STATE INNOVATION EXCHANGE

TAX THE RICH

IMPLEMENTING A STATE TAX ON INVESTMENT GAINS

May 2024

INTRODUCTION

The concentration of wealth in the hands of the elite few impacts every facet of our lives. It is directly connected to expanding wealth disparities and the rising cost of living, the existential climate crisis and the rampant expansion of authoritarianism, and it threatens the very existence of the multiracial democracy that we strive for.

This concentration of wealth did not happen by accident; it is not the result of inevitable forces. It is a product of deliberate policy choices over decades and centuries. Billionaires and centi-millionaires (those with at least $100 million in wealth) in America are amassing wealth, with a record 700% increase in inflation-adjusted unrealized capital gains over the last three decades.

Racism, sexism, and classism are entrenched in our current economic system, by design. As a result, Black, immigrant, and Indigenous people, working class and rural communities, women, and queer people are disproportionately exploited and denied prosperity by our economic policies. Some of these problems could be mitigated if the extremely wealthy paid their fair share toward meeting vital social needs, particularly in terms of spurring opportunities for communities experiencing structural poverty. For example, considerable research has shown that high-quality preschool can play an enormous role in helping every child reach their potential. Given the scale of wealth involved, getting the extremely wealthy to pay their fair share in taxes could raise substantial revenues toward vital initiatives like this.

Unfortunately, the absurd regressivity that is evident at the very top of our tax system at the federal level is even more evident at the state level. This is partly because income taxes, as currently designed at the federal and state level, do not reach unrealized gains. For example, billionaire Jeff Bezos was paid about $1.7 million in total compensation by Amazon in 2022, but his net worth in 2023 increased by a massive $70 billion, which amounts to almost $8 million per hour. Furthermore, states have not levied taxes on broad forms of wealth for almost a century, while other countries, including Switzerland since 1848 and Norway since 1892, have retained their wealth taxes. The extremely wealthy in America have employed armies of lobbyists to ensure that their effective tax rates are kept low and that neither federal nor state taxing authorities can effectively tax intergenerational wealth transfers.

NOTE ON TERMINOLOGY

- *Unrealized gains* are the increased value of assets that have not yet been sold (or "realized").
- *Unrealized capital gains* are a type of unrealized gains, specifically, the increased value of stocks, bonds, and other financial securities that have not yet been sold.

Historically, state legislators, in collaboration with the communities most impacted by these policy choices, have led the fight in challenging corporate and billionaire power by organizing communities and building economies that empower people. Modernizing the tax code is an essential piece of this vision. Taxing unrealized gains, in particular, offers an opportunity to reverse the increasingly widening wealth disparities in the United States and to fund our future.

The extremely wealthy in America have employed armies of lobbyists to ensure that their effective tax rates are kept low and that neither federal nor state taxing authorities can effectively tax intergenerational wealth transfers.

WEALTH TAX OVERVIEW

Wealth includes ownership of many different types of assets, including real estate, vehicles, and art, but the largest category among the very rich is ownership of businesses, stocks, and mutual funds. Through a series of tax loopholes dubbed "buy, borrow, die," the ultra-wealthy can hold on to and use financial securities as collateral for loans (often securities-backed lines of credit) instead of selling investments to cover expenses. The loopholes also allow their inheritors to receive these financial assets on a legally allowed "stepped-up" basis (i.e., based on valuing the inherited stock at the current market value) without paying any capital gains taxes (McCaffery, 2019). This means that all inherited capital gains are provided a tax benefit that would not be allowed if someone sold off their financial securities before their death. To make matters worse, the ultra-wealthy would only need to retire and/or move to a state that does not tax income before realizing their capital gains to avoid state taxation (Galle et al., in press).

For example, although Jeff Bezos relied on public investments in physical and human capital infrastructure in Washington State to establish Amazon, he waited until he moved to Florida (a state without a capital gains tax) before selling $2 billion in Amazon stock, depriving Washington of almost $600 million in state revenue. It is imperative that unrealized gains are taxed, or the massive income and wealth inequalities in our country will continue to grow unabated, with the impacts disproportionately felt by communities structurally denied opportunities (Addo & Darity, 2021).

NOTE ON SECURITIES-BACKED LINE OF CREDIT (SBLOC)

SBLOC is the most common way to borrow in the "buy, borrow, die" scheme and is similar to a home equity line of credit, but financial investments are the collateral instead of real estate. SBLOC's advantages include: (1) no capital gains taxes, (2) flexible repayment schedules, (3) simple and low-cost approval process, and (4) relatively low interest rates.

While no state currently has a wealth tax on a broad range of assets, the U.S. does levy taxes on some forms of wealth. Property taxes are an example of taxing assets before they are sold, though overall the property tax is regressive. Another example is the federal expatriation tax, which includes a tax on net unrealized capital gains for individuals with a net worth of at least $2 million who have relinquished their U.S. citizenship. As tax codes are common but can be complicated, the policy design and implementation of a new wealth tax model could benefit from the experience of other countries, from academics who have spent time researching these models, and from state legislation at the forefront of this reform in this country.

The following is a policy design discussion focused on taxing one major category of wealth: unrealized capital gains. This discussion pulls primarily from academic sources and focuses on real-world policy decisions. This is not meant to serve as "model" language, but instead to provide policy design considerations and options that policymakers should discuss with local groups and impacted communities.

NOTES ON INCOME VS. WEALTH

"Income is the sum of earnings from a job or a self-owned business, interest on savings and investments, payments from social programs and many other sources. It is usually calculated on an annual or monthly basis. Wealth, or net worth, is the value of assets owned by a family or an individual (such as a home or a savings account) minus outstanding debt (such as a mortgage or student loan). It refers to an amount that has been accumulated over a lifetime or more (since it may be passed across generations)." (Source: Pew Research Center)

Realized capital gains are considered income, and unrealized capital gains are sometimes understood as a form of future income. But as these gains are part of assets that the wealthy can use as collateral, we refer to them in this report as a form of wealth, and a tax on unrealized capital gains as a type of wealth tax.

Please note: The case *Moore v. United States* was argued in the Supreme Court in part to decide whether unrealized gains can be treated as income from a federal tax perspective, but states are not necessarily limited by this ruling, as it is focused on Congress' power of taxation under the 16th Amendment.

TYPES OF ASSETS INCLUDED (OR EXEMPTED) AND ASSET VALUATION

The first and perhaps most impactful policy design decision is which types of assets to include as taxable forms of wealth. The broadest definition of wealth includes total net assets, or the market value of all financial and nonfinancial assets after debt. For example, a French wealth tax exempts business assets, shares acquired from capital subscription (e.g., agreement to purchase an IPO), artwork, antiques and collectibles, and intellectual property, and is calculated by taxpayers based on the market value of all their other assets (Garbinti et al., 2023). A U.S. example of a broad wealth tax is 2023 CA AB 259, which, if enacted, would eventually apply a 1% tax on worldwide net worth in excess of $50 million and 1.5% on net worth over $1 billion. Care should be taken when considering what types of assets to exempt, as one study found that European wealth taxes that exempted wealth from owner–manager businesses created a tax loophole for the ultra-rich (Piketty et al., 2023).

Unrealized Capital Gains

While wealth takes many forms, proposals by advocates, academics, and policymakers in the U.S. have primarily focused on taxing one category of wealth: unrealized capital gains. Not only is this form of wealth massive (estimated at $8.5 trillion nationally), but it is likely the most politically feasible to address and the least complicated to tax as well. A tax on unrealized capital gains is a relatively simple idea, but there are several policy design options that interested state policymakers and advocates can consider. Many of these proposals assess the value of unrealized capital gains based on gains or losses relative to a year-end market value, also referred to as mark-to-market. Two of the issues around a tax on unrealized capital gains using mark-to-market valuation are the price volatility of financial markets and the uncertain valuation of illiquid assets (Saez et al., 2021).

UNREALIZED CAPITAL GAINS: ESTIMATED AT
$8.5 TRILLION
NATIONALLY

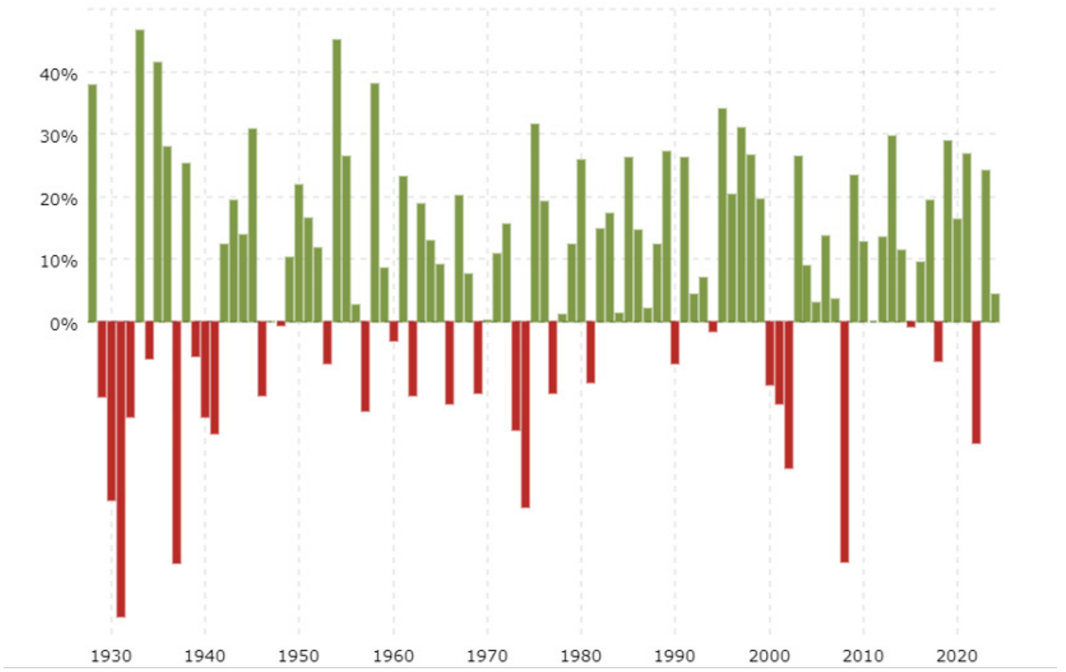
MOST POLITICALLY FEASIBLE AND LEAST COMPLICATED TO TAX

GOAL: ASSESS THE VALUE BASED ON GAINS OR LOSSES RELATIVE TO A YEAR-END MARKET VALUE

NOTE ON FINANCIAL ASSETS

"Financial assets include fixed-claim assets (checking and saving accounts, bonds, loans, and other interest-generating assets), corporate equity (shares in corporations), and noncorporate equity (shares in noncorporate businesses, for instance, shares in a partnership). Financial assets can be held either directly or indirectly through mutual funds, pension funds, insurance companies, and trusts." (Saez & Zucman, 2020)

S&P 500 Historical Annual Returns



Looking at the history of S&P 500 returns above, how can a state budget office develop accurate revenue forecasts when the financial markets shift so quickly? The following policy options include unrealized capital gains tax designs that would help to address these mark-to-market tax concerns.

UNREALIZED CAPITAL GAINS TAX TERMINOLOGY

- "Cost basis" is the original purchase price that the asset was acquired for and is used to calculate net gains or losses.
- "Deemed realized gains" are unrealized gains (or built-in gains) that are treated as realized for tax purposes and therefore potentially subject to taxation.
- "Exemption threshold" is the amount of net wealth exempted from taxation (e.g., the first $10 million) and therefore determines who the tax applies to.
- "Realized capital gains" are the profits from the sale of an asset, calculated as the amount received for the sale minus the cost basis.
- "Recognized gains" are the amount of realized or deemed realized gains that are subject to taxation (e.g., after subtracting deferred gains).
- "Tax limit" is the maximum amount of tax on a given asset (also referred to as a "cap").

Phased Mark-to-Market Unrealized Capital Gains Tax

A relatively straightforward proposal for taxing unrealized capital gains is to tax a portion of the increase in value of the underlying asset by comparing the current fair market value at a given point in time to the original purchase price (i.e., mark-to-market). One way to do this is to phase in the tax by effectively recognizing only a portion of the deemed realized gains every year. This phased-in approach reduces the risk of volatility inherent in a mark-to-market tax, as only a portion of financial assets would be taxable in a given year. Academic writing on this idea proposes that 50% of deemed realized gains should be recognized as taxable income, which would effectively include 50% of these shares as taxable income in tax year 1, 25% (half of 50%) in tax year 2, 12.5% in tax year 3, and so on (Gamage & Shanske, 2022). The percentage of deemed realized gains to recognize for tax purposes is a policy decision: a larger percentage would raise tax revenue more quickly and reduce the risk of the extremely wealthy using lobbyists to weaken the tax code, while a smaller percentage would minimize tax revenue volatility and the concern of impacting illiquid taxpayers (Gamage & Shanske, 2022).

Legislative Example: Phased Mark-to-Market

VERMONT (2024 VT HB 827)

Under this bill, Vermont taxpayers with net assets in excess of $10 million (the exemption threshold) would be required to include 50% of their unrealized capital gains (i.e., deemed realized gains) in their taxable income for the year, as if all assets had been sold at fair market value on the last day of the year. This taxable amount has an annual tax limit that cannot exceed 10% of the taxpayer's net assets in excess of $10 million (Gamage, 2024). The bill also provides for an exclusion of $1 million per category of assets (e.g., real estate, nondistributed interest in a trust, and personal property, such as vehicles or art/collectibles)

CALCULATION EXAMPLE: PHASED MARK-TO-MARKET

Income deemed realized and recognized:

- Assuming a taxpayer holds stock X with fair market value of $25 million and cost basis of $15 million ($10 million deemed realized gain), and stock Y with fair market value of $25 million and cost basis of $30 million ($5 million deemed realized loss), then:
    - Total deemed realized gains from stock X and stock Y = $5 million ($10 million – $5 million), and 50% of deemed realized gains are recognized = $2.5 million.

Tax limit/phase-in cap amount:

- Assuming stock X and stock Y are the taxpayer's total assets ($50 million), and assuming personal debt of $20 million, net assets = $30 million:
    - The cap is 10% of net assets beyond $10 million, or 10% x ($30 million – $10 million) = 10% x $20 million = $2 million.

The lower amount from these two calculations, $2 million, is added to taxable income. All else being equal (assuming no other taxable income or tax credits/deductions) and assuming a Vermont income tax of $17K + 8.75% of taxable income over $279K, this would result in a state income tax of about $168K.

CALCULATION EXAMPLE: PHASED MARK-TO-MARKET FOR JEFF BEZOS

If Jeff Bezos paid this type of unrealized capital gains tax on Amazon shares he owns:

- Assuming Bezos owns about $166 billion in Amazon stocks and has a total net worth of about 198.5 billion, and estimating an effective cost basis of $0, since he only ever bought a single share of Amazon stock, then:
    - Total deemed realized gains = $166 billion, and 50% of deemed realized gains recognized = $83 billion.
    - Tax limit is 10% of net worth beyond $10 million, or 10% x ($198.5 billion – $10 million) = $19.849 billion.

The lower amount from these two calculations, $19.849 billion, is added to taxable income. As above, all else being equal and assuming a Vermont income tax of $17K + 8.75% of taxable income over $279K, this would result in a state income tax of about $1.737 billion.

when calculating the net assets for the tax limit. This helps to simplify the valuation process, as a wealthy individual would only need to assess significant asset holdings, which may have already been done for insurance purposes. This bill does not apply a specific tax rate, but instead adds deemed and recognized capital gains to taxable income for individual income tax calculations. The bill also proportionally reduces the tax for residents who have lived in the state for less than 4 years.

Withholding Tax on Unrealized Capital Gains

Another policy option is to require extremely wealthy individuals to prepay future realized capital gains taxes through a type of withholding tax (i.e., "pay-as-you-go," where a portion of estimated tax is sent periodically to the taxing authority before the full amount is due) on unrealized capital gains. This estimated prepayment could be based on the value of unrealized capital gains above a specific exemption threshold, which could be set high enough to not target illiquid millionaires and could also include progressive tax rates based on the amount of unrealized capital gains (Saez & Zucman, 2020). An academic proposal of this withholding tax includes both liquid and illiquid assets (except for retirement accounts) and recommends that the withholding tax rate be one-tenth of the top federal capital gains tax rate (Saez et al., 2021). As with the phased tax above, compared to traditional wealth tax models, the withholding tax model would help to smooth out asset valuation volatility, which is especially important to states, as they are required to enact balanced budgets (Saez et al., 2021).

Valuing Private Businesses/Unlisted Shares

One area of asset valuation that warrants careful consideration is shares of private businesses, which is a major asset class for many of the ultra-wealthy (Saez & Zucman, 2020). In France, the tax administration provides guidelines on how taxpayers can value stocks from unlisted companies (Garbinti et al., 2023). There are many ways that states could consider valuing unlisted shares.

LARGE PRIVATE BUSINESSES

For large private businesses, the value could be based on secondary market valuation, such as by venture capitalists, private equity funds, financial analysts, or recent stock trades (Saez et al., 2021). For wealthy individuals who are unable or unwilling to sell their private shares to cover a tax on unrealized capital gains, a government-run credit program could be created to provide taxpayers with government loans, secured by their illiquid assets, with interest accrued at the Treasury rate and repayment triggered when either the asset becomes liquid or control of the asset is transferred to another party (Saez et al., 2021).

SMALL PRIVATE BUSINESSES

Shares in small private companies could be valued using a straightforward formula based on book value, sales, and profits; for example, Switzerland has successfully used this type of formula (Saez & Zucman, 2020). By utilizing a formula with easily available information, small private businesses would not incur significant administrative costs if one of their owners were subject to an unrealized capital gains tax. Data on small business employee size shows that over 80% of small businesses have zero employees and another 16% have only 1–19 employees, and additional data on business owners reveals that private businesses with more than five employees are owned by families with a median net worth of only $1.25 million and median business assets of $400K. It is clear that relatively few small businesses would need to be valued, and the ultra-wealthy likely have accountants who track basic financial data on their small businesses, which might be needed when selling these businesses or using them as collateral for a loan. Valuation of defined benefit pension plans could also be based on a simple formula that looks at age, tenure, and current salary to approximate accrued benefits (Saez & Zucman, 2020).

CALCULATION EXAMPLE: SWISS PRIVATE BUSINESS VALUATION FORMULA

The value of private businesses in Switzerland is calculated as a three-year average of current net asset value (i.e., total assets minus total liabilities) and a three-year average based on a double weighted and capitalized earnings value. This sounds more complicated than it is. The formula is:

$$\text{Business Value} = \left[\left(\frac{\text{Average of 3 Years of Adjusted Net Profits}}{\text{Capitalization Rate}}\right) \times 2 + \text{Net Asset Value}\right] \times 1/3$$

Let's suppose that this model is used in the U.S. and a private company had a net asset value of $10 million at the end of 2023 and adjusted net profits of $1 million in 2021, $2 million in 2022, and $3 million in 2023. Let's also assume a capitalization rate (i.e., expected rate of return) of 8%, which would be determined by statute or regulation. This formula results in a total valuation of $20 million:

$$\text{2023 Business Value} = \left[\left(\left(\frac{(\$1M + \$2M + \$3M)/3}{0.08}\right) \times 2\right) + \$10M\right] \times 1/3 = \$20M$$

Source: Eckert & Aebi (2020)

Legislative Examples: Business Valuation

Both a California bill and a Vermont bill use a straightforward business valuation formula of book value plus 7.5 times book profits in a given year. In particular cases, certified appraisal values can be used to determine the worth of private business assets.

CALIFORNIA
(2023 CA AB 259)

50308. (c) (3) (D) For purposes of this part, if a valuation is to be calculated by the proxy valuation formula for business entities, that valuation shall be the book value of the business entity according to GAAP plus 7.5 times the book profits of the business entity for the taxable year according to GAAP. However, if the taxpayer can demonstrate with clear and convincing evidence that a valuation calculated via the proxy valuation formula would substantially overstate the value as applied to the facts and circumstances for any taxable year, then the taxpayer can instead submit a certified appraisal of the value of the taxpayer's ownership interests in the business entity for that year and use that certified appraisal value in place of applying the primary valuation rules of subparagraph (F) or (G).[...]

(F) For business entities for which the valuation calculated by the proxy valuation formula for business entities is less than fifty million dollars ($50,000,000), the value of the taxpayer's ownership interests in the business entity will be presumed to be the percentage of the business entity owned by the taxpayer multiplied by the valuation calculated by the proxy valuation formula for business entities.

(G) For business entities for which the valuation calculated by the proxy valuation formula for business entities is fifty million dollars ($50,000,000) or greater, the taxpayer shall submit a certified appraisal of the value of the taxpayer's ownership interests in the business entity. The value of the taxpayer's ownership interests in the business entity will then be presumed to be the greater of the following: (i) The certified appraisal value. (ii) The percentage of the business entity owned by the taxpayer multiplied by the valuation calculated by the proxy valuation formula for business entities.

VERMONT
(2024 VT HB 827)

5604. (c) (3) (D) Except for assets and entities governed by subdivisions (1) and (2) of this subsection (c), assets excluded under subdivision (A) of this subdivision (3), and assets attached to an ODA, for all other interests in any business entities including all equity and other ownership interests, all debt interests, and all other contractual or noncontractual interests, the fair market value of those interests at the end of any tax year shall be presumed to be the sum of the book value of the business entity according to generally accepted accounting principles for the tax year plus a present-value multiplier of 7.5 times the book profits of the business entity for the tax year according to generally accepted accounting principles, with this entire sum then multiplied by the percentage of the business entity owned by the taxpayer as of the end of the tax year.

However, if the taxpayer can demonstrate with clear and convincing evidence that such a presumption would substantially overstate the fair market value, the taxpayer may instead submit a certified appraisal and then use the certified appraisal value as the fair market value.

INDIRECTLY HELD ASSETS

Another consideration is how to deal with assets that are held by trusts or other intermediaries. To reduce tax avoidance, experts recommend that intermediary assets that are controlled by or for the benefit of wealthy individuals be included in a wealth tax, but allocated based on different levels of priority so that the impact is on the wealthiest individuals who control the funds and much less on nontaxable charities that use trust funds for programmatic purposes (Saez & Zucman, 2020). For example, the trust would be responsible for any tax liability related to trust assets unless the beneficiaries receive all of its income distributions, in which case the entire trust would be subject to the withholding tax (Saez et al., 2021).

Legislative Example: Assets in a Trust

A bill in Washington State specifies how to treat the assets of a trust depending on who benefits from or has control over the trust, as well as what happens when intangible assets are transferred to a minor relative.

WASHINGTON
(2023 WA HB 1473/SB 5486)

Sec. 3. TAX IMPOSED. [...] (4) The tax imposed in this section does not apply to a resident based on that person's status as a trustee of a trust, unless that person is also a beneficiary of the trust or holds a general power of appointment over the assets of the trust.

(5)(a) If an individual is treated as the owner of any portion of a trust that qualifies as a grantor trust for federal income tax purposes, that individual must be treated as the owner of that property for purposes of the tax imposed in this section to the extent such property includes intangible assets. (b) A grantor of a trust that does not qualify as a grantor trust for federal income tax purposes must nevertheless be treated as the owner of the intangible assets of the trust for purposes of the tax imposed in this section if the grantor's transfer of assets to the trust is treated as an incomplete gift under Title 26 U.S.C. Sec. 2511 of the internal revenue code and its accompanying regulations.

(6) Intangible assets transferred after the effective date of this section by a resident to an individual who is a member of the family of the resident and has not attained the age of 18 must be treated as property of the resident for any calendar year before the year in which such individual attains the age of 18.

Unliquidated Tax Reserve Account (ULTRA)

Another option for taxing assets that are difficult to value is to allow wealthy taxpayers to grant the government a "notional equity interest" on the assets in lieu of a tax payment (Galle et al., 2022). This interest would not confer any voting rights and would only be used for future valuation, as the taxing authority would only receive funds after the assets are sold/liquidated. If the value of the assets rises or falls, the government's eventual tax revenue would also rise or fall, as it is effectively pegged to the stock's value, not a set dollar amount. If a taxpayer holds on to these assets for several years, they could defer the tax payments by granting additional equity interest to the government. To address concerns that the wealthy will take advantage of this delay in taxation by lobbying for tax code changes instead of paying their fair share, this policy option could be designed in a way that would only allow taxpayers with liquidity challenges (e.g., all of their wealth is in a single private stock) to defer paying a wealth tax on difficult-to-value assets until their private stocks/assets are sold (Galle et al., 2022). The extremely wealthy, who do not face these liquidity issues, could instead be required to prepay a portion of their deferred tax every year (Galle et al., 2022).

CALCULATION EXAMPLE: ULTRA "OWNERSHIP"

For example, for a 2% unrealized capital gains tax on private stock, the taxpayer could instead provide the government with 2% "ownership" of these assets. If the taxpayer holds on to these stocks, they begin the second tax year with 98% ownership of the private stock (since, in the first tax year, they chose to grant the government 2% notional equity interest in lieu of a tax payment), and therefore the government would receive an additional 1.96% equity interest (i.e., 2% of 98%), for a total of 3.96%.

Legislative Example: ULTRA

A version of an ULTRA was written into a California bill as a liquidity-based optional unliquidated tax claim agreement (LOUTCA).

CALIFORNIA
(2023 CA AB 259)

50310. (a) Liquidity-based Optional Unliquidated Tax Claim Agreements, to be referred to as LOUTCAs, shall be governed by the following rules:

(1) Taxpayers who are specified as liquidity-constrained taxpayers and who have ownership interests in designated highly illiquid assets, such as startup business entities, shall be able to elect to initiate a LOUTCA to be attached to their ownership interests in those designated highly illiquid assets instead of the net value of those ownership interests or the net value of those assets being assessed at the end of a tax year.

(2) Any taxpayer subject to the tax imposed by this part is presumed to not be specified as a liquidity-constrained taxpayer if the taxpayer's designated highly illiquid assets are less than 80 percent of the taxpayer's total net worth. The Franchise Tax Board may adopt regulations in regard to substantiating who is a specified liquidity-constrained taxpayer and in regard to what is a designated highly illiquid asset. It is the intent of the Legislature that most taxpayers subject to the tax imposed by this part should not be specified as liquidity-constrained taxpayers and that publicly traded assets and ownership interests conferring control rights in substantially profitable privately held business entities shall not be designated as highly illiquid assets.

(3) To initiate any LOUTCA, a taxpayer shall sign forms to be created by the Franchise Tax Board that shall have the effect of creating a binding contractual agreement between the taxpayer and the state. A LOUTCA shall be legally binding on the taxpayer, and also on the taxpayer's estate and assigns, until such time as either the taxpayer or the taxpayer's estate reconciles the LOUTCA so as to fully liquidate the accumulated tax claims and to then pay all tax due on those liquidated tax claims.

EXEMPTIONS, DEDUCTIONS/CREDITS, AND LIMITS

As with most taxes, a key policy decision is to determine what amount of a taxable asset should be exempted (i.e., the asset threshold) and what specific tax deductions or credits should be allowed.

Exemption Threshold

A national wealth tax in France, for example, included all French residents and potentially all worldwide assets above a €1.3 million threshold (Garbinti et al., 2023). One study found that having a low exemption threshold (e.g., €1 million) created political opportunities for opponents to highlight cases of illiquid millionaires struggling to pay their wealth tax (Piketty et al., 2023). Applying that lesson, a wealth tax proposed by U.S. Sen. Elizabeth Warren had a $50 million threshold and applied a 2% wealth tax rate up to $1 billion in wealth and a 3% tax rate after that (Saez & Zucman, 2020). An academic paper also proposes a $50 million exemption threshold, which would impact the top 0.05% wealthiest families, or about 100,000 households (Saez et al., 2021).

Legislative Examples: Phase-In Cap

Another taxation limit introduced in recent state legislation is a "phase-in cap amount" to limit the amount of unrealized net gains subject to taxation. For example, a bill in New York would set a phase-in cap of 25% of net assets above a $1 billion exemption threshold, and a bill in Vermont would set a phase-in cap of 10% of net assets above a $10 million exemption threshold.

NEW YORK
(2023 NY SB 1570)

§ 612-a. (b) Subsequent to two thousand twenty-three, resident individual taxpayers with net assets that are worth one billion dollars or more at the end of the last day of any tax year shall recognize gain or loss as if each asset owned by such taxpayer on such date were sold for its fair market value on such date, but with adjustment made for tax paid on gain in previous years. Any resulting net gains from these deemed sales, up to the phase-in cap amount, shall *be included in the taxpayer's income for such taxable year. [...]*
(c) For each date on which gains or losses are recognized as a result of this section, the phase-in cap amount shall be equal to a quarter of the worth of a taxpayer's net assets in excess of one billion dollars on such date.

VERMONT (2024 VT HB 827)

§ 5601. (4) "Phase-in cap amount" means an amount equal to 10 percent of the worth of a taxpayer's net assets in excess of $10,000,000.00 at the end of the day on the last day of an applicable tax year.[...]

§ 5602. TAXATION OF UNREALIZED GAINS
(a) Tax *is imposed for each taxable year on resident individuals with net assets worth more than $10,000,000.00 at the end of the day on December 31 of the taxable year. A taxpayer shall be deemed to realize 50 percent of the gain or loss as though each asset owned was sold for fair market value at the end of the day on that date. A proper adjustment shall be made for assets previously subject to taxation under this section in prior years, pursuant to subsection (b) of this section.*

All other adjustments to the basis of a taxpayer's assets shall be made prior to a partial deemed sale under this section. Any resulting net gains from a partial deemed sale, up to the phase-in cap amount, after accounting for losses carried forward, shall be recognized and included in the taxpayer's taxable income for that taxable year.

Deductions and Credits

The withholding model referenced earlier differs from a basic wealth tax, such as the property tax, in that it allows the withholding to be used as a tax credit when financial assets are sold and capital gains are realized (Saez & Zucman, 2020). This tax credit could have a "withholding account" that carries forward until any of the taxpayer's financial assets are sold and capital gains are realized (Saez et al., 2021). This way, there is no risk of double taxation, as these capital gains are only taxed once.

Similar to the withholding model, the ULTRA policy option would provide that any prepayment of a deferred wealth tax would generate a tax credit that could be applied against a future tax liability from the sale of a difficult-to-value asset (Galle et al., 2022). In order to take into account individual contributions to assets by wealthy individuals, the percentage of the government's "stake" in assets that increase due to financial contributions could also be added to the tax credit (Galle et al., 2022).

CALCULATION EXAMPLE: ULTRA TAX CREDIT

Let's assume that a wealthy individual has difficulty valuing shares of a private company and signs an ULTRA agreement with the government. If, over time, the government builds up a notional equity interest of 10% of those shares and the wealthy individual buys an additional $50 million in that stock, then $5 million (10% of $50 million) could be applied as a tax credit when the stock is sold.

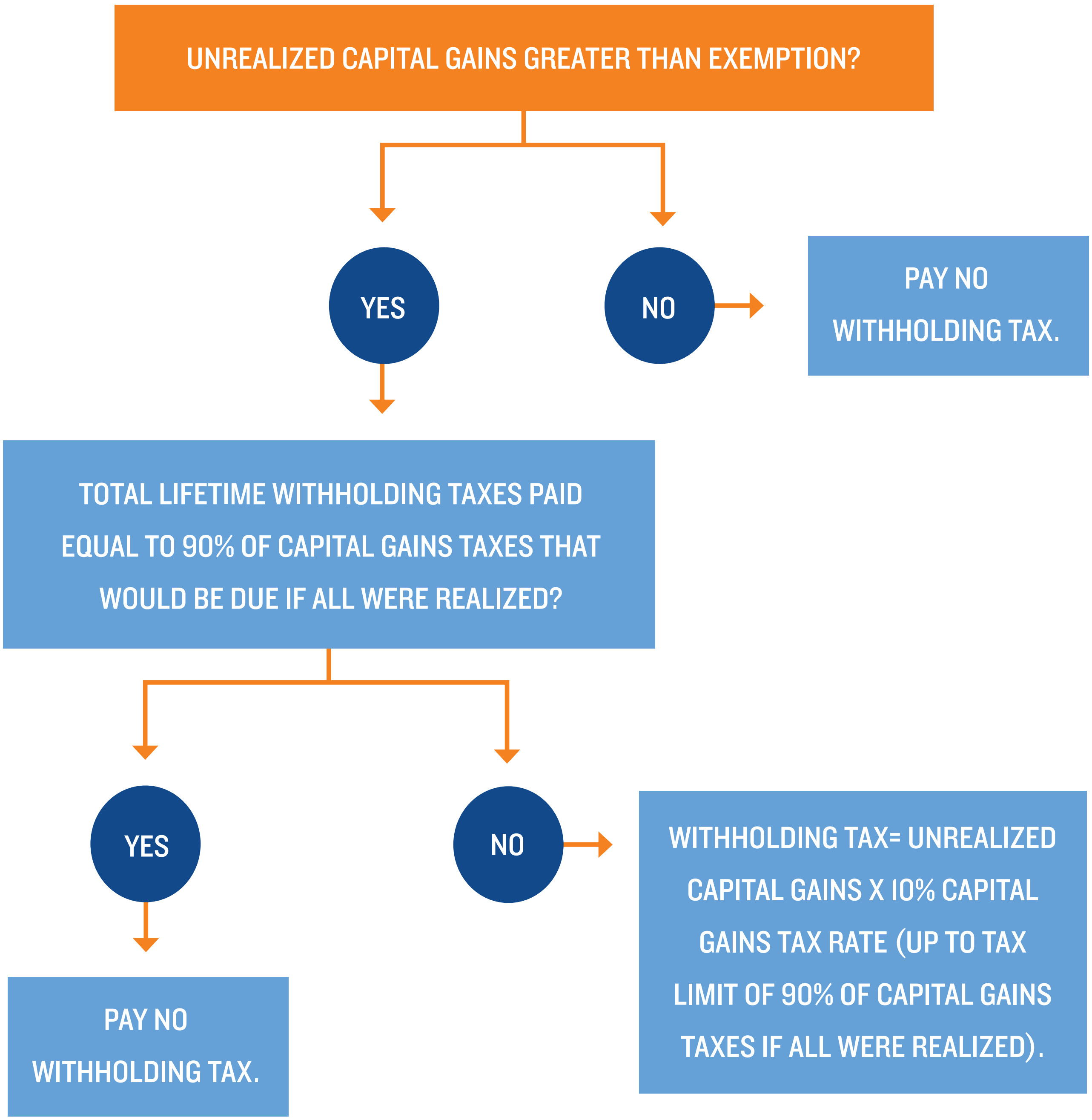
If, soon after, the wealthy individual sells their ownership in this private company for $200 million, then the government would be entitled to $15 million (10% of the $200 million minus the $5 million credit).

As with most taxes, a key policy decision is to determine what amount of a taxable asset should be exempted and what specific tax deductions or credits should be allowed.

Tax Limit

There are many ways that a tax limit can be designed. For example, the French wealth tax provides a tax ceiling of 75%–85% of net taxable income (Garbinti et al., 2023). The phase-in example mentioned earlier includes an annual tax limit of 10% of the taxpayer's net assets in excess of $10 million. And an academic proposal for a withholding tax on future capital gains proposes limiting the withholding to 90% of the potential federal capital gains tax, which would be accumulated over a nine-year period (Saez et al., 2021). See below for more on this model.

Decision Tree: Withholding Tax on Unrealized Capital Gains



WITHHOLDING TAX EXAMPLE FOR JEFF BEZOS

- Assuming Bezos owns about [$166 billion in Amazon stocks,] and given that he has only ever [bought a single share of Amazon stock], we can estimate an unrealized capital gain of $166 billion.

- Assuming a $50 million exemption threshold, a 37% federal income tax rate for the highest income tax bracket, and a withholding rate of 10%, then for tax year 1, the withholding calculation would be: 37% x 10% x $165.95 billion = $6.14 billion.

- If all else stays constant (e.g., no sale or purchase of additional Amazon shares or change in market value), then Bezos would continue to pay $6.14 billion per year through tax year 9, at which point he would have paid $55.26 billion, which is 90% of the $61.4 billion he could have owed based on a 37% tax rate (after the exemption threshold).

- If Bezos sells his shares after that, $55.26 billion in his withholding account would be credited against his realized gains to offset that capital gains tax. If, instead, he continues taking advantage of the "buy, borrow, die" scheme and leaves his Amazon shares to his heirs, then the withholding tax would never be credited back or refunded.

Adjusting the Cost Basis

To ensure that unrealized capital gains are not taxed twice, one policy option is to adjust the cost basis (i.e., the cost used to calculate gains/losses) of these assets based on deemed realized gains or losses. For example, 2024 VT HB 827 would increase the cost basis of assets with deemed realized gains by the amount of gains that are actually recognized, which is the lesser of 50% of total deemed capital gains or the cap amount plus any gains that were offset with the deemed capital losses. This basis increase is proportionally allocated among all assets with deemed capital gains based on their share of total gains. To ensure that deemed capital losses are not taken into account more than once, the bill provides for reducing the basis of these assets by the amount of their recognized deemed capital losses (Gamage, 2024).

ADJUSTED COST BASIS EXAMPLE FOR JEFF BEZOS

Going back to our example of a phased mark-to-market tax on Jeff Bezos:

- Assuming Bezos owns about $166 billion in Amazon stocks and has a total net worth of about 198.5 billion, and estimating an effective cost basis of $0, since he only ever bought a single share of Amazon stock, then:
    - In tax year 1, the lower amount from two calculations (tax limit calculation) results in $19.849 billion being added to Bezos' taxable income.
- Assuming that in the next tax year (tax year 2), Bezos does not sell or buy any additional shares, the value of Amazon stock stays that same, and his net worth holds constant, then the amount applied to his taxable income the previous year would be added to the cost basis in tax year 2:
    - Total deemed realized gains would be $146.151 billion ($166 billion – $19.849 billion), and 50% of deemed realized gains recognized = $73.076 billion.
    - Tax limit is 10% of net worth beyond $10 million, or 10% x ($198.5 billion – $10 million) = $19.849 billion.

The lower amount from these two calculations, $19.849 billion, would again be added to the taxable income and to the cost basis of the Amazon stock shares (for tax year 3). Eventually, all else being equal, the cost basis would become large enough to reduce the deemed and recognized realized gains to below the tax limit.

TAX ADMINISTRATION

While different state revenue agencies promulgate administrative rules to implement their state's unique tax code, there may be additional lessons to learn regarding how to design strong reporting requirements and enforcement tools.

Reporting Requirements

In the French tax system, taxpayers were required to report their wealth tax based on January 1st of the reporting year (Garbinti et al., 2023). For example, if a wealthy taxpayer was filing income tax forms in 2023 for income earned in tax year 2022, they would also complete wealth tax forms for assets as of January 1, 2023 (not 2022). The French tax system provided both a regular tax form and a simplified form for individuals without exemptions or deductions, but a recent study found that simplified reporting may lead to more misreporting of wealth (Garbinti et al., 2023).

A mark-to-market unrealized capital gains tax could follow current tax reporting practices, in which financial institutions share information on assets directly with customers/taxpayers and some third-party reports are shared with the IRS (Saez et al., 2021). This would require filing a new tax form and reporting to the state tax administration both the purchase price and the fair market value of financial assets held by the very wealthy, in order to estimate the taxable value of these unrealized capital gains (Saez et al., 2021). IRS Form 8854, which is used to calculate the federal expatriation tax, is an example of a mark-to-market calculation. Bank valuation of financial securities used as collateral for loans made as part of the "buy, borrow, die" loophole could also be reported to the relevant state tax authority.

Legislative Examples: Tax Forms

An Illinois bill would require the state's department of revenue to create or amend relevant tax forms, and the bill specified asset categories to include in these forms. A California bill with an ULTRA provision included additional reporting requirements that apply even if residents move to another state, as well as requirements placed on a deceased taxpayer's estate.

ILLINOIS (2023 IL HB 3039)

(a) The Department of Revenue shall amend or create tax forms as necessary for the reporting of gains by assets. Assets shall be listed with (i) a description of the asset, (ii) the asset category, (iii) the year the asset was acquired, (iv) the adjusted Illinois basis of the asset as of December 31 of the tax year, (v) the fair market value of the asset as of December 31 of the tax year, and (vi) the amount of gain that would be taxable under this Act, unless the Department determines that one or more categories is not appropriate for a particular type of asset.
(b) Asset categories separately listed shall include, but shall not be limited to, the following:

> *(1) stock held in any publicly traded corporation;*
> *(2) stock held in any private C corporation;*
> *(3) stock held in any S corporation;*
> *(4) interests in any private equity or hedge fund organized as a partnership;*
> *(5) interests in any other partnerships;*
> *(6) interests in any other noncorporate businesses;*
> *(7) bonds and interest bearing savings accounts, cash and deposits;*

(8) interests in mutual funds or index funds;
(9) put and call options;
(10) futures contracts;
(11) financial assets held offshore reported on IRS tax form 8938.

CALIFORNIA
(2023 CA AB 259)

50310. (a) (4) If a taxpayer has initiated a LOUTCA in any prior year, until that LOUTCA has been reconciled and closed, the taxpayer shall annually complete and file any form or forms that shall be created by the Franchise Tax Board for the purposes of reporting any material transactions made with regard to the LOUTCA. These reporting requirements shall continue even if and after the taxpayer is no longer a resident and shall then be enforced as a legally binding contract with the state. Failure to file these annual forms shall be treated as a breach of contract and shall also be subject to the same penalties as failure to file income tax forms for residents who are required to file income tax forms. Upon the death of any taxpayer who has initiated a LOUTCA that has not been fully reconciled and closed, that taxpayer's estate and assigns shall be required to reconcile the LOUTCA so as to fully liquidate the accumulated tax claims and to then pay all tax owed on those liquidated tax claims, treating these claims as an unpaid tax liability of the taxpayer owed to the state.

Enforcement Mechanisms

At the most basic level, the potential revenue from a wealth tax is simply: Tax base = total wealth × top wealth share × (1 − evasion rate) (Saez & Zucman, 2020). Minimizing evasion rates is critical to realizing the full benefits of a wealth tax.

The French wealth tax provided that if a wealthy individual is audited and found to be noncompliant with the wealth tax requirements, they may be required to amend their tax returns for up to the last 10 years, depending on the type of noncompliance issue found (Garbinti et al., 2023). A study looking at European wealth taxes found that tax evasion through the use of offshore accounts was a major detriment, along with weak enforcement due to heavy reliance on self-reported assets, and this study recommends the use of a common reporting standard for offshore assets (Piketty et al., 2023).

Legislative Examples: Penalties

Legislation in Washington State would impose a penalty of either 30% or 50% for understating asset valuations, depending on the level of understatement or misstatement. The bill would also require audits of a percentage of wealthy taxpayers, with the required minimum ramping up from 10% in 2025 to 20% in 2027. Legislation in California would add claims, records, and statements made to comply with the proposed wealth tax's reporting requirements to the state's false claims act, which could result in civil action and treble damages for costs that the state incurs to recover penalties or damages when a false or fraudulent claim is made.

WASHINGTON
(2023 WA HB 1473/SB 5486)

Sec. 10. SUBSTANTIAL WEALTH TAX VALUATION UNDERSTATEMENT PENALTY IMPOSED.
(1) Except as otherwise provided in this section, if any portion of an underpayment of tax due under this chapter is due to a substantial wealth tax valuation understatement, there must be added to the tax an amount equal to:
(a) In the case of any substantial wealth tax valuation understatement that is a gross wealth tax valuation misstatement, 50 percent of the portion of the underpayment due to the valuation understatement; or
(b) In all other cases, 30 percent of the portion of the underpayment due to the valuation understatement.

(2) The penalty imposed under subsection (1) of this section does not apply unless the portion of the underpayment attributable to substantial wealth tax valuation understatements for the calendar year exceeds $5,000.

(3) The penalty imposed in this section is in addition to any other applicable penalties imposed under this chapter or chapter 82.32 RCW on the same tax due, except for the penalty imposed in RCW 82.32.090(7).

(4) For purposes of this section, the following definitions apply:

(a) "Gross wealth tax valuation misstatement" means the fair market value of any financial intangible assets reported on a return required by this chapter is 40 percent or less of the amount determined to be the correct amount of such fair market value.

(b) "Substantial wealth tax valuation understatement" means the fair market value of any financial intangible assets reported on a return required by this chapter is 65 percent or less of the amount determined to be the correct amount of such fair market value.

Sec. 11. ENFORCEMENT. Beginning in calendar year 2025, to the extent that sufficient funds are specifically appropriated for this purpose, the department must initiate audits of at least 10 percent of individuals who are registered with the department to pay the tax imposed in this chapter, increasing to 15 percent in calendar year 2026, and 20 percent in calendar year 2027 and thereafter.

This Washington State bill would also add the following language to the statutory section on tax avoidance:
Sec. 16. RCW 82.32.655 and 2010 1st sp.s. c 23 s 201 are each amended to read as follows:
[...]
(d) Arrangements through which a taxpayer attempts to avoid tax under chapter 84A.--- RCW (the new chapter created in section 21 of this act) through intentional deception, such as by concealing assets or evidence of the location of the taxpayer's domicile in this state, by transferring assets prior to December 31st when the taxpayer effectively retained control of the assets, or by effectively converting taxable assets into nontaxable assets prior to December 31st when the taxpayer engages in a substantially offsetting transaction. This subsection (3)(d) does not apply to substantial wealth tax valuation understatements subject to the penalty in section 10 of this act.

CALIFORNIA
(2023 CA AB 259)

12651. (f) (1) This section shall apply to claims, records, or statements made under Part 27 (commencing with Section 50300) of Division 2 of the Revenue and Taxation Code only if the damages pleaded in the action exceed two hundred thousand dollars ($200,000).

(2) For purposes of this subdivision only, "person" has the same meaning as that term is defined in Section 17007 of the Revenue and Taxation Code.

(3) The Attorney General or prosecuting authority shall consult with the taxing authorities to whom the claim, record, or statement was submitted prior to filing or intervening in any action under this article that is based on the filing of false claims, records, or statements made under the Revenue and Taxation Code.

(4) Notwithstanding Section 19542 of the Revenue and Taxation Code or any other law, the Attorney General or prosecuting authority, but not the qui tam plaintiff, is hereby authorized to obtain otherwise confidential records relating to taxes, fees, surcharges, or other obligations under the Revenue and Taxation Code needed to investigate or prosecute suspected violations of this subdivision from state and local taxing and other governmental authorities in possession of such information and records, and such

authorities are hereby authorized to make those disclosures. The taxing and other governmental authorities shall not provide federal tax information without authorization from the Internal Revenue Service.

(5) Any information received pursuant to paragraphs (3) and (4) shall be kept confidential except as necessary to investigate and prosecute suspected violations of this subdivision.

(6) This subdivision does not and shall not be construed to have retroactive application to any claims, records, or statements made under the Revenue and Taxation Code before January 1, 2024.

Withholding Model Enforcement

The unrealized capital gains tax withholding model could potentially reduce the risk of undervaluing financial assets, as this valuation could provide a future tax credit (Saez & Zucman, 2020). Enforcement could be supported by requiring financial institutions and private businesses to disclose relevant purchase prices and market value estimates, as well as valuing financial assets separately from business operations and assets held indirectly through private businesses, which could limit the risk of tax avoidance through shell corporations (Saez et al., 2021).

Another major benefit of this model for state tax collection is that it reduces "wealth flight," which is more likely after retirement, as wealthy individuals would not be able to avoid paying taxes on their unrealized capital gains during "productive years" and then retire to a state with no income tax to avoid paying taxes on realized capital gains (Saez et al., 2021). Additionally, the tax withholding allowance would presumably only be useful for individuals who realize their capital gains in a state with a similar withholding tax system (Saez et al., 2021). This may mean that an interstate agreement or compact will become an important tool to avoid double taxation and to support cross-state retirement/establishment of residency.

Note on Wealth Flight

"It is possible that the tax could encourage successful entrepreneurs to leave early to avoid the tax. For example, a [California] billionaire might decide to move to Florida now to avoid paying the withholding annual 1% tax on his accumulated gains (instead of moving to Florida later before realizing capital gains). However, it is difficult to move while you are still running a business (and moving the headquarters of the business is much more difficult). Therefore, mobility risk is most important for retired billionaires." (Saez et al., 2021)

An analysis by the Center on Budget and Policy Priorities on interstate migration data and academic studies found the following:

- Large numbers of households — including high-income households — move into higher-tax states every year.
- Highly educated and high-income households in higher-tax states are not disproportionately moving to no-income-tax states.
- State income tax cuts for high-income people haven't meaningfully boosted in-migration.
- State income tax increases for wealthy people have not led to substantial numbers of them moving to lower-tax states, certainly not enough to result in eroding more than a small fraction of the revenue the tax increases generated.
- The most comprehensive nationwide study of millionaire migration ever conducted concluded that "millionaire tax flight is occurring, but only at the margins of statistical and socioeconomic significance."

CONCLUSION

A state tax on unrealized capital gains is a relatively new proposal in the U.S., but not globally, and academic experts have analyzed the strengths and weaknesses of various wealth tax models and developed innovative mechanisms to address some of the greatest challenges to practical implementation and political viability. These lessons can provide state policymakers with a starting point for policy design, but as "laboratories of democracy," state legislatures should prioritize both collaborating with their communities and fostering a spirit of experimenting with, evaluating, and improving their state's tax revenue laws.

The **State Innovation Exchange (SiX)** exists to advance a bold, people-centered policy vision in every state in this nation by helping vision-aligned state legislators succeed after they are elected. If you are working to strengthen our democracy, fight for working families, advance reproductive freedom, defend civil rights and liberties, or protect the environment, **reach out to helpdesk@stateinnovation.org** to learn more about SiX's tailored policy, communications, and strategy support and how to join this network of like-minded state legislators from across the country.

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