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## The Moving Target of Tax Reform

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## THE MOVING TARGET OF TAX REFORM\*

KAREN C. BURKE\*\* & GRAYSON M.P. MCCOUCH\*\*\*

*In 2000, Professor William Turnier proposed a package of three reforms to make the estate tax more “equitable” and “taxpayer-friendly.” All of his proposals—allowing a surviving spouse to inherit a deceased spouse’s unused exemption, replacing the state death tax credit with a deduction, and indexing the exemption for inflation—were eventually enacted. Today, the estate tax remains on the books, but changes in rates and exemptions have severely curtailed its role in the larger federal tax system. Income tax rate reductions for capital gains and dividends have further lightened the tax burden on capital income, and international pressure to reduce the corporate tax burden threatens to accelerate the increasingly unequal distribution of income and wealth. This Article argues that the trend of shifting tax burdens from capital to labor is neither desirable nor sustainable and suggests a deathtime capital gains tax and an accrual-based tax on unrealized appreciation in publicly traded stock as possible measures to make the federal tax system more equitable (though perhaps less taxpayer-friendly).*

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### INTRODUCTION

In 2000, as opposition to the estate tax gathered political momentum and anti-tax rhetoric became increasingly heated, Professor William Turnier brought a note of sanity and moderation to

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the estate tax debate. He proposed three “equitable taxpayer-friendly reforms,”<sup>1</sup> which were explicitly designed to be revenue neutral. More importantly, they were also intended to make the estate tax more user-friendly (or at least less unwieldy) and to stave off more radical calls for repeal.<sup>2</sup> His proposals consisted of (1) allowing a surviving spouse to inherit a decedent’s unused exemption, (2) replacing the state death tax credit with a deduction, and (3) indexing the exemption and rate brackets for inflation.<sup>3</sup> In one sense, Professor Turnier hit a bull’s-eye: all of his proposals were eventually enacted, and opponents of the estate tax ultimately failed to achieve their goal of permanent repeal. In another sense, however, the reforms have been overwhelmed by subsequent developments that have left the estate tax eroded and marginalized. The estate tax remains on the books, but it applies only to a very small number of very large estates, and it plays an ever-diminishing role in the larger federal tax system.

Much has changed since Professor Turnier proposed his package of taxpayer-friendly estate tax reforms in 2000. The 2001 Act<sup>4</sup> targeted the estate tax for repeal, and the 2003 Act<sup>5</sup> slashed income tax rates on capital gains and dividends. From the outset, it was clear that these massive tax cuts were unsustainable in the long run, but they established a new base line of artificially low taxes on capital and capital income that made it practically impossible to restore the pre-2001 status quo. Despite the legislative compromise embodied in the 2010 Act<sup>6</sup> and the 2012 Act,<sup>7</sup> fallout from the earlier tax cuts continues to be felt in decreased federal revenues, increased public debt, weakened progressivity in the federal tax system, and distorted behavioral incentives. Problems of this scope cannot be solved, or even substantially mitigated, by even the most ambitious estate tax

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1. William J. Turnier, *Three Equitable Taxpayer-Friendly Reforms of Estate and Gift Taxation*, 87 TAX NOTES 269, 269 (2000).

2. *See id.* at 270 (describing attempts to “repeal the estate tax, or essentially eviscerate it” as “most unfortunate”); *id.* at 279 (“Reform and not repeal of the estate tax is what should be on the nation’s agenda.”).

3. *Id.* at 270.

4. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of I.R.C.) [hereinafter 2001 Act].

5. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of I.R.C.) [hereinafter 2003 Act].

6. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (codified as amended in scattered sections of I.R.C.) [hereinafter 2010 Act].

7. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013) (to be codified in scattered sections of I.R.C.) [hereinafter 2012 Act].

reform. Instead, it is time to reconsider the need for an effective income tax on capital gains accrued during life and at death, especially in light of rising inequality of income and wealth and mounting international pressure to reduce the corporate tax burden.

Taking Professor Turnier's proposals as a point of departure, this Article begins in Part I by discussing the rationale for those proposals, the statutory provisions that implement them, and the resulting impact on the role and structure of the estate and gift taxes. Part II addresses the interaction of the estate tax exemption and the income tax basis step-up for inherited appreciated property and considers a deathtime gains tax both as an income tax reform measure and as a response to the erosion of the estate tax. Part III turns to the taxation of business income and explores how international pressure to reduce the corporate tax rate threatens to exacerbate inequalities of income and wealth. The Article concludes with suggestions for future tax reform.

### I. REFORMING THE ESTATE TAX

Professor Turnier's first proposal, which was eventually codified in the form of a "portable" exemption, responds to an estate planning dilemma faced by married couples. Although a married couple is often loosely described as a single taxable unit,<sup>8</sup> the estate and gift taxes technically treat each spouse as a separate taxpayer with his or her own exemption, rate schedule, and cumulative tax base.<sup>9</sup> If one

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8. The unlimited marital deduction explicitly rests on the notion that "a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes. Accordingly, no tax should be imposed on transfers between a husband and wife." S. REP. NO. 97-144, at 127 (1981), *reprinted in* 1981 U.S.C.C.A.N. 105, 229.

9. This Article presumes some familiarity with basic estate and income tax concepts. For a helpful general introduction, see generally JOHN K. McNULTY & GRAYSON M.P. MCCOUCH, *FEDERAL ESTATE AND GIFT TAXATION* (2011); JOHN K. McNULTY & DANIEL J. LATHROPE, *FEDERAL INCOME TAXATION OF INDIVIDUALS* (2011); KAREN C. BURKE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS* (2014). Technically, the exemption is implemented in the form of a unified credit that automatically offsets gift and estate taxes on post-1976 taxable transfers (whether made during life or at death) up to the "applicable exclusion amount." See I.R.C. §§ 2010, 2505 (2012). Because the credit can readily be expressed in terms of the amount of taxable transfers that it shelters from gift or estate tax, it is commonly referred to as an exemption, and we adopt that usage here. *Cf.* William J. Turnier & Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions and Exemptions*, 36 U. FLA. L. REV. 1003, 1004 n.4 (1984) (explaining that "an exemption grants an exclusion from taxation at the bottom of a progressive rate structure whereas a deduction grants an exclusion from taxation at the top margin of a progressive rate structure").

spouse dies without exhausting his or her exemption, the surviving spouse does not inherit the unused amount. Accordingly, traditional marital planning dictates that the couple allocate their combined property so that the amount of each spouse's taxable transfers is not less than his or her exemption, ensuring that both spouses make full use of their exemptions and neither spouse's exemption is wasted. To achieve this goal, each spouse must (1) own property with a total value at least equal to the exemption, and (2) make taxable (i.e., nondeductible) transfers with a total value at least equal to the exemption. If the couple's assets are owned disproportionately by one spouse, the first condition can be met by making a tax-free transfer to the poorer spouse.<sup>10</sup> The second condition highlights the danger of overfunding a marital bequest (and consequently reducing the taxable estate below the exemption amount) at the first spouse's death.<sup>11</sup> Thus, a typical estate plan divides the first spouse's estate between a taxable bequest<sup>12</sup> equal to the first spouse's available exemption and a deductible marital bequest of the balance.<sup>13</sup>

The primary rationale for portability is to obviate the need for convoluted and costly planning of the sort just described.<sup>14</sup> If the first spouse fails to make full use of his or her exemption—either because the couple's property was already owned disproportionately by the surviving spouse, or because the marital bequest is overfunded—the portability provision enacted in 2010 allows the decedent's executor to elect to pass on the unused exemption directly to the surviving

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10. The transfer might be outright or, if the richer spouse is unwilling to give up control over the ultimate disposition of the property, in the form of a qualified terminable interest trust. *See* I.R.C. § 2523(a), (b), (f).

11. For example, overfunding may occur if all of the couple's property is held in joint-and-survivor form or if all of the first decedent's property passes (by will, trust, or intestacy) to the surviving spouse.

12. The taxable bequest may be left outright to individuals other than the surviving spouse, or in a trust that has beneficiaries other than the surviving spouse. Such a "family" or "bypass" trust is structured to avoid inclusion in the surviving spouse's estate, with the corollary that the trust assets will not receive a second basis step-up at the surviving spouse's death.

13. The marital bequest may be left outright to the surviving spouse, or in a trust that qualifies for the marital deduction (e.g., a power-of-appointment trust or a qualified terminable interest property trust). *See* I.R.C. § 2056(a), (b)(1), (b)(5), (b)(7).

14. *See* Turnier, *supra* note 1, at 271 ("[T]here is little, if any, justification for compelling taxpayers to go to the expense of engaging in costly estate planning when a simple change in the law could effectively accomplish the same goal at no societal cost other than adding a new section to the code."); Taxation Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, A.B.A. SEC. TAX'N REP., reprinted in 41 TAX LAW. 395, 398–400 (1988) (asserting that "[p]ortability would simplify" estate planning for married couples).

spouse.<sup>15</sup> The new provision offers enhanced flexibility and tax-saving opportunities for married couples, but it does so at the cost of additional complexity and administrative burdens.<sup>16</sup> For the vast majority of estates that fall below the normal estate tax filing threshold, a portability election entails the substantial (and otherwise avoidable) expense of preparing and filing a timely estate tax return.<sup>17</sup> A further administrative complication arises where the first spouse fails to exhaust his or her exemption but leaves taxable bequests of uncertain value. A portability election will preserve the unused exemption, but its value may be indeterminate. The longer the interval between the first spouse's death and the surviving spouse's taxable transfers, the greater the difficulty (for the government as well as the taxpayer) of verifying the amount of the additional exemption properly available to the surviving spouse.<sup>18</sup>

In larger estates that exceed the filing threshold, the tax-driven portability election adds a new dimension to estate planning for married couples. Now a surviving spouse may inherit (or retain) all of the couple's combined wealth without wasting the first spouse's

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15. See I.R.C. § 2010(c)(4)–(5). Even without portability, an overfunded marital bequest can be rectified if the surviving spouse makes a qualified disclaimer. See I.R.C. § 2518. However, the surviving spouse may be reluctant to make a disclaimer if (as is often the case) the disclaimer would result in a financial benefit to other beneficiaries at the surviving spouse's expense.

16. See Jonathan G. Blattmachr, Austin W. Bramwell & Diana S.C. Zeydel, *Portability or No: The Death of the Credit-Shelter Trust?*, 118 J. TAX'N 232, 232 (2013) (“Although touted as a simplification, portability will make planning more complex for many clients because it is yet another option that requires analysis to determine whether relying on it, or at least preparing an estate plan that makes relying on it possible, is beneficial.”).

17. To make a valid portability election, an executor must file an estate tax return. See I.R.C. § 2010(c)(5)(A). For this purpose, the estate is deemed to be subject to a mandatory filing requirement, even if the estate falls below the regular filing threshold. See Treas. Reg. § 20.2010-2T(a)(1) (2012). Moreover, the filing of a “complete and properly-prepared estate tax return” is deemed to include a portability election unless the executor expressly opts out or fails to file a timely return. See *id.* § 20.2010-2T(a)(2), (a)(3); cf. Richard Schmalbeck & Jay A. Soled, *Unnecessary Estate Tax Returns: Removing the Residue of the “Widow's Tax,”* 94 TAX NOTES 235, 237–39 (2002) (recommending streamlined information reporting to facilitate monitoring of subsequent income and transfer tax events as part of larger proposal to eliminate estate tax return filing requirement “when no estate tax is due with respect to a married decedent's estate”).

18. Indeed, there may be an incentive to undervalue a taxable bequest in the first spouse's estate if doing so will increase the amount of the unused exemption available to the surviving spouse. It is hardly surprising, therefore, that the government retains the ability to examine the first spouse's return (even after the expiration of the normal limitation period for tax assessment) to determine the correct amount of unused exemption. See I.R.C. § 2010(c)(5)(B); Treas. Reg. § 20.2010-3T(d).

exemption, but this survivor-take-all plan is not clearly superior to a traditional two-trust plan, which may offer the surviving spouse greater protection from creditors during life and a smaller estate tax liability at death. The computation of the portable exemption amount also creates some unusual tradeoffs (and perverse incentives) for the surviving spouse, especially in connection with a subsequent marriage. The unused exemption inherited from a predeceased spouse does not vanish upon the surviving spouse's remarriage, but it will do so if the new spouse dies leaving the surviving spouse twice widowed.<sup>19</sup> Thus, depending on the circumstances, a surviving spouse who is contemplating remarriage might consider making large taxable gifts (to use an exemption inherited from a predeceased spouse), marrying an impecunious and sickly new partner (in the hope of inheriting a new exemption), or perhaps avoiding remarriage altogether (to preserve an exemption derived from a predeceased spouse).

Professor Turnier's second proposal involved the tax treatment of state death taxes. Conceptually, these taxes are "indistinguishable" from other outlays incurred in settling a decedent's estate that reduce the net amount available for distribution.<sup>20</sup> Starting with a blank slate, therefore, one might logically expect to find an estate tax deduction for state death taxes, along with funeral and administration expenses, creditors' claims, and casualty losses—precisely the result under current law.<sup>21</sup> From the early years of the estate tax until 2003, however, the allowance for state death taxes took the form of a dollar-for-dollar credit rather than a deduction.<sup>22</sup> The state death tax credit reflected a 1926 legislative compromise between proponents of the federal estate tax and opponents who argued that death taxation should be imposed exclusively or primarily at the state level.<sup>23</sup> The credit was originally intended not merely to protect state death

19. See I.R.C. § 2010(c)(4); Treas. Reg. §§ 20.2010-3T(a)–(b), 25.2505-2T(a)–(c).

20. Turnier, *supra* note 1, at 279.

21. See I.R.C. §§ 2053(a) (funeral and administration expenses, claims and encumbrances), 2054 (casualty losses), 2058 (state death taxes).

22. See I.R.C. § 2011. Although the credit remains on the books, it was gradually phased out beginning in 2002 and has no application to estates of decedents dying after 2004. See I.R.C. § 2011(f); 2001 Act, *supra* note 4, § 531(a), 115 Stat. at 72.

23. See Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835, 850 (2006); see also ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, A COMMISSION REPORT: COORDINATION OF STATE AND FEDERAL INHERITANCE, ESTATE AND GIFT TAXES 27–28 (1961) (discussing the history of state and federal death taxation).

taxation from federal intrusion but also to dampen interstate tax competition by subsidizing state death taxes up to the amount of the federal credit.<sup>24</sup> The credit remained unchanged for the next seventy-five years, and, during that time, all of the states enacted “pick-up” taxes to absorb the amount of the federal credit.<sup>25</sup> Although the federal credit did not lead to complete uniformity of state death taxes, between 1976 and 2000 many states abandoned their separate estate or inheritance taxes and came to rely exclusively on pick-up taxes.<sup>26</sup> Thus, by 2000 it was clear that any reduction in the federal credit would result in automatic tax cuts at the state level.

The switch from a credit to a deduction for state death taxes in the 2001 Act seems to have been motivated less by policy considerations than by the need for revenue to reduce the cost of federal tax cuts. At the federal level, the repeal of the credit played a crucial role in bringing the cost of the tax cuts within the constraints imposed by the budget resolution.<sup>27</sup> At the state level, the repeal of the credit prompted a surge of interstate tax competition, resulting in a “race to the bottom” as many states allowed their pick-up taxes to become dormant.<sup>28</sup> Nevertheless, several other states have acted to breathe new life into their pick-up taxes by “decoupling” them from the federal credit, and a few more have replaced their obsolete pick-up taxes with freestanding estate or inheritance taxes.<sup>29</sup> For residents

24. See Cooper, *supra* note 23, at 837–40, 850–59 (discussing “race to the bottom” spurred by Florida’s campaign to attract wealthy residents by cutting taxes); ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, *supra* note 23, at 10–11.

25. See Cooper, *supra* note 23, at 839–40.

26. See Karen Smith Conway & Jonathan C. Rork, *Diagnosis Murder: The Death of State Death Taxes*, 42 ECON. INQUIRY 537, 541–43 (2004).

27. See MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* 209–11 (2005) (noting ten-year projected revenue yield of nearly \$150 billion from accelerated repeal of the federal credit, which reduced the revenue cost of the 2001 tax cuts from \$1.5 trillion to \$1.35 trillion).

28. See Conway & Rork, *supra* note 26, at 550, 555–57; Cooper, *supra* note 23, at 875–76; Joel Michael, *State Responses to EGTRRA Estate Tax Changes*, 103 TAX NOTES 1023, 1026–33 (2004).

29. According to recent surveys, approximately twenty-three states have dormant pick-up taxes and another nine have expressly repealed their death taxes; six states (and the District of Columbia) maintain decoupled pick-up taxes; and the remaining twelve states maintain some form of independent estate or inheritance tax. See Kathleen Caggiano, *Estate Planning Becomes More Complicated As States Tinker with Transfer Tax Regimes*, DAILY TAX REP., No. 101, May 27, 2014, at H-1; JOEL MICHAEL, MINN. H.R. RESEARCH DEP’T, *SURVEY OF STATE ESTATE, INHERITANCE, AND GIFT TAXES* 2–3 (2013), available at <http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf>; 2014 *State Death Tax Chart*, MCGUIREWOODS LLP,



of states with independent estate or inheritance taxes, repeal of the federal credit may result in a net tax increase that is only partially offset by the new deduction. Clearly some states hope to attract wealthy elderly residents by eliminating their death taxes, but it remains unclear whether this strategy achieves the desired result.<sup>30</sup> On the whole, the most significant consequences of repealing the federal credit seem to be the collapse of the federally subsidized system of pick-up taxes, the shift of estate tax revenue from the states to the federal government, and the proliferation of increasingly volatile and complex state death tax legislation.

Professor Turnier's third proposal called for annual inflation adjustments in the estate tax exemption and rate brackets. Noting that Congress had already adopted indexing for various income tax allowances (and more recently for the gift tax exclusion and the GST exemption), he saw "no good justification" not to extend the same treatment to the estate tax.<sup>31</sup> The delicate question was where to draw the base line. Professor Turnier proposed a \$600,000 estate tax exemption with adjustments for inflation occurring after 1987 (when the \$600,000 exemption took effect).<sup>32</sup> Indexing the exemption would have mitigated the estate tax exposure of moderately wealthy taxpayers with estates just above the taxable threshold; conversely, the absence of indexing fueled political support for estate tax repeal.<sup>33</sup>

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resources/publications/taxation/state\_death\_tax\_chart.pdf (last modified Nov. 16, 2014) (prepared by Charles D. Fox IV).

30. Although there appears to be a correlation between low state taxes and elderly in-migration, it is not clear whether the former causes the latter or vice versa. See Karen Smith Conway & Jonathan C. Rork, *State "Death" Taxes and Elderly Migration—The Chicken or the Egg?*, 59 NAT'L TAX J. 97, 123 (2006) (finding "some evidence" that "states that experience high elderly in-migration may be more likely to subsequently eliminate or reduce their incremental [estate, inheritance and gift] taxes"); cf. Jon Bakija & Joel Slemrod, *Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns* 36 (Nat'l Bureau of Econ. Research, Working Paper No. 10645, 2004) (finding evidence "consistent with the idea that some rich individuals flee states that tax them relatively heavily, although it may reflect other modes of tax avoidance as well" and noting that the estimated resulting deadweight loss and revenue loss are "not large" relative to tax revenues).

31. Turnier, *supra* note 1, at 276. In 1997 Congress enacted inflation adjustments for the gift tax annual exclusion and the GST exemption but conspicuously failed to do so for the estate and gift tax exemption; instead, it raised the exemption from \$600,000 to \$1 million over a ten-year phase-in period. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(a), (c), (d), 111 Stat. 788, 845 (codified at I.R.C §§ 2010(a), 2503(b), 2631).

32. See Turnier, *supra* note 1, at 276. This would have yielded an exemption of \$874,000 in 2000. See *id.* at 276-77.

33. See Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 501 (2001).

Only in 2010, when the prospect of permanent repeal had faded, did Congress finally adjust the estate tax exemption (but not the rate brackets) for inflation.<sup>34</sup>

In 2010 and 2012, the impending sunset of the 2001 tax cuts offered Congress an opportunity to reestablish the estate tax as a meaningful source of revenue and progressivity.<sup>35</sup> Instead of maintaining exemptions and rates at their 2001 (or even 2009) levels, however, the 2010 and 2012 Acts raised the exemption to \$5 million (indexed for inflation) and cut the top marginal rate, causing reported estate tax revenue to drop by more than 60% from its pre-2001 level.<sup>36</sup> In addition to gutting the revenue raised by the estate tax, the enlarged exemption amounts to de facto repeal of the estate tax for 99.85% of all decedents: for every 10,000 persons who died in 2011, only fifteen filed a taxable estate tax return in 2012.<sup>37</sup> Furthermore, in contrast to the 2010 estate tax holiday, which imposed a modified carryover basis regime (with generous exemptions) as the price for opting out of the estate tax, the new dispensation perpetuates the unlimited income tax basis step-up for appreciated property acquired from a decedent.<sup>38</sup>

The increased estate tax exemption undermines the incremental reforms proposed by Professor Turnier. Specifically, by adopting a \$5 million taxable threshold coupled with indexing for inflation, Congress has more than quadrupled the value of the exemption contemplated by Professor Turnier<sup>39</sup> with no offset in the form of a

34. See 2010 Act, *supra* note 6, § 302(a)(1), 124 Stat. at 3301.

35. See 2001 Act, *supra* note 4, § 901(a)(2), 115 Stat. at 150; 2010 Act, *supra* note 6, § 101(a), 124 Stat. at 3298.

36. See 2010 Act, *supra* note 6, § 302(a), 124 Stat. at 3301; 2012 Act, *supra* note 7, § 101(a), (c), 126 Stat. at 2315, 2317. The estate tax due reported on returns filed in 2012 was \$8.5 billion, compared to \$23.5 billion reported on returns filed in 2001. The corresponding figures for 2009 and 2010 were \$20.6 billion and \$13.2 billion, respectively. *SOI Tax Stats—Estate Tax Statistics Filing Year Table 1*, IRS (Sept. 19, 2014), <http://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-1>.

37. See Donna L. Hoyert & Jiaquan Xu, *Deaths: Preliminary Data for 2011*, 61 NAT'L VITAL STATISTICS REP. 3 tbl.A (Oct. 2012) (reporting 2,513,171 deaths in 2011); *SOI Tax Stats—Estate Tax Statistics Filing Year Table 1*, *supra* note 36 (showing 3,738 taxable returns filed in 2012).

38. See I.R.C. § 1014(a), (b) (2012).

39. The \$600,000 exemption that took effect in 1987, adjusted for subsequent inflation, is equivalent to a \$1,188,000 exemption in 2011 (rounded to the nearest \$1,000). See U.S. BUREAU OF LABOR STATISTICS, CPI DETAILED REPORT, DATA FOR MAY 2014, at 68–71 tbl.24, available at <http://www.bls.gov/cpi/cpid1405.pdf> (showing average consumer price index of 113.6 for 1987 and 224.939 for 2011). That amount is less than one quarter of the \$5 million exemption enacted in 2010. See *supra* text accompanying note 36.

deathtime gains tax or carryover basis. The increased federal exemption has disruptive effects on state death taxes, indirectly reducing effective tax rates in states that rely on a decoupled pick-up tax<sup>40</sup> and exacerbating disparities between state and federal exemptions in states that impose a separate estate or inheritance tax. The interaction of decoupled state death taxes with the portability election adds yet another layer of complexity for married couples, who are now advised to replace the traditional two-trust plan with a four-trust plan to accommodate differences between state and federal law governing exemptions and marital deductions.<sup>41</sup> The enlarged estate tax exemption is also mirrored in a separate GST exemption, which amplifies the tax incentive to create perpetual trusts.<sup>42</sup> Finally, the effect of a \$5 million indexed exemption (coupled with a 40% maximum rate) is to transform the estate tax into a flat 40% levy on taxable transfers above the exempt amount, superseding the schedule of nominally graduated rates.<sup>43</sup> While this flat-rate structure obviates the need to recast the portable exemption as a deduction,<sup>44</sup> it also highlights the pointlessly convoluted interaction between the rate schedule and the unified credit.<sup>45</sup>

## II. TAXING GAINS AT DEATH

For reasons having more to do with historical accident than considered tax policy, the income tax from its earliest years has generally provided that property acquired from a decedent takes a

40. See I.R.C. § 2011(e) (limiting state death tax credit to the federal estate tax “reduced by the amount of the unified credit”).

41. See Mitchell M. Gans & Jonathan G. Blattmachr, *Quadpartite Will Redux: Decoupling and the Next Generation of Instruments*, 32 EST. PLAN. 3, 14–15 (2005); Michael L. Graham, Mitchell M. Gans & Jonathan G. Blattmachr, *Quadpartite Will Redux: Coping with the Effects of Decoupling*, 32 EST. PLAN. 15, 16–18 (2005).

42. See William J. Turnier & Jeffrey L. Harrison, *A Malthusian Analysis of the So-Called Dynasty Trust*, 28 VA. TAX REV. 779, 789–805 (2009) (discussing hidden costs and shortcomings of dynasty trusts); see also Grayson M.P. McCouch, *Who Killed the Rule Against Perpetuities?*, 40 PEPP. L. REV. 1291, 1297 (2013) (discussing sheltering of generation-skipping trusts from GST tax).

43. The maximum 40% rate applies to cumulative taxable transfers of more than \$1 million dollars. See I.R.C. § 2001(c). As a practical matter, the lower rates apply only to nonresident alien transferors. See I.R.C. §§ 2101, 2102.

44. See Turnier, *supra* note 1, at 272–73 (explaining that the surviving spouse should receive a deduction, rather than a credit, to replicate the effect of a lifetime gift from the first spouse).

45. For U.S. citizens and residents, the convoluted interaction of §§ 2001 and 2010 could be greatly simplified by replacing the unified credit with an exemption expressed as a zero bracket amount in the rate schedule. See Turnier & Kelly, *supra* note 9, at 1014.

fresh basis equal to fair market value in the hands of the recipient.<sup>46</sup> The unlimited basis step-up, which amounts to complete forgiveness of income tax on unrealized appreciation in property owned at death, has been described as a “gaping loophole” in the income tax because of its corrosive effects on revenue, equity, and efficiency.<sup>47</sup> In terms of foregone revenue, the failure to tax gains at death represents one of the largest items in the tax expenditure budget, with an annual revenue cost of around \$50 billion.<sup>48</sup> Moreover, the resulting tax benefits are heavily skewed toward the top of the income distribution, with 65% of the benefits accruing to the top quintile and 21% to the top 1% of households.<sup>49</sup> In terms of efficiency, the unlimited basis step-up has an undesirable “lock-in” effect because it encourages taxpayers to hold appreciated assets until death rather than sell them during life in order to avoid incurring a capital gains tax.<sup>50</sup>

These shortcomings in the income tax treatment of appreciated property owned at death have traditionally been mitigated by the estate tax, which reaches many of the same taxpayers who benefit from the deathtime basis step-up and compensates for much of the foregone income tax revenue.<sup>51</sup> Conversely, measures that weaken the estate tax amplify the adverse effects of the unlimited deathtime basis step-up.<sup>52</sup> Even at the height of anti-estate tax sentiment in 2001, it

46. See I.R.C. § 1014(a), (b). An exception is provided for items of “income in respect of a decedent,” which take a carryover basis in the hands of the recipient. See I.R.C. §§ 691(a), 1014(c).

47. William G. Gale & Joel Slemrod, *Overview*, in *RETHINKING ESTATE AND GIFT TAXATION* 1, 55 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001); see also Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 *COLUM. L. REV.* 1365, 1381 (1970) (describing deathtime basis step-up as the “most serious defect” in the federal tax structure).

48. See CONG. BUDGET OFFICE, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM* 16 (2013); see also *id.* at 6 tbl.1 (showing projected budget cost of \$43 billion for 2013 and \$644 billion for 2014 to 2023).

49. See *id.* at 15 tbls.2 & 16.

50. See Burke & McCouch, *supra* note 33, at 513–14.

51. Compared to a deathtime gains tax, the estate tax is both overinclusive (because it reaches the entire value of property owned at death rather than merely unrealized appreciation) and underinclusive (because of the large exemption). See *id.* at 519. Nevertheless, the estate tax tends to reduce the tax advantage of avoiding capital gains tax by holding appreciated property until death. Assuming a 20% capital gains tax and a 40% estate tax, the estate tax reduces the rate of avoidable tax from 20% to 12% [ $.20 \times (1 - .40)$ ]. See *id.* at 514.

52. See Gerald Auten & David Joulfaian, *Bequest Taxes and Capital Gains Realizations*, 81 *J. PUB. ECON.* 213, 227 (2001); Athiphat Muthitacharoen, *The Impact of the Estate Tax on Capital Gains Tax Realizations: Evidence from the Taxpayer Relief Act of 1997*, at 2 (Cong. Budget Office, Working Paper No. 2010-08, 2010); see also Richard

was clear that the estate tax could not be eliminated without addressing the income tax treatment of appreciated property owned at death.<sup>53</sup> Accordingly, the 2001 Act coupled estate tax repeal for decedents dying in 2010 with modified carryover basis provisions that (in theory, at least) limited the benefit of the tax-free basis step-up at death.<sup>54</sup> With the reinstatement of the estate tax under the 2010 Act, it is hardly surprising that carryover basis faded into oblivion. The more striking feature of the legislation enacted in 2010 (and made permanent in 2012) is the dramatic increase in the estate tax exemption, coupled with the absence of any countervailing limit on the deathtime basis step-up. The simultaneous erosion of the estate and income taxes highlights the need to consider the possibility of taxing gains at death.

Compared to the short-lived experiment with carryover basis, a deathtime gains tax would be relatively simple and effective, and it would raise considerably more revenue.<sup>55</sup> Before 2001, a generic deathtime gains tax was generally assumed to raise less revenue than the existing estate tax because of the latter's higher rates and broader base.<sup>56</sup> Since 2001, however, the revenue raising capacity of the estate

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Schmalbeck & Jay A. Soled, *Estate Tax Relief and the Erosion of Capital Gains Tax Revenues*, 133 TAX NOTES 733, 734 (2011) (noting executor's incentive in nontaxable estate "to attach the highest defensible value to the estate's assets to secure the largest tax basis possible," and estimating lost income tax revenue of \$80 billion over ten years resulting from increased estate tax exemption).

53. See Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 198–201 (2002); Burke & McCouch, *supra* note 33, at 553–55.

54. Even a "watertight" carryover basis system would allow "indefinite deferral of gain for beneficiaries who could afford to postpone selling inherited property." Burke & McCouch, *Estate Tax Repeal*, *supra* note 53, at 199. Furthermore, the efficacy of the carryover basis system in the 2001 Act was undermined by its generous exemptions, which perpetuated a tax-free basis step-up for substantial amounts of inherited property. See *id.* at 201–10.

55. See Burke & McCouch, *supra* note 33, at 554 (concluding that a deathtime gains tax "may be preferable [to carryover basis] in terms of distributional impact and revenue-raising capacity as well as effectiveness in curbing deferral and ameliorating lock-in"); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 441 (1993) (concluding that "it is possible to design a death gains tax that is workable, fair, and raises substantial revenue" and that "taxing gains at death is a more attractive option than carryover basis"). By one estimate, a deathtime gains tax would raise approximately \$78.5 billion over a ten-year period, compared to \$47.8 billion from a carryover basis system. See CONG. BUDGET OFFICE, BUDGET OPTIONS 311–12 (2000) (projecting revenue for 2001 to 2010).

56. The Congressional Budget Office estimated that a deathtime gains tax would raise \$10.5 billion in 2002, compared to \$29 billion from the estate and gift taxes. See CONG. BUDGET OFFICE, *supra* note 55, at 311; CONG. BUDGET OFFICE, THE ECONOMIC AND BUDGET OUTLOOK: FISCAL YEARS 2000–2009, at 46 tbl.3-1 (1999). Other estimates

tax has fallen sharply as a result of the rising exemption and falling top marginal rate, and it now appears that a comprehensive deathtime gains tax would raise more revenue.<sup>57</sup> Moreover, the burden of a deathtime gains tax would be highly concentrated in very large estates, reflecting the disproportionate share of appreciated property in those estates.<sup>58</sup>

Viewed as a gap-closing income tax reform, a deathtime gains tax ideally should reach all unrealized appreciation in property owned at death. A targeted exemption allowing a limited basis step-up may be unavoidable on grounds of administrative convenience, but any such exemption would have significant revenue and distributional effects. In general, the larger the exemption, the lower the revenue yield; at the same time, however, by narrowing the focus of a deathtime gains tax, an exemption would reduce the number of decedents burdened by the tax and concentrate the remaining tax burden on the wealthiest decedents.<sup>59</sup> One approach that would limit revenue loss while preventing the burden of a deathtime gains tax from being shifted

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suggested that a deathtime gains tax might raise considerably less revenue. See James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in *RETHINKING ESTATE AND GIFT TAXATION* 422, 444 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001) (estimating revenue of \$4.5 billion in 1998).

57. One recent study estimated that a deathtime gains tax with no exemption would raise \$561 billion over ten years, compared to \$549 billion from an estate tax (assuming a \$3.5 million exemption and a 45% maximum rate, based on 2009 law). See Robert B. Avery, Daniel Grodzicki & Kevin B. Moore, *Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death* 5 (Fed. Reserve Bd., Divs. of Research & Statistics & Monetary Affairs, Fin., & Econ. Discussion Series, Working Paper No. 2013-28, 2013) (estimating that an estate tax based on 2001 law, with a \$1 million exemption and a 55% maximum rate, would raise \$1.2 trillion over ten years). Compared to 2009 law, the higher exemption and lower marginal rate under current law would reduce the revenue yield of the estate tax even further.

58. According to one study, unrealized appreciation represents 56% of the value of estates of \$10 million or more (but only 36% on average for all households). See Poterba & Weisbenner, *supra* note 56, at 439–40 tbl.10-8 (noting that the ratio of unrealized appreciation for stock and mutual funds is also “much higher for the wealthy”). Moreover, active business assets represent nearly half of the value and more than 70% of unrealized appreciation in estates of \$10 million or more (but less than 1% of the value and a “negligible fraction” of unrealized appreciation in estates of less than \$1 million). *Id.*; see also Avery, Grodzicki & Moore, *supra* note 57, at 18 (noting that “the share of unrealized capital gains in the gross estate increases with the size of the gross estate, ranging from about 12 percent of the smallest estates to 55 for gross estates over \$100 million”).

59. By one estimate, an exemption for \$1.3 million of gain and \$3 million of additional gain in assets passing to a surviving spouse would reduce the ten-year revenue yield of a deathtime gains tax from \$561 billion to \$200 billion, while raising the share of the tax burden borne by the top wealth group (i.e., the top 1% of the top quintile) from 59.1% to 92.3%. See Avery, Grodzicki & Moore, *supra* note 57, at 5, 21, 38 tbl.5.

down the wealth scale would be to allow exemptions for tangible personal property of de minimis value (on grounds of administrative convenience) and for a specified amount of appreciation in the decedent's principal residence (consistent with the exclusion of gain on a lifetime sale).<sup>60</sup> To allay concerns about hardship and bunching of income, a further concession might be allowed in the form of carryover basis for transfers to a surviving spouse (consistent with a view of the married couple as a single taxable unit) and for items of income in respect of a decedent (consistent with current law).<sup>61</sup>

From a broader perspective, the failure of current law to tax unrealized appreciation at death may be viewed as a symptom of a recent trend toward preferential income tax treatment of capital income. For a brief period after 1986, capital gains were taxed at the same rate as ordinary income, but in subsequent years capital gains rates have plummeted.<sup>62</sup> Specifically, the 2003 Act reduced those rates still further and extended them to qualified dividend income.<sup>63</sup> Since capital gains and dividend income are heavily skewed toward the top of the income distribution, the recent tax cuts have undermined the progressivity of the income tax and impaired its effectiveness as an instrument for mitigating inequality of income and wealth.

### III. TAXING BUSINESS INCOME

Income inequality in the United States has clearly risen during the last thirty years, with the top 1% (and even more so the top .1% and .01%) capturing an increasing share of income compared to all other groups.<sup>64</sup> While the causes of rising income inequality remain

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60. *Cf.* I.R.C. § 121 (2012) (excluding \$250,000 of gain on sale of principal residence). While difficult to justify from a tax policy perspective, this exclusion would enhance the progressivity of the deathtime gains tax, reflecting the inverse relationship between the share of net appreciation represented by a decedent's principal residence and the size of the estate. According to one study, the principal residence accounts for more than 90% of net appreciation in estates of less than \$500,000 and only 3.6% of net appreciation in estates of \$10 million or more. *See* Poterba & Weisbenner, *supra* note 56, at 439–40 tbl.10-8.

61. *See* Burke & McCouch, *supra* note 33, at 522, 535–39 (discussing marital bequests); Zelenak, *supra* note 55, at 395–401, 432–33 (endorsing carryover basis for marital bequests and noting that carryover basis for items of income in respect of a decedent avoids “valuation problems” and obviates the need for subsequent adjustments “if the amount ultimately received does not equal the amount included in income at death”).

62. *See* 2003 Act, *supra* note 5, § 301(a), 117 Stat. at 758; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311(a), 111 Stat. 788, 831.

63. *See* 2003 Act, *supra* note 5, §§ 301(a), 302(a), 117 Stat. at 758, 760.

64. *See* CONG. BUDGET OFFICE, TRENDS IN THE DISTRIBUTION OF HOUSEHOLD INCOME BETWEEN 1979 AND 2007, at xi (2011) (“[T]he share of total market income

unclear, the top income group has also experienced a sharp rise in business income (consisting of net income from sole proprietorships, partnerships, and S corporations).<sup>65</sup> By repealing the *General Utilities*<sup>66</sup> doctrine and reducing the top marginal individual income tax rate below the top marginal corporate tax rate, the 1986 Act<sup>67</sup> prompted a large-scale shift in the form of business organizations from corporations to S corporations and other passthrough entities and a consequent rise in the amount of business income reported by high-income individuals. One prominent economist has dismissed concerns about increasing income inequality as misguided, arguing that changes in tax reporting have “create[d] the false impression of a sharp rise in the incomes of high-income individuals, even though there was only a change in the legal form of that income.”<sup>68</sup> The rapid shift from C corporations to S corporations may well account for a significant portion of the increase in top incomes between 1986 and

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received by the top 1 percent of the population more than doubled between 1979 and 2007, growing from about 10 percent to more than 20 percent.”). Although increased income inequality may portend heightened wealth inequality, the evidence of increasing wealth inequality is less clear. See THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 347–50 (Arthur Goldhammer trans., 2014) (discussing rise of wealth inequality in the United States); Fabian T. Pfeffer, Sheldon Danziger & Robert F. Schoeni, *Wealth Disparities Before and After the Great Recession*, 650 ANNALS AM. ACAD. POL. & SOC. SCI. 98, 114–15 (2013) (noting that rising wealth inequality was exacerbated by 2007 to 2009 recession and subsequent uneven recovery); cf. Wojciech Kopczuk, *Taxation of Intergenerational Transfers and Wealth* 51–52 (Nat’l Bureau of Econ. Research, Working Paper No. 18584, 2012) (describing evidence of changes in wealth concentration as “somewhat inconclusive” and noting that changing composition of wealth among top wealth holders may be “consistent with both income inequality increases and relative stability of wealth concentration”); Wojciech Kopczuk & Emmanuel Saez, *Top Wealth Shares in the United States, 1916–2000: Evidence from Estate Tax Returns*, 57 NAT’L TAX J. 445, 467 (2004) (characterizing the “dramatic increase in top incomes” as a “labor income phenomenon” consistent with “stability of the top wealth shares since the mid-1980s”).

65. See CONG. BUDGET OFFICE, *supra* note 64, at 16–17 (noting that business income was “the fastest growing source of income for the top 1 percent,” rising from 10% in 1981 to 27% in 2005 and then tapering off); see also Jon Bakija, Adam Cole & Bradley T. Heim, *Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data 2–3* (Apr. 2012) (unpublished manuscript) (noting that salary and business income accounted for 63% of the increased income share of the top 0.1% between 2001 and 2010).

66. See *Gen. Util. & Operating Co. v. Helvering*, 296 U.S. 200, 206 (1935) (allowing corporation to distribute appreciated property without recognizing corporate-level gain).

67. See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101(a), 302(a), 631(a), 100 Stat. 2085, 2096, 2218, 2269.

68. Martin Feldstein, *Piketty’s Numbers Don’t Add Up*, WALL ST. J., May 15, 2014, at A15 (“The changes in tax rules since 1980 create a false impression of rising inequality.”).



1988.<sup>69</sup> Nevertheless, the proliferation of S corporations and partnerships (including LLCs) hardly offers a complete explanation of rising income inequality, since the “dramatic changes in income shares at the very top of the distribution . . . were to a large extent labor income phenomena.”<sup>70</sup>

The tax-driven behavioral response to the 1986 Act has contributed to the erosion of the corporate tax base. Between 1980 and 2008, the share of net business income reported by C corporations fell from nearly 70% to 40%, while the combined shares attributable to S corporations and partnerships rose from less than 14.5% to 47.6%.<sup>71</sup> By 2022, individual income taxes on business income are projected to be nearly equal to corporate tax revenues.<sup>72</sup> The corporate tax (along with the estate tax) has traditionally been viewed as a significant source of progressivity in the federal tax system.<sup>73</sup> In 2010, the top 1% of households bore nearly half of the total corporate tax burden, reflecting the skewing of capital income toward the top of the income distribution.<sup>74</sup> While the corporate tax remains the third largest source of federal revenue (behind the individual income tax and payroll taxes), the decline of the corporate tax limits its contribution to overall progressivity.<sup>75</sup> Moreover, the

69. See Roger H. Gordon & Joel B. Slemrod, *Are “Real” Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?*, in *DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 240, 243–46 (Joel B. Slemrod ed., 2000); George A. Plesko, “*Gimme Shelter?*” *Closely Held Corporations Since Tax Reform*, 48 NAT’L TAX J. 409, 411 (1995) (noting “dramatic” 36.5% increase in number of S corporations between 1986 and 1987); cf. Feldstein, *supra* note 68, at A15 (asserting that changes in taxpayer behavior “occurred gradually over many years”).

70. Kopczuk, *supra* note 64, at 51 (emphasis omitted); see also CONG. BUDGET OFFICE, *supra* note 64, at 19 (attributing much of the increase to earnings).

71. See George A. Plesko & Eric J. Toder, *Changes in the Organization of Business Activity and Implications for Tax Reform*, 66 NAT’L TAX J. 855, 860–61 (2013) (noting that 18% drop in number of C corporation returns was offset by 742% rise in number of S corporations during the same period).

72. See *id.* at 859.

73. See Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21 J. ECON. PERSP. 3, 11–13 (2007).

74. See CONG. BUDGET OFFICE, *THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES*, 2010, at 14 (2013) (noting that “CBO allocates most of [the corporate income] tax to capital income, which constitutes a larger share of income at the top of the distribution”).

75. See JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34229, *CORPORATE TAX REFORM: ISSUES FOR CONGRESS* 3 (2014) (noting that in recent years the corporate tax accounts for around 10% of federal tax revenues and 2% of gross domestic product); Piketty & Saez, *supra* note 73, at 22–23 (attributing “dramatic drop in progressivity” of federal taxes at the top of the income distribution “primarily to a drop in corporate taxes”

decline in corporate tax revenue is not fully offset by the rise in individual income tax revenue attributable to passthrough business income.<sup>76</sup>

From 2003 through 2012, the maximum tax rate for corporations and individuals was 35%, and the maximum tax rate on qualified dividends and capital gains was 15%.<sup>77</sup> In most situations, the passthrough form offered tax advantages over the corporate form. To the extent shareholders could earn the same rate of return on investments outside the corporation, the 15% tax on distributed earnings represented an extra burden.<sup>78</sup> Owners of closely held C corporations (many of them in the top income tax bracket) might nevertheless have found it advantageous to accumulate earnings within the corporation, withdrawing modest compensation and foregoing corporate distributions.<sup>79</sup> If the owner retained the stock until death, his or her share of undistributed corporate earnings could generally have been withdrawn tax-free by virtue of the deathtime basis step-up.

The 2012 Act raised the maximum tax rate on dividends and capital gains to 20% beginning in 2013; it also raised the maximum individual tax rate to 39.6% while leaving the maximum corporate tax rate at 35%.<sup>80</sup> The resulting rate structure may be unstable, however, in light of current proposals to reduce the maximum corporate tax rate to 28% or less. Reducing the corporate tax rate to 28% would produce the largest gap (11.6 percentage points) between the

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and estate and gift taxes, combined with a shift from capital income to labor income in the top income group).

76. See Plesko, *supra* note 69, at 413; Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by \$140 Billion*, 130 TAX NOTES 987, 989 (2011) (estimating that increased individual income tax revenue replaces only two-thirds of lost corporate tax revenue).

77. See 2003 Act, *supra* note 5, §§ 105(a), 301(a), 117 Stat. at 755, 758; I.R.C. § 11(b)(1)(D) (2012).

78. The tax burden of investing in a C corporation (as compared to a passthrough entity) depends on (1) the statutory corporate and individual tax rates, (2) the tax rates for dividends and capital gains, (3) the dividend payout rate, and (4) the capital gains realization rate. See Plesko & Toder, *supra* note 71, at 863–64.

79. See *id.* at 868. Even more favorable tax treatment may be available for certain “small business” stock. See I.R.C. §§ 1202, 1244.

80. See 2012 Act, *supra* note 7, §§ 101(b)(3), 102(b)(1), 126 Stat. at 2316, 2318. In 2013, dividends and capital gains also became subject to the additional 3.8% tax on net investment income enacted in 2010. See I.R.C. § 1411. The 2012 Act slightly narrowed the advantage of passthrough taxation. Assuming a 50% dividend payout rate and a 50% capital gains realization rate, the weighted average combined corporate and individual tax rate is now 46.6% (compared to the maximum individual tax rate of 39.6%). See Plesko & Toder, *supra* note 71, at 866–67, 866 tbl.2.

maximum tax rates on corporate and passthrough business income since 1981.<sup>81</sup> Indeed, any reform that pushed the maximum corporate tax rate significantly below the maximum individual tax rate would upend the tax incentives affecting choice of organizational form and restore C corporations as tax shelters for high-income individuals.<sup>82</sup> A low corporate tax rate would enhance the after-tax return on retained corporate earnings, creating a significant advantage compared to investments outside the corporation: the longer the earnings remained reinvested within the corporation, the greater the advantage.<sup>83</sup>

A reduced corporate tax rate encourages retention and reinvestment of corporate earnings. If the combined corporate-shareholder tax rate on corporate distributions were the same as the maximum individual tax rate, shareholders would enjoy a higher after-tax return on reinvested corporate earnings than on alternative investments outside the corporation. Accordingly, owner-managers would be encouraged to shift funds into the corporation and to

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81. See Plesko & Toder, *supra* note 71, at 868.

82. See Peter C. Canellos, *Corporate Tax Integration: By Design or Default?*, in CORPORATE TAX REFORM: A REPORT OF THE INVITATIONAL CONFERENCE ON SUBCHAPTER C 129, 135 (George K. Yin & George Mundstock eds., 1988) (noting that before 1986 the corporate tax often functioned as “a shelter rather than a burden”). For recent proposals, see Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1335–40 (2013).

83. If dividends and capital gains are taxed at the same rate, the advantage of earning a higher after-tax return inside the corporation depends on the difference between the maximum individual and corporate tax rates and the length of deferral. To illustrate, suppose a corporation incurs \$28 of tax on \$100 of earnings (at a 28% corporate rate), leaving \$72 to be distributed to shareholders or reinvested in the corporation. A \$72 dividend would attract a tax of \$14.40 (at a 20% rate), leaving \$57.60 to be invested outside the corporation, which would grow to \$77.08 at the end of five years (at a 10% rate of return, subject to a 40% individual tax). Alternatively, the corporation could retain and reinvest the \$72, which would grow to \$101.93 at the end of five years (at a 10% rate of return, subject to a 28% corporate tax). A \$101.93 dividend would attract a tax of \$20.39 (at a 20% rate), leaving \$81.54 after tax. The \$4.46 difference between \$81.54 and \$77.08 reflects the advantage of investing \$57.60 at an after-tax rate of 7.2% rather than 6% ( $\$57.60 \times [1.072^5 - 1.06^5]$ ). See Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 TAX NOTES 641, 646–48 (2010). The example could be further refined to illustrate the interaction between the corporate tax and the additional tax on net investment income. See Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* 19 n.34 (Ctr. in Law, Econ. & Org., Legal Studies Research Paper Series No. 13-5, 2013) (noting that pretax corporate earnings that are used to pay the corporate income tax are not subject to the tax on net investment income).

minimize the amounts they withdraw as compensation.<sup>84</sup> Current law already makes it fairly easy to disguise the labor component of entrepreneurial activity as invested capital and to defer tax until returns are realized, often in the form of low-taxed capital gains.<sup>85</sup> If the investment is retained until death, the unrealized gain may escape tax altogether as a result of the deathtime basis step-up. Reduced corporate tax rates would encourage owner-managers to understate their compensation, thereby increasing the retained earnings invested at the corporation's higher rate of return and exacerbating the problem of taxing labor income under current law.<sup>86</sup>

Reduced corporate tax rates cannot realistically be limited to publicly traded corporations. The incentive to shelter corporate earnings might be mitigated, however, by setting the combined corporate-shareholder tax rate far enough above the maximum individual tax rate to deter closely held businesses from choosing to be taxed as C corporations. It would also be necessary to curtail the deathtime basis step-up, to prevent appreciated corporate stock from escaping tax altogether. One possible approach would be to reduce the stepped-up basis in corporate stock by the deceased shareholder's ratable share of corporate earnings (less any taxable lifetime distributions to the shareholder), by analogy to the treatment of income in respect of a decedent.<sup>87</sup> Such a targeted measure would raise the intractable problem of allocating undistributed corporate earnings at the shareholder's death, while allowing all other assets to continue to receive an unlimited basis step-up. A simpler and more comprehensive approach would be to impose a deathtime gains tax, which would reach unrealized appreciation not only in corporate stock but more generally in property owned at death. The advantages of lifetime deferral could be further neutralized by taxing unrealized

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84. See Kleinbard, *supra* note 83, at 66 (noting the "practical futility of policing capital stuffing" if corporate capital earns a higher after-tax return than noncorporate capital, and suggesting a low (or zero) rate on all capital income). Understatement of compensation is already rampant in S corporations, which are widely used to avoid payroll taxes and the § 1411 tax on net investment income. See Burke, *supra* note 82, at 1339.

85. The problem of "carried interest" represents a particularly egregious example of this phenomenon. See *Tax Reform and the Tax Treatment of Capital Gains, Hearing Before H. Comm. on Ways & Means & S. Comm. on Fin.*, 112th Cong. 4 (2012) (statement of Leonard E. Burman).

86. See Kleinbard, *supra* note 83, at 46–47 (noting that the strategy of understating compensation is "not to convert labor income into capital income" in the first instance, since the combined corporate-individual tax rate on distributed earnings may be as high as the individual rate on compensation).

87. See Halperin, *supra* note 83, at 654.

gains in publicly traded corporate stock on an accrual basis,<sup>88</sup> possibly as a replacement for the existing corporate tax.

Given increased international competition and offshore migration of profits, shifting a portion of the tax burden on corporate equity to shareholders offers potential efficiency gains. Since individual taxes are generally imposed regardless of income source, such taxes tend to be neutral for purposes of international allocation, and increasing taxes at the shareholder level would make it easier to reduce the corporate tax rate without encouraging sheltering by high-income individuals.<sup>89</sup> While reducing the corporate tax rate would be regressive as a stand-alone measure, the net effect of a corporate rate cut coupled with restoration of the higher pre-1997 tax rates on dividends and capital gains might be progressive.<sup>90</sup> The progressivity of the combined reform reflects the extreme skewing of the benefits of the 2003 tax cuts toward the top of the income distribution.<sup>91</sup> The 2003 tax cuts represent a costly and regressive form of shareholder-level relief from the burden of the corporate double tax. By contrast, European countries have reduced corporate tax rates while increasing taxation of corporate equity income at the shareholder level.<sup>92</sup> Although the corporate tax remains politically popular, shifting more of the corporate tax burden to shareholders may raise more revenue and enhance progressivity.

The 1986 Act increased corporate taxes to pay for a reduction in individual taxes, but that approach is “neither desirable nor possible” in today’s climate of global capital mobility and international

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88. An accrual-based tax would reach the annual change in value of a corporation’s outstanding equity. *See infra* notes 96–98.

89. *See* GRAVELLE, *supra* note 75, at 44.

90. *See* Rosanne Altshuler, Benjamin H. Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX. REV. 355, 370–72 (2010) (finding that such a measure would be progressive even if a portion of the corporate tax is shifted to labor).

91. In 2010, the top 1% of households realized almost 70% of capital gains, while the top 0.01% realized nearly 47%. *See Tax Reform and the Tax Treatment of Capital Gains*, *supra* note 85, at 5 (statement of Leonard E. Burman). In 2011, the top 2% of returns reported 53% of all dividends. *See* JANE G. GRAVELLE & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R43418, THE TAXATION OF DIVIDENDS: BACKGROUND AND OVERVIEW 4 (2014); *see also* THOMAS L. HUNGERFORD, CONG. RESEARCH SERV. R42131, CHANGES IN THE DISTRIBUTION OF INCOME AMONG TAX FILERS BETWEEN 1996 AND 2006: THE ROLE OF LABOR INCOME, CAPITAL INCOME, AND TAX POLICY 14 (2011) (citing changes in income from capital gains and dividends as largest contributor to rising inequality between 1996 and 2006).

92. *See* Altshuler, Harris & Toder, *supra* note 90, at 380–81 (referring to “American exceptionalism”).

competition.<sup>93</sup> Broadening the corporate tax base to pay for a reduction in corporate tax rates would impose higher taxes on nearly 60% of net business income.<sup>94</sup> Passthrough businesses would also suffer the loss of business tax preferences without reaping any benefit from the lower corporate tax rates. Given the expansion of the passthrough sector since 1986, business tax reform inevitably implicates individual tax reform. In considering business tax reform, it is important to keep in mind how earlier tax and regulatory changes have shaped “the current landscape of organizational form.”<sup>95</sup> Lowering corporate tax rates and broadening the tax base would give closely held businesses an incentive to choose to be taxed as C corporations and might ultimately reverse the post-1986 trend toward single-level taxation of most business income.

One approach that deserves further consideration is an accrual-based tax on unrealized appreciation in publicly traded stock.<sup>96</sup> A mark-to-market system for publicly traded stock would raise significant revenue without shifting the corporate tax burden from capital to labor.<sup>97</sup> Compared to other corporate tax reform proposals, accrual-based taxation would mitigate problems of income sheltering and lock-in of gains until death.<sup>98</sup> Taxing shareholders on their share of distributed earnings and accrued capital gains may be viewed as a superior form of corporate-shareholder integration since it avoids the administrative problem of allocating corporate income to individual

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93. Michael J. Graetz, *The Tax Reform Road Not Taken—Yet*, 67 NAT'L TAX J. 419, 428 (2014).

94. See Plesko & Toder, *supra* note 71, at 868–69 (noting that corporate tax rate cuts would benefit only 5.6% of business taxpayers while broader base would increase burden for the remaining 94.4%).

95. *Id.* at 869.

96. For recent discussions of mark-to-market proposals, see sources cited in David Hariton, *Should Share Repurchases Be Dividends to Remaining Holders?*, 144 TAX NOTES 175, 176 n.5 (2014). See generally Martin A. Sullivan, *Can Marking Stock to Market Replace the Corporate Tax?*, 143 TAX NOTES 139 (2014) (suggesting mark-to-market system offers a potential end-run around intractable problems of corporate taxation); David S. Miller, *The Zuckerberg Tax*, N.Y. TIMES, Feb. 8, 2012, at A27 (proposing mark-to-market taxation of publicly traded stocks of “superwealthy” founders and investors such as Mark Zuckerberg). For a more targeted proposal to tax continuing shareholders on accrued appreciation when a corporation repurchases outstanding stock, see Hariton, *supra*.

97. See Joseph Bankman, *A Market-Value Based Corporate Income Tax*, 68 TAX NOTES 1347, 1347–50 (1995) (discussing the possibility of replacing the corporate tax with a tax measured by annual changes in the value of corporate equity).

98. See Eric Toder & Alan D. Viard, *Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax*, TAX POL'Y CENTER 28 (Apr. 4, 2014), <http://www.taxpolicycenter.org/UploadedPDF/413090-Major-Surgery-Needed.pdf>.

shareholders. Viewed as a replacement for the existing corporate tax, a mark-to-market system would also eliminate the strongest reason for retaining preferential capital gains tax rates.<sup>99</sup> Mark-to-market taxation, in conjunction with a deathtime gains tax, would enhance vertical equity by curtailing the advantages (currently concentrated among high-income investors) of lifetime deferral and deathtime forgiveness of tax on unrealized appreciation in publicly traded stock.<sup>100</sup>

Since 1986, legislative changes have greatly expanded the availability of passthrough treatment as an alternative to the double-tax corporate system,<sup>101</sup> resulting in a sharp discontinuity between the tax treatment of publicly traded and nonpublicly traded entities. Accrual-based taxation of publicly traded corporate stock would accentuate the discontinuity. Nevertheless, a classification explicitly based on public trading might provide a welcome opportunity to rationalize business taxation without sacrificing the ideal of a single-level tax on business income.<sup>102</sup> Taxing distributions and accrued capital gains would approximate passthrough taxation, except that taxation of gains attributable to nonpublicly traded entities would be deferred until realization. The rationale for excluding nonpublicly traded entities from accrual-based taxation is based on the impracticability of requiring market valuation of equity interests in such entities.

Because accrual-based taxation would apply only to publicly traded entities, it would potentially sidestep the problem of financing a reduction in corporate tax rates with an increased tax burden on

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99. See Leonard E. Burman, *Taxing Capital Income Once*, 98 TAX NOTES 751, 751–52 (2003) (arguing that “the most compelling argument for lower capital gains tax rates on corporate stocks is as an offset to double taxation” and that in the absence of double taxation “there would be no good reason to retain a tax preference for capital gains”).

100. Eliminating the corporate tax, however, would result in a net revenue loss and provide a tax cut for many high-income individuals even after taking into account increased taxes on unrealized gains. The effect on progressivity would ultimately depend on other tax and spending measures adopted as part of the overall reform. See Toder & Viard, *supra* note 98, at 40.

101. For example, Congress has repeatedly liberalized the eligibility requirements for S corporations. See, e.g., I.R.C. § 1361(b)(1)(A) (maximum number of shareholders), (b)(3) (qualified subchapter S subsidiary), (c)(1) (family aggregation), (c)(6) (tax-exempt organizations) (2012).

102. In determining which entities are subject to accrual taxation, it would be necessary to specify a threshold level of active trading. See Toder & Viard, *supra* note 98, at 31. Depending on how that threshold is specified, a mark-to-market system might actually result in a simplified system of business taxation if most large partnerships (and S corporations) were removed from the passthrough system.

more than half of all net business income. Such a reform need not be linked directly to changes in passthrough taxation, nor would it jeopardize earlier choices concerning forms of business organization. Since passthrough entities already allow losses to be deducted at the individual level, the deferral of unrealized gains would continue to offer a significant advantage. Thus, the problem of corporate sheltering by high-income individuals would be greatly reduced since closely held businesses would have an incentive to maximize tax deferral by choosing passthrough treatment. Deferral of unrealized appreciation in passthrough interests should be viewed, however, not as a tax break for high-income passthrough owners but rather as a practical response to valuation difficulties, and it should not extend beyond the owner's death. Taxing passthrough owners on unrealized gains at death would thus complement a mark-to-market regime for publicly traded entities.

#### CONCLUSION

The massive tax cuts of recent years have eviscerated the estate tax and slashed tax rates on dividends and capital gains, resulting in a dramatically reduced tax burden on capital and capital income. Among the pernicious consequences of this tax-cutting frenzy are decreased federal revenue, reduced progressivity, and increased behavioral distortions flowing from artificial disparities in the taxation of labor and capital. In fact, there are good reasons for strengthening rather than weakening taxes on capital and capital income. Eliminating the preferential treatment of dividends and capital gains would not only enhance progressivity but also help to finance a modest reduction in U.S. corporate tax rates and reduce incentives for corporate sheltering by high-income individuals. Given the heavy concentration of wealth and capital income at the top of the income distribution, taxing accrued capital gains during life and at death would mitigate some of the most glaring defects of the existing tax system. Ironically, a reduction in the corporate tax, driven by international tax competition and global capital mobility, might provide a window of opportunity to introduce accrual taxation of publicly traded corporate stock and ultimately pave the way for a deathtime gains tax on all appreciated property (including closely held stock and passthrough interests). Finally, a reinvigorated estate tax, with a modest exemption (indexed for inflation) and a graduated rate schedule, would be fully compatible with these other reforms. While it may be impossible to restore the pre-2001 status quo, there is



no need to perpetuate the mistakes of the intervening years. It is time to learn from those mistakes and consider far-reaching tax reforms that are likely to prove more equitable, though perhaps less taxpayer-friendly, than in the past.