

DEMOCRATS TURN TO TAX REFORM TO REDUCE WEALTH DISPARITY

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Wealth Tax
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Income Tax Marginal Rates

The U.S. Federal deficit is expected to reach \$1 trillion in 2019. Meanwhile, a hedge fund billionaire recently purchased a New York City condominium for \$238 million, and it is estimated that the top 0.1% possess almost the same amount of wealth as the bottom 90% of all households.

When it comes to tax policy, Democrats have traditionally focused on tax relief, including a negative income tax, for poor and working-class families.¹ Several recent pronouncements and extensive press coverage indicate a new approach, designed to tax the wealthiest individuals at significant rates of tax.

Three progressive Democrats have made the news in recent days – Senators Sanders and Warren and Representative Ocasio-Cortez. These proposals, if enacted, would raise the marginal income tax rates and capital gains rates, increase the estate tax rates, lower the lifetime exemption, and add a wealth tax.

THE SANDERS PROPOSALS

2017 Proposal

Senator Bernie Sanders (D-V.T.) presented a white paper on “Options to Finance Medicare for All” in 2017. In that paper, Sanders suggested the following:

- Impose higher marginal income tax rates:²
 - 40% on income between \$250,000 and \$500,000
 - 45% on income between \$500,000 and \$2 million
 - 50% on income between \$2 million and \$10 million (In 2014, only 136,000 households, the top 0.1% of taxpayers, had income between \$2 million and \$10 million.)
 - 52% on income above \$10 million (In 2014, only 16,700 households, just 0.02% of taxpayers, had income exceeding \$10 million.)
- Eliminate special reduced rates for capital gains and qualified dividends.

¹ Senator Kamala Harris (D-C.A.) has, for example, proposed the Lift the Middle Class Tax Act. The proposal would provide a refundable tax credit of \$6,000 for married couples earning up to \$60,000 a year. Single filers making up to \$30,000 and single parents earning up to \$80,000 would get a credit of \$3,000. The credit would then start to phase out. Couples and single parents with earnings of more than \$100,000 and single filers making more than \$50,000 would no longer be eligible.

² The current highest Federal rate is 37%.



- Introduce higher graduated estate tax rates to replace the current 40% flat tax:
 - 45% for the value of an estate between \$3.5 million and \$10 million
 - 50% for the value of an estate between \$10 million and \$50 million
 - 55% for the value of an estate in excess of \$50 million
 - An additional 10% surtax would apply to estate value in excess of \$500 million (\$1 billion for married couples)
- Eliminate common estate planning techniques, such as G.R.A.T.'s (grantor retained annuity trusts) and dynasty trusts:
 - A G.R.A.T. is an irrevocable trust that pays an annual annuity to the grantor (creator) of the trust. If the grantor dies during the term of the trust, the assets are included in the grantor's estate. If not, the assets pass to the beneficiaries with no gift tax other than the gift tax paid at inception. If the assets have appreciated in excess of the I.R.S. assumed rates of return (which is often the case with successful startup companies), that "excess" appreciation will pass to beneficiaries free from estate or gift taxes.
 - Dynasty trusts are long-term trusts designed to reduce estate, gift, and generation-skipping taxes at each generational level, thereby allowing accumulations of wealth for generations.
- Impose a wealth tax on the top 0.1%:
 - An annual 1% Federal wealth tax would apply to the wealthiest 0.1% of U.S. households.
 - The tax would apply to the net worth exceeding \$21 million for a household (essentially those individuals that would be subject to the current U.S. estate tax). A household with \$21.5 million would pay 1% of \$500,000, or \$5,000.

2019 Proposal

Senator Sanders recently announced that he would introduce a bill "For the 99.8%" Family farmers would be offered a special exclusion from estate tax of up to \$3 million, and the conservation easement would increase to \$2 million. The bill would also include the following proposals:

- Impose higher marginal income tax rates:
 - Reduce the amount exempted from estate tax to \$3.5 million (the exemption in effect in 2009 and a reduction from the current \$11.4 million), which would affect 0.2% of all Americans.
 - Increase the estate tax rate to 45% for estates between \$3.5 million and \$10 million.
 - Increase the estate tax rates on bigger estates, so that estates worth between \$10 million and \$50 million would be taxed at 50%, estates of

more than \$50 million would be taxed at 55%, and estates in excess of \$1 billion would be taxed at 77% (the top rate for 1941-1976).

- End tax breaks for dynasty trusts.
- Strengthen the “generation-skipping tax,” by applying it (with no exclusion) to any trust established to last more than 50 years.
- Limit the use of G.R.A.T.’s and “intentionally defective grantor trusts,” both techniques commonly used to reduce gift taxes on transfers to beneficiaries.
- Close the valuation discount “loophole.”

THE WARREN PROPOSAL

Senator Elizabeth Warren (D-M.A.) is preparing to propose a new “ultra-millionaire” wealth tax on those with a net worth over \$50 million. The proposal would create an **annual 2% wealth tax** on those with a **net worth above \$50 million** and impose an **additional 1% on net worth above \$1 billion**.

Senator Warren’s proposal has come under attack from other Democrats and Independents. Former Mayor Mike Bloomberg has asserted that the tax would violate the U.S. Constitution (as a prohibited “direct tax”), a view shared by a number of conservative legal scholars but disputed by other legal authorities (discussed below) and compared this type of tax with Venezuelan socialism.

A Hill-HarrisX survey found that 74% of registered voters back an annual 2% tax on people with assets over \$50 million and a 3% tax on people with assets in excess of \$1 billion. The poll showed support for the idea among people of all ages and races and from both political parties.

THE OCASIO-CORTEZ PROPOSAL

Freshman Representative Alexandria Ocasio-Cortez (D-N.Y.) has proposed a 70% marginal tax rate on income of \$10 million to fund a “New Green Deal” to combat climate change and economic inequality.

A recent Hill-HarrisX survey of 1,001 registered voters found that 59% supported Ocasio-Cortez’s proposal. A recent Fox News poll found that 70% of registered voters backed hiking taxes for families making more than \$10 million a year.

THE REPUBLICAN PROPOSAL

In contrast, Senators Mitch McConnell (R-K.Y.) and two other senators, Chuck Grassley (R-I.A.) and John Thune (R-S.D.), are sponsoring a bill that would repeal the Federal estate tax.

Is a Wealth Tax Constitutional?

Article I Section 8 of the U.S. Constitution provides that “Congress shall have power to lay and collect taxes, duties, imposts and excises.” Article I Section 9 provides that “no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.”

“Passage of any of these proposals will await the 2020 elections.”

The definition of “direct tax” is not readily apparent. A direct tax is a tax on real or personal property imposed solely by reason of its being owned by the taxpayer. In contrast, indirect taxes are levied upon the happening of an event, such as the transmission of property. Income tax is clearly a direct tax, but it is specifically permitted by the 16th Amendment. Estate taxes have been permitted since this amendment was enacted in 1916. Those taxes were not perceived by the Supreme Court as indirect taxes, but taxes for the privilege of transferring property.³

Some legal scholars believe that there may be early Supreme Court precedent in *Hylton v U.S.* (1796) that suggests that “direct” taxes should be narrowly construed, identifying “capitation” taxes (imposed equally on every individual) and taxes on land as types of direct taxes. Those scholars also believe that the Supreme Court case of *Pollack v Farmers’ Loan and Trust Company* (1895), striking down an income tax (pre-16th Amendment), was incorrectly decided. They conclude that a wealth tax does not seem to be a direct tax either as a functional or a categorical matter.⁴

The legality of an annual wealth tax may be enhanced (in this author’s opinion), if it were characterized as a non-refundable prepayment of estate tax, fully creditable against future estate tax, with possible indexing for inflation.

Effect on Foreign Persons

Nonresident alien individuals (whose estates may be liable for U.S. estate tax on U.S.-situs assets) never benefited from the enhanced lifetime exemption. Those estates are offered only an exemption amount of \$60,000. Only the Republican proposal to eliminate the U.S. estate tax would offer some relief.

It is not clear whether the wealth tax proposals would apply to nonresident aliens with respect to U.S. situs assets. It should be noted that the net investment income tax (the additional 3.8% tax on certain investment income) specifically excludes amounts paid to nonresident aliens. This suggests that there could be a similar exemption to wealth tax for nonresident aliens. It is not clear whether the Sanders proposal to end dynasty trusts would apply to trusts established by nonresident alien grantors.

There has been no discussion, as yet, about increasing the statutory 30% withholding tax on payments of taxable U.S.-source income to foreign persons or for eliminating the many exemptions from U.S. tax (e.g., qualified interest and capital gains).

CONCLUSION

Democratic proposals for income and wealth redistribution, while popular among the Democratic base, are controversial. Passage of any of these proposals will await the 2020 elections and would only appear possible with a Democratic sweep of both houses of Congress and possibly the Presidency as well.

All of these proposals address the burgeoning Federal tax deficit. This, coupled with the growing U.S. perception that disparities between rich and poor are widening, makes the passage of some, if not all, of these proposals a possibility in the future.

³ *New York Trust Company v. Eisner*, 1921, 256 U.S. 345.

⁴ Walter Dellinger, et. al., “We Need a National Debate on a Federal Tax on Wealth.” *Indiana Law Journal*.