Budget Model

Senator Wyden's Billionaires Income Tax: Budgetary Effects

Summary: PWBM projects that Sen. Wyden's billionaire income tax proposal would raise $507 billion over the budget window, more than half of which would come from a one-time transition tax on previously accrued, unrealized capital gains on publicly traded assets.

Introduction

On October 27th, Senator Ron Wyden released draft legislation for a new "Billionaires Income Tax". Under Wyden's proposed tax, for tax filers with a net worth of more than $1 billion, gains on publicly traded assets would be taxed on an annual basis regardless of realization, a process sometimes called "accrual" or "mark-to-market" taxation. For non-publicly traded assets, the Wyden proposal would impose a deferral charge at the point of realization that effectively makes up for gains accrued prior to realization.

Background

Under current law, taxes on capital gains are due upon "realization," that is, when assets are sold. A capital gain is equal to the sales price less the original purchase price (or "cost basis") of the asset. Investors owe tax on capital gains whenever they sell property that has appreciated in value. Most other forms of income (such as wages and dividends) are taxed in the period in which they are earned, as the income involves a transaction where the recipient receives cash. By contrast, capital gains can accrue without a sale, thereby allowing the tax liability to be deferred.

The realization-based nature of capital gains taxation presents an opportunity for tax savings for two reasons. First, deferring realization produces larger after-tax returns over time since the tax is not part of annual compounding; the tax is only applied once at the end of the holding period. Second, as detailed in a previous PWBM brief, capital gains avoid taxation entirely when appreciated assets are held unrealized until death. The asset's cost basis is "stepped up" to its market value at time of death. This "step-up basis at death" allows benefactors to pass larger after-tax estates to their heirs. Both factors can reduce effective tax rates for wealthy households, making deferral a key tax planning strategy.

The Proposal

Under Senator Wyden's "Billionaires Income Tax," households that either earned $100 million in income or whose net worth exceed $1 billion for three consecutive years would be subject to "anti-deferral" taxation.

Any price appreciation on "tradable" assets, such as public stock, would be "marked to market" on an annual basis and taxes paid on an annual basis. For "non-tradable" assets like real estate and closely held businesses, investors would owe an additional "deferral recapture amount" upon *realization*, representing an interest charge on deferred liability. The interest rate would be set to the average of the yields on certain U.S. Treasury bills and notes, plus 100 basis points.

The Wyden proposal also contains a one-time transition tax. For tradable assets, the one-time transition tax would be payable over a five-year period on the amount of outstanding unrealized gains. For non-tradeable assets, the transition tax would be owed upon realization.

Moreover, applicable taxpayers would no longer receive the benefit of stepped-up basis at death. All transfers of appreciated property other than charitable gifts would be treated as realization events for tax purposes.

The Wyden proposal differs from an annual tax on net worth as, for example, previously proposed by Senator Warren. The Wyden proposal would tax a change in asset values whereas the Warren proposal would tax the total value of wealth regardless of the change in its value.

Budget Effects

PWBM projects the proposal would raise $507 billion over fiscal years 2022-2031. Table 1 shows the annual composition of the expected new revenues.

Table 1. Estimated Budgetary Effects of Senator Wyden's Tax Proposal

Billions of Dollars

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Year	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	Total
Receipts	51	71	73	74	76	39	28	30	32	35	**507**

Most of the projected revenue, equal to $344 billion, is raised in the first five years, a result of the transition tax on tradable assets.

Future Work: Modeling Dynamics

The 10-year estimate provided in Table 1 are "conventional" and consistent with standard budgetary analysis. Future work might consider additional dynamic responses as well. To date, accrual or mark-to-market taxation has received little attention in the academic literature, in part, due to technical computational challenges.[1] We briefly summarize some issues that might be subject to future analysis:

- Accrual taxation for publicly traded assets removes the "lock in" effect, allowing capital to move more easily take advantage of more attractive returns, improving market signals.

- Accrual taxation for non-publicly traded assets, however, presents several unique frictions even with taxes owed at realization. The interest rate formula for computing the "deferral recapture amount" does not adjust with project risk, encouraging higher risk and return projects to seek non-public investments, thereby reducing market signaling. Annual valuations would be needed for most angel, venture, and other private investments that could someday produce significant value for shareholders since the exact time path of valuation impacts taxes owed. For example, consider two companies that each produced a $2 billion dollar "exit" (realized) value for its respective company founder. Substantially lower taxes---in fact, akin to the tax treatment under current law---would be owed if one of the companies happened to "pop" in value very close to its exit even though both companies exit for the same amount. In fact, annual valuations would be needed even for private companies that have little chance of "popping" if its investors are otherwise wealthy.
- Liquidity presents other frictions. For publicly traded assets, assets could be presumably sold to pay the annual tax bill. For non-publicly traded assets such as a family business, however, borrowing against the asset might be impossible, quite costly, or prohibited by contract (e.g., a sporting franchise). A portion of those assets would then need to be sold upon death to pay the tax bill, and new investors could produce agency issues within the business.
- Tax planning methods would still be generally available to divide total household assets above $1 billion into separate tax entities where each separate tax entity falls below $1 billion. Newer tax reduction vehicles could also emerge.

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1. In a dynamic setting, modeling the change from realization to accrual taxation requires tracking "vintages" of capital investment, each of which must be represented using a separate state variable. This exercise quickly runs up against the classic "curse of dimensionality." Approximation methods still need to be developed. ↩