Creating Opportunity Through a Fairer Tax System: The Case for Taxing Extreme Wealth Holdings and "Real" (Book) Corporate Profits and for Improving IRS Funding

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Testimony Before the United States Senate Committee on Finance
April 27, 2021

Thank you, Senators, for your invitation to speak with you today. I am a professor of tax law at Indiana University—Bloomington, Maurer School of Law. I previously served in President Obama's Treasury Department, in the Office of Tax Policy. I have advised on and helped draft a variety of tax reform efforts at the federal and state and local levels. I have published over seventy articles and academic essays on topics related to tax reform.[1]

I am primarily devoting this written testimony to discussing the Ultra-Millionaire Tax Act of 2021 and the broader case for levying a federal tax on extreme wealth holdings. As is well known, both wealth and income inequality have exploded over recent decades, with the gains from economic growth disproportionately going to the richest Americans.[2] Meanwhile, as I will explain, our tax system is broken as applied to the ultra-wealthy, with many harmful consequences. A new federal tax on extreme wealth holdings, like the Ultra-Millionaire Tax Act, should be a central component of reforms for fixing this disgraceful state of affairs.

Secondarily, I will more briefly write in support of both the Real Corporate Profits Tax Act of 2021 and proposals for improving IRS funding and for making it and other tax-enforcement funding less dependent on the annual appropriations process. All of these proposals go together as reforms for raising revenues needed for public investment while helping to fix some of the ways in which our tax system is currently broken and easily exploited by tax gaming by ultra-wealthy individuals and families and by large corporations. For the reasons I will explain, I strongly support all of these reform proposals.

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[1] Most of my published and forthcoming scholarship can be found on SSRN, here: https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=364730. My academic bio and CV can be found here: https://www.law.indiana.edu/about/people/bio.php?name=gamage-david.

[2] Chuck Marr, Samantha Jacoby, Sam Washington, & George Fenton, *Asking Wealthiest Households to Pay Fairer Amount in Tax Would Help Fund a More Equitable Recovery* 2-6, CENTER ON BUDGET AND POLICY PRIORITIES REPORT, April 22, 2021, available at https://www.cbpp.org/research/federal-tax/asking-wealthiest-households-to-pay-fairer-amount-in-tax-would-help-fund-a.

I. The Case for a New Federal Tax on Extreme Wealth Holdings

A. The U.S. Tax System is Broken as Applied to the Ultra-Wealthy, With Many Harmful Consequences[3]

The U.S. tax system does a very poor job of taxing the ultra-wealthy.[4] The ordinary rich—say, well-compensated doctors–typically pay quite a lot of income tax, doing their part to support the nation. By contrast, most billionaires and mega-millionaires pay tax on only a small portion of their true economic gains. Indeed, many working-class individuals, such as nurses, teachers or firefighters, pay tax on a much larger share of their economic gains than do most of the wealthiest Americans.

So how do billionaires and mega-millionaires escape paying their fair share? The answer is that our income tax generally does not reach large fortunes unless property is sold, or money is paid out in salaries or in stock dividends. Thus, by borrowing against appreciated assets and playing other financial games, the very rich can avoid taxation and still fund their lavish lifestyles.

Most Americans predominantly earn wage and salary income, which the U.S. income tax measures reasonably well.[5] By contrast, the ultra-wealthy predominantly earn income that arises from the returns to owning wealth (or that can be made to appear as though it arises from the returns to owning wealth), which the U.S. income tax measures dreadfully.[6]

This deep failure of the U.S. tax system has profound implications beyond just the resulting windfall for the ultra-wealthy. To begin with, this failure undermines the fairness of the entire tax system, especially by creating obstacles for members of historically disadvantaged groups to catch up to those who were born into greater privilege. As Palma Strand and Nicholas Mirkay—among many others[7]—have documented, the federal income tax operates "directly to increase wealth inequality, deepening pre-existing historically-based racial wealth disparities."[8] Specifically, by heavily taxing wage and

[3] This Section presents a summary of the analysis in Parts I and II of my forthcoming article, co-authored with John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 N.C. L. REV. __ (*forthcoming*), available at https://ssrn.com/abstract=3801164. Further support and elaboration of the arguments and analysis in this Section can be found in that Article.

[4] I use both the term "ultra-wealthy" and the phrase "billionaires and mega-millionaires" in this testimony to refer to households in the top 0.1% (more or less) of wealth in the United States, a group that is estimated to consist of approximately 175,000 households who collectively own between 15% and 20% of national wealth. *Id.* at 11-13.

[5] Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, Sept. 11, 2019, at 4, available at https://ssrn.com/abstract=3452274.

[6] *Id.* at 4-8.

[7] *E.g.*, Jeremy Bearer-Friend, *Should the IRS Know Your Race? The Challenge of Colorblind Tax Data*, 73 TAX LAW REVIEW 1, 39-41 (2019) (listing studies finding that tax policies have disparate racial outcomes); Dorothy A. Brown, *Shades of the American Dream,* 87 WASH. U. L. REV. 329 (2009).

[8] Palma Joy Strand & Nicholas A. Mirkay, *Racialized Tax Inequity: Wealth, Racism, And The U.S. System of Taxation*, 15 NW. J. L. & SOC. POL'Y. 265, 266 (2020).

salary incomes, and only lightly taxing the returns to owning wealth, the tax system obstructs historically disadvantaged groups from building wealth and economic power, while protecting the comparative economic power of historically advantaged groups that started accumulating financial wealth and related social capital during more illiberal periods.[9]

Beyond that, the failure of the U.S. income tax to meaningfully tax the ultra-wealthy creates massive inefficiencies and economic waste. The tax gaming strategies that ultra-wealthy taxpayers use to escape income taxation come at a cost, and these costs generally increase as the strategies get more complicated and aggressive to cover more economic income.[10] Examples of these costs include reduced liquidity, the costs of taxpayer borrowing, transaction costs of tax-loss harvesting, deviating from taxpayers' risk-reduction and diversification preferences, the excessive complexity of more sophisticated forms of tax gaming, and the cost to businesses from using inefficient capital structures in order to generate tax savings. As C. Eugene Steuerle explained in his seminal book on the topic, "insofar as capital income is concerned, the individual income tax is primarily a discretionary tax."[11] As a result, at least with respect to the investment income of the ultra-wealthy, the income tax is effectively just a tax on the limitations to tax gaming that deter wealthy taxpayers from gaming away all of their tax liabilities, so that "the discretionary income tax on capital income is a tax on liquidity, risk reduction, and diversification rather than a tax on income."[12]

A key takeaway here is that tax gaming by the ultra-wealthy typically involves real economic costs and so the flaws in the income tax harm the overall U.S. economy. While incurring these costs may be rational for individual taxpayers, it is exceedingly wasteful to an economy as a whole.[13] In other words, the productive potential of the overall economy is diminished because scarce resources are devoted to tax gaming at the expense of productive investment and business activity.

Furthermore, the manner in which the personal income tax is broken and readily exploited by the ultra-wealthy's tax gaming undermines the administrability of the entire tax system.[14] This is because the ways in which the income tax fails with respect to the ultra-wealthy harm the integrity and functioning of the overall tax system, generating

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[9] *Id.* at 279.

[10] David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 375–82 (2014), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2465522.

[11] C. EUGENE STEUERLE, TAXES, LOANS, AND INFLATION: HOW THE NATION'S WEALTH BECOMES MISALLOCATED 18 (Brookings Institution 1985).

[12] *Id.* at 19. My co-author John Brooks and I would add lack of complexity to Steuerle's list, as we view the excessive complexity of tax-motivated investment strategies as perhaps the largest form of economic waste, because this complexity interferes with designing investment and business strategies so as to maximize economic productivity and related pre-tax returns. Gamage & Brooks, supra note 3, at 29.

[13] Gamage, *supra* note 10, at 375–82.

[14] Gamage & Brooks, supra note 3, at 29-31.

excessive and unnecessary legal complexity and uncertainty to the detriment of a great many small businesses and ordinary Americans.

Finally, on top of all that, tax gaming by the ultra-wealthy deprives the government of much needed revenues that could be used to fund public investment,[15] undermines the public's tax morale and compliance norms,[16] and likely also harms the public's faith in our overall economic and political system.[17] For these and other related reasons,[18] it is crucial that the tax system be reformed so that the ultra-wealthy cannot so easily escape paying their fair share. The revenues at stake are large and needed. But the many real social and economic harms that result from the ways in which our tax system is currently broken as applied to the ultra-wealthy are even stronger reasons for why we urgently need reform.

B. Limiting the Capital Gains Rate Preference and Stepped-Up Basis on Death are Only Partial Fixes for the Deep Flaws in the Income Tax

President Biden is reportedly proposing to raise the top capital gains tax rate so as to end the capital gains rate preference for taxpayers with income over $1 million and also limiting the special-preference provision that steps-up basis upon death.[19] If enacted, these reforms would be important partial steps toward fixing the deep flaws in the U.S. tax system and alleviating the harmful consequences of those deep flaws.

Unfortunately, as my co-author John R. Brooks and I explain in a forthcoming article, both history and theory imply that these reforms are unlikely to be fully successful or politically sustainable on their own.[20] This is because the structure of the U.S. political system creates pressures that tend to undermine reforms of this sort over time, making such reforms politically fragile, unless the reforms are accompanied by current-assessment reforms like an annual wealth tax.

These pressures include that federal budget rules make it so that much of the tax revenue that might theoretically be raised by reforms like the ones President Biden is proposing—if those reforms were sustained—will show up outside of the budget scoring window. This then makes it much more politically difficult to legislatively bolster and strengthen such reforms, while making it much easier politically for a future Congress to legislatively weaken or repeal such reforms. Indeed, absent an accompanying current-assessment reform, a future Congress might well find that proposals for undoing Biden's

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[15] *Id.* at 20-21.
[16] *Id.* at 25-26.
[17] *Id.* at 26.
[18] *Id.* at 19-31.
[19] Jim Tankersley, *Biden Will Seek Tax Increase on Rich to Fund Child Care and Education*, NY TIMES, April 22, 2021, available at https://www.nytimes.com/2021/04/22/business/economy/biden-taxes.html.
[20] This Section summarizes analysis from Part III of my forthcoming article with John R. Brooks, *supra* note 3.

reforms by partially reenacting the capital gains rate preference would be scored as raising tax revenue within the relevant budget window, despite that the true effects would be large revenue losses outside of the budget window.

Moreover, because President Biden's reforms would mostly retain the realization-based nature of the income tax, ultra-wealthy taxpayers would mostly continue to enjoy the choice of when to realize their tax liabilities—that is, when to exercise the option value of deciding in which future political regime a deferred tax liability would be realized, assessed, and paid. This creates strong incentives for ultra-wealthy taxpayers both to wait for (favorable to them) future legal or political changes and to lobby and exert other political pressures in the hopes of creating such future changes.

For these and related reasons,[21] President Biden's proposed reforms of limiting the capital gains tax rate preference and limiting the special provision offering step-up of basis upon death should be thought of as important steps toward fixing the personal tax system with respect to the ultra-wealthy, but not as complete solutions. A complete solution requires a current-assessment reform like an annual wealth tax, to accompany reforms like those proposed by President Biden.[22]

C. An Ideal Tax System Should Tax Both Income (or Consumption) and Wealth

There are two major groups of philosophical theories about what a democratic nation should ideally tax. The first group of theories looks to taxpayers' ability to pay. The second group of theories looks to the benefits that taxpayers receive from the state. Both groups of theories strongly support taxing both income (or consumption) and wealth, at least as an ideal matter.

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[21] Further support for and elaboration of everything in this Section can be found in my forthcoming Article with John R. Brooks, *id*.

[22] In my view, there are two primary models for a complete solution to fixing the personal tax system with respect to the ultra-wealthy. The first primary model would be to transform the personal income tax into a form of progressive spending tax along with also enacting an annual wealth tax. The annual wealth tax would play a critical role in this model, because, among other reasons, absent the annual wealth tax, transforming the personal income tax into a progressive spending tax would turbocharge deferral and thereby almost guarantee that the reforms would prove politically unsustainable when faced by gaming by the ultra-wealthy. *See* Gamage & Brooks, *supra* note 3, at 48-51. The second primary model would be to transform the personal income tax into an accrual income tax (rather than a cash-realization based tax) such as through a mark-to-market reform. Although this approach could be viable without an accompanying annual wealth tax, implementing an annual wealth tax to accompany the accrual income tax reforms could help bolster the weaknesses in the accrual income tax reforms and also help ensure that taxpayers' prior wealth accumulations were sufficiently included in the overall personal tax base. In an unfinished draft article, I will explain how an annual wealth tax can be integrated with accrual income tax reforms (like a mark-to-market reform) so as to bolster the accrual income tax provisions and better limit the overall costs from tax gaming. Notably, if desired, an allowance-exemption for new investments can be built into the annual wealth tax, so as to partially exempt new investments from the annual wealth tax in order to prevent possible over-taxation of new investments by the combined annual wealth tax and accrual income tax regimes.

Beginning with theories based on ability to pay, consider three sample taxpayers: imagine that in a given year that Taxpayer A has $50 million of wealth and $10 million of income, whereas Taxpayer B has $50 million of wealth and $1M of income, and Taxpayer C has $20M of wealth and $10M of income.

Can there be any doubt that Taxpayer A has greater ability to pay as compared to either Taxpayer B or Taxpayer C? The reason that Taxpayer A has greater ability to pay is that both wealth and income are sources of economic power and wellbeing. All else being equal, having more of either wealth or income makes someone better off in the sense of ability to pay.

Over an infinite time horizon, wealth and income are highly related, and it is often said that income equals consumption plus changes in wealth. But neither humans nor tax regimes survive unchanged over infinite time horizons. As John Maynard Keynes famously quipped, "In the long run we are all dead." Similarly, in the long run, tax rates and other tax rules will inevitably be changed. Thus, when considering ability to pay, the short run matters. And, in the short run, wealth and income provide distinct information on taxpayers' ability to pay.

Moving on to theories based on benefits that taxpayers receive from the state, among the most important of such benefits are the protections the state provides to both accumulated wealth and to newly earned gains in the forms of military and police protections and protections from the legal system. Absent such protections provided by the state, it would be difficult and dangerous to accumulate and maintain billions or mega-millions in wealth. It would also be difficult to earn new millions or to increase the worth of one's prior wealth holdings.

Much more could be said about the philosophies of what a democratic government should ideally tax. But this short discussion should suffice to explain why the major philosophical theories support that an ideal tax system should tax both wealth and income (or possibly both wealth and consumption instead).

Indeed, we can see an example of these justifications in the fee structures charged by private equity financiers. The typical fee structure charges both a two percent management fee on the total wealth invested plus an additional twenty percent fee on the profits earned from managed investments.[23] There is good reason for this dual fee structure, on both the wealth invested and the income earned from that invested wealth. Private equity fund managers provide services both in the form of protecting and sustaining prior wealth accumulations and in the form of helping to grow new income from that wealth. The same is true of the services and benefits that the state provides to taxpayers—these services both help protect prior wealth accumulations and help with the earning of new income.

[23] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits In Private Equity Funds*, 83 NYU L. REV. 1, 1 (2008).

Overall then, when comparing two taxpayers who both have the same annual income, if one has much greater wealth, then—all else being equal—the taxpayer with much greater wealth should pay more tax.

D. A Wealth Tax is Definitely Constitutional

Despite misleading statements sometimes made to the contrary, the Constitution clearly and unambiguously grants Congress the power to levy an annual wealth tax.[24] For sure, there are constitutional uncertainties surrounding wealth tax proposals, and there is no guarantee that the Supreme Court would uphold any particular design for an annual wealth tax. Nevertheless, it is important to understand that Congress clearly has the power to levy an annual wealth tax, and that the constitutional uncertainties are only in regard to how such a tax must be designed.

The primary question is whether the Constitution and Supreme Court precedent authorize a uniform wealth tax, or whether instead an annual wealth tax would be considered to be a form of direct tax that must be apportioned amongst the states by population. There are mixed Supreme Court precedents on this question. On the one hand, the holdings of two notable Supreme Court cases—the 1895 case of *Pollock v. Farmers' Loan & Trust*[25] *and* the 1920 case of *Eisner v. Macomber*[26]—suggest that an annual wealth tax might be considered to be a direct tax that must be apportioned. However, both of these two Supreme Court cases have been at least partially overturned by subsequent Supreme Court decisions.[27] Moreover, there is a long line of Supreme Court precedents supporting that an annual tax on extreme wealth holdings like the proposed Ultra-Millionaire Tax (in contrast to a tax based solely on the ownership of property itself like local government property taxes) should be considered a form of excise tax (as in the Supreme court decisions upholding the corporate income tax and estate and gift tax, among others), that would not need to be apportioned.[28] All sources considered, the most faithful interpretation of the overall body of Supreme Court precedents and of constitutional structure and history supports that the Supreme Court

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[24] *See, e.g.,* John R. Brooks & David Gamage, *Why a Wealth Tax is Definitely Constitutional*, available at https://ssrn.com/abstract=3489997; *United States v. Ptasynski*, 462 U.S. 74, 79 (1983) (explaining that "Congress' power to tax is virtually without limitation" but that there is "one specific limit on Congress' power to impose indirect taxes" and that limit is the uniformity requirement).

[25] 157 U.S. 429 (1895), *affirmed on rehearing*, 158 U.S. 601 (1895).

[26] 252 U.S. 189 (1920).

[27] *E.g., Helvering v. Bruun*, 309 U.S. 461 (1940) (substantially limiting the holding of *Eisner v. Macomber*); *Knowlton v. Moore*, 178 U.S. 41 (1900) (substantially limiting the holding of *Pollock v. Farmers' Loan & Trust).*

[28] *E.g., Flint vs. Stone Tracy Co.*, 220 U.S. 107 (1911); *Patton v. Brady*, 184 U.S. 608 (1902); *Knowlton v. Moore*, 178 U.S. 41 (1900); *Nicol v. Ames,* 173 U.S. 509 (1899).

should uphold a uniform tax on extreme wealth holdings rather than requiring that it be apportioned.[29]

Of course, the Supreme Court could decide otherwise, such as by reviving *Pollock v. Farmers' Loan & Trust* or *Eisner v. Macomber* to require that a tax on extreme wealth holdings be apportioned amongst the states by population. But all this would mean is that the wealth tax would need to be so apportioned. Congress passed five different apportioned Direct Tax Acts in the late 1700s and early 1800s, each levied on specific forms of wealth based solely on their ownership, so that these partial wealth taxes were considered to be direct taxes. To my knowledge, no one has ever disputed that these early Direct Tax Acts were clearly and unambiguously constitutional. Thus, these early Direct Tax Acts provide guidance and precedent for how we could design a modern apportioned tax on extreme wealth holdings.

There are some complexities involved in designing a modern apportioned tax on extreme wealth holdings, and I cannot fully explain all of the relevant detail here. My co-author John R. Brooks and I are in the process of developing comprehensive recommendations and analysis in an unfinished draft article.[30] A partial summary of our recommendations would be to follow the approach used by the 1798 Direct Tax Act which accomplished apportionment by combining uniform taxes on buildings and enslaved persons[31] with a residual tax on land value within each state, with that residual tax structured to make the apportionment formulas work.[32] We would recommend modifying this approach somewhat by accompanying a uniform tax on extreme wealth holdings (like the proposed Ultra-Millionaire Tax) with a residual tax on all real property within each state that is valued for purposes of local government real property taxes, and then adding in a substantial circuit-breaker so that—for example—individuals and families with annual household income of less than, say, four hundred thousand dollars would be exempt from the residual tax. It is also worth considering giving state governments the option to pay the residual tax via requisitions instead of having the tax levied on real property within the state, as was done in the Direct Tax Acts of 1813, 1815, and 1816.[33]

If the additional tax revenues raised by this residual tax or requisitions were used to fund general federal government expenditures, then this structure would arguably be inequitable, because larger revenues would be raised from states with less wealthy populations and smaller revenues from states with more wealthy populations. But such

[29] Ari D. Glogower, David Gamage, & Kitty Richards, *Why A Federal Wealth Tax Is Constitutional,* ROOSEVELT INSTITUTE ISSUE BRIEF (2021), available at https://ssrn.com/abstract=3784560.

[30] John R. Brooks & David Gamage, *The Indirect Tax Canon, Apportionment, and Drafting a Constitutional Wealth Tax* (unfinished draft manuscript available upon request).

[31] It is inescapable that the apportionment clause was largely (if not entirely) designed to protect the horrendous institution of slavery from what slaveholders would have considered to be excess taxation, and so analyzing the historical precedents for designing an apportioned direct tax requires—as disturbing as this is—analyzing how "property" in the form of enslaved persons was then taxed.

[32] Act of July 14 § 2, 1 Stat. at 598.

[33] Charles F. Dunbar, *The Direct Tax of 1861*, 3 Q.J. ECON. 436, 443-44 (1889).

inequities are easily remedied by spending the revenues raised by the residual tax or requisitions primarily within states with less wealthy populations. One way of accomplishing this would be to use the extra residual tax and requisition revenues to fund grants to state legislatures, with sufficiently larger grants given to states with less wealthy populations so as to resolve any inequities, similar to what is done by other federal nations like Canada and Australia through their fiscal equalization regimes. Another approach would be to use the residual tax revenues to fund a spending program that would primarily benefit states with less wealthy populations—this is in a sense how the Medicaid program currently works. Perhaps the easiest solution would be to fund new income tax credits. Such new credits could be designed so that most Americans with, say, annual income of less than four hundred thousand dollars would receive credits larger than their liabilities under the residual tax or requisitions, and with Americans owning real property and having higher annual incomes then paying for the difference. In that manner, the overall structure—of a residual tax or requisitions funding tax credits—could be made progressive while resolving any potential interstate inequities.

As this short discussion suggests, there are some complexities involved in designing an apportioned wealth tax and choices must be made about how to spend revenues so as to resolve potential inequities. But these challenges are all surmountable. Congress could design the apportionment regime as a fallback clause to be added to a uniform tax on extreme wealth so that the fallback apportionment regime would only go into effect in the event of an adverse Supreme Court ruling. Alternatively, Congress might opt to wait and see what happens, and only legislate an apportionment regime later if it becomes needed in the event of an adverse Supreme Court ruling. There are pros and cons to either approach. Either way, any revenues that might otherwise be lost from a potentially adverse Supreme Court ruling could be made up for either by making the fallback apportioned wealth tax retroactive to the date of the original legislation or by levying sufficiently higher wealth tax rates for the initial years following the apportioned wealth tax coming into effect.

Again, the key takeaway is that Congress clearly and unambiguously has the power to levy an annual wealth tax. The constitutional uncertainties about how such a tax must be designed create some complexities and challenges, but these challenges are fully and readily surmountable. Properly designed, a federal wealth tax is definitely constitutional.

E. The Proposed Ultra-Millionaire Tax Would be both Administrable and Superior at Valuation as Compared to the Existing Income Tax

Valuation and measurement are key challenges in designing any form of taxation, especially with respect to ultra-wealthy individuals and families. The existing income tax does a reasonably decent job at measuring and valuing wages and salaries paid in money— the primary form of income earned by most Americans. But the existing income tax does an abysmal job at measuring and valuing the true economic gains of most ultra-wealthy taxpayers.

Consider that the best evidence from the economics literature implies that the existing income tax only ever reaches less than a quarter of the true investment income of most ultra-wealthy taxpayers.[34] This is abysmal indeed.

For comparison, although the existing estate and gift tax has been much derided for how easy it is to game around and avoid, the best evidence from the economics literature implies that the existing estate and gift tax reaches about half of the true value of the wealth transferred by the estates of ultra-wealthy taxpayers.[35] Over sufficiently long time periods, investment income and wealth become similar, and so while these estimates are not directly comparable, the measurements are comparable enough to conclude that the existing estate and gift tax probably does a better job of valuation and measurement with respect to ultra-wealthy taxpayers as compared to the existing income tax.

The proposed Ultra-Millionaire Tax would almost certainly be much better at valuation and measurement as compared to either the existing income tax or estate and gift tax (with respect to ultra-wealthy taxpayers). To begin with, many of the most important forms of tax avoidance games for escaping the estate and gift tax involve making transfers through trusts, and most of these sorts of games would be ineffective for escaping an annual wealth tax like the proposed Ultra-Millionaire Tax.[36] Furthermore, the proposed Ultra-Millionaire Tax includes anti-abuse rules for limiting many of the valuation games most commonly used to avoid the estate and gift tax.[37] Specifically, in accordance with the recommendations that I and others have made in prior writing,[38] the proposed Ultra-

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[34] Jenny Bourne et al., *More Than They REALIZE: The Income of the Wealthy*, 71 NAT'L TAX J. 335. For discussion of this evidence, see Gamage & Brooks, *supra* note 3, at 14-16.

[35] Brian Raub, Barry Johnson, & Joseph Newcomb, *A Comparison Of Wealth Estimates For America's Wealthiest Decedents Using Tax Data And Data From The Forbes 400*, NATIONAL TAX ASSOCIATION PROCEEDINGS, 103RD ANNUAL CONFERENCE ON TAXATION at 128-135 (2010).

[36] Jason S. Oh & Eric M. Zolt, *Wealth Tax Design: Lessons from Estate Tax Avoidance*, UCLA SCHOOL OF LAW, LAW-ECON RESEARCH PAPER NO. 20-01, at 1, available at https://ssrn.com/abstract=3526515 ("Second, other structures … work well to minimize estate taxes but are of limited use for structuring around an annual wealth tax. Projecting wealth tax revenue using estate tax revenue without considering the revenue consequences of these strategies will understate wealth tax revenue.").

[37] *See* Sec. 2902(d), authorizing the Treasury Department to establish valuation rules that may utilize "retrospective and prospective formulaic valuation methods" and which may "require the use of formulaic valuation approaches for designated assets, including formulaic approaches based on proxies for determining presumptive valuations, formulaic approaches based on prospective adjustments from purchase prices or other prior events, or formulaic approaches based on retrospectively adding deferral charges based on eventual sale prices or other specified later events indicative of valuation" and which may prohibit "the use of valuation discounts.".

[38] *E.g.,* David Gamage, Ari D. Glogower, & Kitty Richards, *How to Measure and Value Wealth for a Federal Wealth Tax Reform*, ROOSEVELT INSTITUTE ISSUE BRIEF (2021), available at: https://ssrn.com/abstract=3817773; David Gamage, *Five Key Research Findings on Wealth Taxation for the Super Rich* (2019), available at: https://ssrn.com/abstract=3427827.

Millionaire Tax authorizes the Treasury Department to require formulaic valuations based on proxy measurements, prospective measurements, or retrospective measurements, as best balances the goals of valuation accuracy, preventing gaming, and ensuring administrative and compliance ease for different categories of assets.[39] Working with law professors Brian Galle and Darien Shanske and economist Emmanuel Saez, I have been developing a model set of valuation and enforcement rules for a wealth tax reform.[40] The proposed Ultra-Millionaire Tax authorizes the Treasury Department to review and adopt our model rules or perhaps to develop superior alternatives.

Ultimately, no form of taxation is completely immune to tax gaming responses, especially by ultra-wealthy taxpayers. But a proposal for tax reform should not be compared to some impossibly perfect ideal, but rather to plausible real-world alternatives. In that light, the proposed Ultra-Millionaire Tax is almost guaranteed to do a much better job at valuation and measurement with respect to ultra-wealthy taxpayers as compared to either the existing income tax or estate and gift tax. Moreover, because many of the tax gaming responses to a wealth tax would be distinct from the responses to an income tax, the overall costs of tax gaming can be minimized by levying both a wealth tax and an income tax (or, alternatively, both a wealth tax and a progressive consumption tax).[41]

All of this can be achieved in a reasonably administrable manner. Our proposed model rules are based in part on the best features of the Swiss wealth tax, which has been a pillar of the Swiss tax system for well over a hundred years[42] and which is generally viewed as being both reasonably administrable and "difficult to avoid with standard tax planning techniques."[43] For instance, our proposed model rules generally recommend using market-trading prices for valuing publicly traded assets, for which these prices are easily obtainable. For many other assets, our proposed model rules recommend using formulaic valuations based on readily available information—for example, we recommend that most privately held businesses be valued based on accounting information that is already being reported for federal tax purposes. We recommend only relying on appraisals for the more limited sets of assets for which it is

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[39] Sec. 2902(d).

[40] An explanation of a work-in-progress draft of these rules, as tailored for a wealth tax reform proposal designed for the State of California, can be found here: https://eml.berkeley.edu/~saez/galle-gamage-saez-shanskeCAwealthtaxMarch21.pdf

[41] In addition to the more general reasons why levying two tax instruments with distinct gaming responses (such as both a wealth tax and an income tax) reduces the overall costs from tax gaming—as explained in Gamage, *supra* note 10—it is also the case that generating annual information on taxpayers' wealth assists in the enforcement of both an income tax and an estate and gift tax. *See* Jean-Blaise Eckert & Lukas Aebi, *Wealth Taxation in Switzerland*, WEALTH TAX COMMISSION BACKGROUND PAPER NO. 133, at 12 (2020) ("Tax authorities also appreciate the fact that the wealth tax requires individuals to annually report their net wealth. The annual fluctuations in net wealth, together with statistical data on annual spending of individuals and households, allow the tax authorities the check the plausibility of the taxpayer's declared income. Thus, one may argue that the wealth tax also has a control function for income tax purposes.").

[42] Eckert & Aebi, *id.* at 3.

[43] *Id.* at 12.

neither possible to calculate valuations based on market-trading prices or reasonable formulaic valuations. Even then, for assets for which we recommend that appraisals be required, we recommend only requiring an appraisal once every ten years unless the taxpayer has engaged in a transaction that would substantially change the value of the asset, with the reported values from the appraisals then adjusted via formulas for subsequent years. Our overall proposed approach thus minimizes the use of appraisals and resulting administrative and compliance costs. We also recommend special allowance provisions for especially liquidity constrained taxpayers and for certain especially hard to value assets.

In summary, although no form of taxation is perfect, the proposed Ultra-Millionaire Tax is almost guaranteed to be superior at valuation and measurement with respect to the ultra-wealthy as compared to the existing income tax or estate and gift tax, and with limited administrative and compliance burdens.

II. The Case for Taxing "Real" (Book) Corporate Profits

The U.S. corporate tax system is perhaps even more broken than the personal tax system. The Republicans' 2017 tax overhaul—the "Tax Cuts and Jobs Act" (TCJA)—improved the corporate tax system in some ways but made it much worse in other ways.[44] Arguably, the most profound change made by the TCJA was to slash the top statutory corporate income tax rate from 35% to 21%. Although this change has probably helped alleviate some of the international and financial-engineering pressures on the corporate tax system, it has come at a large cost to federal revenues and to the progressivity of the overall tax system, and has opened the door to a new set of abusive tax games involving the use of the corporate form for tax sheltering purposes.[45]

The corporate tax system is in dire need of comprehensive reform. In my view, a comprehensive reform package should do all—or at least most—of the following: (a) raise the overall top corporate tax rate back to a level close to the top individual rate, as it was prior to the TCJA; (b) reform the corporate tax so that it would be partially destination-based, and only partially source-based, with the effective top rate on the source-based component then being set similar to other nations' source-based corporate tax rates, and with the effective top rate on the new border-adjusted destination-based component then making up the difference; (c) further incorporate carbon-based sustainable-development adjustments into the new border-adjusted destination-based component of the reformed corporate tax; (d) terminate the check-the box regulations and abolish both Subchapter

[44] I discuss this in a prior co-authored article, David Kamin, David Gamage, Ari Glogower, Rebecca Kysar, Darien Shanske, et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1493 (2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.
[45] *Id.* at 5-16.

K and Section 199A, while reforming Subchapter S, so that all large business entities would be taxed as corporations and without unnecessary and harmful preferences for remaining pass-through entities; (e) transform the corporate tax more fully in the direction of being a profits-only entity tax while equalizing the tax treatment of debt and equity financing, either through more comprehensive cost-of-capital allowance rules or by combining much tighter limitations on interest deductions with more generous expensing allowances; (f) more comprehensively limit the entity-level deductibility of high salaries and other forms of compensation; and (g) require partial, but only partial, book-tax conformity.[46]

I note this all as background, because a comprehensive reform package of this sort is not currently on the table. What is on the table are more limited sets of partial reforms. In the absence of more comprehensive reforms like those I note above, I will now explain why I support the Real Corporate Profits Tax Act of 2021 as a significant positive move toward improving the corporate tax system.

In my view, the best analysis of issues related to proposals for book-tax conformity can be found in a 2009 article by law professor Daniel Shaviro.[47] As Shaviro explains,[48]

> "One of the hallmarks of the 'Enron era' in corporate governance was companies' increasing proficiency in reporting high earnings to investors and low taxable income to the Internal Revenue Service.' Enron has passed from the scene, and, perhaps, so have the worst abuses of the Enron era, but the book-tax gap, or excess of reported financial accounting income over taxable income, persists. In 2003, for example, all taxpaying corporations that filed U.S. returns were estimated to have reported pretax book income of $899 billion, as compared to net taxable income of only $455 billion, leaving a book-tax gap of $444 billion-an amount almost equal to the net taxable income that was reported. While the gap's exact causes, though much studied, remain imperfectly understood, most analysts agree that its persistence offers suggestive evidence of two ongoing, distinct evils. The first is earnings management, or managerial manipulation of reported financial accounting income in the hope of favorably influencing one's stock price or otherwise serving managerial goals. The second is tax sheltering, or reducing one's U.S. federal income tax liability through various maneuvers that, even if lawful when engaged in, would likely be barred if they drew the government's close attention. Managerial incentives to engage in both remain strong, even if managers have grown less aggressive since the peak of the Enron era."

To summarize, corporate taxpayers generally keep two sets of accounting books: one for reporting earnings to the Securities and Exchange Commission and to shareholders and other investors and potential investors, and another for reporting earnings to the Internal Revenue Service for tax purposes. Most analysts agree that corporate taxpayers often try to inflate reported earnings in the first set of books, so as to appear more

[46] I am in the process of developing these recommendations in an unfinished work-in-progress article.
[47] Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 Geo. L.J. 423 (2009).
[48] *Id.* at 425-26.

profitable to shareholders and to other investors and potential investors. Most analysts likewise agree that corporate taxpayers often try to deflate reported earnings in the second set of books, so as to pay less tax.

Some have proposed requiring full book-tax conformity, so that corporate taxpayers would be required to use the same set of books for both tax and financial accounting purposes. This has been the historical approach used by the German tax system, for example. However, as Shaviro persuasively explains, and as I suspect the Republican-invited witnesses to this hearing will emphasize, there are a number of problems and harmful consequences that might result from moving to full book-tax conformity that would probably make it not a good idea to do.

But we needn't choose between all or nothing. Shaviro recommends an approach for accomplishing 50% book-tax conformity. Part of his reasoning—but summarized in my words—is that the potential harms and problems from book-tax conformity likely increase on the margin as the effective conformity percentage rises from 0% to 100%. By contrast, the advantages of book-tax conformity from reducing perverse incentives for inflating earnings reported to investors and for deflating earnings reported for tax purposes almost certainly do not similarly increase on the margin, and quite possibly decrease on the margin. It follows that there is probably an optimal percentage for requiring book-tax conformity of less than 100% but more than 0%. As Shaviro elaborates,[49]

> "Taxable income and financial accounting income, while using a shared concept, serve very different purposes--determining current-year tax liability on the one hand, and providing a particular informational input to investors on the other. It is not surprising, therefore, that the two measures both ideally and actually have differences.
>
> Yet the persistent book-tax gap, or excess of reported financial accounting income over taxable income, reflects not these differences but corporate managers' incentives to engage in two socially undesirable activities: tax sheltering on behalf of shareholders and earnings management on their own behalf. Moving in the direction of requiring book-tax conformity would have the desirable feature of creating Madisonian tension between the managers' twin aims, reducing the incentive to play games and the scope of what they could accomplish.
>
> Absent political incentive problems, it might indeed make sense to adopt a one-book system or something close to it, notwithstanding the differences between the two measures' purposes. However, Congress, for the most part, currently confines its dark arts to the design of taxable income, while largely leaving accounting income to FASB, which helps make the Madisonian strategy less promising with respect to its decisions than those of corporate managers. A more directly involved Congress might be expected to worsen financial accounting income more than improve taxable income and in any event could not be required to keep the two measures in lockstep when it wanted to add opposite tax and accounting preferences to each.
>
> My suggested proposal, generally requiring a 50% adjustment of taxable income towards financial accounting income for large, publicly traded companies, is not a perfect solution to the competing considerations in this complicated but important area. Yet it would substantially improve current law if adopted, and even if just seriously considered, may help to advance the ongoing debate."

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[49] *Id.* at 483-84.

The Real Corporate Profits Tax Act of 2021 is similar to Shaviro's proposal for partial book-tax conformity, but also different in important respects. To begin with, the Real Corporate Profits Tax Act would create a surtax of 7% of every dollar of book income above $100 million. As an addition to current law, this would effectively make the top corporate tax rate on large corporations 28% (the current top statutory rate of 21% plus the new 7% surtax rate), with an effective book-tax conformity percentage of 25% (the 7% surtax rate / the 28% combined rate). The Real Corporate Profits Tax Act of 2021 would thus not go as far as Shaviro's proposal in requiring book-tax conformity.

The underlying mechanics are also different, as the 7% surtax would be based on complete book-tax conformity, but the book-tax conformity rules would only apply to that 7% surtax. Nevertheless, as with Shaviro's proposal, this should reduce the perverse incentives that corporate managers currently face to inflate earnings reported for financial accounting purposes and to deflate earnings reported for tax purposes, while largely avoiding the problems that might arise from more complete book-tax conformity. In particular, it seems rather unlikely to me that the mere existence of the 7% surtax rate would induce Congress to harmfully meddle with the FASB's decision-making as to financial accounting rules.

Overall, there is a very strong case for moving to partial, but only partial, book-tax conformity for corporate taxpayers. The Real Corporate Profits Tax Act of 2021 is a reasonable approach for accomplishing this. All factors considered, the Real Corporate Profits Tax Act would raise substantial revenues needed to fund public investment, would significantly improve the progressivity of the overall tax system, and would reduce the perverse incentives corporate taxpayers currently face both to inflate earnings reported for financial accounting purposes and to deflate earnings reported for tax purposes so as to avoid tax. And it would accomplish all this while minimizing the potential harms that might result from more complete book-tax conformity. For all of these reasons, I support the Real Corporate Profits Tax Act of 2021 as an important and significant step toward a better corporate tax base.

III. The Case for Improving IRS Funding and Making Tax-Enforcement Less Dependent on the Annual Appropriations Process

There is general agreement amongst tax experts that the IRS has been starved of funding over the recent decade and that this has been tremendously harmful to the tax system in a wide variety of ways.[50] The need for improving IRS funding is overwhelming.

[50] *See, e.g.,* Leandra Lederman, *Valuation as a Challenge for Tax Administration*," 96 Notre Dame L. Rev. 1495, 1497 (2021) ("Audit rates are generally low, due to resource constraints. The Internal Revenue Service (IRS) in

The most straightforward way to improve IRS funding would be to substantially increase the funding allotted through the annual appropriations process. And this should indeed be done, and promptly. But history suggests that this, alone, is insufficient. For instance, despite that the Affordable Care Act (ACA) required the IRS to take on substantial new obligations in order to enforce the tax provisions of the ACA, insufficient funding was granted to the IRS to accomplish these purposes, which harmed both the implementation of the ACA and the enforcement of the tax system more generally.

It is thus time to consider going beyond just relying on the annual appropriations process to also provide dedicated multi-year mandatory funding streams and other more reliable funding appropriations to the IRS and perhaps also to other agencies charged with substantial tax enforcement obligations. Promising approaches for accomplishing these goals include: (a) appropriating funding that is essentially exempt from general annual limits via what is typically referred to as an "allocation-adjustment" mechanism; and (b) creating a multi-year "mandatory" funding stream provided directly through new authorizing law.

In addition to these proposals for improving IRS funding, I would also strongly recommend: (a) increasing third-party information-reporting requirements; and (b) extending the federal False Claims Act to tax claims (but with high exemption limits so that only tax fraud by ultra-wealthy individuals and families and by large businesses and corporations would be liable for tax claims under the extended False Claims Act).[51]

To further emphasize the need for increased and more-reliable tax-enforcement funding and for accompanying reforms to improve tax enforcement, I will close by quoting testimony recently provided to the House Ways and Means Committee by my colleague Leandra Lederman:[52]

> "Most important, enforcing the tax laws increases the fairness of the tax system. A progressive income tax tends to reduce income inequality. However, a recent study found that tax evasion unravels that effect. This is because higher-income taxpayers tend to have more opportunities for tax evasion. Taxpayer fairness thus calls for enforcement of the tax laws. It also calls for enforcement where there is more opportunity for noncompliance, even if these audits are more expensive to conduct because they cannot simply be done by correspondence, for example. Enforcement depends on IRS resources, so part of taxpayer fairness is adequately funding the IRS."

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particular has seen its audit rates decline since 2010, as Congress has starved it of funding."); Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential*, TAX NOTES FEDERAL, November 18, 2019.

[51] The provisions of New York State's False Claims Act that apply to tax claims are a good starting point for a model for such reforms. I am also in the process of developing further recommendations as part of the model valuation and enforcement rules that I am developing for wealth tax and related reforms.

[52] Leandra Lederman, *The Importance of Enforcement to Taxpayer Fairness*, at 6, Prepared Testimony for the Hearing "Taxpayer Fairness," October 13, 2020, U.S. House of Representatives, Committee on Ways and Means, Oversight Subcommittee, available at: https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/Lederman--Prepared%20Testimony%20for%20the%20Hearing%20FINAL%20UPDATED%2010-12-20.pdf

Thank you again for inviting me to speak with you today, on these critical issues and reform proposals for creating opportunity through a fairer tax system. I look forward to answering any questions you might have.