

What the Debate over 'Wealth Taxes' Misses

By Eugene Steuerle Fri, Jan 17, 2020

Why not create greater parity between households with IRAs and more wealthy households who accrue untaxed capital income outside of retirement accounts? asks our guest columnist, an economist.



The current debate over wealth taxes mostly focuses on whether the very rich are under-taxed, but gives little attention to the most efficient and fairest ways to tax them and capital income more generally. Here are three specific questions that any well-designed effort aimed at raising taxes on the wealthy should answer:

- How do the changes address double taxation?
- Is there any reason why gains unrealized by time of death should be subject to income tax, as under current law, only for heirs of decedents who die with money in retirement accounts?
- When is the best time to tax wealth and/or returns from capital?

Double tax issues

The wealthy already may be taxed through corporate income taxes, individual income taxes, and estate taxes. Few believe these taxes combine efficiently to raise revenue or that the burdens are distributed fairly. Some individuals are subject to all of these taxes on their capital income, some none. These double tax issues could become magnified should a new wealth tax simply be grafted onto the existing tax structure.

Consider how the corporate tax can combine with the individual income tax (both statutory income tax rates and a "net investment income tax") to create a double tax. For now, I'm ignoring the estate tax. A new wealth tax can create a triple tax for the stock owner of a corporation that recognizes its income currently and then pays the remaining income (after corporate income tax) out as dividends.

Suppose the return on capital is 6%. Then a 2% percent wealth tax is roughly equivalent to a 33% income tax rate on that capital income. However, that wealth tax can combine with a 21% corporate income tax rate and a potential individual income tax rate of 23.8% (the 20% tax on qualified dividends plus the 3.8% net investment income tax).

After taking into account interactions, the total tax rate on that return is still over 70%, well above the current nearly 40% potential combined corporate and individual income tax rates.

By contrast, the partnership owner of real estate who uses interest and other costs to completely offset rent revenues, while earning a 6 percent net return entirely in the form of capital gains on the property, owes no corporate or individual income tax currently, and simply pays the 2 percent wealth tax, for a combined tax rate of 33 percent on the income generated by this property.

Double taxes (or triple taxes) aren't new by any means. What to do about them depends upon the purpose of those taxes. But at very high levels of assessment, where the effective income tax rate can approach or exceed 100%, this issue becomes a lot more important. And, as far as I can tell, almost none of the proponents of a wealth tax have dealt with or even discussed it.

Taxation of gains accrued at death

Among the issues that arise in assessing higher taxes on the wealthy is whether Congress should continue to forgive income taxes on gains accrued but not yet taxed by time of death because the underlying assets have not been sold.

Both the holder of a regular IRA account and the owner of corporate stock with accrued capital gains have income earned during their lifetime but not yet taxed by time of death. Yet only the latter gets permanent forgiveness of the tax, because the heir's basis in the asset is "stepped up" to the value at the time of the original owner's death.

In contrast, heirs of an IRA or other retirement account must over their lifetimes pay tax on all gains accrued by their deceased benefactors. (In fact, Congress just passed a new law requiring heirs to recognize income and pay income tax over ten years on inherited retirement accounts.)

Now I recognize that the two cases are not exactly equivalent. IRA owners get an extra tax break by deferral of taxes on their wages (because the contribution to a traditional IRA is deductible). But I suggest that the same holds for many wealthy taxpayers for whom the returns to wealth often derive from returns to labor and entrepreneurship for which tax was also deferred. Why not create greater parity between households with IRAs and more wealthy households who accrue their untaxed capital income outside of retirement accounts?

Timing of taxation on returns from wealth

Regardless of the level of tax assessed on the wealthy, when to tax them raises very important efficiency issues. See my earlier two-part discussion [here](#) and [here](#). Among the concerns that carry over to wealth taxation, successful entrepreneurs become wealthy mainly by earning a very high rate of return on their business assets and human capital, then saving most of those returns within the business.

Because the societal returns to most great entrepreneurial ideas dissipate as the new idea ages, and the skills of the entrepreneurs often don't pass onto their children, rich heirs tend to generate lower rates of return for society, not just themselves, than their entrepreneurial forebears.

Thus, it may be better for society to collect tax on the accumulated unrealized gains at death rather than taxing them during life and reducing the entrepreneur's wealth accumulation. As Winston Churchill once stated, "The process of creation of new wealth is beneficial to the whole community. The process of squatting on old wealth though valuable is a far less lively agent."

Answering the three questions raised at the beginning of this post can help channel efforts to raise—or for that matter, lower—taxes on the wealthy more efficiently and equitably.

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