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WEALTH MATTERS

Taxing the Wealthy Sounds Easy. It's Not.

By Paul Sullivan
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Taxing the wealthiest Americans at a higher rate may be good politics, since most voters won't be affected. But while two recent proposals sound simple enough, they could be difficult to put into effect.

And if the experience with the alternative minimum tax is any guide, using tax policy to target one group can backfire.

One tax proposal comes from Alexandria Ocasio-Cortez, a new Democratic congresswoman from New York who has said that an increase in income taxes could help fund other initiatives, like work on climate change. She said in an interview on "60 Minutes" that the rate on earnings over $10 million could be 60 or 70 percent, up from the current rate of 37 percent. This tax, on what she called the "tippy tops" of earners, would be graduated like the rest of the income code, so only a portion of the millionaires' income would be taxed at that high rate.

And Senator Elizabeth Warren, the Massachusetts Democrat preparing for a presidential campaign, has proposed a wealth tax of 2 percent on people with a net worth above $50 million and 3 percent on those with a net worth over $1 billion.

Ms. Warren worked with Emmanuel Saez and Gabriel Zucman, two respected economists at the University of California, Berkeley, whose research focuses on income inequality. They estimated that such a tax would raise $2.75 trillion over 10 years, which sounds like a lot but would account for just 1 percent of gross domestic product.

The devil, though, is in the details.

Such targeted tax policies have often been riddled with loopholes, as was the case with the highest marginal tax rates in the 1970s; become overly complex to enact, like the alternative minimum tax; or created unintended consequences that affected taxpayers beyond those originally intended.

Ms. Warren's wealth tax, for example, has three major challenges.

First, there is a huge gap in wealth between $50 million and $1 billion. There are far more people with wealth in the tens and hundreds of millions of dollars in the United States — 39,735, according to Wealth-X, which tracks wealth in the world — than there are billionaires — 680 — who would pay the higher 3 percent tax.

If raising revenue is the object, increasing the tax rate for people at several intervals between $50 million and $1 billion, which are very different levels of wealth, would bring in more revenue, wealth experts said.

As it stands, billionaires would contribute just $300 billion of the $2.75 trillion the higher rates are projected to raise over 10 years. Adding in rates would also allow Ms. Warren to increase the rate again for billionaires.

A bigger issue is that a wealth tax may not be constitutional. The 16th Amendment provides only for an income tax. The estate, gift and generation-skipping taxes pass muster because they're deemed excise taxes on the transfer of wealth, not on the wealth itself.

"Senator Warren's proposal is based on a study by two scholars, and she's pursuing that," said Joanne Johnson, head of wealth advisory group at J. P. Morgan's private bank. "There is a lot of extremely important analysis that still has to occur."

A third issue is logistical. A wealth tax would be like an estate tax levied every year. Figuring out the tax owed on large estates is complicated, costly and time-consuming. The Internal Revenue Service gives estates a year to file a return, but even then, executors often have to file extensions. And on the other end, auditors go through the returns, which can take years before an estate is settled.

The process requires not just lawyers and accountants but valuation experts who assess the worth of assets like closely held family businesses.

"It would be a highly cumbersome tax return to prepare on an annual basis," said Jeff Moes, executive vice president and chief fiduciary officer at FineMark National Bank & Trust, which serves high-net-worth clients. "Every federal estate tax goes through an audit, and presumably this would go through an audit as well. They'd have to figure out if the valuation methodology is correct."

"A billionaire would have a return that would be literally three feet high," he added. "Our $100 million clients own multiple closely held businesses. All of them would require an expert valuation and five-year financials."

And then the government would need to have enough auditors to verify everything that was submitted. In 2018, for example, an estimated 4,000 estate tax returns will be filed, with tax owed on 1,900 of them. That's a tenth the number of tax returns that would be filed under Ms. Warren's wealth tax plan.

As for Ms. Ocasio-Cortez's idea, many economists have noted that a rate of 70 percent for the highest tax bracket has been in place before. But the tax environment in the 1970s was different from today's. (That top marginal kicked in at $200,000, or roughly $800,000 in today's dollars.)

Back then, people could average their income over several years to reduce the large tax bite. There were also far more deductions that people could take than there are now.

Maury Cartine, a partner at the accounting firm Marcum and a certified public accountant for 50 years, said that when the highest tax bracket was 70 percent in the 1970s, the tax on earned income — as opposed to investment income — was limited to 50 percent. At that time, an individual taxpayer could also deduct interest on any type of loan — car, educational, credit card — and not just on a home.

"A taxpayer could refinance appreciated rental property, take the proceeds to buy a yacht or some very nice jewelry and still deduct the interest," Mr. Cartine said.

These deductions have been whittled away over the years. And in the current tax code, even deductions like those on state and local taxes or mortgage interest have been eliminated or curtailed. In other words, a 70 percent rate would be a much higher rate today, given the limited deductions, than it was in the 1970s.

It's also worth looking back at the unintended consequences from similar policy-driven tax proposals.

The alternative minimum tax was started in a different form in 1969. It was largely meant to target the 155 Americans who had incomes over $200,000 (roughly more than $1 million today) and hadn't paid any income tax. It was reformulated in 1982 but never indexed to inflation.

So as incomes rose, more and more affluent people were hit by the tax, which reduced deductions and set a minimum tax rate of 26 and 28 percent. Affluent professionals living in areas with high property and state taxes that could be deducted, like the Northeast, were often subject to it.

Timothy Speiss, partner in charge of the personal wealth advisers group at EisnerAmper, an accounting firm, said that by 2017, the alternative minimum tax had affected more affluent people than the truly wealthy.

The Tax Policy Center noted that 27 percent of people earning $200,000 to $500,000 and 62 percent of people earning $500,000 to $1 million paid more in taxes in 2017 because of the tax, while only 20 percent of people earning more than $1 million paid higher taxes.

A simpler example of unintended consequences is what's called the loss carry-forward provision. It allows people to deduct up to $3,000 a year in investment losses against their ordinary income. Yet that $3,000 was set in 1978, when it was worth significantly

more and fewer people were broadly invested in financial markets through their retirement plans. It hasn't been adjusted in 40 years.

"Any parameter that is not indexed to inflation automatically creates unintended consequences as more people become subject to it," said Gil Charney, director of the Tax Institute at H & R Block. "It's also another example of the marriage penalty. It's $3,000 per return, not per person."

Late this past week, Senator Bernie Sanders of Vermont, a potential Democratic presidential candidate, took a different tack in taxing the rich. He proposed applying an estate tax with a top rate of 77 percent for estates exceeding $1 billion.

How Senator Warren's or Representative Ocasio-Cortez's proposal would work rests as much on proper execution as on the definition of wealthy.

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