America’s rich never sell their assets. How should they be taxed?

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It is tempting to tax them during their lives. It is wiser to do so after their deaths

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Editor’s note (June 20th 2024): *The Supreme Court has ruled in Moore v United States, upholding the tax at issue (the “mandatory repatriation tax”). The court declined to weigh in on the constitutionality of a tax on unrealised gains.*

What is income, really? Ask an economist and they might describe “Haig-Simons” income—the value of a person’s consumption of goods and services, plus the change in their net worth over a certain period. A lawyer might refer to Section 61(a) of the IRS Code 26, which defines “gross” income as “all income from whatever source derived”, including but not limited to commission, interest, property deals and wages. An accountant might talk about how to reduce that gross income, via deductions or carve-outs, to a skinnier “taxable income base”.

The answer matters. Whether governments should levy taxes on unrealised capital gains, as well as realised ones, is a topic of hot debate. In March, during the State of the Union address, Joe Biden reiterated his commitment to imposing a “billionaire minimum income tax” if re-elected. This would include a 25% tax on unrealised capital gains for Americans with more than $100m in assets, which he expects would raise $500bn (2% of GDP) over a decade. The Supreme Court is also considering the question. Its justices are poised to issue an opinion in *Moore v the United States*, a case in which the plaintiffs are arguing that a one-off tax on gains from an overseas investment was unconstitutional, since the 16th amendment, which enshrines in America’s constitution the federal government’s right to impose income taxes, does not apply to unrealised income.

A large portion of ultra-rich Americans’ wealth is in unrealised gains. Since the release of the “Secret IRS Files” by ProPublica, an investigative-journalism outfit, in 2021, a strategy known as “buy, borrow, die” has come under particular scrutiny. It allows those who employ it to avoid income and capital-gains taxes altogether.

Say you own a successful business—so successful that your stake in it is worth $1bn. How should you fund your spending? If you pay yourself a wage of $20m a year, the federal government will collect 37%, or some $7.4m. So perhaps you should take a salary of $1 and sell $20m-worth of shares. If these were gifted to you upon founding the firm, the entire sum represents capital gains and will be taxed at 20%, which would mean a $4m hit. What if, instead, you called up your wealth manager and agreed to put up $100m-worth of equity as collateral for a $20m loan. In 2021 the interest rate on the loan might have been just 2% a year, meaning that returns from holding the equity, rather than selling it, would easily have covered the cost of servicing the borrowing. Because the proceeds of loans, which must be eventually repaid, are not considered income, doing so would have incurred no tax liability at all.

The strategy is even more compelling once the “stepped-up basis” is considered. When the holder of an asset dies, the value for capital-gains assessments is “stepped up” from its purchase cost to its value at the time of death. In this way, “buy, borrow, die” does not simply defer capital-gains taxes—it can eliminate them entirely. Nothing is paid on gains made between the original purchase of an asset and the value at the death of the original holder.

Taxman confounded

Low interest rates and booming stockmarkets make a “buy, borrow, die” strategy particularly attractive. At Morgan Stanley and Bank of America (BoA), both of which run large wealth-management businesses, the total value of securities-backed loans to clients leapt from around $80bn in 2018 to almost $150bn in 2022. Banks are more than happy to make such loans. As lending tends to be collateralised by securities that can be easily seized and sold, it is treated as low-risk by regulators.

During the past few years of high interest rates, however, borrowing against assets has become a riskier proposition. At Morgan Stanley such loans are structured as revolving lines of credit; three-quarters of them appear to have floating interest rates. If borrowing adds up to, say, 50% of a portfolio at a lofty valuation then a rout in the market can leave debtors with nothing. In 2022, after the share price of Peloton collapsed, John Foley, founder of the exercise-bike firm, ended up scrambling to restructure his loans, selling a $55m house in the Hamptons just months after he had bought it. At BoA and Morgan Stanley the value of loans secured in such a manner had crept down by the end of 2023.

Yet politics, rather than high interest rates, represents the biggest threat to the strategy. There are three arguments against Mr Biden's proposal: that it is unfair, that it is unconstitutional and that it would be an administrative burden. The fairness argument rests on the idea that unrealised gains are, in many ways, unreal. After all, the value of assets could change the day after a tax is paid. This perhaps explains why a survey by academics at New York University in 2021 found 75% of Americans oppose such taxation.

A clue as to whether the Supreme Court believes that wealth taxes are constitutional will arrive in the coming days, when justices opine on *Moore*. The plaintiffs were taxed under the Tax Cuts and Jobs Act, which was passed in 2017 and imposed a mandatory repatriation tax on the earnings, since 1986, of foreign corporations in which American shareholders own at least 50% of the stock. The levy applies regardless of whether the earnings were distributed to shareholders.

If the justices side with the plaintiffs, they may stop the push for an unrealised-gains tax in its tracks. But they seem unlikely to do so. Sonia Sotomayor, speaking for the court's liberals, has noted that the concept of "realisation" was "well established" when the relevant constitutional amendment was ratified in 1913. As such, the early-20th century lawmakers could have specified that unrealised assets were to be left alone had that been what they intended. On top of this, at least two conservative justices have suggested they will not weigh in on the constitutional point.

As for the idea that wealth taxes on private assets are unworkable, that is too simplistic. Versions of them are already widely used in America, undermining arguments that they are impossible to administer in the country. Levies on property at the local or state level in effect act as taxes on unrealised capital gains. Every single American state has property taxes, which range from 0.3% to 2.3% of the property value each year. In more than half of states, property values are reassessed annually. Mr Biden's plan also seeks to minimise headaches. It includes measures to smooth volatility so that losses incurred in one year can be offset against gains in another.

Still, the bureaucratic effort to levy a new countrywide tax, on a small pool of people, on every kind of asset they might hold,would be wince-inducing. Valuing assets such as bonds and stocks is relatively straightforward. But private assets, whether a Picasso or an

investment in a startup, would be another matter entirely. Adam Michel of the Cato Institute, a libertarian think-tank, points out that it took 12 years for the IRS and Michael Jackson's estate to reach a court-mediated agreement on the value of the late pop star's assets. "Going through such a process every year for all taxpayers with assets near some threshold is unworkable," he argues. Several European countries that have tried to levy wealth taxes and ultimately abandoned the effort have described administrative costs as a reason why.

Thankfully for Mr Biden, there is a less radical alternative that would have much the same effect as going after unrealised assets. Eliminating the stepped-up basis, which Mr Biden also hopes to do, would remove lots of the incentive to buy, borrow and die. It would also probably avoid a serious legal challenge and be easier to administer. Such a move would raise a quarter of the sum the president expects his grander plan to fetch. Taxing capital gains at death would raise another hefty chunk. And closing a few additional loopholes would just about cover the rest. ■