# Tax Avoidance by the Ultra-Rich

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Chair Wyden and Ranking Member Crapo, I'm submitting this written testimony at the hearing held by the Senate Finance Committee: The 2025 Tax Policy Debate and Tax Avoidance Strategies. My testimony pertains to tax avoidance by ultra-rich Americans.

I currently serve as Senior Advisor on tax policy for the Patriotic Millionaires and as an Associate Fellow at the Institute for Policy Studies, an affiliation I've had since 2013. Prior to joining the staff of the Patriotic Millionaires, I served as Tax Counsel to Americans for Tax Fairness. For the better part of the four decades between my graduation from law school and joining Americans for Tax Fairness in 2021, I practiced tax law. In my practice, I advised taxpayers in income and estate tax planning and represented them in tax controversies. I represented the taxpayers in *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), a case involving a tax-advantaged solar water heater leasing transaction, which set the standard in the Ninth Circuit for the determination of economic substance.

In both my career as a tax lawyer, and since then as a federal tax policy advocate, tax avoidance by the ultra-rich has been a substantial focus of my work. It is, in my opinion, a substantial contributing factor to the extreme concentration of wealth in America today, which is driving a democracy-threatening concentration of political power, together with economic and social instability.

My discussion of tax avoidance by the ultra-rich in these remarks is limited to efforts by the ultra-rich to structure their affairs in ways that avoid taxation, as opposed to engagement in criminal tax evasion or civil tax fraud. Accordingly, my remarks are not intended as criticism of the ultra-rich. Their activities in this area are permissible under the law, even if the tax consequences they seek are challenged by the Internal Revenue Service and not upheld in court.

In my experience assisting ultra-wealthy clients, their concern regarding taxes was limited to the impact taxes had on their wealth. Unlike for most Americans, tax obligations don't impact decisions the ultra-rich make regarding purchases, career choices, college affordability, retirement related matters, or whether a spouse must work. Consequently, ultra-rich clients of mine sometimes opted out of tax avoidance. They didn't see it enhancing their quality of life.[1] By the same token, limiting tax avoidance by the ultra-rich has no impact on them other than to

[1] That thinking likely accounts for a portion of estate tax paid by the ultra-rich today, since the estate tax is largely avoidable by those willing to undertake the planning involved in doing so.

reduce the amount of wealth they accumulate. It won't preclude a kid from attending college, delay anyone's retirement, or make anyone work longer hours.

In the following paragraphs, I'll discuss first the mechanics of tax avoidance by the ultra-rich; specifically, design flaws in the tax system, which we refer to as loopholes, the strategies devised by the ultra-rich and their advisors to exploit loopholes, and how they could be narrowed or closed. I'll then discuss the importance of IRS enforcement, and the work of the Treasury Department and Congress, in containing tax avoidance by the ultra-rich. Lastly, I'll discuss what I see as a fundamental structural problem in the federal tax system as it applies to the ultra-rich.

**The Mechanics of Tax Avoidance by the Ultra-Rich: Loopholes, the Strategies Devised to Exploit Them, and How They Could be Narrowed or Closed**

Our income tax system has design flaws, which we refer to as loopholes, that are exploited by the ultra-rich and their advisors to devise tax avoidance strategies. One type of loophole is a rule that assigns vastly different tax consequences to minor differences in circumstances. Another type of loophole is a rule that lacks a clear demarcation of what is needed to qualify for favorable tax treatment. Still another is a rule that leaves taxpayers with too much flexibility in attributing taxable income among multiple taxpayers. Following are specific examples of loopholes and the tax avoidance strategies used by the ultra-rich to exploit them.

<u>The Stepped-Up Basis Loophole and its Associated Avoidance Strategies: Buy-Borrow Die, Swap Til You Drop, and Sports Teams, the Everlasting Tax Shelter</u>

If a taxpayer sells an appreciated asset one day before his death, he must pay tax on the gain he realizes. But if his inheritor sells that same asset shortly after the taxpayer's death, the gain, potentially in the billions of dollars, escapes income taxation. That's the stepped-up-basis rule. It's the loophole exploited through the buy-borrow-die strategy.

<u>Buy-Borrow-Die</u>. Buy-borrow-die is straightforward in its operation: Ultra-rich Americans buy investment assets and never sell them. Instead, they borrow against them whenever they need cash. After they die, their inheritors then sell what typically are highly appreciated assets with no income tax consequence.

Closing the Buy-Borrow-Die loophole could be accomplished in one of two ways, either requiring the recognition of gain on death or limiting the basis of assets in the hands of inheritors to the basis of a decedent immediately prior to death, a framework known as carryover basis. Under either alternative, exceptions to the general rule could be established to avoid unduly harsh consequences for taxpayers with smaller estates and families owning farms or small businesses.

<u>Swap Til You Drop</u>. A variation of buy-borrow-die is known as "swap til you drop." That strategy allows real estate moguls to buy and sell real estate investments throughout their lifetimes,

avoid taxation on the gain from their sales, effectively cash out if they so choose, and avoid taxation on all gain, including the gain from recapture of depreciation deductions claimed with respect to their real estate holdings.

Swap til you drop incorporates the like-kind exchange rules, another loophole, into buy-borrow die. The like-kind exchange rules define a special category of income – gain from the sale of real property held for investment or for use in a trade or business – and allow taxation of that gain to be deferred if the proceeds from the sale are reinvested in a timely manner in real property held for investment or for use in a trade or business. Here's how it might work: John Rich buys a small office building for $10 million, paying $2.5 million in cash and paying the remainder of the purchase price with the proceeds of a $7.5 million loan. Five years later, John sells the small office building for $20 million and uses the net proceeds (after repayment of the loan), along with the proceeds of a new $37.5 million loan, to purchase a shopping center for $50 million. He avoids taxation of his $12 million gain (which includes recapture of $2 million of depreciation deductions claimed by John to offset rental income from the building) by structuring the transactions as a like-kind exchange. After seeing the shopping center double in value to $100 million, John sells it and uses the net proceeds, along with the proceeds of a new $187.5 million loan, to buy an office complex for $250 million. He avoids taxation on his $65 million gain (which includes the recapture of additional depreciation deductions) by structuring the transactions as a like-kind exchange. John continues to buy and sell real property in this fashion throughout his life. At his death, he owns a $4 billion real estate empire, which his children inherit and sell, not having to pay any income tax on the gains John deferred throughout his lifetime.[2]

Swap til you drop also exploits a third loophole, the right to claim depreciation deductions on real estate that is not depreciating economically.[3]

Closing the stepped-up basis loophole would neutralize much of the tax avoidance associated with Swap Til You Drop. That tax avoidance could be further reduced by limiting the amounts of

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[2] Even real estate moguls who want to cash out can employ swap til you drop. That's because the difference between an interest in real property held for investment and an AAA rated corporate bond is more blurry than most people think. Some high-end real property is subject to very long-term leases to highly creditworthy tenants, often Fortune 500 companies, with the lease terms imposing all costs of ownership during the lease term on the tenant. Economically, the owner of such a property owns a stream of payments, much the same as the owner of a bond. The right to possession of the building 30 years or more in the future is an insignificant part of the value of the property. But even though ownership of such a property (or, in some cases, a fractional interest in such a property) is the economic equivalent of owning a corporate bond, the property qualifies as real property held for investment for purposes of the like-kind exchange rules. By using the property as the replacement property in a final like-kind exchange, an ultra-rich person effectively can retire from the real estate business but still perpetuate the swap til you drop strategy.

[3] In some cases, real estate owners benefit from a loophole that allows them to claim deductions for depreciation deductions on real property where it is a lender who bears the economic risk of loss with respect to the depreciation. For example, if a taxpayer finances the purchase of a $100 million building with $75 million of nonrecourse debt, the risk of loss associated with depreciation deductions that reduce the taxpayer's cost basis below $75 million is borne by the lender. This loophole exists because the so-called "at-risk rules", enacted in 1976, do not apply to many debt-financed real estate activities.

gain that can be deferred in like-kind exchange transactions and/or by tightening the requirements for a replacement property to qualify as "like-kind."

Sports Teams: The Everlasting Tax Shelter. The everlasting tax shelter – more commonly known as sports team ownership – is yet another variation on buy-borrow-die.[4] In this variant of buy-borrow-die, an ultra-rich American buys a sports team, the great majority of which now are owned by billionaires or "centi-millionaires." Most of the value of sports teams is attributable to intangible assets, such as player contracts and goodwill. The rules allowing the amortization of intangible assets for income tax purposes apply even though those assets collectively are typically appreciating in value. That treatment allows ultra-rich sports team owners to shelter substantial sums of income from taxation.

Moreover, ownership interests in sports teams qualify for stepped-up basis treatment, and the deductions for amortization of intangible assets are not subject to recapture upon death. That allows the inheritor of a sports team to claim the same amortization or depreciation deductions all over again.

Here's how the everlasting tax shelter created by a sports team might work: A billionaire purchases a sports team for $1 billion. Over the following 15 years, the billionaire claims amortization deductions for $900 million of the purchase price, avoiding income tax of $360 million otherwise payable on $900 million of income. The billionaire then dies, leaving ownership of the team to his spouse, at a time the team is valued at $2 billion. The billionaire's spouse then claims amortization deductions over the following 15 years totaling $1.8 billion, thereby avoiding $720 million of income tax otherwise payable on $1.8 billion of income. The billionaire's spouse then dies, leaving ownership of the team to the billionaire's children when the team is valued at $3 billion. Over the following 15 years the billionaire's children claim amortization deductions totaling $2.7 billion, thereby avoiding income tax of $1.08 billion otherwise payable on income of $2.7 billion. Over the course of the family's ownership, the income tax benefits total over twice the billionaire's original investment in the team. If the billionaire's children retain ownership of the team until their deaths, the appreciation in value of the team over the course of the family members' lives will escape income tax entirely.

Closing the stepped-up basis loophole would neutralize the tax avoidance associated with sports teams as everlasting tax shelters.[5]

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[4] For an extended discussion of the everlasting tax shelter, *see* Anderson, Sarah, and Lord, Bob, [Sports Teams: The Everlasting Tax Shelter for Billionaires](https://inequality.org/great-divide/sports-teams-tax-shelter-billionaires/) (Inequality.org, July 12, 2021), https://inequality.org/great-divide/sports-teams-tax-shelter-billionaires/ [accessed Sep. 3, 2024]

[5] Additionally, the amortization deduction for intangible assets could be reformed to require taxpayers who elect to claim the deduction also to recognize as income the appreciation of intangible assets that are increasing in value. Under current rules, a sports team owner may amortize the value of a player's contract included in the purchase price of the team, while not having to recognize the appreciation in value in the contracts of players entered after the purchase of the team.

The Long-Term Capital Gains Holding Period Loophole and Its Associated Avoidance Strategy: Short-Term to Long-Term Gains Conversion

The rule for determining whether the gain from sale of a capital asset is short-term or long-term is another where a miniscule difference in circumstances gives rise to a major difference in tax treatment. Specifically, a one-day difference in the holding period of a capital asset (one year versus one year and one day) can mean a difference of seventeen percentage points in the applicable income tax rate on the gain from the sale of the asset.

Converting Short-Term Gains to Long-Term Gains. Asset managers have devised ways to create investments that are virtually certain to move in opposite directions. Those investments can be sold on consecutive days, at holding periods of 365 and 366 days, respectively. At that point, one investment will have generated a gain and the other a loss, in equal amounts. If the asset generating the loss is sold after 365 days, the loss will be short-term. If the asset generating the gain is sold after 366 days, the gain will be long-term.

That strategy – manufacturing corresponding amounts of short-term losses and long-term gains – has little tax avoidance potential by itself. But for an ultra-rich taxpayer whose investment activity generates substantial amounts of short-term capital gains, the potential tax avoidance from the strategy is enormous.

If an ultra-rich taxpayer, a hedge fund investor or manager for example, expects to generate short-term gains from his investments, the effect of manufacturing short-term losses and long-term gains is to convert the taxpayer's short-term investment gains into long-term gains. For example, if the taxpayer has $10 million of short-term gains from his investment activity and also manufactures $10 million of short-term losses together with $10 million of long-term gains, the short-term losses will offset the taxpayer's short-term gains from his investment activity, leaving the $10 million of manufactured long-term gains as taxable income. The net effect of manufacturing the short-term losses and long-term gains is to convert the taxpayer's actual short-term gains to long-term gains for income tax purposes.

In 2022, ProPublica reported on the possible use of such a strategy by billionaire Jeffrey Yass to avoid $1 billion in tax.

This strategy is almost certain to draw an IRS challenge if detected. If the primary purpose for the activity leading to the generation of short-term losses and nearly matching long-term gains is to avoid tax, the gains and losses will be disregarded for income tax purposes. But if an ultra-rich taxpayer can show the activity was motivated by a potential for an overall profit, the tax treatment could be sustained. And, perhaps more significantly, if an ultra-rich taxpayer's activity generating short-term losses and long-term gains goes undetected, the taxpayer wins.

There is no need to rely on IRS enforcement to contain this particular tax avoidance strategy, however. The strategy could be neutralized through legislation by modifying either the manner in which capital gains and losses are categorized or the manner in which losses are applied to offset gains. For example, if an additional category, mid-term gains, were established for gains or losses of greater than one-year and less than two years, with a tax rate only slightly lower than the applicable rate for short-term gains applied to mid-term gains, the tax avoidance potential of the strategy largely would be eliminated. Alternatively, if the rule for offsetting capital losses against capital gains were modified to require that short-term losses be offset first against long-term gains of between one and two years, the opportunities for tax avoidance using the strategy would be reduced dramatically.

The Roth IRA Loophole and its Associated Avoidance Strategy: The Gigantic Roth IRA

Roth IRAs, established by the 1997 Tax Act, allow for an unlimited amount of income or gain to escape income taxation. Unsurprisingly, ultra-rich taxpayers have seized on the opportunity.

Traditional IRAs have been around since 1974. Collectively, they currently hold trillions of dollars in retirement funds. Some ultra-rich taxpayers have accumulated stupendous amounts in their traditional IRAs. Mitt Romney, for example, was reported to hold over $100 million in a traditional IRA.[6] The opportunity of the ultra-rich to avoid tax through traditional IRAs, however, is limited. At some point, whatever they accumulate inside a traditional IRA must be distributed and taxed. And unlike average taxpayers, they (or their descendants if the IRA is distributed after their death) are not likely to be taxed in a lower income tax bracket.[7]

That's not the case with Roth IRAs. When an ultra-rich taxpayer accumulates huge gains inside a Roth IRA, the gains never are taxed.

Oversized Roth IRAs. Not long after Roth IRAs were created, avoidance planners went to work devising strategies to stuff the income of ultra-rich taxpayers into Roth IRAs. In IRS Notice 2004-8, for example, the IRS identified as a listed transaction a strategy where a Roth IRA was used to hold the stock of a corporation that provided administrative services to the Roth IRA holder's established business, thereby diverting a large portion of the business' income to the Roth IRA.[8]

[6] *See*, Cohan, William, What's Really Going on With Mitt Romney's $102 Million IRA (The Atlantic, Sep. 10, 2012) https://www.theatlantic.com/politics/archive/2012/09/whats-really-going-on-with-mitt-romneys-102-million-ira/261500/ [accessed, Sep. 3, 2024]
[7] Traditional IRAs also can cause the tax rate applied to gains on investments made inside the IRA to be the rate on ordinary income, as opposed to the rate on long-term capital gains that would apply if the investments were made outside the IRA.
[8] *See*, Notice 2004-8 - Abusive Roth IRA Transactions (IRS Website) https://www.irs.gov/businesses/notice-2004-8-abusive-roth-ira-transactions [accessed Sep. 3, 2024]

In 2021, we learned that billionaire Peter Thiel had grown a Roth IRA from a starting point of a few thousand dollars to over $5 billion, all exempt from income tax.[9] In 2014, I commented on Max Levchin's $275 million Roth IRA accumulation.[10]

According to reporting by [Forbes](https://www.forbes.com/sites/deborahljacobs/2012/03/26/why-and-how-congress-should-curb-roth-iras/) in 2012, Roth IRAs originally were created to avoid budget shortfalls within the 10-year window associated with the deductibility of contributions to traditional IRAs.[11] They did not appear to have a specific retirement-planning related purpose.

Assuming, however, that a retirement planning need exists that is addressed by Roth IRAs and not by traditional IRAs, the gigantic Roth IRA loophole could be narrowed or closed by limiting the accumulations permitted inside Roth IRAs to a maximum amount that conceivably could be needed for retirement, perhaps $10 million.

Project 2025's Turbocharged Roth IRAs: The Potential for Unprecedented Billionaire Tax Avoidance.

Project 2025, it must be noted, would expand the Roth IRA loophole immeasurably. Universal Savings Accounts, as proposed in Project 2025, effectively would be turbocharged Roth IRAs. The annual contribution limit would be $15,000, more than double the annual limit of $7,000 per year for Roth IRAs. Far more troubling, however, is a feature expressly included in the Universal Savings Account proposal. The Project 2025 white paper states that Universal Savings Accounts to be "highly flexible" and for taxpayers to "be able to invest their USAs as they see fit, including, for example, in a closely held business."

In no event should the Universal Savings Account proposal from Project 2025 be enacted. The proposal, as presented, would allow massive accumulations of wealth to escape tax entirely.[12] Almost all businesses start small. If the founder of a future Amazon, Apple or Alphabet were to start the business in an entity owned by a Universal Savings Account, the amount of gain escaping income tax for individual Americans would be in the hundreds of billions and, if the size of our largest businesses continues to grow, could well exceed one trillion dollars.

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[9] *See*, Elliot, Justin et. al., Lord of the Roths: How Tech Mogul Peter Thiel Turned a Retirement Account for the Middle Class Into a $5 Billion Tax-Free Piggy Bank (ProPublica, Jun. 24, 2021) https://www.propublica.org/article/lord-of-the-roths-how-tech-mogul-peter-thiel-turned-a-retirement-account-for-the-middle-class-into-a-5-billion-dollar-tax-free-piggy-bank [accessed Sep. 3, 2024]

[10] *See*, Lord, Bob, The 0.01 Percent's "I Reap All" Accounts (Truthout, Oct. 30, 2014) https://truthout.org/articles/the-0-01-percent-s-i-reap-all-accounts/?amp [accessed, Sep. 3, 2024]

[11] See, Jacobs, Deborah, Why--And How--Congress Should Curb Roth IRAs (Forbes, Mar. 26, 2012) https://www.forbes.com/sites/deborahljacobs/2012/03/26/why-and-how-congress-should-curb-roth-iras/ [accessed Sep. 3, 2024]

[12] See, Lord, Bob and Pearl, Morris, Project 2025: Will the rich ever pay tax again? (Fortune, Sep. 6, 2024) https://fortune.com/2024/09/06/project-2025-rich-pay-tax-again-universal-savings-account-politics/ [accessed, Sep. 6, 2024]

Partnership Income and Gain Allocations and their Associated Avoidance Strategy: Carried Interest

"Carried Interest" refers to the strategy used by private equity, venture capital and real estate development fund managers to have the income they receive in consideration for the services they perform for their investors characterized as long-term capital gain.

The loophole underlying carried interest is the flexibility, under Section 704 of the Internal Revenue Code and the regulations issued under it, that entities taxable as partnerships have in allocating items of income and loss among their partners (or, in the case of a limited liability company that elects partnership tax treatment, its members). Generally, an item of income or loss of a partnership can be allocated to any of its partners if the allocation has "substantial economic effect."

That very flexible rule allows long-term capital gains of partnership operating, say, a venture capital fund, in part to the managing partner of the fund in amounts disproportionate to the capital contributions of the managing partner. For example, a managing partner that contributed only one percent of the capital raised by the fund might be allocated 20 percent of the fund's long-term capital gains.

Several members of Congress have proposed legislation to address the carried interest strategy. Their proposals likely would greatly reduce or even eliminate tax avoidance by the ultra-rich from the strategy. Another alternative would be to close the loophole that enables the strategy by not allowing the allocation of capital gain realized at the partnership level to be allocated in a manner disproportionate to the contributions of capital that gave rise to the gain.

Partnership Distributions and Their Associated Avoidance Strategy: Basis Shifting

The rules governing the tax treatment of distributions of partnership assets to partners largely allow for distributions of illiquid assets to avoid the recognition of income. In situations where the partners desire to sell an asset, the distribution of the asset to a minority partner prior to its sale can be structured to allow the remaining partners to defer recognition of their shares of the gain from the sale.

Here's an example of how it might work: ABC, LLC elects to be treated as a partnership for federal income tax purposes. The three members, A, B, and C, contribute $49 million, $49 million, and $2 million respectively for their 49 percent, 49 percent, and 2 percent respective interests in ABC. ABC buys multiple properties, including an office building for $100 million funded in part with the proceeds of an $80 million loan secured by the building. After several years, depreciation deductions have reduced ABC's cost basis in the building to $80 million, while its value has increased to $150 million. At the time, C's share of the net fair market value of ABC's assets is $5 million. The office building has been refinanced and is subject to a $145 million loan. ABC distributes the building to C, subject to the loan, in liquidation of C's interest.

C's basis in building is $145 million. Sometime after the distribution, C sells the building for $145 million, recognizing a gain of just $5 million. The remaining $65 million of ABC's unrealized gain from the building does not vanish; it effectively is lodged in ABC's other assets. Effectively, $65 million of ABC's basis in those other assets is shifted into the building. Hence the term "basis shifting."

Congress has narrowed the basis shifting loophole previously.[13] Significant tax avoidance opportunities, however, still remain. The IRS recently announced new rules from the IRS and Treasury Department intended to further restrict basis shifting transactions.[14] Consideration should be given to whether legislation is needed to foreclose remaining opportunities for tax avoidance through basis shifting.

<u>The Life Insurance Loophole and its Associated Avoidance Strategies: Variable Universal Life Insurance and Irrevocable Life Insurance Trusts (ILITs)</u>

The permanent life insurance loophole is driven by the special treatment of the combination of what are essentially two separate assets, an investment account and a pure insurance policy, into one asset for income tax purposes. As a result, the income and gains inside the investment account, which would be taxable if the account were treated as a separate asset, generally are not subject to income tax and, if they are paid out as part of the death benefit, may be excluded from income at that time as well.

<u>Variable Universal Life Insurance</u>. Variable universal life insurance refers to policies that allow for the premium payments to vary over the term of the policy. This structure allows for substantial premiums to be paid in the early years of the policy term, having the effect of building the investment account value, thereby reducing the cost of insurance to fund the death benefit.

Private placement life insurance is a type of variable universal life insurance especially suited for tax avoidance by the ultra-rich. Unlike conventional variable universal life insurance policies, which provide a relatively limited menu of options for investment of the investment account, private placement life insurance allows investment in assets favored by the ultra-rich. A law firm website explains:

> The key factor distinguishing PPLI policies from conventional VUL policies (those available to the general public) is the range of investment options. While insurance carriers provide limited investment choices for conventional VUL policies, with PPLI insurance, the policy owner can select from a wider array of investment options, including actively managed accounts, hedge funds (including

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[13] *See,* Internal Revenue Code Sections 704(c)(1)(B) and 737.

[14] *See*, [New IRS, Treasury guidance focuses on "basis shifting" transactions used by partnerships](https://www.irs.gov/newsroom/new-irs-treasury-guidance-focuses-on-basis-shifting-transactions-used-by-partnerships) (IRS website, Jun. 17, 2024) https://www.irs.gov/newsroom/new-irs-treasury-guidance-focuses-on-basis-shifting-transactions-used-by-partnerships [accessed Sep. 4, 2024]

"funds of funds") and alternative assets (for example, credit products, private equity, real estate funds, commodities, currencies and non-correlated investments).[15]

Irrevocable Life Insurance Trusts. Irrevocable life insurance trusts (ILITs) add to the tax avoidance potential of life insurance products by allowing the value of life insurance policies and, ultimately, their death benefit, to pass to the insured taxpayer's descendants with little or no estate and gift tax cost. Further, ILITs can be structured to be fully-exempt from generation-skipping transfer tax, which allows ultra-rich families to avoid wealth transfer tax for an unlimited number of generations on sums that easily reach into the billions of dollars.

The life insurance loophole could be closed, or at least narrowed, by limiting the tax-advantaged treatment of life insurance to policies of the type and in the amount of death benefit needed to provide financial security to families of no more than modest wealth, and for policies needed in commercial settings, such as so-called "key person insurance" and insurance needed to fund buyouts of deceased business owners. The ILIT loophole could be narrowed by enacting reforms to narrow the scope and duration of the generation-skipping transfer tax exemption as it applies to trusts. For example, for a trust that holds a life insurance policy, the allocation of generation-skipping tax exemption could be delayed until the death of the insured.

The Estate, Gift, and Generation-Skipping Transfer Tax Loopholes and Their Associated Avoidance Strategies: Intentionally Defective Grantor Trusts (IDGTs), Zeroed-Out Grantor Retained Annuity Trusts (GRATs), Valuation Discounts, and Dynasty Trusts

In a 2022 report, Dynasty Trusts: Giant Tax Loopholes That Supercharge Wealth Accumulation, I identified the principal estate, tax and generation-skipping tax loopholes and their legislative solutions.[16] In a 2017 report, Estate Tax Schemes: How America's Most Fortunate Hide Their Wealth, Flout Tax Laws, And Grow the Wealth Gap, the Senate Finance Committee Democratic Staff identified the same loopholes.[17] Little has changed since the publication of those reports. The loopholes remain open.

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[15] Private Placement Life Insurance: An Overview (Loeb & Loeb, LLP website, Dec. 2022) https://www.loeb.com/en/insights/publications/2022/12/private-placement-life--insurance--an-overview [accessed Sep. 4, 2024]

[16] *See*, Lord, Bob, Dynasty Trusts: Giant Tax Loopholes that Supercharge Wealth Accumulation (Americans for Tax Fairness, Feb. 2, 2022) at p. 10-21. https://americansfortaxfairness.org/wp-content/uploads/DT-2.2.pdf [accessed Sep. 4, 2024]; For a more detailed discussion of the estate- and gift-tax reforms proposed in the foregoing report see Daniel J. Hemel & Robert Lord, "Closing Gaps in the Estate and Gift Tax Base" University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 937 (Nov. 24, 2021) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3904454. [accessed Sep. 4, 2024]
For a more detailed discussion of the generation-skipping tax reforms proposed in the foregoing report see Hemel & Lord, "Revitalizing the Generation-Skipping Transfer Tax," SSRN (Sep. 10, 2021). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3920038 [accessed Sep. 4, 2024]

[17] Estate Tax Schemes: How America's Most Fortunate Hide Their Wealth, Flout Tax Laws, And Grow the Wealth Gap (Senate Finance Committee Democratic Staff, Oct. 12, 2017) https://www.finance.senate.gov/imo/media/doc/Wyden%20Report%20-%20Estate%20Tax%20Schemes%20101217.pdf [accessed Sep. 7, 2024]

The estate, gift and generation-skipping tax loopholes and the tax avoidance strategies enabled by them are egregious. In 2013, Bloomberg News reported on an ultra-wealthy family's use of zeroed-out grantor retained annuity trusts, or GRATs, to transfer an $7.9 billion of wealth at no estate or gift tax cost.[18] At that time, Richard Covey, the tax lawyer who developed the zeroed-out GRAT strategy estimated that wealthy Americans had avoided $100 billion or more of estate tax through GRATs between 2000 and 2013, which was estimated to be one-third of all estate and gift tax collected during that period. In all likelihood, the amount of estate tax avoided through zeroed-out GRATs since 2013 substantially exceeds the $100 billion estimated to have been avoided before then. In 2021, ProPublica reported that over half of the 100 richest Americans had used GRATs and other trusts to avoid tax.[19]

The somewhat esoteric mechanics of how zeroed-out GRATs work to avoid estate tax have been widely reported. I won't repeat them here. But the essence of what they allow ultra-rich taxpayers to do is straightforward and noteworthy:

Effectively, the systematic use of zeroed-out GRATs allows ultra-rich taxpayers to repeatedly sell assets to their children, with the taxpayers receiving payment only from the income produced by the assets or the return of fractional interests in the assets themselves. If the assets perform well over the subsequent two years, the children retain what's left after payment of the purchase price (plus a nominal amount of interest). Taxwise, it's treated as a tax-free gift, even though the children have paid nothing. If the assets perform poorly, the sale is entirely unwound, but the assets can be "sold" again (and again and again). There is no limit to the number of sales. Finally, as the tax-free gifts pile up and the ownership of assets passes from the taxpayers to their children, the taxpayers continue to pay the income tax on income produced by the children's assets, while the children retain the income, effecting additional tax-free gifts.

<u>The Income Categorization Loophole and its Associated Avoidance Strategies: Conversion of Income Category</u>

Tax avoidance planners thrive on gray areas, where the lines between substantially different tax results are blurry. Often, the line between income that is taxed at ordinary income rate and income taxed at a preferential rate, such as long-term capital gain income or qualified business income, is quite blurry.

Consider, for example, income from real estate activities. The gain from the sale of raw land held for appreciation is clearly capital gain, while the sale of completed houses by homebuilders

[18] See, Mider, Zachary, [Accidental Tax Break Saves Wealthiest Americans $100 Billion](https://www.bloomberg.com/news/articles/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion?sref=I6K1T2KU) (Bloomberg News, December 16, 2013) https://www.bloomberg.com/news/articles/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion?sref=I6K1T2KU [accessed Sep. 4, 2024]

[19] *See*, Ernsthausen, Jeff et. al., [More Than Half of America's 100 Richest People Exploit Special Trusts to Avoid Estate Taxes](https://www.propublica.org/article/more-than-half-of-americas-100-richest-people-exploit-special-trusts-to-avoid-estate-taxes) (ProPublica, Sep. 28, 2021) https://www.propublica.org/article/more-than-half-of-americas-100-richest-people-exploit-special-trusts-to-avoid-estate-taxes [accessed Sep. 4, 2024]

is clearly ordinary income from the operation of a business. But those are the endpoints of a vast continuum, which allows for structuring, sometimes aggressive structuring, of real estate activities to maximize the income that is taxed at capital gains rates. For example, the owner of raw land might take the necessary steps to obtain a favorable change in zoning, and then sell the property at a gain to a development entity in which he has an ownership interest. The owner might take it a step further and submit a plat map for government approval before selling. Where along the continuum the owner's gains become subject to tax at ordinary rates is far from clear – there are numerous court decisions in this area involving a practically infinite variety of fact patterns – and tax professionals take advantage of that lack of clarity.

The opportunity for avoidance is made greater by the ability of ultra-rich taxpayers to sell property between entities in which they own substantial interests for purposes of locking in partial capital gain treatment for property that ultimately will generate on ordinary gain when sold.

For example, a taxpayer who holds land she wishes to develop and sell as finished lots might hold the land originally in one entity and take modest steps to position the property, such as obtaining a zoning change. She then could cause that entity to sell the property at the very highest price considered to be a reasonable estimate of fair market value to a second entity involved in the development of lots. The gain recognized by the first entity on the sale would be reported as capital gain. The income generated by the combined activities of the two entities taken together could not remotely qualify for capital gain treatment. But by separating the activity between two entities, an ultra-rich taxpayer may cause a substantial portion of the income to be taxed as long-term capital gain.

Similarly, the qualified business income classification, created by the Tax Cuts and Jobs Act, presents opportunities for tax avoidance by the ultra-rich. The line between income from a business and compensation is at best blurry and virtually arbitrary. Ultra-rich business owners who hold their businesses through S corporations, for example, often pay themselves very modest salaries that are substantially less than the value of the services they perform. By doing so, they convert what would be ordinary income from compensation into qualified business income qualifying for preferential treatment.[20]

The complexity of the rules governing the categorization of income makes addressing the avoidance strategies based on it difficult. The best approach may be to limit the benefits of income categorization to taxpayers with income below a specified threshold, such as $1 million.

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[20] In 2021, ProPublica reported on ultra-rich business owners who took multi-million dollar reductions in compensation between 2017 and 2018, in one case a $20 million pay cut, the year the deduction for qualified business income took effect. *See*, Faturechi, Robert, and Elliot, Justin, [How the Trump Tax Law Created a Loophole that Lets Top Executives Net Millions by Slashing Their Own Salaries](https://www.propublica.org/article/how-the-trump-tax-law-created-a-loophole-that-lets-top-executives-net-millions-by-slashing-their-own-salaries) (ProPublica, Aug. 19, 2021) https://www.propublica.org/article/how-the-trump-tax-law-created-a-loophole-that-lets-top-executives-net-millions-by-slashing-their-own-salaries [accessed Sep. 3, 2024]

The Selective Realization Loophole and Its Associated Avoidance Strategies: Loss Harvesting and Basis Management at Death

Economic income or loss associated with the appreciation of assets generally is not subject to income taxation until the income or loss is realized, typically on the sale of the asset. Aside from the avoidance of tax associated with deferral of gain recognition until assets are sold, the realization requirement loophole allows for avoidance strategies based on the control taxpayers have over realization of losses and their ability to cause recognition of losses while gains go unrecognized.

Loss Harvesting. Loss harvesting refers to the strategy of triggering losses needed to offset previously recognized gains. According to recent Financial Times reporting, the strategy is becoming standard in the asset management industry.[21]

Loss harvesting refers to the practice of triggering losses from an investment portfolio in amounts sufficient to offset any gains recognized by an ultra-rich taxpayer. Because ultra-rich taxpayers typically have large diversified holdings, they typically will hold some investments that have declined in value. They are able to avoid taxation because they are free to recognize, through asset sales,[22] whatever portion of their unrealized losses they desire, while the gains they have recognized in any one year typically will only be a small portion of their unrealized gains.

Loss harvesting could be addressed by limiting the losses that may be applied by a taxpayer in any year against gains in the same year to the same percentage of the taxpayer's unrealized losses as the percentage of the taxpayer's unrealized gains that the taxpayer has recognized in that year. Any disallowed losses could be carried over to subsequent tax years.

Basis Management at Death. Basis management at death refers to the strategy of transferring depreciated assets in non-recognition transactions prior to death to preserve the ability of an ultra-rich taxpayer's donees to recognize the losses associated with those assets, while allowing appreciated assets to pass at death, causing the unrealized gains to be eliminated for income tax purposes.

This strategy is the exploitation of both the selective realization loophole and the stepped-up basis loophole.

[21] See, Schmitt, Will, and Franklin, Joshua, JP Morgan brings in over $15bn from wealthy clients looking to cut tax bills (Financial Times, Jun. 24, 2024) https://www.ft.com/content/67a2d441-76bb-446c-b690-7666c5b2da81 [accessed, Sep. 2, 2024]

[22] On the surface, liquidating a loss position would require an ultra-rich person to discontinue the investment, since the wash sale rules of Internal Revenue Code Section 1091 would cause the loss to be disallowed if the security generating the loss is repurchased within 30 days of the date it is sold. Typically, however, the 30-day waiting period to restore a position does not pose a substantial investment risk. Further, asset managers have developed strategies to mitigate the investment risk associated with the 30-day waiting period.

Here's an example of how it might work: Suppose an ultra-wealthy taxpayer approaching death has made two stock purchases, one for $10 million and the other for $30 million, both having a current value of $20 million. If the taxpayer sells both holdings prior to death, she will have no overall gain or loss. If she retains both holdings in her estate and leaves them to her spouse, who then sells both holdings, her spouse also will have no gain or loss, as the basis of each holding will be adjusted to equal the fair market value of the holding on the date of death. But if the taxpayer gives the holding that she purchased for $30 million to her spouse prior to death, her spouse will take her $30 million basis. If she then allows the holding she purchased for $10 million to pass to her spouse at death, the basis of that holding will be stepped-up to $20 million. Her spouse then could sell both holdings and recognized a loss of $10 million for income tax purposes, which could be used to offset other gains, even though economically the couple will have realized no total gain or loss. This result would be obtained even if both holdings were in stock of the same corporation.

The basis management at death strategy could be eliminated by closing the stepped-up-basis loophole. Alternatively, the strategy could be addressed by making two modifications to the rules that apply to the determination of basis of gifted assets. First, the basis a spouse takes in a gifted asset could be limited to fair market value at the time of the gift if the asset ultimately is sold at a loss, as is the case for any other gift recipient. Second, the rule that limits the basis of gifted property that is sold at a loss to fair market value at the time of the gift could be extended to all gifted property if the property is sold after the donor's death.

**Tax Enforcement and Ultra-Rich Tax Avoidance**

IRS Audits of the Ultra-Rich. The role of the IRS and, consequently, the funding of the IRS, are important to containing tax avoidance by the ultra-rich in three respects. First, audits of the ultra-rich are a primary vehicle for identifying avoidance strategies that should be challenged under current law, resulting in increased tax collections. Second, audits of the ultra-rich identify avoidance strategies that should be addressed administratively, by IRS ruling or Treasury regulations, for example, or legislatively by Congress.[23] Third, increased auditing of taxpayers engaged in avoidance transactions is a deterrent not only of future avoidance activity by the taxpayers who are audited (specific deterrence), but by other taxpayers as well (general deterrence).[24]

Penalties. Penalties for inaccurate reporting by taxpayers play an important role in limiting tax avoidance transactions. Internal Revenue Code Section 6662 imposes various penalties, several of which have potential applicability to underpayments of tax attributable to tax

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[23] In a recent announcement regarding new guidelines for partnership basis shifting transactions, the IRS noted: "The guidance issued today by Treasury and the IRS follows work by IRS exam teams, which have seen repeated instances of abusive basis-shifting taking place in sophisticated maneuvers by related-party partnerships." New IRS, Treasury guidance focuses on "basis shifting" transactions used by partnerships, above at n.14.

[24] *See*, Estimating specific deterrence revenue from additional audits of high-income and high wealth individuals (United States Treasury Department, Feb. 2024) https://home.treasury.gov/system/files/136/Specific-Deterrence-Paper.pdf [accessed Sep. 3, 2024]

avoidance strategies that are not upheld. Those penalties have some *in terrorem* in an audit setting and may be useful to IRS counsel and IRS appeals officers in settlement negotiations. However, in many cases, tax avoidance strategies employed by the ultra-rich will be the subject of opinion letters from tax lawyers stating their opinion is that the transactions involved more likely than not will be respected by a court. Those opinion letters make the imposition of penalties difficult to sustain and, therefore, of less value to IRS auditors, counsel and appeals officers.

The penalties imposed under Internal Revenue Section 6707A have the potential to rein in extreme tax avoidance by the ultra-rich. Section 6707A creates two types of transactions, reportable transactions and listed transactions, which, once identified as such by the IRS, must be disclosed on income tax returns to avoid the penalty imposed by Section 6707A. Listed transactions are tax avoidance transactions considered abusive by the IRS.[25] The penalty applies to the failure to disclose and, critically, applies even if the transaction itself is upheld by a court.

And the Section 6707A penalty for failing to disclose a listed transaction is daunting: 75 percent of the tax the taxpayer sought to avoid through the transaction. For taxpayers attempting to evade modest amounts of income tax through a listed transaction, Section 6707A creates Hobson's choice: don't disclose the listed transaction, and the penalty nearly doubles the tax cost[26] if the taxpayer is audited;[27] or disclose the listed transaction and face the near certainty of audit.

<u>The Section 6707A Loophole: A Penalty Cap for the Ultra-Rich</u>. Unfortunately (and somewhat remarkably), the Section 6707A penalty is far less effective in the case of ultra-rich taxpayers attempting to avoid tax through listed transactions. The amount of the penalty – 75 percent of the tax the taxpayer sought to avoid – is capped at $100,000. That effectively makes it a regressive penalty. The penalty for failing to disclose a listed transaction decreases from 75 percent for a taxpayer seeking to avoid $100,000 in tax, to 10 percent for a taxpayer seeking to avoid $1 million in tax, to 1 percent for a taxpayer seeking to avoid $10 million in tax.

An experience I had as a tax lawyer illustrates the significance of this "penalty loophole." I'd spent several years assisting a client regarding a listed transaction described in IRS Notice 2004-8.[28] The amount of tax involved was relatively modest and my work in the matter centered mostly on the penalty, as an agreement on the actual tax liability was reached relatively early on in the process. An accountant friend of mine who was helping a client of his own regarding a similar transaction called me to ask about my negotiations with the IRS regarding my client's case. When I started to explain why I thought the IRS was wrong in the way it had calculated the Section 6707A penalty, he cut me off, saying: "Bob, we're looking at $15 million in tax. We

[25] The IRS manual refers to listed transactions as "abusive tax avoidance transactions."
[26] Additional penalties, such as those for a substantial understatement of tax under Internal Revenue Code Section 6662, also could apply.
[27] For the tax liability resulting from an undisclosed listed transaction and the Section 6707A penalty, the statute of limitations remains open indefinitely. Internal Revenue Code Section 6501(c)(10).
[28] *See* n.8 above and accompanying text.

don't care about the $100,000 penalty." The upshot couldn't be clearer: Section 6707A, a strong deterrent to taxpayers of moderate wealth seeking to avoid modest amounts of tax, is no more than a minor nuisance to ultra-rich taxpayers seeking to avoid enormous amounts of tax.

**Congressional Action to Limit Ultra-Rich Tax Avoidance**

Limiting tax avoidance by the ultra-rich is a never-ending battle, pitting armies of highly-paid tax experts hired by the ultra-rich against dedicated, capable public servants at the IRS, Treasury Department and Justice Department whose work is constrained by the budgets of those agencies. The participation of Congress in that battle is needed to level the playing field, thereby keeping tax avoidance by the ultra-rich from driving the country's economic inequality to unhealthy levels, and maintaining the confidence of average Americans in the fairness of the tax system.

Congress plays two crucial roles. The first is the careful vetting of proposed legislation, with the assistance of legislative counsel and outside experts, to identify and eliminate from the legislative text potential opportunities for tax avoidance. Regardless of how much care is taken in the drafting of legislation, however, tax avoidance strategies will emerge.

Which means Congress also must respond to the emergence of avoidance strategies with loophole-closing legislation.

One example where Congressional vetting of proposed legislation fell short is the 1990 legislation that created the GRAT loophole. Ironically, GRATs were part of a legislative response to a prior tax avoidance strategy known as the grantor retained income trust, or GRIT. Unwittingly, when Congress closed the GRIT loophole, it opened the GRAT loophole.[29]

Another example of how these two roles have and haven't worked in the past, in a bipartisan fashion, is the response to the tax shelter transactions of the 1970s and early 1980s. Those tax shelter transactions were driven by the ability of taxpayers to claim tax credits and paper losses driven by depreciation deductions on assets purchased with the proceeds of debt and used in a leasing activity.[30] Often, equipment with a five-year depreciation period for income tax purposes was used for the tax shelter transaction.

IRS audits detected the tax shelter activity and challenged the tax benefits claimed by taxpayers.[31] Congress responded in 1976 by enacting the "at-risk rules" of Internal Revenue

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[29] *See*, Accidental Tax Break Saves Wealthiest Americans $100 Billion, above at n.16.
[30] Typically, the asset purchased by the tax shelter investors would be leased back to the seller, with the lease payments and debt service payments nearly equal in amount. As structured, and if respected by the IRS, the transactions would generate tax reductions in the years immediately following the purchase far greater than the taxpayer's cash outlay. At some point, when depreciation deductions declined and payments on debt were allocated more to nondeductible principal and less to deductible interest expense, the tax shelter transaction would begin to generate taxable income, a problem the taxpayer often would overcome through additional tax shelter purchases.
[31] *See, e.g.*, *Pearlstein v. Commissioner*, TC Memo 1989-621.

Code Section 465. Those rules limited the losses a taxpayer could claim from an activity to the amount the taxpayer had “at-risk.” In many cases, taxpayers did not face a risk of having to pay debt incurred in tax shelter transactions, causing their amount at-risk to be limited to their cash outlay and defeating the purpose of the shelter transactions.

The at-risk rules did not entirely close the loopholes exploited by the tax shelter leasing transactions, but did narrow those loopholes substantially.

But the at-risk rules left a possible loophole in their treatment of debt incurred to purchase real estate. An exception to the general rule of the at-risk rules applied to qualifying real estate indebtedness, the proceeds of which were deemed to be at-risk.

Then, in 1981, Congress passed the Economic Recovery Tax Act of 1981 (ERTA), which shortened the useful life of real property to 15 years for purposes of determining allowable depreciation deductions. That opened the door to new tax shelter activity. The increased depreciation deductions allowed under ERTA combined with the exception to the at-risk rules for the proceeds of debt incurred to purchase real estate, allowed new shelters to be structured using commercial real estate.

ERTA represented perhaps a missed vetting opportunity. The opportunity to exploit the reduction of the depreciation period for real estate together with the exception in the at-risk rules for real estate indebtedness was a predictable one that could have been foreclosed.

Finally, in 1986, Congress essentially shut the door on tax shelter leasing transactions with the passive activity loss rules. Those rules generally disallowed deductions for losses from rental activities and activities in which the taxpayer did not materially participate, until the taxpayer disposed of its interest in the activity.

In 1976 and 1986, Congress fulfilled its role regarding tax avoidance activity of the ultra-rich in an admirable way. And Congress enacted additional measures in 1982 and 1984 to narrow loopholes allowing tax shelter activity.

Whatever vetting failure occurred in the passage of ERTA was overshadowed by the passive activity loss rules. Those rules were so well conceived that, although their fears ultimately proved to be entirely misplaced, some tax lawyers at the time thought their work for ultra-rich clients might dry up and require them to change their areas of practice.

The array of open loopholes today and the tax avoidance strategies of the ultra-rich associated with them present a challenge to Congress. Those tax avoidance strategies are exacerbating an already extreme level of economic inequality. The failure of Congress to close the loopholes that enable those strategies is fueling the perception of many Americans that the tax system is unfairly rigged in favor of the ultra-rich.

Crafting the legislation required to close some of the loopholes discussed above may present a challenge, but it is a challenge that can be met. And, in at least one area, the legislative solutions are clear. The loopholes driving the massive levels of estate, gift and generation-skipping tax avoidance have relatively obvious legislative fixes. For example, Chair Wyden and Sen. King's GRAT Act, introduced earlier this year would effectively close both the grantor trust and GRAT loopholes and shut down the intentionally defective grantor trust and zeroed-out GRAT loopholes. Sen. Warren and Sen. Sanders also have introduced legislation that would effectively close those loopholes, as well as other estate, gift and generation-skipping tax loopholes.

**The Most Fundamental Loophole: A Tax System Not Designed to Constrain Wealth Concentration and the Ultimate Avoidance Strategy: After-Tax Growth Rates of Accumulated Wealth of the Ultra-Rich Greater than the Growth Rate of America's Total Wealth**

American wealth is more concentrated in the hands of the ultra-wealthy than at any time since the Gilded Age.

The extreme concentration of wealth in America is the result of policy choices in multiple areas; antitrust, labor and intellectual property law to name a few. But the role of tax policy is unique on this front. Our tax system is the last line of defense – the firewall – against undue wealth concentration. The likely reason it hasn't provided that defense – the design flaw in play – is that the Internal Revenue Code lacks a reliable, working mechanism to limit wealth concentration.

Wealth concentration occurs when the rate at which the rich grow their wealth is greater than the rate at which the country's total household wealth grows.[32] Absent taxation, that situation is bound to be the norm. Besides the obvious advantage of being able to make lucrative investments the rest of us lack the capital to make, the wealthy also are not required to consume the bulk of their income on living expenses.

Consequently, a well-functioning tax system should have a mechanism that reliably reduces the after-tax rate at which the wealth of the richest Americans grows to a rate no greater than the rate at which the country's total household wealth grows. That mechanism would require one or more of three bases for taxation: a tax on true economic income, a tax on extreme wealth, or a tax on the intergenerational transfer of extreme wealth.

Viewing tax avoidance of the ultra-rich through that lens, our tax system itself is fundamentally flawed. Currently, our tax system contains one of the three mechanisms capable of directly containing wealth concentration: a tax on the intergenerational transfer of wealth, as embodied

[32] In 1982, the wealthiest American, Daniel Ludwig, controlled $2 billion of wealth. Today, some 42 years later, the wealth of the wealthiest American stands at about $250 billion, depending on the day. That means the wealth of the richest American has doubled seven times in those 42 years, or every six years on average. At that pace, after another 12 years and two more doublings, America would have its first trillion-dollar fortune.

in our estate, gift, and generation-skipping tax system.[33] But through what has become commonplace planning for the ultra-rich, that tax is entirely avoidable, even by the nation's billionaires. Seven years ago, Chair Wyden's office published a white paper outlining the various strategies through which the ultra-rich are massively avoiding estate, gift and generation-skipping taxation and he and others have introduced bills to address the systematic avoidance of wealth transfer taxation, but to date, no meaningful action has been taken.[34]

Unfortunately, we've waited too long. Even if our system of wealth transfer taxation were reformed tomorrow, decades would pass before America's dynastic wealth, much of which has been lodged in so-called dynasty trusts, would be subject to meaningful levels of taxation. Consequently, although the restoration of a functional, robust wealth transfer tax system would be a welcome development, constraining undue wealth concentration in America within a reasonable timeframe will require one or both of the other possible mechanisms for doing so: a tax on true economic income or a tax on extreme wealth.

Members of this committee and other members of Congress have made proposals to use each of those other reliable mechanisms to constrain wealth concentration. Chair Wyden has proposed a system of mark-to-market taxation for the ultra-rich, which, together with the current income tax system, would function to tax the economic income of the ultra-rich. President Biden has proposed a minimum tax on the economic income of the ultra-rich. Hopefully, one or both of those proposals will receive serious consideration in the near future.

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[33] Theoretically, the federal income tax could work to contain wealth concentration if it translated to a sufficient tax on true economic income. Currently, however, it is insufficient in at least two respects. First, avoidance strategies including those outlined in these remarks allow the ultra-rich to escape taxation on their true economic income. In some cases, they even are able to artificially reduce the income upon which they pay tax with the artificial reductions never being recovered as taxable items of income. Second, even if all the avoidance strategies could be neutralized, the failure to tax economic income as it is generated causes the effective annual tax rate to be too low to sufficiently constrain the accumulation of wealth by the ultra-rich. For example, consider an ultra-rich American who achieves a not uncommon ten percent annual rate of return on an investment held for 30 years. If the gain at the end of those 30 years is taxed at the current 23.8 percent rate applicable to long-term capital gains, the effective annual tax rate on the annual true economic income from the investment would be 10 percent. That rate is not remotely sufficient to contain the rate of accumulation of wealth by the ultra-rich to a rate equal to or less than the growth rate of the nation's aggregate wealth. To cause the effective annual rate on the economic income from that investment to be 23.8 percent, the one-time tax applied after a 30-year holding period would need to be increased to 48.1 percent.
[34] *See* Estate Tax Schemes: How America's Most Fortunate Hide Their Wealth, Flout Tax Laws, And Grow the Wealth Gap at n.17 above.