taxpayer if a wealth tax similarly allowed taxpayers to “carryover” net negative wealth in one year to offset net positive wealth in a subsequent year.

111. See, e.g., Miranda Perry Fleischer, *Not So Fast: The Hidden Difficulties of Taxing Wealth*, in *WEALTH* 261, 284–85 (Jack Knight & Melissa Schwartzberg eds., 2017); Erik M. Jensen, *The Constitution Matters in Taxation*, 100 *TAX NOTES* 821, 829–30 (2003); Daniel Hemel & Rebecca Kysar, *The Big Problem with Wealth Taxes*, *N.Y. TIMES*, Nov. 7, 2019, <https://www.nytimes.com/2019/11/07/opinion/wealth-tax-constitution.html>.

112. See, e.g., Hemel, *supra* note 15, at 769–72 (arguing that the constitutional uncertainty is highest for a wealth tax, low for a mark-to-market capital income tax, and “fairly rounded to zero” for a retrospective capital income tax).

depending again on how the capital income tax reform would be structured.<sup>113</sup> The literature offers robust arguments as to why a federal wealth tax would be constitutional. At the same time, capital income tax reforms could face constitutional risks similar to those faced by a wealth tax.

Article I, Section VIII of the Constitution grants Congress a broad “Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States . . . .”<sup>114</sup> The “apportionment requirement” in Article I, Section II and Article I, Section IX, however, requires that any “direct” tax must be apportioned among the states according to their respective populations.<sup>115</sup> Because it would require a proportionally higher tax burden on a relatively poorer but more populous state, the apportionment requirement is commonly understood to preclude any modern progressive federal tax which is subject to the requirement.<sup>116</sup>

Arguments that a federal wealth tax would be unconstitutional typically focus on elements of the historical record suggesting that the founders considered a wealth tax to be a form of “direct tax” that should be apportioned.<sup>117</sup> One difficulty with this approach, however, is the diversity of conflicting statements and views in the historical record, which complicate the project of determining either the term’s contemporaneous common public meaning or its subjective meaning to the founders. For example, Professor Erik Jensen—who generally argues for a broad reading of the term “direct taxes” that would preclude a federal wealth tax—nonetheless concedes that

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113. This Essay focuses on descriptive analysis of the constitutionality of a wealth tax or an improved capital income tax, which may be distinguishable from predictive analysis of what arguments might resonate with a Supreme Court if it were hostile to a broad federal taxing power. As described in this Section, any particular Supreme Court justices could find grounds to uphold or strike down either a wealth tax or an improved income tax.

114. U.S. CONST. art. I, § 8, cl. 1. This broad federal taxing power replaced the ineffective system under the Articles of Confederation, whereby Congress could requisition funds from the states. See ARTICLES OF CONFEDERATION of 1781, art. VIII, ¶¶ 1–2; *id.* art. IX, ¶ 5.

115. U.S. CONST. art. I, § 2, cl. 3; *id.* art. I, § 9, cl. 4. This requirement would not apply to a subfederal wealth tax, such as a local property tax assessment.

116. See Glogower, *supra* note 54, at 720; *but see* John R. Brooks & David Gamage, *Why A Wealth Tax Is Definitely Constitutional* (Jan. 9, 2020) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3489997&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3489997&download=yes) (arguing that an apportioned wealth tax combined with a system of “fiscal equalization program” with the states to mitigate its regressive effects would be feasible).

117. See, e.g., *infra* notes 125–127 and accompanying text.

the interpretation of the term is obscured by a “fuzzy historical record.”<sup>118</sup>

The seriatim opinions in the formative early Supreme Court case of *Hylton v. United States*<sup>119</sup> suggested that the direct tax definition should be read narrowly to include only real property and possibly personal property.<sup>120</sup> More importantly, the opinions suggest that the apportionment requirement was not intended to restrain the federal taxing power, and that its scope should be interpreted in light of this intent.<sup>121</sup>

Professors Bruce Ackerman and Calvin Johnson consequently argue that the apportionment requirement should not inhibit a federal wealth tax.<sup>122</sup> Professor Ackerman argues that the apportionment requirement should be understood as an ambiguous concession in a compromise between northern and southern states over the representation of persons held in slavery, but that it did not represent any broader principles of fiscal policy or federalism.<sup>123</sup> Professor Johnson argues even more broadly that apportionment should be understood as a mistake that the founders did not even understand, and should never be interpreted as a “hobble” to the federal taxing power.<sup>124</sup>

Other scholars argue that the direct tax definition should be read broadly to preclude an unapportioned wealth tax. Professor Erik Jensen argues that— notwithstanding the fuzzy historical record—the term “direct tax” should be defined broadly as all “unavoidable” taxes, and that the founders intended for the apportionment requirement to limit Congress’s power with respect to such taxes.<sup>125</sup> Professors Daniel Hemel and Rebecca Kysar similarly argue that a

118. Erik M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2414 (1997).

119. 3 U.S. (3 Dall.) 171 (1796).

120. *Id.* at 175 (opinion of Chase, J.); *id.* at 177 (opinion of Paterson, J.).

121. *See id.* at 174 (opinion of Chase, J.) (holding that the Constitution granted Congress “a general power . . . without any restraint” and that it would only require apportionment of taxes when it could “reasonably apply”).

122. Ackerman, *supra* note 52, at 56–58; Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution*, 7 WM. & MARY BILL RTS. J. 1, 30 (1998); *see generally* Dawn Johnsen & Walter Dellinger, *The Constitutionality of a National Wealth Tax*, 93 IND. L.J. 111 (2018).

123. Ackerman, *supra* note 52, at 7–13; *id.* at 58 (“Given the Reconstruction Amendments, there is no longer a constitutional point in enforcing a lapsed bargain with the slave power.”). Ackerman argues that, even if the direct tax definition is construed to require apportionment for real estate, a broader wealth tax that includes real property should still not be subject to this requirement, since it would be qualitatively different from a tax on real property alone. *Id.* at 56–58.

124. Johnson, *supra* note 122, at 14–24.

125. Jensen, *supra* note 118, at 2356, 2377–79; Jensen, *supra* note 111, at 829; Erik M. Jensen, *Interpreting the Sixteenth Amendment (By Way of the Direct-Tax Clauses)*, 21 CONST. COMMENT.

“wealth tax[] would very likely be classified by courts as [a] direct tax[]” requiring apportionment.<sup>126</sup> They argue that even Alexander Hamilton—who generally held a broad view of the federal taxing power—believed that a tax on real estate or on an individual’s property would be a direct tax.<sup>127</sup>

The statements of Alexander Hamilton, however, exemplify the challenge of drawing conclusions from an ambiguous, and at times contradictory, historical record. For example, even as Hamilton stated that a tax on real estate would be a direct tax, he also argued that the distinction between direct and indirect taxes is “uncertain and vague” with no “antecedent settled legal meaning.”<sup>128</sup> Perhaps even more importantly, Hamilton also argued that the direct tax definition should not be interpreted in a manner that would restrain the federal taxing power<sup>129</sup> or that would result in an “absurd” result that would limit the federal power to enact any particular form of tax.<sup>130</sup> Finally, the interpretation and reconciliation of Hamilton’s arguments is further complicated by the fact that he adopted internally inconsistent positions<sup>131</sup> and evidently believed that an apportioned tax on real estate was feasible,<sup>132</sup> which likely explains why he argued in the first instance that a tax on real estate would be a direct tax.

The Sixteenth Amendment, ratified in 1913, provided that Congress could tax income without apportionment, irrespective of whether an income tax is categorized as a direct tax or not.<sup>133</sup> The Amendment did not define, however, exactly what constituted income for these purposes.<sup>134</sup> As a result, ambiguity in the scope of the term “income” leaves uncertain the limits of Congress’s power to define the income tax base.

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355, 367 (2004); Erik M. Jensen, *Taxation and the Constitution: How to Read the Direct Tax Clauses*, 15 J.L. & POL. 687, 691 (1999).

126. See Hemel & Kysar, *supra* note 111.

127. *Id.*

128. Brief for United States, *Hylton v. United States*, 3 U.S. (3 Dall.) 171 (1796), *reprinted in* 8 THE WORKS OF ALEXANDER HAMILTON 378, 378–79 (Henry Cabot Lodge ed., 1904).

129. *Id.* at 380 (“It would be contrary to reason . . . to adopt a principle for regulating the exercise of a clear constitutional power which would defeat the exercise of the power.”).

130. *Id.* at 380–81.

131. For a discussion of the inconsistency of Hamilton’s views and writings on the direct tax definition, see Jensen, *supra* note 118, at 2360.

132. Brief for the United States, *supra* note 128.

133. U.S. CONST. amend. XVI. The Sixteenth Amendment also did not address whether Congress could also tax another base—such as wealth—without apportionment. See Glogower, *supra* note 54, at 740.

134. See Glogower, *supra* note 54, at 740.

Because of the uncertainty as to the scope of the Sixteenth Amendment, a reform to improve the taxation of capital income could also be subject to constitutional challenge, depending how it would be structured. The Supreme Court precedent suggests that a mark-to-market reform, which simply eliminated the realization rule, would most likely be constitutional under the Sixteenth Amendment. This method would still tax a base of a taxpayer's income each year, as measured by the change in asset values each year, only without waiting for a realization event as a prerequisite for generating a tax liability. The Court has held that the realization rule is not a constitutional requirement,<sup>135</sup> and many current tax rules already tax income in exactly this manner.<sup>136</sup>

The analysis grows less certain, however, in the case of other possible income tax reforms. A realization-based retrospective method that still taxes the difference between a taxpayer's amount realized and basis in the asset, but simply imposed an interest charge to account for the timing of the gains,<sup>137</sup> would almost certainly be constitutional as well, as structurally comparable to the current income tax.

Other possible capital income tax reforms—with a structure even closer to that of a wealth tax—could similarly face greater constitutional uncertainty. For example, a retrospective method that does not account for the taxpayer's basis or that picks an arbitrary basis, and simply accounts for a taxpayer's asset value<sup>138</sup> upon either a realization event or the taxpayer's death would be structurally equivalent to a wealth tax.<sup>139</sup> In this case, the only differences

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135. See *Helvering v. Bruun*, 309 U.S. 461, 468–69 (1940) (requiring a lessor to include in gross income the value of a building repossessed by a lessee and prior to a disposition of the building); *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (describing realization as a rule of “administrative convenience” rather than a constitutional requirement).

136. See, e.g., I.R.C. § 475 (2018) (mark-to-market rules for dealers in securities), § 1272 (requiring inclusion of interest income prior to disposition in the case of original issue discount). Whether the Supreme Court would uphold the constitutionality of a mark-to-market reform, however, is not entirely free from doubt. See *Murphy v. United States*, 992 F.2d 929, 931 (9th Cir. 1993). In *Murphy*, the Ninth Circuit upheld a tax on unrealized gains under section 1256 under a “constructive receipt” principle, but declined to suggest whether Congress could tax unrealized gains in the absence of a constructive receipt. *Id.*

137. See, e.g., the methods described *supra* notes 39–40 and accompanying text.

138. See, e.g., note 40 and accompanying text (describing Professors Auerbach and Bradford's proposed methods for a retrospective capital income tax).

139. David Bradford argues that Professor Auerbach's method would tax an imputed gain, regardless of whether the taxpayer experienced an actual gain or loss. Bradford, *supra* note 40, at 777 n.51. In effect, this method can be understood as “reconstructing” an imputed basis in the asset, based solely upon the value at realization, the holding period, and the imputed rate of return. *Id.* This

between these methods and a wealth tax would be the formula used to calculate the tax liability due for a given asset value, the periodicity of the tax, and its formal characterization as either a tax on wealth or capital income.

A capital income tax that treats death as a realization event could face other constitutional challenges. Scholars have argued that a retrospective system that treats death as a realization event would face essentially zero constitutional risk, as it would be similar to an estate tax.<sup>140</sup> Indeed, the Supreme Court has upheld transfer taxes, at death or otherwise, as excises that are not subject to apportionment.<sup>141</sup> In these cases, however, the transfer arising from the death—rather than the event of the taxpayer’s death alone—forms the basis for the constitutional analysis.<sup>142</sup> That is, these cases do not suggest that the tax is indirect simply by virtue of the occurrence at death. If this were the case, then a taxpayer might argue that any other occurrence—such as the arrival of the midnight hour—could similarly form a permissible basis for taxation.

For this reason, a retrospective tax imposed at the time of a taxpayer’s death would not necessarily benefit from any additional constitutional support, beyond the general holdings suggesting that realization is not a constitutional requirement in all events. Of course, Congress could attempt to characterize the realization-at-death rule in a retrospective tax as a form of an estate tax, since it would share similarities with an estate tax—albeit with a more complex method of calculating the resulting tax liability—but this recharacterization may not assist the constitutional analysis if the rule is in fact designed as an element of the income tax. Drawing constitutional distinctions in this case might appear purely formal, but formalist interpretations of the constitutional provisions also form the basis for the arguments that a wealth tax would be unconstitutional in the first place.<sup>143</sup>

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analysis illustrates the economic similarities between any wealth tax (which similarly applies a formula to a taxpayer’s asset value) and a nominal tax on income that operates similarly by imputing an amount of income and a corresponding basis.

140. See Hemel, *supra* note 15, at 769; *id.* at 769, 771 (“A retrospective capital gains tax, by contrast, fits snugly within the Supreme Court’s definition of taxes that need not be apportioned among the states.”).

141. See *Scholey v. Rew*, 90 U.S. (23 Wall.) 331, 331 (1874); see also *Bromley v. McCaughn*, 280 U.S. 124, 135–36 (1929) (upholding a gift tax under a similar logic, as a tax on the transfer of the property rather than the mere holding of property).

142. See *Scholey*, 90 U.S. at 347 (“[T]he succession or devolution of the real estate is the subject-matter of the tax or duty.”).

143. See *Glogower*, *supra* note 54, at 780–83.

Once the rationale for the Court's reasoning for upholding transfer taxes at death falls away and does not apply to a retrospective tax imposed at the time of a taxpayer's death, the constitutional analysis of such a tax and a wealth tax would be less readily distinguishable.

A capital income tax calculated as an imputed return to the taxpayer's basis<sup>144</sup> would also be structurally comparable to a wealth tax, with the only differences being the choice of basis or net asset value as the starting variable for calculating the tax liability, and the formula used to translate this starting variable into a tax liability. Unlike mark-to-market taxation, however, this method would tax presumed, rather than observed, income. For this reason, it could be understood as one further step removed from the definition of income in the Sixteenth Amendment and more structurally similar to a wealth tax. Of course, this method could also allow for a correction upon realization, to ensure that over time the taxpayer is only taxed on the total gain or loss actually experienced.<sup>145</sup> It is unclear, however, to what extent the Sixteenth Amendment grants Congress the power to tax notional income in a certain year that the taxpayer does not experience, even if Congress provides a notional offsetting loss in a subsequent year.<sup>146</sup>

The innate ambiguities in the definition of income under the Sixteenth Amendment also leave Congress opportunities to replicate the economic effects of a wealth tax through the income tax in a manner that would further confound the constitutional distinctions between income and wealth taxes.<sup>147</sup>

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144. See, e.g., *supra* notes 32–35 and accompanying text.

145. See *supra* note 35 and accompanying text.

146. See U.S. Const. amend. XVI (“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”). The current income tax rules already provide for the notional taxes of income and losses in years other than those in which they are experienced to account for particular challenges that arise in measuring income. See, e.g., Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 2004) (providing rules for the taxation of notional income in the form of a “qualified income offset”). On the other hand, it is uncertain whether the Sixteenth Amendment should be interpreted to grant Congress the power to simply declare that a taxpayer has taxable income of \$100 in Year 1 and will receive an offsetting tax loss or deduction of \$100 in Year 10, if the taxpayer in fact has no taxable economic activity in these years. See, e.g., *United States v. Singer*, 82 U.S. (15 Wall.) 111 (1872). In *U.S. v. Singer*, the court considered a tax on distilled spirits that set a floor of taxable spirits at 80% of the distillery's production capacity. *Id.* The taxpayer objected that a tax on production capacity could amount to a tax “levied upon nothing” in the case of a nonproductive distillery, much like a tax on a presumed return to basis. *Id.* at 116. In this case, the Court upheld the tax, but on the narrow grounds that the minimum tax simply served as a backstop to the normal income tax, as an anti-abuse rule to prevent taxpayers from evading tax by hiding their production. *Id.* at 120.

147. See generally Glogower, *supra* note 54, at 739–40.

For example, Congress could implement a wealth-adjusted income tax, where a taxpayer's wealth affects the total income tax liability due, in the same manner that any number of exogenous taxpayer attributes affect income tax liabilities under current law.<sup>148</sup> In a similar manner, the Court has upheld Congress's ability to deny or delay cost recovery deductions under the income tax,<sup>149</sup> which also has the effect of taxing wealth, albeit without formally labeling the tax as such.

These considerations do not suggest that the Court would or should find a capital income tax to be unconstitutional as well. Rather, this discussion illustrates how, in the case of the constitutional analysis as well, the difference between a wealth tax and capital income tax reforms may be less significant or simple than it initially appears. Furthermore, the question of *how* a capital income tax reform is structured may be just as consequential as its formal labeling as an income tax. More generally, these considerations illustrate the problems with adopting a rigid or formalistic approach to the constitutional analysis of capital income and wealth tax taxes, and with the assumption that Congress has clear authority to tax one but not the other.

#### IV. TAXING CAPITAL INCOME AND WEALTH IN A PROGRESSIVE TAX SYSTEM

This Part describes the circumstances when an improved capital income tax or a wealth tax would unambiguously differ as different measures for comparing taxpayers in a progressive tax system, depending on how the role of the progressive tax base is understood. As described in Part III, both an improved capital income tax and a wealth tax share many commonalities in their economic effects, administrability, and constitutional analysis, and these considerations may depend more on the particular structures of the reforms contemplated. As a result, policymakers should not reach categorical conclusions that one reform direction is intrinsically more desirable than the

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148. *See id.* at 752–58 (describing various methods for “wealth integration,” whereby a taxpayer’s wealth affects the tax liability due on the taxpayer’s base of taxable income).

149. *See, e.g.*, I.R.C. § 162(c), (e)–(f) (disallowing deduction for illegal payments, lobbying costs, and fines and penalties); Glogower, *supra* note 54, at 741–43. Professor Joseph Dodge argues that it would be inconsistent for the Sixteenth Amendment to require some forms of cost recovery deductions in calculating taxable income while allowing Congress to deny other types of cost recovery deductions. *See* Joseph M. Dodge, *Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX REV. 369, 392 (2007) (“The constitutional text offers no basis for distinguishing some costs of producing income from others.”).



other based on these considerations alone.

Aside from the considerations, the choice between the two instruments also may not matter if policymakers' general goal is to increase tax progressivity by raising taxes on the wealthiest taxpayers. Both an improved capital income tax and a wealth tax would have the mechanical effect of increasing the overall tax burden on the wealthiest taxpayers. This basic similarity would imply a general agnosticism as to which reform would be more desirable from a normative perspective, leaving policymakers to weigh the two reforms based on the various considerations described in Part II above.

The fact that policymakers could raise more tax revenue from the wealthiest taxpayers under either reform, however, still leaves unanswered a predicate question of *which* taxpayers should pay relatively more or less in taxes. Answering this question will depend on normative assumptions as to the measure of inequality that the tax system should mitigate, and therefore how taxpayers should be compared in a progressive tax system. This question also has implications for whether the progressive tax base has a role in articulating this basis for comparing taxpayers.

There is no conclusive answer to the question of what measure of inequality policymakers should adopt for redistributive policy. For the same reason, there is also no conclusive answer to the question of how taxpayers should be compared in a progressive tax system. If the progressive tax system is understood to have a purpose of mitigating differences in both income and wealth, then a capital income tax and a wealth tax would measure these differences across taxpayers differently. As a result, an improved capital income tax and a wealth tax would serve different roles in comparing taxpayers, even if they may have similar effects as mechanical instruments for generating a larger tax burden on the wealthiest taxpayers.

#### *A. Comparing Taxpayers in a Progressive Tax System*

*The Functions of the Progressive Tax Base.* The progressive tax base serves two distinct functions. First, the tax base serves a mechanical function, as one of the variables used to determine tax liabilities. In previous work, I have referred to this function of the tax base as the "calculating" function of the base.<sup>150</sup> For a very simple example, Section 1 of the Code calculates tax liabilities by applying the applicable tax rates to the taxpayer's base of taxable

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150. Glogower, *supra* note 11, at 1461.

income.<sup>151</sup>

The progressive tax base also serves as a basis for comparing taxpayers in a progressive tax system, and therefore determines how much more or less they should pay in tax as compared to other taxpayers. In this respect, the tax base also embeds a normative, as well as a mechanical, dimension. For example, in the federal income tax the amount of the taxpayer's taxable income determines her applicable rate brackets, and higher income taxpayers generally pay tax at proportionally higher rates.<sup>152</sup> In previous work, I have referred to this normative function of the tax base as the "comparing" function of the base.<sup>153</sup>

*Ability to Pay and Measures of Inequality.* The comparing function of the progressive tax base orders taxpayers based on their relative "ability to pay."<sup>154</sup> The definition of the term "ability to pay" will depend upon normative choices as to the proper basis for comparing taxpayers and the measure of inequality that the progressive tax system should mitigate.<sup>155</sup> For example, under one view taxpayers should be compared on the basis of their endowments or earning ability, and income serves as a partial but imperfect signal of endowment.<sup>156</sup> Under a view of distributive justice that would instead compare taxpayers on the basis of their ex-post economic outcomes—rather than their ex ante opportunities—ability to pay would instead measure taxpayers' relative economic circumstances.<sup>157</sup> From this perspective, ability

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151. I.R.C. § 1(a)–(d), (j). Of course, many additional factors also affect the taxpayer's final tax liability, such as the filing status and availability of credits.

152. I.R.C. § 1(a)–(d), (j). Of course, progressive adjustments to account can also be implemented through tax rules other than the rate schedule, such as rules defining the taxable base and available credits.

153. Glogower, *supra* note 11, at 1461.

154. *Id.* This Essay does not consider the independent case for progressive taxes under an alternative benefit theory of fairness in taxation. See Richard A Musgrave, *Fairness in Taxation*, in THE ENCYCLOPEDIA OF TAXATION & TAX POLICY, 135, 135 (Joseph J. Cordes et al., eds., 2005).

155. See Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 459 n.173 (2000) ("This phrase ['ability to pay'] is intended as a mere notation for the idea that taxpayers should not bear the revenue burden equally; that is, some taxpayers are able to, and therefore should, shoulder a larger tax burden than others.").

156. See, e.g., Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation*, 18 CAN. J. LAW & JUR. 47, 47–48 (2005) (describing a view that, from a fairness perspective (rather than strictly from an efficiency perspective), individuals should be taxed on their endowments rather than their earned income, because otherwise "two taxpayers with identical endowments could end up paying vastly different amounts in tax simply because one likes to work and spend while the other prefers leisure").

157. See, e.g., Glogower, *supra* note 11, at 1445–51 (describing a basis for comparing taxpayers

to pay may be measured by reference to a taxpayer's income, wealth, or a combined measure of both.<sup>158</sup> Finally, as described in Section IV.B below, under a welfarist approach that would maximize a weighted measure of individuals' aggregate utility, the progressive tax base indicates the taxpayer's relative level of utility.<sup>159</sup>

These different understandings of ability to pay reflect different views on how inequality should be measured and mitigated. For example, policymakers could seek to equalize individuals' marginal utility or total utility,<sup>160</sup> or an objective measure of taxpayers' resources or economic outcomes.<sup>161</sup>

### B. *The Role of the Tax Base in Optimal Income Tax Theory*

The principle of taxation in accordance with ability to pay plays a different role within optimal tax theory, which would design tax rules to maximize a weighted measure of aggregate social welfare,<sup>162</sup> and provides a method for assessing the social welfare resulting from different tax systems.<sup>163</sup>

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based on their economic outcomes, as measured by their relative economic power). This view that taxpayers should be compared and progressively taxed on the basis of their economic outcomes as a normative matter—and not merely because of the administrative advantages of taxing observed economic outcomes—dates back to the writings of Henry Simons and his definition of the tax base. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 32 (1992) (“Simons’ definition of income . . . must be read in light of the gloss of *control* of economic resources . . . . It is this exercise of control that gives a person the ‘ability to pay’ taxes . . . .”).

158. See Glogower, *supra* note 11, at 1437–38 (describing a basic choice between measuring ex post economic outcomes or ex ante choices, such as whether to earn income, save, or make risky investments).

159. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1946–48 (1987); *infra* notes 164–165 and accompanying text.

160. See Amartya Sen, *Equality of What?*, in LIBERTY, EQUALITY, AND LAW: SELECTED TANNER LECTURES ON MORAL PHILOSOPHY 137, 140–55 (1987).

161. See, e.g., *id.* at 155–58 (describing Rawls’ alternative view of justice as requiring equality of primary social goods including income and wealth); see also Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFFAIRS 283, 288–98 (1981) (contrasting the principles of equality of welfare and equality of resources).

162. LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* 31 n.31 (2002). See *infra* note 168 and accompanying text (the choice of the social welfare function in an optimal tax analysis can reflect a range of views of distributive justice).

163. See Bankman & Griffith, *supra* note 159, at 1945 (describing the role of optimal tax theory within a welfarist view of distributive justice).

Within this frame, progressive taxation would focus on “the tradeoff between the potential social benefit of a more equal distribution . . . and the economic costs . . . required by a redistributing tax system,”<sup>164</sup> rather than strictly taxing individuals according to their ability to pay.<sup>165</sup> This method of analysis asks how to achieve a desired degree of redistribution at the lowest social cost and formalizes the evaluation of possible tradeoffs between the two objectives.

Optimal tax theory, however, similarly depends upon an antecedent and normative choice as to how inequality should be measured and mitigated. A traditional optimal tax analysis presumes that policymakers seek to achieve a specified level of equality of utility,<sup>166</sup> and that progressive taxation would be justified under a principle of declining marginal utility of income.<sup>167</sup> Within this general framework, a social planner may optimize the tax system to reflect a wide range of views of distributive justice, as reflected in different weights on the utility of representative individuals in the social welfare function.<sup>168</sup>

In principle, the progressive tax base would also play a different role in an optimal income tax analysis for reasons similar to why the concept of ability to pay would play a different role. Economists James Banks and Peter Diamond argue “that an initial choice of an ideal tax base drawn from an asserted concept of fairness is not a good starting place for [tax] policy.”<sup>169</sup>

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164. Joel Slemrod, *Introduction to TAX PROGRESSIVITY AND INCOME INEQUALITY* 1, 2–3 (Joel Slemrod ed., 1996).

165. *See id.* at 2. (arguing that the “ability-to-pay principle fails as an operational guide to tax progressivity” because it does not independently specify how much more taxpayers with greater ability should pay). The term “ability-to-pay” may still be used within an optimal tax analysis, however, in reference to the assumption that taxpayers experience declining marginal utility of income. *See, e.g.*, Musgrave, *supra* note 154, at 136–37 (characterizing a goal of welfare maximization as one application of the ability to-pay-principle).

166. *See, e.g.*, LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 42 (2008) (describing a social welfare function weighted to reflect “the degree of aversion to inequality in the distribution of utility levels”). Kaplow refers to this adjustment to reflect the social preference for an equality of utility as the first “concavity” in the social welfare function. *Id.* at 42–43. For arguments for the positive taxation of capital income within an optimal tax framework, see Diamond & Saez, *supra* note 23, at 177–83; David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 *TAX L. REV.* 355, 413–31 (2015).

167. *See* KAPLOW, *supra* note 166, at 42–43 (referring to the principle of declining marginal utility as accounting for the “second concavity” in the social welfare function).

168. *Id.* at 42–44 (describing how the choice of the social welfare function in an optimal tax analysis will incorporate a specific view of distribution of justice); *see also* Emmanuel Saez & Stefanie Stantcheva, *Generalized Social Marginal Welfare Weights for Optimal Tax Theory*, 106 *AM. ECON. REV.* 24, 25 (2016) (describing how optimal tax theory can accommodate a broad range of views of fairness through the choice of the social marginal welfare weight).

169. James Banks & Peter Diamond, *The Base for Direct Taxation*, in *DIMENSIONS OF TAX DESIGN*:

Rather, they argue that tax analysis should instead evaluate the economic consequences of different tax structures, and then determine which structure best maximizes utility levels in accordance with the chosen social welfare function:

We conclude that the consideration of an ideal tax base lends itself to too many concerns and conflicting answers to be viewed as a good starting point for the consideration of taxation. An alternative start is by examining the economic equilibria that occur with different tax structures . . . . Thus, optimal tax theory is based on a consequential philosophy. For each tax structure it describes the economic equilibrium, and thus the utility levels of the different economic agents. Then it asks which of these equilibria offers the utility levels judged best by a social welfare function.<sup>170</sup>

This perspective, however, also depends upon antecedent and contingent normative choices as to the measure of inequality progressive taxation should mitigate.<sup>171</sup> In an optimal tax analysis, even the assumption that policymakers should optimize the tax system to equalize taxpayers' utility—rather than to equalize particular attributes such as income or wealth—reflects a particular and contingent view of distributive justice.<sup>172</sup> That is, while a welfarist frame argues that the criterion to *maximize* under any chosen theory of distributive justice should be welfare,<sup>173</sup> this same argument does not also lead to the conclusion that the criterion to *equalize* should also necessarily be welfare, instead of some other measure of social outcomes that would be equalized according to a different view of distributive justice.

For an example of this distinction, Banks and Diamond consider the possibility that policymakers could instead evaluate tax policy in accordance with a “social income” function rather than a “social welfare function,” and only dismiss this alternative because of the problems with designing policy to *maximize* income, but not necessarily because of any problems with designing

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THE MIRRLEES REVIEW 548, 551 (James Mirrlees et al. eds., 2010).

170. *Id.* at 555.

171. *See supra* notes 166–168 and accompanying text.

172. *See Sen, supra* note 160 (describing the principle of equality of utility as just one possible conception of distributive justice).

173. *See, e.g., Kaplow, supra* note 166, at 41 (describing that the normative premise of welfarism “is that the only relevant aspect of a regime is the manner in which it affects each individual’s well-being”); Bankman & Griffith, *supra* note 159, at 1951.

policy to *equalize* income.<sup>174</sup> Furthermore, they suggest that policymakers might nonetheless design tax policy to limit variations in income (rather than strictly variations in utility) even within the context of an approach primarily focused on optimizing a social welfare function.<sup>175</sup>

Any approach that accordingly moves away from a strict focus on equalizing taxpayer utility could, in turn, imply a positive role for the progressive tax base as articulating an “asserted concept of fairness,” and as a basis for comparing taxpayers in accordance with this view. That is, if the policymaker’s criterion for distributive justice is to limit differences in income or wealth—rather than strictly in utility—then this approach would imply measuring taxpayer’s relative income or wealth and comparing them on this basis.

### C. *Wealth and Capital Income as Progressive Tax Bases*

These different understandings of the progressive tax base can explain when a wealth tax and a capital income tax may be comparable or even interchangeable, and where they would diverge. With respect to the mechanical calculating function of the tax base, a wealth tax can be roughly replicated through a capital income tax. That is, the tax liability resulting from a tax on the wealth base can be reproduced—to a degree—through the rate-equivalent capital income tax.<sup>176</sup> Similarly, in a traditional optimal tax analysis that does not afford normative weight to the choice of a particular tax base, policymakers might favor either a wealth tax or a capital income tax, depending on which instrument can optimize the chosen social welfare function.<sup>177</sup> The choice between a wealth tax and a capital income tax matters, however, in a case where the measure of equality to be mitigated is in fact the taxpayer’s wealth or income,<sup>178</sup> rather than their utility, which may be

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174. See Banks & Diamond, *supra* note 169, at 600 (“While we share a concern about income distribution, a social income evaluation function is no substitute for a social welfare function . . . . This approach appears to give too much weight to encouraging work, particularly by low earners . . . .”).

175. *Id.* (“Nevertheless, one might consider limiting income variation . . . which would also imply rejecting possible Pareto gains.”).

176. See *supra* notes 57, 58–59 and accompanying text. Of course, the two instruments will yield different tax liabilities in the case of higher or lower investment returns, as described above.

177. *Supra* notes 162–170 and accompanying text.

178. See, e.g., *supra* note 161 and accompanying text.

derivative from either.<sup>179</sup>

To illustrate these different understandings of the role of the progressive tax base, consider the case of two representative taxpayers. As described above, assume *Wealth Holder 1* has \$10,000 of wealth which earns a 10% risk-free investment return each year, for a total annual return of \$1,000.<sup>180</sup> Now consider *Worker 1*, with no saved wealth and \$1,000 of labor income. Of course, generating any particular tax liability for *Wealth Holder 1* could be achieved through a tax on either her income or wealth, albeit with potentially different costs of taxation.

If, however, policymakers specifically seek to order taxpayers on the basis of both their income and wealth, then a capital income tax and a wealth tax would not serve this function in the same manner. Very simply, the wealth tax and the capital income tax would yield different measures of each taxpayer's relative position in reference to this normative basis for redistribution. For example, measuring each taxpayer's income alone would suggest *Wealth Holder 1* and *Worker 1* are in similar economic circumstances, when in fact *Wealth Holder 1* has additional economic resources in the form of her saved wealth.<sup>181</sup>

This perspective might appear tautological or conclusory: A wealth tax and an income tax are different if taxpayers should be compared on the basis of their economic circumstances, and wealth and income measure economic circumstances differently. The presumption underlying an optimal income tax analysis, however—that the social welfare function should be weighted to represent a social preference for equality of utility rather than income or wealth—is no less conclusory and is similarly normatively contingent. Ultimately, this choice of the normative baseline for comparing taxpayers will depend on the nature of the social preference for equality and the factors by which it should be measured.

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179. See *supra* notes 174–175 and accompanying text.

180. See *supra* note 58 and accompanying text.

181. *Worker 1* may have the ability to earn income from labor in subsequent years as well, and therefore could have more human capital than *Wealth Holder 1*. The purpose of this simplified example is merely to illustrate the differences between accounting for wealth and capital income as measures of ability to pay. For a discussion of how human and financial capital may be reconciled as measures of taxpayer's relative economic circumstances, see Glogower, *supra* note 11, at 1467–76.

## V. CONCLUSION

An improved capital income tax and a wealth tax represent two of the most promising reform directions to reverse the regressive effects of the 2017 tax legislation and to rebuild the progressive tax system. This Essay considers how these reforms may be compared and evaluated.

This Essay's concept of a rate-equivalent capital income tax or wealth tax can help to clarify the assumptions underlying comparisons of these reform alternatives in the literature, and to allow for consistency in evaluating their economic effects.<sup>182</sup> As this Essay argues, in many respects the differences between an improved capital income tax and a wealth tax are narrower than they might appear, and the particular structure of each reform may matter more than their formal labels.<sup>183</sup> For this reason, policymakers should not reach categorical conclusions that one reform direction is intrinsically more desirable than the other. Both instruments would have similar economic effects, and both would encounter similar challenges in administration and tax avoidance opportunities, which could be overcome with similar potential solutions. On the question of constitutionality as well, the differences between a wealth tax and an improved capital income tax may be narrower than the literature sometimes assumes.

As this Essay describes, however, an improved capital income tax and a wealth tax can unambiguously differ in one critical respect: as different measures for comparing taxpayers in a progressive tax system.<sup>184</sup> This distinction, however, will depend in turn on a normative choice as to how inequality should be measured and mitigated by the tax system. For example, the choice between a capital income tax and a wealth tax could have different consequences, depending upon whether one assumes that the progressive tax system should mitigate differences in utility, income, wealth, or a combination thereof.

While this Essay focuses on the comparison of capital income tax and wealth tax reforms, policymakers should also not assume that these reform alternatives are mutually exclusive. Rather, both the similarities and differences between the two tax instruments ultimately suggest why policymakers should instead consider how they might be coordinated. As I have argued in prior work, the integration of taxes on capital income taxes and

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182. *See supra* Parts III, IV

183. *See supra* Sections III.A, III.B.

184. *See supra* Section IV.C.



wealth could more accurately tailor tax burdens to taxpayers' relative economic circumstances, while avoiding the disadvantages of exclusive reliance on one instrument or the other.<sup>185</sup> The considerations described in this Essay ultimately indicate why policymakers should consider a more comprehensive approach to the roles of income and wealth in the tax system, instead of simply choosing between an improved capital income tax or a wealth tax.

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185. See Glogower, *supra* note 11, at 1452–83.