https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

REALIZATION AND RECOGNITION UNDER THE INTERNAL REVENUE CODE

By Richard A. Epstein*

Abstract: *Over its entire life, the Internal Revenue Code (like other tax systems) has never tried to tax economic income as such, because of the administrative and liquidity problems that arise from taxing any combination of values consumed and from appreciation (or depreciation) of capital stocks. Instead, the common practice limits tax occasions to a realization of income from sale or other disposition of property. Even then, if the proceeds of the transaction are not cash or marketable securities, as with many corporation reorganizations, taxation is deferred until these assets are converted in cash or marketable securities.*

Any effort to eliminate these twin filters by taxing income—and income regardless of realization—will overburden government agencies and private taxpayers, while reducing economic activity. A wealth tax scores even worse by these welfare measures, creating massive problems of evasion and enforcement that will reduce capital formation across the board in the effort to transfer wealth from the ultra-rich to everyone else. A simple tax structure with affordable rates is the only path to economic prosperity.

KEY WORDS: administrative constraints, Haig-Simons, liquidity constraints, progressive taxation, realization, recognition, valuation, wealth tax

Suppose that you have just made partner at a major law firm, which gives you a promised income over the next twenty-five years to generate income whose present value is estimated to be $25 million. Your pleasure in this achievement would be quickly curtailed if the Internal Revenue Service sent you a tax bill for $10 million on the assumption that the best estimate of the effective tax rate would be 40 percent over that entire period. You are then told that there is a silver lining to this immediate imposition. Once the money rolls in for future years you will pay no tax at all, given this prepayment. Indeed, you might even get a refund if those initial estimates prove too high. You do not, of course, have $10 million on hand, but when you look at the definition of income under the Internal Revenue Code, you

* School of Law, New York University; richard.epstein@nyu.edu. Competing Interests: The author declares none. The essay is dedicated to the memory of my three great tax teachers: Boris Bittker and Marvin Chirelstein of the Yale Law School, and Walter Blum of the University of Chicago, whose voices I still hear whenever I write on tax issues. My thanks to Charles Delmotte and Erick Sam, who were fellows at the Classical Liberal Institute, for their comments on an earlier draft of this essay, and to Gideon Rapaport, New York University School of Law, Class of 2023 for his valuable and careful research assistance.

doi:10.1017/S0265052523000079
© 2023 Social Philosophy & Policy Foundation. Printed in the USA. This is an Open Access article, distributed under the terms of the Creative Commons Attribution licence (https://creativecommons.org/licenses/by/4.0/), which permits unrestricted re-use, distribution, and reproduction in any medium, provided the original work is properly cited.

discover to your dismay that it includes "compensation for services," which you have just received in the form of that partnership interest.[1] Under this tax regime, a promotion becomes an occasion for mass bankruptcy.

Nonetheless, that epic consequence does not apply for reasons that are unrelated to this barebones definition of income. Rather, the Internal Revenue Code operates under an ironclad rule that the receipt of the partnership interest in your firm is not a "taxable event," so that the tax becomes due in the typical case only when the cash is received. There is thus no reason to guess the value of that partnership interest. Instead, it is only necessary when the cash is paid out—which is when the levy is put into place.

This little tale of woe should remind us that patterns of taxation are always sensitive to two major factors—the timing of the tax, and the form in which the wealth is received—both of which push back the time at which certain accretions to wealth (like the partnership interest) are taxed. Literally since the beginning of the income tax, these two constraints have played a huge role in organizing our tax system. But with the rise of progressive thought in the United States, the mood has changed, especially now that the Biden administration has been in power for over two years. The proposals are many, the two most important of which are these: first, the elimination of the so-called realization requirement for the collection of the income tax, on all or at least some class of assets, and second, the imposition of a wealth tax that in no way depends on the occurrence of a taxable event, such as the receipt of income or the transfer of a property by way of gift or will.

The current battle lines are drawn in this fashion. On one side of the academic debate are those who have little quarrel with the current tax structure, and who generally favor only incremental reforms, chiefly involving changes in rate structures, up or down, as exemplified—whether for good or ill—by the Trump administration's tax reforms of 2017. These reforms generally lowered rates for individual income, corporate, and capital gain taxes; reduced the taxation on foreign income brought back to the United States; and limited to $10,000 the deductibility of state and local taxes against the federal income tax.[2] Those reforms have been highly controversial, with the Republicans saying that the reduction in taxation on corporations and the well-to-do would work in the end to increase wages for

[1] 26 I.R.C § 61 (a)(1). Section 61(a) defines "gross income," which then has to be adjusted for certain deductions, e.g., business expenses and depreciation allowances, to determine net or taxable income.

[2] Tax Cuts and Jobs Act of 2017, Pub. Law. 115-97. For my brief defense of this legislation, see Richard A. Epstein, "We Need Flatter Taxes, Cleaner Rules," *Hoover Defining Ideas*, October 3, 2017, available at https://www.hoover.org/research/we-need-flatter-taxes-cleaner-rules. For a systematic defense, see Phil Gramm and Michael Solon, "Tax Reform Unleashed the U.S. Economy," *Wall Street Journal*, March 4, 2019, available at https://www.wsj.com/articles/tax-reform-unleashed-the-u-s-economy-11551740837?mod=searchresults&page=1&pos=1. For the opposite view see Joseph Stieglitz, "Donald Trump's Tax Cuts for the Rich Won't Make America Great Again," *The Guardian*, July 27, 2017, available at https://www.theguardian.com/business/2017/jul/27/donald-trump-tax-cuts-rich-america-lower-taxes-deregulation.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

workers who would not otherwise be in greater demand, and with the Democrats saying that the sop to the rich would do nothing to help working men and women, and instead would only expand income inequality for the benefit of the super-rich. The progressive message to date has met an uncertain future, for the Democratic effort to remove the flat tax limitation in the Illinois state tax system was rejected by the public 55 percent to 45 percent.[3]

This essay does not enter into this short-term debate, but rather it asks a different question about the fundamental structure of the tax code, which has been called into question by those who believe that the taxation system should do more, and far more at that, to redress fundamental inequalities of wealth and income in the United States. The proposals in question seek to change the fundamental basis on which the income tax is calculated. The more modest proposal calls for the elimination of the aforementioned realization requirement of the Internal Review Code, which treats the conversion of wealth from one form to another, as by sale or barter, as an occasion for the recognition (i.e., inclusion into taxable income) of tax gain, be it ordinary or capital in nature. This is measured as the difference between the amount realized from the transaction less the adjusted basis of the property that has been transferred.[4] The more radical proposal seeks to impose an annual tax on wealth wholly without regard to any realization event. To develop these issues, I will proceed by describing how the current taxation system operates, with its (terms to be defined later) realization requirement and nonrecognition provisions. Thereafter, I will contrast it with the two proposed systems. In doing so, I will also contrast the first proposed reform that eliminates the realization requirement for taxable income with the second that imposes a tax on wealth in addition to any taxes imposed on income.

To put my cards on the table, I strongly defend the continuation of the older system in the face of these new proposals. I do not do so because I think that the current structure is ideal, for there is much to be said against it. As a matter of the first principles of political economy, I have long

[3] Shelby Bremer, "Illinois' Graduated Income Tax Proposal Rejected, AP Projects, as Pritzker-Backed Committee Concedes Defeat," *NBC Chicago*, November 4, 2020, available at https://www.nbcchicago.com/news/local/chicago-politics/illinois-graduated-income-tax-proposal-where-vote-on-amendment-stands/2363905/.

[4] Internal Revenue Code (I.R.C.) § 1001

(a) Computation of gain or loss. —The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized. —The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) Recognition of gain or loss. —Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

advocated a single flat tax on income as the sole source of general revenues, subject to an exception that exempts income (especially in the form of shares or real estate) that is immediately put to productive uses, so that the entire system moves closer to a consumption tax.[5] Other taxes may well be imposed, but these should be as a substitute for fines or fees that should be imposed on pollution on the one side, or on the use of public highways on the other. Otherwise, the case for the flat tax is that it allows the government to choose whatever level of taxation it wants to meet its revenue targets while preventing efforts to make the tax either progressive or regressive in effect. The objective under this system is not to create a mechanism to redistribute wealth, which progressive taxes and transfer taxes do, but to provide stable funding for certain public goods that, as a first approximation, supply individuals with collective net benefits that are in some rough sense proportionate to wealth.[6] The inability to pick out special groups for taxation will tend to slow increases in the rate of taxation, and through that one mechanism, also slow increases in the overall size of government. That principle has been strongly supported by all champions of limited government, including Aristotle, Locke, and Hayek, but widespread arguments in favor of income (or wealth) redistribution have toppled that former consensus. These newer arguments praise redistribution, tied to the ability to pay, as a proper end of society for which income taxation is the ideal mechanism, because it tends to interfere less with productive activities than specialized taxes or levies on particular activities that are more likely to distort the relative prices of goods and services.[7]

I. Realization and Recognition: A Primer

The current legal structure uses the following two-part system to determine how the income tax is paid. The background legal norm states that a simple change in the level of wealth, either up or down, is not a "taxable event." Instead, the determination of a taxable event takes place in two stages. As noted previously, the first requires some realization event, whereby a particular asset is disposed of by sale or some other form of disposition (such as a lease) in exchange for some other monetizable item, which is properly taxable as income. Putting refinements aside, the law does not tax all realized income and instead develops a second screen whereby the gain on some realized income is not "recognized" or included in taxable income at the time of its receipt. The tax is deferred until some later time

[5] Richard A. Epstein, "Can Anyone Beat the Flat Tax?" *Social Philosophy and Policy* 19, no. 1 (2002): 140; Richard A. Epstein, "Taxation in a Lockean World," *Social Philosophy and Policy* 4, no. 1 (1986): 49.

[6] For this general rationalization, see (as ever) Mancur Olson, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1965).

[7] See Louis Kaplow and Steven Shavell, "Why the Legal System is Less Efficient than the Income Tax in Redistributing Income," *Journal of Legal Studies* 23, no. 2 (1994): 667.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

when it is thought appropriate to tax the gain, which has been manifest, typically, in cash or fully marketable securities.

There are many illustrations of this two-stage program in practice. In most cases, the Internal Revenue Code contains explicit provisions that call for nonrecognition, but not (ironically) for becoming a member of a firm, as in the opening example. Thus, typically, the contribution of appreciated property into a partnership or corporation is not a taxable event.[8] Instead, the parties receive a lower basis for their shares in the corporation or the partnership interest, leading to a higher amount realized when and if the interest in the partnership or shares of the corporation are sold for cash and marketable securities, or (at the partnership or corporate level) the assets are similarly disposed of. Like-kind exchanges of real property rely upon a similar device.[9] The owner of appreciated property, after making various adjustments, uses the basis he had on the property surrendered as the basis of the property received in the swap, and the gain is then recognized only upon the ultimate disposition of the acquired property. The same rule applies to the many forms of corporate reorganizations, whether with assets or shares, where again, the ultimate resolution of the tax accounts waits for a final disposition of the property.[10] Similar rules also apply to the spin-off of one corporation from another.[11]

To this key nonrecognition rule, there is one main exception that comes into play when there is not a straight property-for-property transaction. When the values of the exchanged properties are not equal, one taxpayer may receive additional consideration, called a "boot," in the form of cash or marketable securities, which are generally treated as income when received, because of their liquidity. This boot can be properly taxed at the time of the receipt, at least to the extent that it represents gain from the disposition of the property. The recognition of that gain does not alter the basis in the property received (because there has been no return of capital), but it obviously reduces the potential taxable gain received at some future time. To the extent that the boot received exceeds gain, the money is treated as a return of capital, which in turn lowers the adjusted basis (to preserve the possibility for future taxable gain) in the shares that remain.[12]

In addition to these basic nonrecognition provisions, there is a highly questionable rule that allows the transfer of appreciated property at death to receive a "stepped-up" basis equal to the then fair market value of property.[13] This provision's net effect is to cancel out the basic logic of the

[8] See I.R.C. § 351 (corporations); § 721 (partnerships).
[9] See I. R.C. § 1031.
[10] See I.R.C. § 368.
[11] See I.R.C. § 355.
[12] By way of example: suppose that you own property with a basis of $1,000 and a market value of $2,500. It is exchanged for a property worth $2,000 with $500 in boot to equalize the deal. The $500 in boot is subject to an immediate tax. The basis of the property remains $1,000, and the last $1,000 in gain is taxed when the $2,000 property is sold, assuming its value is unchanged.
[13] See I.R.C. § 1014.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

nonrecognition rule—that the gain initially deferred will be taxed eventually—by adopting a rule that in effect allows for the gain to escape income taxation, even if that wealth remains subject to the estate tax because it is transmissible at death. To be sure, the rule has a surface symmetry insofar as any unrealized loss at the time of taxation is also eliminated. But in practice, that loss can always be obtained (at least for marketable securities) by first selling depreciated property for a loss, which then is reflected on the tax return for the last period, making these nonrecognition rules a quasi-elective provision dependent upon the alertness of the taxpayer who remembers to make these timely dispositions for recognizing tax losses prior to death. In theory, however, a more sensible proposal (especially with marketable securities) *might be* to tax the appreciation at death, even at the cost of having to sell some assets into the marketplace to pay off the residual liabilities, a task that leads to more difficult issues in valuing illiquid assets also transferred at death. This tax liability at death could be offset by a repeal of the estate tax, which necessarily applies to all assets no matter how difficult to value. These dual requirements have been a fixture of the Internal Revenue Code from the beginning. They have endured precisely because the general efforts to expand the tax base give rise to liquidity and valuation problems that the deferment of income, even after a technical realization, avoids.

II. Why Realization and Recognition?

Under the current institutional arrangements, these twin restraints on realization and recognition form an essential part of any sound system of taxation. The starting point for the basic argument lies in the economic definition of income, the so-called Haig-Simons definition, which contains two key elements—wealth increase within any given period, and resource consumption during that time. As famously formulated by Henry Simons, personal income is defined as the "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of a store of property rights between the beginning and end of the period in question."[14] The point of this definition is to capture the full income from consumption and change in net worth, and the realization requirement (let alone any nonrecognition rules for realized income) has no role whatsoever to play on either half of the basic definition. According to the theory, in a world devoid of transaction costs and administrative uncertainty, this definition of income would supply the perfect base for taxation.

[14] Henry Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), 50. I explored the limitations of this definition as applied to depreciable personal property and casualty losses in Richard A. Epstein, "The Consumption and Loss of Personal Property under the Internal Revenue Code," *Stanford Law Review* 23 (1971): 454. Nonetheless, the 2017 tax reforms have sharply cut back on the deductions given to casualty losses by restricting them to only those losses stemming from disasters declared by the federal government. Internal Revenue Service, "Casualties, Disasters and Thefts," available at, https://www.irs.gov/pub/irs-prior/p547--2017.pdf.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

Ironically, in some contexts this definition points to the reason for postponing taxation even though there has been, apparently, an admitted realization of gain in the form of the receipt of property. The most famous case of this sort is *Eisner v. Macomber*,[15] where Justice Mahlon Pitney refused to impose an income tax on a recapitalization transaction organized by Standard Oil of California. Under the deal, Standard paid a 50 percent dividend in common stock on each share of Standard Oil common stock outstanding. Once completed, Standard made an appropriate bookkeeping adjustment to increase the corporation's capital account from the earned (that is, taxable, if distributed) surplus of the corporation. Note that this realization does *not* result in an increase in net worth taxable under the Haig-Simons definition of income.[16] And since no ready cash comes out, the tax is deferred. The analysis has two steps. First, the new stock issued reduces the value of the original shares by one-third each by adding new shares of common stock. Second, the loss on existing shares is exactly offset by the receipt of new shares. So, if each share were worth $15 before the transaction, afterward, each new share was worth only $10. And $15 x 2 = $10 x 3. Accordingly, the Court refused to impose a tax on the new shares, referring to the Sixteenth Amendment, which reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[17] It then held that "Income may be defined as the gain derived from capital, from labor, or from both combined," and further that this definition was not satisfied because what was needed was something "severed" from the capital rather than "accrued" to it. Indeed, today, the correct result is reached by treating this transaction as a tax-free recapitalization under Section 368(a)(1)(e).

In dissent, Justice Holmes urged that the stock dividend should be taxed because the transaction was a close substitute for one in which cash was first distributed to the shareholder, which counts as taxable income, and then reinvested in the corporation at the option of the shareholder, given an increase in basis.[18] The second transaction is in fact materially different from the first, for the taxpayer was under no obligation to reinvest the cash distributed in the corporation.

The instance reflects a pattern in the Internal Revenue Code's evolution whereby transactions that do not take cash or property out of the corporation are rightly then treated by statute as nonrecognition, because it is

[15] 252 U.S. 189 (1920).

[16] Haig-Simons formula defines income to be consumption plus change in net worth.

[17] U.S. Constitutional Amendment 16. The Amendment was passed to overrule the Supreme Court decision in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), which held that "imposing a tax on the income or rents of real estate, imposes a tax upon the real estate itself." The issue is in fact more complicated because the rental income from real estate is in exchange for both the use of the property and services rendered in connection with that use. It is thus a joint case, as service income is not subject to the direct tax requirement.

[18] *Eisner*, 252 U.S. at 220 (Holmes, J., dissenting).

utterly unwise to force their inclusion into the income tax system. In addition, even when gain is realized under the Code, if there is lack of cash or a monetizable equivalent, the *nonrecognition* provisions mentioned above kick in. Take these issues in turn.

Subjective value and personal consumption: It is enormously difficult for anyone to assign a dollar value to any element of consumption, which could include more than the pleasure gotten from some particular asset that does (or does not) depreciate over time. The point remains even if we tie the value of consumption to its market value, which cannot be determined where there is no ready market that links buyers to sellers. Thus, consider the art collector whose paintings cover the walls of his house. Clearly, the art offers evident consumption value for both the owner and any other resident of the house, and it would surely be possible with at least some high-value art pieces to rent them out for a positive income, so that the intrepid tax-master could "impute" that value to the owner, with some consumption value left over for family members, guests, and even the cook and the butler.

At this point, yet another issue arises, which is how to pay the tax? Any effort to monetize consumption necessarily requires some transformation from utility to wealth. However, individuals with high consumption value and little income cannot pay the tax in "utiles." They may have to liquidate their financial assets, broadly conceived to include, for example, both jewelry and artwork, to cover the tax. Any such regime of forced sales could engulf the market as millions of individuals find themselves in the same cash-constrained position, so that in the end, there is a uniform (if tacit) consensus that ordinary consumption should be out of the regular tax base even if it is a bona fide component of income under the Haig-Simons formula. The situation is even worse with standard personal pleasures—a good marriage, a peaceful day in the country—which are impossible to value in a reliable fashion. And if these are taken into account, should there be offsetting deductions for a loss of a loved one, a divorce, dismissal from a job, or any of the other misfortunes of life? None of these countless exercises is worth doing. It should be, moreover, of some but limited comfort that assets of this sort are possessed in varying degrees by all individuals, so that their removal from the tax base does not have any obvious redistributive consequence between individuals or even between members of different wealth groups. After all, even if rich people have greater nonpecuniary satisfactions than poor people, there is nothing that guarantees that these differences are at the same ratios as held for pecuniary income. The result is an admitted distortion in that people will substitute too much leisure (or family home care) for otherwise taxable income.

Since these assets practically escape the tax system, the law resorts to an imperfect offset by denying a deduction for any expenditure used to generate these various consumption goods, including for artwork and the cost of any insurance on one hand, and cleaning and restoring the item on the other. The removal of that income has nontax values by creating a private

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

sphere into which government cannot intrude with its vast investigative powers. The denial of the deduction, however, invites a nonintrusive, if imperfect, correction of the basic income shortfall, but it survives because it is administratively workable. The denial of the offset necessarily eliminates all the valuation issues from the mix, especially those that arise from self-help measures. Nor is there any liquidity problem in denying deductions, and taxing the income received. There are technical problems with individuals who spend borrowed capital, but these situations are typically resolved in the same parsimonious fashion:[19] the loan does not get taken into income when the money is received, and there is no deduction when the loan is repaid. Instead, when the transaction is closed through either repayment or default, the transaction will either zero out or generate income to the taxpayer to the extent that the loaned amount exceeds the amount repaid.[20] Moreover, that result is consistent with the Haig-Simons definition because there is no net increase in wealth from either the loan or its repayment. The income comes from the activities undertaken with the borrowed proceeds that are separately accounted for.

Changes in net worth: A similar set of difficulties besets the second half of the Haig-Simons formulation because valuation and liquidity create problems in the absence of a sale or even an arm's length mortgage (which does not set the fair market value of the asset, but offers a lower bound as to what that might be.) Homes and artwork are only two of the many kinds of assets held for long periods and likely to appreciate substantially in value. The same can be said with the many closely held corporations where complex capital structures (not common with most public corporations) create a two-tier valuation problem.

First, there has to be a valuation of the business itself when it is not up for sale. On that question, corporate earnings are at best a weak proxy for value, because a close-knit group of shareholders acting collectively can manipulate share value through the adjustments of salary and expense payments in any given period. Next, since control of the firm is often divided in complex ways, the valuation of fractional interests of individual shareholders are devilishly difficult to valuate. These complex interrelationships have a

[19] I ignore here the many complications that arise when loans are secured in part by mortgages, whether on a recourse (i.e., personal basis) or nonrecourse basis. See, e.g., *Crane v. Commissioner*, 331 U.S. 1 (1947); and *Commissioner v. Tufts*, 461 U.S. 300 (1983). These cases created opportunities for tax shelters, which for these purposes are defined as allowing economic losses today that do not reflect decreases in value in exchange for an obligation to repay upon realization at some later point in time. For ingenious efforts to escape the "back-end" gain, see Martin Ginsburg, "The Leaky Tax Shelter," *Taxes* 53 (1975): 719. There are additional issues when these assets are held by limited partnerships that need not be addressed here. See Richard A. Epstein, "The Application of the Crane Doctrine to Limited Partnerships," *Southern California Law Review* 45 (1972): 100.

[20] *United States v. Kirby Lumber*, 284 U.S. 1 (1931) (agreeing with the regulation that provided: "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.") For codification, see I.R.C. § 7872(a)(1).

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

business justification because the corporate structure of a closed (for example, family) corporation serves at least two functions. First, it creates an orderly transition of control between generations, which could result in the older generation taking a less-risky equity position in the form of preferred shares, in exchange for yielding daily control to the next generation.[21] It thus becomes difficult to allocate the value between the preferred and common stock, without extensive knowledge of the terms on which both were issued.

Second, these complex structures are also used to prevent any individual shareholder from selling his or her shares to an outsider without the consent of the remaining shareholders. In all closely held corporations, there is a genuine fear of letting strangers take a seat at the table with family and friends. The addition of strangers complicates affairs in multiple dimensions and raises questions as to whether information can be kept confidential or whether there are hidden conflicts of interest under a common strategy on both routine operations and major corporate transactions. So, the common practice is that all transfers of stock ownership on such occasions as death or divorce are made among members of the group only. The gains are realized when the entire business is sold to a third party or made the subject of a going-public transaction.

By way of contrast, only in public corporations does market price become a reliable indicator of share value. In this case, the entire system is designed to ensure that any shareholder may sever, by the sale of stock, his or her relationship to the firm at any time, without affecting those dealings existing shareholders have among themselves and without upending the firm. Here fungibility of shares is the key to market alienability, which usually requires simple corporate structures (typically with only a single class of shares) to facilitate exchange. When a large number of unrelated individuals join in a corporate venture, as Berle and Means wrote over ninety years ago, the real separation between (passive) ownership and (active) management is made more tolerable by allowing unhappy shareholders an exit right to sell—with no questions asked—their shares to outsiders who might be in a better position to monitor the firm.[22] For that reason, David Slawson's 1967 proposal to tax the unrealized appreciation of corporate shares was confined only to publicly traded stock,[23] where the valuation issues could be kept under control.[24]

[21] See I.R.C. § 306.

[22] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932). On the value of the sale option, which can lead to corporate takeovers, see Henry Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (1965): 110.

[23] David Slawson, "Taxing as Ordinary Income the Appreciation of Publicly Held Stock," *Yale Law Journal* 76 (1967): 523. For the record, I was one of the (skeptical) student editors who worked on his paper in the summer of 1967. "If appreciation of publicly-traded stock were taxed annually as ordinary income, whether or not the stock was sold, the tax system would become genuinely progressive without impairing industry's accumulation of capital" (ibid., at 624).

[24] Slawson, "Taxing as Ordinary Income," 645.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

Nonetheless, solving the valuation problem does not necessarily mean that taxing unrealized appreciation is wise, given the creation of other distortions. First, in a good year, the prospect of substantial market-wide appreciation could lead to a glut of sales that would drive down the share prices, which could lower values and thus the taxes. Alternatively, people could borrow money to leverage their portfolio, perhaps to unduly high risk levels. Neither form of coerced behavior seems attractive.

More importantly, the Slawson proposal will reduce the number of initial public offerings. Roughly speaking, the financing of any new proposed venture goes through a normal three-stage development sequence. At the initial stage, the venture's capital requirements and the risks are both high and difficult to assess. Hence, the original inventor or team will tend to finance most of the costs by themselves, sometimes relying on savings (which could include net winnings from previous successful ventures) or even credit card debt. The second stage tends to involve some form of joint venture with a specialized firm that readies the business for the third stage: an initial public offering or sale (IPO) as a complete business to some larger entity.

It is at the IPO stage that the Slawson proposal misfires. So long as the venture is private, changes in net worth lie outside the taxation system. But once the shares become publicly traded, all future unrealized appreciation becomes subject to taxation. Since most ventures at this stage yield a positive return, the higher tax will inhibit the current holders from either selling to an existing firm or going public. The higher tax rates may well make it cheaper to keep the business as a private corporation. But at this point, the social losses come from the inability to achieve two important social ends made possible by selling out or going public. First, the third stage releases capital so that the successful entrepreneurs can restart the growth cycle with some new venture. Second, it prevents those individuals willing to accept a lower rate of return for a less risky venture from buying into more stable businesses. It is always a mistake as a matter of tax policy to think about any given year in isolation in setting tax rates. The critical social objective is to maximize the long-term value of firms. This will depend on the ability to create high capital values, which will make it easier for the firm to hire more workers, make more investments, and pay larger dividends. Truncation of the cycle makes no sense at all.

After reviewing these various permutations, it appears that today's basic structure of the Internal Revenue Code has it about right. At this juncture, any revenue demands should be met by raising taxes within the basic framework, without adopting any different system of taxation. One hidden advantage of that approach is that it will tend to generate more social output than a heavier tax scheme that requires developing a new array of regulations before it can be gotten up and running. To the predictable protest that the revenues are not sufficient for current programs, the answer is that governments should not live beyond their means, but should cut public expenditures to sustainable levels; nor should legislators ever be allowed to

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

escape budget constraints by levying special taxes on particular industries to raise general revenues. As will become even more apparent with the wealth tax, these distortions will magnify, leading to departures from the jurisdiction and unwillingness for productive individuals from overseas to set up residence here. On a smaller scale, that happened in Maryland, where higher taxes led to an exit of millionaires on the one side and a decline in overall revenues on the other.[25] Worse still, efforts to tax particular kinds of transactions, such as imposing a floating 0.25 percent tax as New Jersey contemplated (later scaled back to 0.1 percent) on various financial transactions, gave rise to threats from both the New York Stock Exchange and Nasdaq to take their backroom operations elsewhere, including to Texas, which is now actively courting both organizations[26] (and which just landed the prominent Silicon Valley firms Hewlett Packard,[27] Tesla,[28] and Oracle).[29] As a general rule, it is foolhardy to seek to impose taxations on highly elastic assets or transactions. Since New Jersey has no locational advantage, this taxing venture will fail. The clear lesson here is that keeping sound tax principles is a break on higher taxation, which in turn takes bloated states, like New Jersey, and pressures them to live within their means.

III. The Leap to Wealth Tax

The more radical proposal still calls for a wealth tax, in this instance as a profound extension on the estate or gift tax. The latter are imposed not on the realization of gain, but on the transfer of an asset from one person to another without any transformation in amount or form. The basic theory of taxation for the estate and gift tax is that both the state and federal government have the right to impose taxation on the asserted privilege that the law gives them to make these transfers either during life or at death.[30] The chief

[25] Joseph Bishop-Henchman, "Maryland's Millionaires Missing After Tax Hike," Tax Foundation, March 12, 2010, https://taxfoundation.org/marylands-millionaires-missing-after-income-tax-hike/: "[T]he Comptroller of Maryland has reported that the number of "millionaire" returns tumbled sharply between 2007 and 2008, a 30% drop in filers and 22% drop in declared income. Rather than income taxes from this group rising by $106 million, they fell by $257 million."

[26] Alex Alley, "NYSE and Nasdaq Threaten to Leave New Jersey If Transaction Tax Goes Ahead," Data Centre Dynamics, October 20, 2020, https://www.datacenterdynamics.com/en/news/nyse-and-nasdaq-threaten-leave-new-jersey-if-transaction-tax-goes-ahead/.

[27] AP, "Hewlett Packard Enterprise to Move Headquarters to Texas," December 2, 2020, https://apnews.com/article/houston-california-greg-abbott-texas-1ce5ef41c6e20e84b5954de11fa3c8a7.

[28] Jessica Bursztynsky, "Oracle Is Moving Its Headquarters from Silicon Valley to Austin, Texas, December 11, 2020, https://www.cnbc.com/2020/12/11/oracle-is-moving-its-headquarters-from-silicon-valley-to-austin-texas.html.

[29] Katie Canales, "Oracle Is Moving Its Headquarters from Silicon Valley to Austin, Texas—The Latest Tech Giant To Flee the Tech Capital for the Southern State," December 11, 2020, available at https://www.businessinsider.com/oracle-moving-to-austin-hq-silicon-valley-texas-2020-12.

[30] See *Knowlton v. Moore*, 178 U.S. 41, 47 (1900):

> Taxes of this general character are universally deemed to relate, not to property *eo nomine*, but to its passage by will or by descent in cases of intestacy, as distinguished from taxes imposed on property, real or personal as such, because of its ownership and

instrument is the estate tax, but the gift tax had to be added into the mix because of the obvious circumvention risk that wealthy transferors would shift to inter vivos gifts, including those done on the eve of death to avoid the estate tax. Although Elizabeth Warren invokes two law professor letters to treat these cases as constitutional precedents, clearly they are not.[31] The wealth tax is an annual tax, but the estate and gift tax can only be levied once, at the time of transfer. The gift tax can be avoided altogether by not making any such transfers, and the estate tax is necessarily postponed until death. In practice, the system has several safe harbors. The contemporary gift tax contains, as a matter of legislative grace, an annual exclusion from the tax of $17,000 per each donor/donee pair, allowing a married couple to transfer $34,000 per year to each child or grandchild (as well as others) outside the transfer tax system. It also provides for a tax-free transfer during life between spouses.[32]

The wealth tax relies upon a single, but critical, modification of the estate and gift tax: there is no need for any taxable event. It holds that individuals may be taxed on their simple accumulation of wealth regardless of whether it is transferred or retained. The base of this tax is typically defined very broadly. To avoid evasion, it covers all marketable and nonmarketable assets, tangible or intangible, which may be taxed on an annual basis, typically on a progressive scale. The wealth tax, moreover, is keyed to the aggregate wealth at the time the tax is imposed, without regard to whether

> possession…. Such taxes so considered were known to the Roman law and the ancient law of the continent of Europe.

Knowlton in turn relied on *Magoun v. Illinois Trust & Savings Bank*, 170 U.S. 283 (1898):

> [Inheritance taxes] are based on two principles: 1. An inheritance tax is not one on property, but one on the succession. 2. The right to take property by devise or descent is a creature of the law, and not a natural right — a privilege, and therefore the authority which confers it may impose conditions upon it. From these principles it is deduced that the States may tax the privilege, discriminate between relatives, and between these and strangers, and grant exemptions; and are not precluded from this power by the provisions of the respective state constitutions requiring uniformity and equality of taxation.

[31] See Letter of 17 Law Professors, January 24, 2019, https://www.warren.senate.gov/imo/media/doc/Constitutionality%20Letters.pdf, which does not mention that the tax sustained in *Knowlton v. Moore* was based on the privilege of transfer (Bruce Ackerman, first signatory). See also second letter of the same date (Dawn Johnson, first signatory) https://www.warren.senate.gov/imo/media/doc/Constitutionality%20Letters.pdf. The Johnson letter rests on Dawn Johnson and Walter Dellinger, "The Constitutionality of a National Wealth Tax," *Indiana Law Journal* 93, no. 1 (201): 111, relying chiefly on *Hylton v. United States*, 3. U.S. (3 Dall.) 171 (1796), which held that a tax on carriages was not a direct tax subject to apportionment. But Alexander Hamilton, who argued *Hylton*, recognized that a tax "on their whole real or personal estate" is a direct tax, and thus had to be apportioned, such that individuals in richer states paid only a lower tax. For discussion, see Richard A. Epstein, "Elizabeth Warren's Unconstitutional Wealth Grab," Hoover Institution, *Defining Ideas*, February 4, 2019, available at https://www.hoover.org/research/elizabeth-warrens-unconstitutional-wealth-grab.

[32] It was just these provisions that were at stake in *United States v. Windsor*, 570 U.S. 744 (2013), which held that a same sex couple was entitled to the marital deduction under federal law.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

that entire asset portfolio has gone up or down in value, and regardless of any other tax, including a progressive tax on income, or additional sums used to pay such common taxes as those levied on real estate or sales. Therefore, it is possible to owe a large wealth tax on a large estate even if there has been a loss in value or assets.

The *annual* tax rates are large: originally, Elizabeth Warren proposed rates at 2 percent for wealth between $50 million and $1 billion, with a 4 percent surcharge (originally 2 percent) for amounts over $1 billion.[33] In her latest version, now embodied in legislation for an "Ultra-Millionaire Tax," the same 2 percent wealth tax will be imposed on persons owning more than $50 million in assets, but goes up to 3 percent, on wealth of $1 billion or more, which would bring in $300 billion per year of new revenue.[34] But that figure will be increased to 6 percent if other new legislation provides "to all residents of the United States comprehensive protection against the costs of health care and health-related services."[35] The tax will be imposed on all asset classes, worldwide, in order to minimize the risk of tax evasion,[36] and there is a narrow tax deferment option for some people who face serious liquidation problems.[37] And at least 30 percent of the tax returns so supplied shall be audited annually, out of the 100,000 households subject to the tax.[38] In most cases, the expectation is that parties subject to the tax will either have

[33] See Warren Democrats, "Ultra-Millionaire Tax," available at https://elizabethwarren.com/plans/ultra-millionaire-tax.

Rates and Revenue

- Zero additional tax on any household with a net worth of less than $50 million (99.9% of American households)
- 2% annual tax on household net worth between $50 million and $1 billion
- 4% annual Billionaire Surtax (6% tax overall) on household net worth above $1 billion

[34] Elizabeth Warren, "Warren, Jayapal, Boyle Introduce Ultra-Millionaire Tax on Fortunes Over $50 Million," March 1, 2021 available at https://www.warren.senate.gov/newsroom/press-releases/warren-jayapal-boyle-introduce-ultra-millionaire-tax-on-fortunes-over-50-million. See Ultra-Millionaire Tax of 2021, S. 510, 117th Cong. (2021). The full text of the legislation is available at https://www.warren.senate.gov/imo/media/doc/MCG21295.pdf.

[35] S. 510 § 2901(b)(2)(A) & (B). It is unclear whether this increase in tax will be triggered if a comprehensive program only applies to citizens or legal aliens in the United States.

[36] Ibid., § 2902. All assets are included in the net worth calculation, which will produce more revenue and reduce opportunities for avoidance and evasion:

> All household assets held anywhere in the world will be included in the net worth measurement, including residences, closely held businesses, assets held in trust, retirement assets, assets held by minor children, and personal property with a value of $50,000 or more.

[37] Ibid., § 2905(c). Taxpayers will be permitted to defer payment of the tax with interest for up to five years:

> For the rare taxpayer with an extremely high net worth but liquidity constraints that make it difficult to pay this additional tax, there will be an option to defer payment of the tax for up to five years, with interest. The IRS will also be instructed to create rules for cases where deferment is required in truly exceptional circumstances to prevent unintended negative impacts on an ongoing enterprise or a taxpayer facing unusual circumstances that would advise for delay.

[38] Ibid., § 2905.

to borrow money or sell assets to meet the tax. Warren's consistent claim is that "The Ultra-Millionaire Tax would bring in at least $3 trillion in revenue over 10 years—without raising taxes on the 99.95% of American households that have net worth below $50 million."[39]

As conceived, the rates of the annual wealth tax are only a small fraction of those that are placed on estate taxes, which today are set at 40 percent of the value of the taxable estate, which as of 2021 is at $11.7 million or $23.4 million for a married couple.[40] However, the new wealth tax would not displace the estate tax but would be used to tighten up the valuation rules used in estate tax determinations. The law will contain a higher enforcement budget given the huge number of annual audits.[41] It will develop "systematic third-party reporting that builds on existing tax information exchange agreements adopted after the Foreign Account Tax Compliance Act."[42] It is generally thought that these valuations will be of use in curbing abuse because third-party valuations are not tainted by the risk of self-dealing, which arises when two or more related entities make some arrangement for the purpose of tax avoidance.[43] Finally, an "exit tax" of 40 percent will be imposed on the net worth over $50 million of any person who renounces citizenship to avoid the tax.[44] The estate tax remains in place for wealth held by the taxpayer at the time of death,[45] and of course the wealth tax paid does not offer any deduction from the income tax.[46]

[39] Ibid.

[40] The estate tax exclusion was doubled between 2018 and 2026 by the Tax Cuts and Jobs Act passed in 2017. Tax Cuts and Jobs Act, H. R. 1, 115th Cong. § 11061. For the estate tax exemption amount, see "IRS Estate Tax," https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax.

[41] Valuing assets for the purposes of the Ultra-Millionaire Tax will provide an opportunity to tighten and expand upon existing valuation rules for the estate tax:

> The IRS already has rules to assess the value of many assets for estate tax purposes. The Ultra-Millionaire Tax is a chance for the IRS to tighten these existing rules to close loopholes and to develop new valuation rules as needed. For example, the IRS would be authorized to use cutting-edge retrospective and prospective formulaic valuation methods for certain harder-to-value assets like closely held business and non-owner-occupied real estate.

Warren Democrats, "Ultra-Millionaire Tax." Saez and Zucman repeat much of their earlier academic work in a joint letter to Senator Warren, which essentially updates their earlier analysis by noting that the increase in overall asset values allows for a higher rate of collection, even with the lower surcharge in the newer legislation. See Emmanuel Saez and Gabriel Zucman, "Letter of Elizabeth Warren," dated February 24, 2021, available at https://www.warren.senate.gov/imo/media/doc/Wealth%20Tax%20Revenue%20Estimates%20by%20Saez%20and%20Zucman%20-%20Feb%2024%2020211.pdf.

[42] Warren Democrats, "Ultra-Millionaire Tax."

[43] Leandra Lederman, "When the Price Isn't Right: The Role of Third Parties in Tax Valuation," *Notre Dame Law Review* 1495 (2021): 96: "In effect, the presence of a third party information-reporter reduces the taxpayer's opportunity to evade tax because the taxpayer knows that the government has been notified of the payment. Third-party reporting, with the return matching that often accompanies it, can be considered an invisible audit."

[44] See Warren Democrats, "Ultra-Millionaire Tax."

[45] Ibid.

[46] Ibid., S. 510 § 2905(b).

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

The most prominent support for a progressive economic wealth tax comes from Emmanuel Saez and Gabriel Zucman, who claim that the recent advances in governance should handle the administrative challenges raised by the act.[47] They accept that the European experience with wealth taxes has not been entirely happy but claim that these logistical difficulties can be overcome. The first of their proposed fixes deals with evasion through cross-border transactions, which they believe can be countered by greater cooperation and information sharing. On this point, their prediction is likely to prove overly optimistic. The ability of parties to conceal wealth through dummy corporations and other devices is extraordinarily large, meaning that the coordination will require far more than sharing information returns. It will also require sharing investigative resources and overcoming the likely obstacles when various tax havens spring up. Second, they claim that the low exemption levels under the earlier taxes created liquidity problems that a revised wealth tax can reverse. As I show later, they seriously underestimate these problems. And third, they criticize earlier systems of wealth taxation that "relied on self-assessments rather than systematic information reporting."[48] These three weaknesses led to reforms that gradually undermined the integrity of the wealth tax: the exemption of some asset classes such as business assets, preferential treatment of others such as real estate, or repeal of wealth taxation altogether. "[L]everaging modern information technology, it is possible for tax authorities to collect data on the market value of most forms of household wealth and use this information to prepopulate wealth tax returns, reducing evasion possibilities to a minimum."[49] But as should be evident from the earlier discussions, it is not sufficient to figure out the stand-alone valuation of discrete assets. It is also necessary to figure out how to value the *fractional* interests in assets held in common by related parties. Wealth is often split among family members in order to minimize the burden imposed by the progressive income tax. Because neither Saez nor Zucman are tax planners, or even lawyers, they fail to appreciate the powerful tools that these aforementioned professionals can use to either diminish or negate the wealth tax—but only at a real cost to productive social activities. Indeed, for people skilled in these occult planning arts, it takes little imagination to see that every single problem dealing with valuation and liquidity can gut a wealth tax that pays no respect to realization and nonrecognition rules.

Saez and Zucman are also insensitive to valuation and administration difficulties of this novel tax.[50] Any huge asset base requires extensive

[47] Emmanuel Saez and Gabriel Zucman, "Progressive Wealth Taxation," *Brookings Papers on Economic Activity* (September 5 and 6, 2019), available at https://www.brookings.edu/wp-content/uploads/2019/09/Saez-Zucman_conference-draft.pdf, for one example of many of their joint work taking this position.

[48] Ibid., at 3.

[49] Ibid.

[50] Ibid.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

settlement negotiation between the government and the taxpayer in large estate tax cases, where the tax itself is often only finally determined years after the tax return is filed. In effect, the most straightforward approach asks the taxpayer to pay taxes on those minimum amounts owing with interest payments on the rest of the claimed tax while the matter remains open. The number of huge estates that make it into the tax system each year is relatively small, at least compared to the 100,000 or so taxpayers that must be dealt with annually in a wealth tax system, given that the government is now obliged by statute to audit at least 30 percent of the "taxpayers required to pay the tax." Keep in mind, this leaves in limbo those cases that are close to the boundary line as administrative resources are diverted to handle the statutory audit requirements.

The valuation burden is likely to set up this destructive cascade. The inability to resolve the wealth tax in year one will make it uncertain how much wealth will be subject to the tax in year two, thereby delaying the resolution in that year. The problems will only accumulate year after year, increasing the need to set ever-larger amounts for future taxes—assets that will likely have to be kept in liquid form.

In one heroic effort to deal with this valuation problem, Professor David Gamage tries to short circuit the process by valuing assets other than publicly traded securities with "formulaic prospective valuation methodologies."[51] There are three steps to his approach: (1) the starting point for valuation, (2) periodic (such as annual) formulaic updates, and (3) reconciliation at the point of a sale or other disposition. A much more modest version of this approach makes good sense in dealing with gain or loss in an income tax system. Just that approach is taken with depreciable assets where the Internal Code uses as its initial point for valuation the historic cost of the depreciable asset.[52] The valuation could fluctuate during the period that the asset is held, but the standard methodology that in principle allows for a deduction against cost each year is a rough proxy for the reduction in value.[53] Ideally the depreciation schedule should be tied to the expected useful life of the asset, but in practice depreciation tables tend to give large, if implicit, subsidies to investments in capital assets, by allowing write-offs over shorter periods of time.[54] But even if the rates today are wrong, the principle is sound. It is too costly to force interim recalculations of gain and loss. So long as there is a systematic downward bias (which

[51] David Gamage, Working Paper, "Five Key Research Findings On Wealth Taxation for the Super Rich," at 12 App'x. A (2019), https://ssrn.com/abstract=3427827.

[52] 26 U.S. C. § 167(a).

[53] Gamage, "Five Key Research Findings On Wealth Taxation for the Super Rich." This rule is subject to important qualifications for the depreciation of mortgaged property, as noted in the text.

[54] See, e.g., "IRS Tax Law Offers 100-Percent, First-Year 'Bonus' Depreciation," https://www.irs.gov/newsroom/tax-law-offers-100-percent-first-year-bonus-depreciation. Note that the ad hoc preferences tied to asset classes and particular dates increases the opportunities for interest group lobbying.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

can be concealed by intermediate gains), it is best to allow the deductions to offset against current income. Later on, when the property is sold in a recognition transaction, the final correction can be made so that the net gains or losses over the life of the transaction are brought into balance, even if the timing of those gains and losses departs from economic precision in order to achieve more efficient administration. This may result in the recapture of the depreciation previously recognized if the estimate for it was greater than the reduction in market value, aside from capital gain or loss arising from the sale price and historic cost.

That system cannot work for a wealth tax because, unlike depreciation, there is no necessary downward valuation pressure on a portfolio that contains a dizzying array of assets, which can go up or down in various years. The ultimate amount owed will depend not only on the difference between the beginning and ultimate values. All intermediate changes matter and these are highly variable. Suppose a taxpayer's wealth goes from $1 billion to $2 billion to $1 billion in three successive years. In that case, a higher tax for year two will have to be reduced by the tax owing for year one, which may not yet be determined. The same adjustments for the previous two years of taxation will be needed for year three—and so on. Hence, no shortcuts are available. Indeed, ironically, at the very least in year one, it will have to be determined whether, as seems correct in principle, the amount of the wealth tax estate should also be reduced because the anticipated wealth tax payments in future years operate like an implicit lien on the initial asset base. The Ultra-Tax allows deductions of "debts,"[55] which is not likely to be read as covering these future payments that are necessarily uncertain in amount. But in principle, indefinite liabilities should be estimated as best they can. And were that to be the case, making the needed adjustment creates the arresting circularity in which the reduction in value for future wealth taxes reduces the estate below either the $50 million or $1 billion marks. It is unclear whether the costs needed to prepare for the wealth tax will be allowed as a deduction against the income tax. It should certainly be under the Haig-Simons definition of income, given that these administrative expenditures are hardly consumption outlays.

These problems are compounded with respect to assets held overseas, especially if they are held indirectly with other individuals (some of whom are not subject to the tax) in complex, multilayered investment vehicles. It is not even clear whether or how these agencies will cooperate with the United States, as Saez and Zucman suppose, or act as tax havens for foreign depositors.

The rejected approach of taxing only marketable securities avoids these issues but allows for wholesale evasion because huge portions of wealth for high net-worth individuals are commonly held in private corporations,

[55] Warren Democrats, "Ultra-Millionaire Tax." See S. 510 § 2902(a), which offers no definition of "debts."

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

partnerships, and trusts. None of these are easily valued. As with the estate tax, a two-tier investigation with evaluations of the firms themselves is followed by an evaluation of the fractional interest of each party. Given the heavy cumulative taxes at the $1 billion level, the incentive to fractionate various interests will be even greater, which will further complicate the valuation problem. If the individual shareholders or partners each have blocking rights against the other, the firm's shares could easily have a reduced value by these forms of division. Thus, if a business held by one party is worth $1 billion, the creation of complex holdings of four people could reduce that value by, say, $200 million, unless the assessor chooses to disregard the legal transfer of ownership. But if accepted, several millions in potential surcharge (depending upon the 3 or 6 percent rate) will be either lost or contested. Issues such as marital status could have huge impacts on the valuation of firms that are held by divorced spouses or estranged children, who may or may not cooperate among themselves in dealing with their assets.

These issues will not be easily resolved even if, as one purports to hold, the latest and most advanced valuation techniques are employed. Those sophisticated weapons are available to both sides so that the battle of experts in constant litigation could easily turn against the government on specific key issues. But even if the ultimate amount owing is determined, the liquidity issue is exceedingly serious for assets of closely held corporations. One suggestion that is made on this point is that the government take a fractional interest in the business, which could then be sold off to a private party (a recognition transaction of sorts) so that it receives some cash immediately, and further cash on a delayed basis when the government disposes of that interest. The entire scheme is wishful thinking. Selling a fractional interest in an ongoing business is an extraordinary challenge, even in transactions between willing buyers and sellers. A simple buy-sell agreement could run to hundreds of pages of complex terms and conditions.

Those agreements can only be reached after both buyer and seller discharge their duties of due diligence so that the buyer knows that the price paid is sensible relative to the asset pool and the seller has the same assurances. For this process to work tolerably well, sensitive trade secret information must be collected, shared, and updated on a confidential basis. The transaction becomes yet more complicated if, as is commonly the case, third party insurance, guarantees, loans, and options have to be considered as well. The increase in the number of parties makes these transactions laborious. Forced sales of this sort never work in the best of circumstances. The new buyer is justifiably suspicious that the insiders can freeze out the new investors by exercising control over business transactions, their salary, and dividend structure. The insiders are concerned that any confidential information tendered to the outsiders to facilitate part of the transaction could be used by the potential buyer in separate businesses that it or related parties happen to own.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

In addition, any sale of a partial interest could easily trigger other obligations to buy or sell shares under collateral agreements or covenants so that the number of transactions snowballs. This will not be easier if it is known that a further dilution of interests could be required if the same process has to be done a year later and every year after that, with each new potential buyer that comes into the mix. The sale alternative is an open invitation for value destruction in closely held private enterprises, which means that whatever is gained from the wealth tax will be lost in some part through a decline in profits, reduction in employment levels, and other negative economic effects.

Moreover, similar problems arise by trying to raise funds in the lending markets. The typical corporate loan transaction has the following inexorable logic. The corporation needs funds, say, to construct a long-term capital asset. Internal funds are insufficient for the project, so the bank arranges a loan, often secured by the new capital asset, to furnish the funds for the project. Therefore, the loan proceeds will be put to work in the business to generate sufficient cash to pay back the loan, leaving a residual benefit for the firm. Thus, the loan allows for synchronization of income and expenditures over time, giving it a win/win structure. Of course, reaching this happy state of affairs is difficult, which is why documentation, due diligence, and other steps have to be taken to make this a reality. Loan agreements for complex deals can easily reach hundreds of pages covering all the anticipated contingencies regarding the use of funds, impacts of external regulation, sale and disposition of other assets, guarantees, and a thousand other points.

All of those transactional imperatives remain in place when the loan is requested to pay off taxes, but now the prospect of mutual gain disappears from view. By definition, the loan is needed because liquidity may be insufficient, given that liquid assets are also needed for other business functions. The large cushion of assets could provide a basis for the loan, but it remains to be seen how these loan agreements can work themselves through a heavily regulated banking system that is likely to reduce the ability of lenders to fund these transactions. And loans that are made for these tax postponement purposes will necessarily reduce the capacity of any entity to borrow for productive uses, especially since the next contingent obligation is only one year away. And if the loan goes into default, the foreclosure procedures will be difficult if marketable securities or similar assets do not serve as the collateral. Owing to these difficulties, there is a distinct possibility that the government may well become the lender of last resort, without any knowledge of how it should best structure the transaction. The loan will require extensive disclosures, on the one hand, and give rise to the possibility that government will become co-owner of some joint venture if default occurs. No private firm would want the government, which always has a tax lien for unpaid taxes, to share further in its venture, even as a holder of preferred stock or bonds. The bottom line here is clear.

Whether one proceeds by sale or loan, payment of the wealth tax will systematically shrink the asset base on which that tax is levied even in the best of scenarios. At worst, the firm's internal operations will suffer because of the hits to its governance structure needed to raise the additional capital. The firm's major operators will owe fiduciary duties to an unidentified class of strangers, and their preoccupation with these tax and governance issues will reduce the value of the firm by amounts that far exceed the value of the lien on them.

The situation is further compounded because of additional long-term changes. One feature of this proposed law that should raise eyebrows is the insistence that any individual who renounces their citizenship will have to pay a hefty exit tax equal to 40 percent of the value of the property over $50 million.[56] Exit taxes are generally a sign of fatal weaknesses in the confidence that a government places in its own institutions. These barriers to exit are only imposed when the internal economic climate is not conducive to productive activity. But these taxes are more than an unhappy sign; they are also a powerful signal to change behavior before the tax is imposed. One feature of American life is that a hospitable business climate encourages foreign investment, which gives an upward push on internal growth by providing employment opportunities, loans, real estate investment, and other business deals with suppliers and customers across the board. But none of this will happen with the potential entrants into the United States who are well-advised to take their business elsewhere rather than face the danger of this tax, which could be expanded or raised at any time. That itself is no idle prospect because Senator Warren, with a stroke of a pen, had initially quadrupled the surcharge on households above $1 billion from 1 to 4 percent, without any fresh analysis at all. Hence, foreigners with the best plans are likely to steer clear of the United States, including listing companies on U.S. exchanges, lest that provide a jurisdictional hook.

The cash flows are also likely to run in the opposite direction. American entrepreneurs who think that they will be subject to the tax at some future time will make their exit plans early, when their business is relatively small, to have the appreciation take place after separation. Under the Internal Revenue Code, the income that goes offshore is usually out from underneath taxes if it is realized later. The double movement reinforces the negative consequences mentioned above. The wealth tax will be frustrated, while at the same time, the interim gains from business activities will be lost. None of this is idle speculation, for we know that state estate taxes are subject to intense pressures because of the risk that well-heeled residents will move to some other state to avoid the one-time estate tax that is imposed. For example, just that happened in California in the early 1980s when the legislature found it necessary to repeal the state estate tax in order to blunt the mass exodus of Californians to Nevada, which had no estate tax.

[56] Warren Democrats, "Ultra-Millionaire Tax"; S. 510 § 2903(b)(2)(c)(1).

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press

In the interim, the population movement cost California income, real estate taxes, and sales taxes, which were regained once California repealed its estate tax in a classic example of intergovernmental competition. The same results will happen here, so that the lofty revenue ambitions for the tax will be limited by so many different forms of (legal) avoidance that the system will fall of its own weight.

The conclusion, therefore, should be clear. Experiments with taxes of this sort are harmful because once tried, they will induce powerful responses even after the taxes are removed. We have had other experiments with novel taxes. The special luxury taxes that were some years ago imposed on jewelry and boats turned out to be genuine disasters before they were repealed.[57] The European countries that have toyed with low-level versions of a wealth tax found that they were both difficult to administer and led to a mass exit of high net-worth individuals.[58] There is no way to make this system work in the manner that its proponents hope. The existing tax structure honed over a century is not perfect, but it is far better than the wealth tax, a tax that is best left unborn. The same is true for the idea of scrapping the current rules on realization and recognition, which should stay exactly where they are.

Law, New York University

[57] A 10 percent luxury tax was imposed in 1991 on a variety of luxury goods such as watches, expensive furs, boats, yachts, panes, and jewelry. Revenue collection dramatically underperformed projections as demand for the covered luxury goods fell by a substantial amount. Jobs in the luxury products industry suffered significantly. In just two years, the luxury tax was repealed. "What went wrong with the luxury tax was that, in trying to go after the rich guys' toys, Congress put the toymakers out of business. The rich guys meanwhile, bought other toys (including foreign-made ones) not covered by the tax; or they bought used toys and refurbished them." James K. Glassman, "How to Sink an Industry and Not Soak the Rich," *Washington Post*, July 16, 1993, https://www.washingtonpost.com/archive/business/1993/07/16/how-to-sink-an-industry-and-not-soak-the-rich/08ea5310-4a4b-4674-ab88-fad8c42cf55b/.

[58] Greg Rosalsky, "If a Wealth Tax is Such a Good Idea, Why Did Europe Kill Theirs?" February 26, 2019, https://www.npr.org/sections/money/2019/02/26/698057356/if-a-wealth-tax-is-such-a-good-idea-why-did-europe-kill-theirs.

https://doi.org/10.1017/S0265052523000079 Published online by Cambridge University Press