Prepared Testimony for the Senate Budget Committee

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Oral Testimony

Chairman Whitehouse, Ranking Member Grassley, and members of the Committee, thank you for the opportunity to testify before you.

Today on Tax Day, I describe two simple ways that the wealthy legally avoid taxes, and how curbing them would raise three quarters of a trillion dollars to pay for Congressional priorities and protect our fiscal path.

First, the wealthy often label their income in ways that trigger less tax. The “Gingrich-Edwards loophole” – so-named after two prominent users – is a focus of Chairman Whitehouse’s new bill today and also my academic research.

The Gingrich-Edwards loophole enables high-end workers to classify their labor income as what is called “pass-through” income and thereby escape Medicare taxes.

Coauthors and I have shown that U.S. top earners are dominated by lawyers, consultants, and managers of everyday medium-sized businesses like car dealership chains and beverage distributors.[1]

If you’re a lawyer, consultant, or business manager and get paid in W2 wages like the rest of us, you owe Medicare taxes on that income.

But if you do that same work and also own part of the business you work at, you can get paid in Schedule E pass-through income and thereby escape Medicare taxes. Same labor income. But labeled in a way that triggers less tax.

The result is what the Treasury Inspector General has called a “multibillion dollar employment tax shelter”[2] that is unavailable to everyday Americans. Closing the Gingrich-Edwards loophole for high-end workers would raise $306 billion over the next ten years.[3]

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[1] Smith, Matthew, Danny Yagan, Owen Zidar, and Eric Zwick. “Capitalists in the Twenty-first Century.” *The Quarterly Journal of Economics* 134, no. 4 (2019): 1675-1745.
[2] Treasury Inspector General for Tax Administration. “Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations.” *Reference Number: 2005-30-080* (2005). http://www.treasury.gov/tigta/auditreports/2005reports/200530080fr.html.
[3] U.S. Department of the Treasury. “General Explanations of the Administration’s Fiscal Year 2024 Revenue Proposals.” (2023). https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.

Second, in research now forthcoming in the *Oxford Review of Economic Policy*, Greg Leiserson and I estimated that the Forbes 400 wealthiest Americans from 2010 to 2018 paid an average Federal individual income tax rate of eight percent on their full income, including capital gains on unsold stock.[4]

How is that possible? Top business owners make most of their income from rising stock values. They do not pay individual income tax on that income until they sell. And if they never sell and instead bequeath the stock to their heirs, no one ever pays income tax on those billions of "unrealized" capital gains.

Think of two people who created enormous personal wealth during their lifetimes: entertainer Frank Sinatra and WalMart owner Sam Walton. At current federal tax rates, Frank Sinatra would pay about 40 percent in federal income tax on his wage income – much more than Sam Walton would pay on his stock income under low effective individual tax rates, even after factoring in corporate income taxes.[5]

Congress has three options for raising effective tax rates on top business owners and closing the gap between a Sinatra tax burden and a Walton tax burden. It can raise effective corporate income tax rates, raise dividend and capital gains rates, or tax unrealized gains as in Senator Wyden's Billionaires Income Tax proposal.[6] Here, I will discuss that proposal's child – President Biden's Billionaire Minimum Income Tax – which has fifty-five cosponsors in the House, would cover the twenty thousand households with wealth over one hundred million dollars, and in its latest version would raise $436 billion over ten years.[7]

My written testimony contains a plain-English FAQ, but here's how the minimum tax would work. If a covered household is already paying twenty-five percent on their income including unrealized gains – like a star actor earning wages – they would pay no extra tax. But if tax-free unrealized gains allows them to pay less than twenty-five percent, they would owe a top-up payment to meet the twenty-five percent minimum.

Those top-up payments could be paid over five to nine years and would be a prepayment of capital gains tax owed upon sale, gift, or bequest.[8] Charity would be exempt. Illiquid taxpayers could opt out of prepayments on their private stock gains and instead pay later with interest.

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[4] Leiserson, Greg, and Danny Yagan. "What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?" (2021). https://www.whitehouse.gov/cea/written-materials/2021/09/23/what-is-the-average-federal-individual-income-tax-rate-on-the-wealthiest-americans/. The eight percent estimate is in nominal terms. I extended the analysis for publication, which estimates an average Federal individual income tax rate on the wealthiest 400 Americans over the 1992-2020 period of 9.6 percent in nominal terms and 12.0 percent in real (inflation-adjusted) terms. Yagan, Danny. "What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?" *Oxford Review of Economic Policy* (forthcoming). http://eml.berkeley.edu/~yagan/Top400TaxOxREP.pdf.

[5] Yagan, Danny. "What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?" *Oxford Review of Economic Policy* (forthcoming). http://eml.berkeley.edu/~yagan/Top400TaxOxREP.pdf.

[6] Wyden, Ron. "Billionaires Income Tax." (2021). https://www.finance.senate.gov/download/billionaires-income-tax-one-pager.

[7] U.S. Department of the Treasury. "General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals." (2023). https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.
H.R.8558. "Billionaire Minimum Income Tax Act." (2022). https://www.congress.gov/bill/117th-congress/house-bill/8558?s=1&r=46.

[8] Prepayment could also be implemented without the minimum income tax: all wealthy taxpayers could be equally subject to prepayment on their unrealized gains, regardless of how much they pay in standard income taxes. For more on the concept of capital gains prepayment (also called capital gains withholding), see: Saez, Emmanuel,

Slow and partial prepayment on public stock gains, combined with prepayments from liquid taxpayers on their private stock gains, would preserve incentives to take companies public.

The minimum tax is flexible and makes space for compromise. For example, Congress could dial the minimum tax rate down to fifteen percent. Entrepreneurs taking a company public could be granted twenty years to pay.

I look forward to your questions.

Frequently Asked Questions about the President's Proposal to Impose a Minimum Income Tax on the Wealthiest Taxpayers (the "Billionaire Minimum Income Tax")[9]

The President's Fiscal Year 2024 Budget includes a proposal to Impose a Minimum Income Tax on the Wealthiest Taxpayers – colloquially called the Billionaire Minimum Income Tax. Here I answer some frequently asked questions about the proposal, drawing from the description in the Department of the Treasury's Fiscal Year 2024 Greenbook.

What is the Billionaire Minimum Income Tax?

The Billionaire Minimum Income Tax would ensure that the wealthiest households pay at least 25 percent of their income, including net unrealized capital gains, in taxes as they earn it. It works by requiring some households with over $100 million of wealth to partially prepay their future capital gains tax to meet the 25 percent overall minimum.

In September 2021, Greg Leiserson and I estimated that America's 400 wealthiest families between 2010-2018 paid an average Federal individual income tax rate of only 8 percent on their income, including income in the form of appreciation on unsold stock and other assets. This type of income is known as unrealized capital gains, and it is taxed only if and when the owners sell the assets. If the owners never sell, the income escapes income tax forever.[10]

The President's proposal would ensure that the wealthiest households pay at least 25 percent of their income including unrealized gains in Federal income tax. If an ultra-wealthy household is already paying 25 percent on their income including unrealized gains, they would pay no extra tax. But if tax-free unrealized gains allows them to pay less than 25 percent, they would owe a top-up payment to meet the 25 percent minimum. The minimum tax would apply to the top 0.01 percent, those with over $100 million in wealth.

Initial top-up payments could be paid equally over nine years. Thereafter, any additional top-up payments could be paid equally over five years. The top-up payments would be a prepayment of tax obligations that these households will owe when they later realize their gains, either at sale (as under current law) or upon

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Danny Yagan, and Gabriel Zucman. "Capital Gains Withholding." University of California Berkeley (2021). http://eml.berkeley.edu/~yagan/CapitalGainsWithholding.pdf

[9] I am grateful to the numerous colleagues who contributed to this FAQ.

[10] For simplicity, I refer to gains on both capital and ordinary assets as capital gains, and I use the term sales to include both sales and exchanges. When an asset with gains is given to someone else, the basis of the asset carries over and the gain could be subject to tax at a future date. However, it would only be taxed if and when the recipient sells or exchanges the asset.

gift or bequest (under another Presidential proposal limited to the extremely wealthy). Illiquid taxpayers could opt out of the prepayments entirely on their nontradable assets and instead pay later with interest.

The Treasury Department estimates that the minimum income tax would raise $437 billion over ten years.

<u>What would the minimum income tax achieve?</u>

The minimum income tax would prevent the wealthiest Americans from shielding their income from income tax. Under the minimum income tax, the ultra wealthy would pay at least 25 percent in Federal income taxes on their income as they earn it.

Assessing a minimum tax as capital gains income accrues would also reduce the so-called "lock-in effect," which would encourage investment decisions based on the productivity of the investment rather than the structure of the tax code. The current tax system encourages the wealthy to hang on to low-return investments, rather than reallocate that capital to higher-return investments like a promising start-up. The reason is that, by deferring capital gains taxes, the wealthy effectively get a zero-interest loan from the government in the amount of the deferred tax. Earning a low return with this zero-interest loan can be more profitable than earning a higher return without this loan – creating incentives to lock in capital in the low-return investment. The minimum income tax would reduce the amount of tax that the wealthy can defer, thereby reducing the lock-in effect and potentially freeing up capital for more productive and efficient investments.

<u>How would the minimum tax work, in practice?</u>

The following paragraphs walk through the example detailed in Tables 1 and 2 below. Throughout, this FAQ assumes that other proposals included in the President's Budget would also be in effect, including a proposal that would increase the tax rate on long-term capital gains for high-income taxpayers, as well as a proposal that would tax gains for high-wealth taxpayers upon gift or bequest and thus end the provisions that allow them to never pay income tax on their gains.

Take an example of someone who has $5 billion in taxable income (which excludes unrealized capital gains) and pays $1.5 billion in income tax (excluding the minimum tax). Let's say this billionaire also holds publicly traded stock with $5 billion net unrealized gain accumulated over many years.[11]

In the first year under the minimum income tax, the billionaire's current income tax rate including unrealized gains would be computed as 15 percent: $1.5 billion divided by $10 billion (taxable income plus net unrealized capital gain). That billionaire would therefore owe a $1.0 billion top-up tax to meet the 25 percent minimum: $1.5 billion plus $1.0 billion equals $2.5 billion in income taxes, which is 25 percent of his or her $10 billion in income. That $1.0 billion top-up tax would be a prepayment of the capital gains tax owed at future sale, gift, or bequest of the publicly traded stock.

Since it is the billionaire's first year subject to the minimum income tax, he or she could pay that $1.0 billion top-up tax over nine years – that is, $111 million per year for nine years. The first column of Table 1 walks through this first-year example.

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[11] In practice, an affected taxpayer's taxable income would likely be substantially smaller than their unrealized gains, but using the same value helps simplify the numbers in this example and better illustrate the operation of the tax.

Table 1: Example Prepayments under the Minimum Income Tax

	Year under the minimum income tax		
	First	Second	Third
Taxable income (excludes unrealized gains)	$5.0	$5.0	$5.0
Cumulative net unrealized gains	$5.0	$5.0	$5.5
Income tax (excluding the minimum tax)	$1.5	$1.5	$1.5
Income including cumulative net unrealized gains	$10.0	$10.0	$10.5
Income tax rate including unrealized gains in income and excluding the minimum tax	15%	15%	14%
Prior minimum tax assessments	$0.0	$1.0	$1.0
Income tax (excluding new minimum tax assessment) plus prior minimum tax assessments	$1.5	$2.5	$2.5
Income tax rate including unrealized gains in income before new minimum tax assessment	15%	25%	24%
Top-up tax rate required to ensure a 25% income tax rate	10%	0%	1%
New minimum tax assessment	$1.0	$0	$0.125
Income tax including prior and new minimum tax assessments	$2.5	$2.5	$2.625
Income tax rate under the minimum tax	25%	25%	25%
Years over which new minimum tax assessment can be paid	9	5	5
Annual installment due under new minimum tax assessment	$0.111	$0.000	$0.025
Total top-up payment collected this year	$0.111	$0.111	$0.136

Notes: All dollar figures are in billions.

Now let’s move to the second year. Let’s say that everything looks the same as in the first year. The billionaire again earns $5 billion in taxable income (which excludes unrealized gains) and again pays $1.5 billion in income tax (excluding the minimum tax). His or her publicly traded stock position is unchanged, meaning it still reflects $5 billion in cumulative net unrealized gains.

In the second year, the system would compute the income tax rate as exactly 25 percent because the income tax paid in this computation is deemed to include the minimum tax incurred in prior years (even if not yet fully paid). Thus, there would be no change to the billionaire’s scheduled installment payment from last year. He or she would pay his or her $1.5 billion in tax on taxable income plus the second annual installment of $111 million, as determined in the first year, as a prepayment of future capital gains tax.

There is a simple formula for new minimum income tax payments. The new minimum income tax in any given year equals 25 percent of the sum of taxable income and net unrealized gains, minus the sum of income tax (excluding any new minimum tax assessment) and any prior year minimum income top-up tax that was assessed (even if still being paid in installments). In the second year in the system, this formula would show that the example billionaire owes zero new top-up tax: 25 percent of $10 billion, minus the sum of $1.5 billion and $1 billion.

Now let's move to year three. Let's say that the billionaire's stock portfolio rises by $500 million, while everything else remains the same. The system would assess a new top-up tax of $125 million payable over five years in equal installments to keep the income tax rate from dropping below 25 percent. That $25 million per year for five years would be in addition to the remaining seven years of $111 million annual installments assessed in the first year.

Finally, let's say that in year four, the billionaire sells all his or her stock and recognizes $5.5 billion of net capital gains. Let's say that the top capital gains tax rate is 44.6 percent, as it would be under the President's FY 2024 Budget. The billionaire would owe $2.453 billion in capital gains tax on the recognized capital gains.

In our example, the billionaire would have already prepaid $358 million of that capital gains tax under the minimum income tax. That $358 million would be allowed as a credit and reduce his or her capital gains tax due in year four from $2.453 billion to $2.095 billion. Table 2 walks through this fourth-year example. All remaining top-up tax installments due on gains in years one and three would no longer be due.

This example shows how the minimum income tax would ensure that the ultra wealthy pay at least 25 percent of their income including unrealized gains in taxes.

Table 2: Credit of Example Prepayments under the Minimum Income Tax

Realized capital gains in year four	$5.5
Capital gains tax in year four	$2.453
Credits (cumulative paid-in prepayments under the minimum tax prior to year four)	$0.358
Capital gains tax due in year four	$2.095
Remaining top-up tax installments scheduled	$0

Notes: All figures are in billions. The top capital gains rate (inclusive of surtaxes) under the FY 2024 Budget would be 44.6 percent.

<u>In the previous example, what would have happened in the third year if the value of the stock portfolio had fallen by $500 million rather than risen?</u>

The system would have reduced the billionaire's remaining installment payments by $125 million in total. Before this adjustment, the billionaire's tax rate including all previously assessed top-up tax payments would be 26 percent. Reducing the remaining installment payments by $125 million reduces that tax rate to 25 percent.

<u>Stocks are volatile. Won't those subject to the minimum income tax pay huge amounts of tax in boom years and get huge refunds when their unrealized stock gains turn into losses?</u>

A key feature of the minimum income tax is that it collects only partial prepayment of capital gains tax and does so gradually over several years. As a result, payments are smoothed over time, and taxpayers will often have paid less than their eventual income tax bill even when stock prices fall, making large refunds rare.

For example, during the tech boom of the late 1990s, tech stocks grew dramatically and then collapsed quickly. Taxpayers who bought in early and saw their wealth rise with the bubble likely would not have paid enough tax by 1999 in order to require any refund at all in 2000. In a stylized example of a taxpayer who saw their assets rise sharply beginning in 1994, he or she would have prepaid only about 9 percent of their unrealized gains in tax by 2000.[12] If the tech stocks fell by half, that 9 percent prepayment would have translated to a 19 percent tax rate. Because the tax rate would remain less than the long-term capital gains rate, there would be no overpayment and therefore no refund necessary.

However, in some instances, some taxpayers may overpay, such as a wealthy investor who bought into the stock market in 2006, prepaid some tax in 2007, and then saw all gains wiped out in 2008. Without selling their stocks, such taxpayers would receive a refund, just as ordinary taxpayers do when they overpay via withholding or estimated tax payments. Refunds would equal the amount by which paid-in prepayments exceed the long-term capital gains rate (inclusive of surtaxes) times unrealized gains.

Charitable gifts could also trigger a refund of prior prepayments. For example, giving all of one's appreciated assets to charity would trigger a full refund of any paid-in prepayments because the taxpayer would no longer hold assets with net unrealized gains.

<u>What about nontradable assets? Will owners of private businesses have to sell their stock in order to pay this tax? How would valuation of nontradable assets work?</u>

No. The minimum income tax is designed so that taxpayers would not need to sell their private business stock to pay the tax, while also limiting incentives to hold nontradable assets to avoid taxes.

Taxpayers would be treated as "illiquid" if tradable assets held directly or indirectly (e.g., via hedge funds) by the taxpayer make up less than 20 percent of the taxpayer's wealth. Illiquid taxpayers could elect to exclude nontradable assets from their minimum income tax liability calculation and instead pay in full at realization with interest. The interest charge would not exceed ten percent of the unrealized gain. As a result, illiquid taxpayers would not need to sell nontradable assets to pay the minimum income tax.

Fully exempting nontradable assets would create strong incentives to hold wealth in nontradable assets. However, under the minimum income tax, nontradable assets would not be fully exempt. Liquid taxpayers would owe minimum income tax payments on the unrealized gains of their nontradable assets. While illiquid taxpayers would not have to make any minimum income tax prepayments on their nontradable assets, they would owe prepayments on their tradeable assets, and would owe an interest charge on the tax due on gains on nontradable assets when they realize them.

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[12] Suppose the minimum income tax had been in force by 1994. Consider a taxpayer at the end of 1994 with a portfolio of public tech stocks worth $1 billion, with $1 billion of basis. Suppose that the value of that portfolio doubled each year for the next five years and was thus worth $32 billion at the end of 1999, with $31 billion of unrealized gains. Assuming conservatively that the taxpayer had no other assets or income (which could reduce their minimum tax prepayments), they would have made $2.85 billion in minimum tax payments through tax year 1999, equal to 9.2 percent of the taxpayer's $31 billion in unrealized gains. Suppose the portfolio declined by half in 2000 and was thus worth $16 billion at the end of 2000, with $15 billion in unrealized gains. The already-paid-in amount of $2.85 billion would be 19 percent of the taxpayer's $15 billion in unrealized gains, far below the proposed capital gains rate.

As an example, some ultra-wealthy people hold most of their wealth in tradable assets like public company stock, while also owning sports teams that are private companies. Those taxpayers can easily prepay some tax on their teams' unrealized gains.

Valuations of nontradable assets would not be needed annually, and modest undervaluation would be acceptable because the minimum tax merely collects partial prepayment of tax that will ultimately be collected in full later. The tax would rely on measurements of value that the taxpayer already has—such as valuations for investment, borrowing or financial statement purposes—and increase those by a conservative floating annual return in between valuations, with avenues for appeal.

Does the law tax non-cash income in other contexts?

Yes, regularly. For example, if Berkeley were to compensate me with a new car this year instead of cash, the law would treat that new car as income and I would pay income tax on it, just as I would for cash compensation.

There are several instances in which the tax code has for decades taxed capital gains regardless of whether the underlying assets have been sold. Gains on futures contracts are already fully taxed annually, regardless of whether they have been sold. Gains on financial securities and derivatives held by securities dealers other than for inventory are also fully taxed annually, regardless of whether they have been sold. In addition, for certain types of debt, the tax code taxes the interest earned as if there were regular interest payments even when such payments are not actually made.