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Commentary: *New York Times* Investigation Highlights Failures in Taxing Income From Wealth

By Samantha Jacoby

The recent *New York Times* investigation of the Trump family's tax planning efforts[1] highlights a broader failure of the tax system: much of the income from wealth, such as the appreciation of stocks or real estate, is taxed lightly or not at all due to a series of policy choices. Boston College professor Ray Madoff recently wrote, "[t]his situation — generous exclusions from income taxes combined with easy evasion of estate and gift taxes — has given the wealthiest a free pass on the costs of running the country."[2] More specifically:

- The tax code explicitly favors income from wealth over income from work, taxing it at lower rates and allowing much of it to avoid taxation entirely.
- The tax code contains numerous loopholes that enable wealthy households, aided by tax planning experts, to further reduce their taxes on income from wealth, including reclassifying their labor income as income from wealth in order to secure the new 20 percent "pass-through" deduction.
- Years of funding cuts have depleted the IRS to the point where it can't effectively enforce the nation's tax laws.

But just as poor policy and budget choices created this situation, true reform can help address it, creating a stronger, fairer tax system.

Tax Code Favors Income From Wealth Over Income From Work

People who earn their income from work (for example, from wages or salaries) typically have income and payroll taxes withheld from every paycheck; if their tax liability for the year exceeds those withheld taxes, they pay the balance at tax time. But people who get the bulk of their income

[1] David Barstow, Susanne Craig, and Russ Buettner, "Trump Engaged in Suspect Tax Schemes as He Reaped Riches From His Father," *New York Times,* October 2, 2018, https://www.nytimes.com/interactive/2018/10/02/us/politics/donald-trump-tax-schemes-fred-trump.html?action=click&module=Top%20Stories&pgtype=Homepage.

[2] Ray D. Madoff, "Trump and the Failure of the American Tax System," *New York Times,* October 11, 2018, https://www.nytimes.com/2018/10/11/opinion/trump-bezos-estate-tax.html.

from wealth experience a very different tax code, which lets them pay tax on that income at lower rates, choose when to pay the tax, and potentially arrange their affairs so that they — and even their heirs — don't pay tax on it at all. Some of the biggest tax preferences favoring the wealthy are described below.

Preferential tax treatment of capital gains. Capital gains taxes are levied on the growth in the value of an asset, like stock, in the period since the owner bought it and are usually imposed when the owner sells the asset. Even though the large bulk of capital gains go to the wealthy, who are best able to afford taxes, policymakers have chosen to tax those gains at a much lower rate (a maximum of 20 percent) than income from work (a maximum of 37 percent). Further, because capital gains taxes are only due when the gain is "realized," filers can delay paying them for years or even avoid them altogether.

Even when the owner sells the asset, special provisions can enable the owner to continue delaying paying capital gains tax. One example is a "like-kind exchange." Selling or exchanging property generally triggers capital gains tax if the asset's value has grown, but real property (that is, land and buildings) held for use in a trade or business or for investment does *not* trigger capital gains tax if it's exchanged for "like-kind" real property. And any gain on a like-kind exchange isn't subject to tax until the owner sells the replacement property.

Originally meant to exempt small-scale and barter transactions (such as farmers trading horses) from taxation, like-kind exchanges are now used extensively in the commercial real estate industry. For example, suppose an investor bought a building for $500,000 and its value has risen to $800,000. She thinks the building has little additional appreciation potential and wishes to invest in a new geographic area. If she sells it for $800,000, she'll owe tax on the $300,000 capital gain. But if she exchanges it for a similar building, the $300,000 won't be subject to tax until she sells the replacement building — and she could continue deferring tax by exchanging that building for yet another one.

"Stepped-up basis." If someone holds an investment asset without selling it until death, neither she nor her heirs will ever owe capital gains tax on the growth in its value during her lifetime. This tax break enables parents with assets that have appreciated over time (such as stock or real estate) to pass them to their children free of capital gains tax.

Suppose a married couple bought $100,000 of stock and held onto it for many years as its value rose to $300,000, giving them a $200,000 "unrealized" capital gain. If they sell the stock, they will owe capital gains taxes on that $200,000 gain. But if they hold on to that stock until they die, neither they nor their heirs will pay capital gains taxes on the $200,000 increase in value.

Weaker estate tax. Lottery winners and even recipients of unemployment benefits must pay income taxes on those amounts. But heirs don't face income or payroll taxes on their inheritances. As a result, the estate tax is critical in preventing large amounts of wealth from accumulating over multiple generations without ever facing taxation. Indeed, more than half of the value of estates worth over $100 million consists of unrealized capital gains that would *never* be taxed without the estate tax.[3]

Yet policymakers have severely weakened the estate tax in recent decades. Most recently, the 2017 tax law doubled the amount that a wealthy couple can pass tax-free to their heirs, from $11 million to $22 million. Today, fewer than one-tenth of 1 percent of all estates are expected to owe any estate tax, which means that significant capital gains that have never been taxed get passed down to heirs tax-free.[4]

Corporate rate cuts. A major feature of the 2017 tax law was a deep cut in the statutory corporate tax rate, from 35 to 21 percent. This mostly benefits shareholders and highly compensated employees such as CEOs; in fact, a third of the benefits from corporate rate cuts ultimately flow to the top 1 percent of households, the Tax Policy Center estimates.[5] The corporate tax cut also opened up a wide gap between the top individual tax rate and the corporate rate, giving wealthy individuals a powerful incentive to shelter large amounts of their income in corporations, as explained below.[6]

Loopholes Enable Wealthy to Reduce Taxes Further

Loopholes in the tax code allow wealthy households to reduce their taxes beyond even the large explicit tax preferences for income from wealth listed above.

One example is a special type of trust known as a grantor retained annuity trust (GRAT), which policymakers created as another tool to allow wealthy individuals to pass along considerable assets tax-free. A wealthy individual — the trust owner — puts assets such as stock or real estate into a trust in return for a stream of fixed payments, typically over two years, that total the initial value of those assets plus interest at a rate set by the Treasury. If the assets in the trust rise in value by more than the Treasury rate, the gain goes to the trust beneficiary (such as the trust owner's child) tax-free. If they don't, the assets still go back to the trust owner through the fixed payments received. Such techniques have been described as a "heads I win, tails we tie" bet.[7]

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[3] Chuck Marr, Brandon DeBot, and Chye-Ching Huang, "Eliminating Estate Tax on Inherited Wealth Would Increase Deficits and Inequality," Center on Budget and Policy Priorities, April 13, 2015, https://www.cbpp.org/research/federal-tax/eliminating-estate-tax-on-inherited-wealth-would-increase-deficits-and.

[4] Roderick Taylor, "New Estate Tax Cut Encourages More Wealthy Individuals to Skirt Capital Gains Tax," Center on Budget and Policy Priorities, May 17, 2018, https://www.cbpp.org/blog/new-estate-tax-cut-encourages-more-wealthy-individuals-to-skirt-capital-gains-tax.

[5] Tax Policy Center, T17-0180 - Share of Change in Corporate Income Tax Burden; By Expanded Cash Income Percentile, 2017, June 6, 2017, https://www.taxpolicycenter.org/model-estimates/distribution-change-corporate-tax-burden-june-2017/t17-0180-share-change-corporate.

[6] David Kamin *et al.,* "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation," *Minnesota Law Review,* Vol. 103, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

[7] Zachary Mider, "How Wal-Mart's Waltons Maintain Their Billionaire Fortune," *Bloomberg*, September 12, 2013, https://www.bloomberg.com/news/articles/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes.

Wealthy taxpayers may also lower their gift tax bills by artificially valuing their assets at less than their true value.[8] Using the "minority ownership discount," for example, a taxpayer who owns a minority share of a business can pay gift taxes on *less* than her share of the business's fair market value upon gifting the business to her child, even if she still retains practical control over the business.

In some other cases, artificially *increasing* the value of assets also can provide tax benefits. For example, taxpayers might seek to overstate the value of assets they donate to tax-exempt entities in order to claim a larger charitable deduction. Although taxpayers generally must obtain an independent valuation for large charitable donations, they often shop around to find the most favorable valuation.

In addition, the wide gap between the top individual tax rate and the corporate rate encourages wealthy individuals to shelter large amounts of income in corporations. For example, a wealthy bond investor with a multi-million-dollar bond portfolio can transfer it to a new corporation that she has created solely to hold these assets — and as a result, pay tax on the portfolio's interest income at roughly half the tax rate that she would pay if this income faced the individual income tax rate.[9] She might eventually have to pay taxes on dividends or capital gains on the wealth that accrues in the corporation, but she could defer that second layer of tax for decades and even avoid it altogether by passing the corporation on to her heirs. Before the 2017 law took effect, the corporate and top individual rates were close enough to each other that this type of sheltering didn't make sense for most taxpayers.

These deliberate preferences and loopholes favoring income from wealth over income from labor also encourage high-income filers to find loopholes that allow them to recharacterize their earnings from labor as income from wealth. For example, wealthy professionals such as lawyers and consultants can set up special S-corporations in order to take their earnings as corporate profits rather than as wages, thus reducing their payroll taxes. This strategy gained notoriety a number of years ago due to its use by Newt Gingrich and John Edwards,[10] but now, many high-income filers can combine the Gingrich-Edwards loophole with the new pass-through tax break created by the 2017 tax law to cut their taxes even more.

The new tax break provides a 20 percent deduction on certain pass-through income — income that the owners of businesses such as partnerships, S corporations, and sole proprietorships report on their individual tax returns, which previously was taxed at the same individual tax rates as their wage and salary income. The deduction creates an incentive for high-income individuals to reclassify as much of their salaries as pass-through income as possible, which enables them to avoid or reduce payroll taxes on those salaries while also shrinking the income tax rate they pay on that income.

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[8] The gift tax is imposed on the gift-giver rather than the recipient, and the amount of tax is based on the value of the gift. Accordingly, a low appraisal value generates lower gift taxes.

[9] Chuck Marr, Brendan Duke, and Chye-Ching Huang, "New Tax Law Is Fundamentally Flawed and Will Require Basic Restructuring," Center on Budget and Policy Priorities, August 14, 2018, https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring.

[10] Michael Moss and Kate Zernike, "THE 2004 CAMPAIGN: THE NORTH CAROLINA SENATOR; Campaign Releases Edwards's Earnings," *New York Times,* July 10, 2004, https://www.nytimes.com/2004/07/10/us/2004-campaign-north-carolina-senator-campaign-releases-edwards-s-earnings.html.

Fully 61 percent of the benefit from the pass-through deduction will flow to the top 1 percent of households in 2024, the Joint Committee on Taxation (JCT) estimates.[11] Just 4 percent will go to the bottom two-thirds of households combined.[12]

Underfunded IRS Ill-Equipped to Police Tax Evasion by Wealthy

Policymakers haven't given the IRS adequate resources to ensure that wealthy households pay the taxes they owe under law. Enforcement funding is *23 percent below* the 2010 level, after adjusting for inflation. As a result, the share of tax returns that the IRS audits, especially for high-income individuals and large corporations, continues falling, IRS data show.[13] The audit rate for individuals with over $1 million in income fell from 12.5 percent in 2011 to 4.4 percent in 2017; for large corporations (those with assets over $10 million), it fell from 17.8 percent in 2012 to 7.9 percent in 2017.[14]

This is particularly concerning given that the 2017 tax law creates massive new opportunities for tax avoidance. The combination of an underfunded IRS and a tax system rife with tax avoidance opportunities invites wealthy individuals and profitable corporations to engage in schemes that may cross the line into illegal tax evasion by extracting benefits that go beyond even the large, explicit tax breaks they receive under current law.

Sound Policy and Budget Choices Can Make Tax Code Fairer

There are a number of sound proposals to fix these costly policy problems. To begin with, policymakers should substantially reform the parts of the tax code that favor income from wealth over income from work. For instance, they should repeal the like-kind exchange rules that permit real estate developers to delay — sometimes indefinitely — paying capital gains tax. Along the same lines, they should limit stepped-up basis. President Obama's fiscal year 2016 budget proposed to repeal stepped-up basis for most gains over $100,000; the JCT estimated that this proposal (along with a small increase in the maximum rate on capital gains and dividends) would have raised $250 billion over ten years.[15]

Policymakers should also close loopholes that allow affluent taxpayers to further reduce their taxes. For example, the Obama Administration proposed legislation and regulations to address abuses associated with GRATs; policymakers should adopt these and other proposals to strengthen the estate and gift tax system. Raising the corporate tax rate would also help deter wealthy individuals from sheltering their income within corporations. In addition, proposals exist to close the loopholes that allow high-income earners to reclassify their income from labor as income from wealth. For instance, the Obama Administration's fiscal year 2015 budget included a proposal to

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[11] Chuck Marr, "JCT Highlights Pass-Through Deduction's Tilt Toward the Top," Center on Budget and Policy Priorities, April 24, 2018, https://www.cbpp.org/blog/jct-highlights-pass-through-deductions-tilt-toward-the-top.

[12] *Ibid.*

[13] "2017 Internal Revenue Service Data Book," https://www.irs.gov/pub/irs-soi/17databk.pdf.

[14] *Ibid.*

[15] David Kamin, "Capital: Paths to a Fairer and Broader U.S. Tax System," Washington Center for Equitable Growth, August 2016, https://equitablegrowth.org/wp-content/uploads/2016/08/081016-kamin-taxing-capital.pdf.

eliminate the Gingrich-Edwards loophole described above. And the 20 percent pass-through deduction is fundamentally flawed and should be repealed.

Finally, policymakers should increase IRS funding — particularly its enforcement budget. The agency plays an essential role in government, collecting nearly all of the revenue that funds federal programs. Policymakers should give it sufficient resources to fulfill its mission.