

# Restoring Democracy Through Tax Policy

REPORT BY JEREMY BEARER-FRIEND  
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## ABOUT THE GREAT DEMOCRACY INITIATIVE

The Great Democracy Initiative develops policy blueprints that offer solutions to the most pressing problems of our time. From taming the concentration of power in our economy to fundamentally reforming our broken government, GDI aims to generate policy ideas that confront the forces that have rigged our society in favor of the powerful and connected.

## ABOUT THE AUTHOR

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# Introduction

Closing tax loopholes has long been a central priority for both center-left and progressive tax policy proposals.<sup>1</sup> This approach provides an appealing messaging strategy by focusing on tax cheaters and by prioritizing incremental change. It is also necessarily inadequate. While closing loopholes is by no means detrimental, designing a tax platform around tax loopholes is insufficient to achieve progressive policy priorities: It's inherently reactive and small in scale. A preoccupation with legislative fixes to loopholes also creates the negative inference that our tax administrators are not positioned to close loopholes on their own, shifting responsibility for loophole closing away from the Treasury Department while consuming scarce room on the congressional tax agenda.

Repealing the so-called Tax Cuts and Jobs Act (TCJA) of 2017 is also insufficient as a progressive tax platform.<sup>2</sup> While there are many elements of TCJA that should be repealed, the pre-TCJA baseline was no promised land; inequality was already rampant prior to TCJA, our infrastructure was already crumbling, and the federal government was failing to provide basic services to the American people. The deep pockets of concentrated wealth left outside of our tax base prior to TCJA also produced political inequality. Indeed, the passage of TCJA is a natural consequence of these pre-TCJA trends: wealth concentration enabled by a broken tax code allowed huge businesses and their owners to further tilt tax policy in their favor, compounding their wealth and political power even further. Meanwhile, middle class workers continued to see themselves shut out of both the political process and the purportedly growing economy.

An alternative approach to loophole closing or TCJA repeal is to view tax policy as central to restoring our democracy. To the extent rising inequality and the collapse of the middle class is a threat to our Constitution and the values it enshrines, tax policy offers a direct answer to this crisis.<sup>3</sup> More than just closing tax loopholes or repealing fly-by-night tax giveaways to the rich, tax policy can be central to the functioning of our democracy by rebuilding the middle class and reviving the full potential of our public institutions.

This report proposes a suite of tax policies to put forth an affirmative vision of tax policy. These proposals are rooted in four principles:

1. Taxpaying is a civic act that shapes a citizen's relationship to their government. The fiscal citizenship embodied in taxpaying in turn offers clear priorities for tax policy and also clear standards.
2. Tax policy should value hard work and empower workers relative to holders (and hoarders) of capital. Our current tax code privileges capital over labor, derived from economic theories that treat the optimal tax rate on capital as zero. This report rejects tax preferences for capital over working people.
3. Tax policy has enormous regulatory potential that has yet to be realized. Taxes can be used to increase worker bargaining power, improve democratic accountability, and combat monopolies.
4. Tax proposals need to match the scale of our vision. Building a just society with opportunity and economic security for all will require a reinvigoration of public funding at the scale of the New Deal.<sup>4</sup>

Consistent with these principles, this report is organized as follows. First, tax policy must level the playing field between workers and holders of capital. This requires taxing limited liability, removing preferential tax rates on investment income, ending inequality for tax withholding, and enacting a national wealth tax. Second, tax policy should embrace the regulatory potential of the taxing power by removing subsidies for monopolies, ending tax preferences for multinationals relative to domestic businesses, and empowering agencies to institute Pigouvian taxes. Third, tax policy should restore civic identity by improving the experience of taxpaying, improving tax data transparency, and reviving the use of federal trust funds.

# I. Level Playing Field Between Workers and Investors

This section provides alternatives to our current tax policy status quo of putting investors before workers. It is motivated by the widely recognized arc of our economy, in which economic growth has been decoupled from wage growth.<sup>5</sup> The unraveling of the middle class in the midst of record economic growth forces us to reconsider tax preferences for investors that allegedly grow the economy—we cannot expect these tax preferences to also benefit households outside the top of the income ladder. This makes the forgone revenue of preferred rates on passive investment income less defensible since these tax giveaways also prevent investment in institutions known to create shared prosperity, such as infrastructure and education. The ongoing decline of our middle class also makes clear that the economic benefits of not taxing capital appear speculative, while the fairness implications of offering preferred tax rates to billionaires over middle class workers is immediate and unambiguous.

## A. TAX LIMITED LIABILITY

The US has taxed businesses as separate from their owners since the Civil War, when the income tax was applied to firms in addition to high-income individuals.<sup>6</sup> While this approach continues to this day through the corporate income tax, the corporate tax base has substantially diminished as a share of federal revenue since its peak in the 1950s.<sup>7</sup> Innovations in legal form, including the creation of limited liability companies (LLCs) in the late 70s, have chipped away at the corporate tax base. These new firms granted business owners protections from creditors and litigants while allowing firms to elect out of corporate tax treatment. Today, more than 50 percent of all business income is earned through pass-through entities, including LLCs. As commercial enterprises evolved, tax policy failed to catch up.

There are multiple justifications for entity-level taxes. First, a principle of tax eclecticism allows tax rates to be lower on each specific taxable base by diversifying the risk of tax avoidance across multiple revenue baskets.<sup>8</sup> Second, entity-level taxes serve as a backstop for the individual income tax, preventing wealthy taxpayers from sheltering their income in more tax favorable instruments.<sup>9</sup> Third, the corporate tax also protects democratic values by serving as a regulatory device to counteract the unbridled powers of large businesses.<sup>10</sup> Firms have enormous influence over our democracy and this

influence is as true for LLCs as other business enterprises. Lastly, an entity-level tax reflects the benefits of limited liability enjoyed by corporate shareholders and LLC members; the benefits of limited liability should come with a price. Any one of these justifications is sufficient to embrace entity-level taxes on firms.

## **The corporate tax also protects democratic values by serving as a regulatory device to counteract the unbridled powers of large businesses.**

Critics of taxing limited liability often point to the effect on small businesses and workers, but taxing limited liability does not necessarily require higher effective tax rates on small businesses. First, many pass-through businesses are not actually small businesses. Private-equity firms, for example, are typically structured as pass-through entities and enjoy the tax benefits of pass-through tax treatment. We could also easily lengthen the rate structures for businesses to create different brackets for the genuinely small pass-through businesses that would now be under the umbrella of an entity-level tax. Indeed, our corporate income tax already included differentiated tax brackets for over a century, beginning with exemption amounts for low amounts of corporate income in the 19th century and replacing them with lower rate brackets in the 1930s.<sup>11</sup> TCJA removed the lower tax rate brackets for C-corporations to impose a flat rate on all corporate income, so that even small firms with low-incomes would pay the same rate as large conglomerates. The reduced tax rates on lower brackets could also be clawed back for larger firms through phaseouts, so that high-income companies would not benefit from the lower brackets and reducing the appeal of sheltering individual income in corporate form.<sup>12</sup> A surtax on undistributed profits, combined with anti-abuse rules, would prevent tax avoidance through misuse of the lower brackets. A bracket structure for entity-level taxes would improve the political viability of taxing limited liability, so that most small business owners would not face the same liability as giant multinationals. Alternatively, a standard business deduction for firms could function as a zero bracket for a portion of the income from small businesses.<sup>13</sup>

A tax on limited liability is unlikely to be passed on to workers through lower wages. A review of the economic literature on corporate tax incidence shows no conclusive impact on wages from entity-level taxes.<sup>14</sup> More recently, TCJA's \$1.4 trillion giveaway in corporate tax rate cuts<sup>15</sup> has not yielded wage gains, but it did produce record returns to investors through stock buybacks.<sup>16</sup> Expanding the corporate tax revenue base to include limited liability would increase revenue without impacting wages or stunting small businesses.

## Policy proposals:

- Amend Internal Revenue Code (IRC) § 7701 to include Limited Liability Companies and Limited Liability Partnerships as corporations for corporate income tax purposes;
- Repeal subchapter S of Internal Revenue Code, so that entity-level tax applied to all incorporated firms whose owners enjoy limited liability; and
- Amend IRC § 11 to revive the corporate income tax rate schedule prior to TCJA, including lower tax brackets within the corporate tax rate schedule that phaseout benefits of a lower bracket for higher incomes. Alternatively, allowing small firms with limited liability to claim a standard business deduction would have a similar impact on effective tax rates for small businesses while also simplifying tax filing requirements for small businesses.<sup>17</sup>

## B. REMOVE PREFERENTIAL TAX RATES FOR INVESTORS OVER WORKERS

Middle class workers face substantially higher marginal tax rates than billionaire investors. This is due, in part, to preferential tax rates on long-term capital gains and qualified dividends. Tilting tax policy to investors over workers violates basic principles of fairness and should be rejected whole cloth.

The contorted logic for arguing that taxing capital at the same rate as labor would also hurt workers is the claim that investment choices are more sensitive to tax rates than labor choices, and thus tax rates on investment will either deter investment necessary for economic growth or simply be passed on to workers through lower wages. In short, workers have no choice to work, but capital is mobile. The best rejoinder to this faulty logic is our own economy. For many years, the income tax rate on capital was not lower than the income tax rate on labor; real investment in the U.S. was uncorrelated with capital gain tax rates.<sup>18</sup> Economic growth has also been decoupled from wage growth for over a generation, raising doubts that the benefits enjoyed by investors ever trickle down to the majority of workers. We also have substantial reason to believe that much of the income reported as capital gains at the top of the income distribution is actually labor income—unlike rank and file workers, economic elites have the means to structure their compensation in more tax-favorable ways.<sup>19</sup>

Beyond this historical record, the most relevant counterfactual to evaluate our tax policy choices is not simply an otherwise equivalent world with and without a fair tax rate on capital, but a world with higher tax rates on capital that *also* includes the public investments that taxes afford and a world without such investments. Return on investment in an economy is driven not only by the tax rate, but also by the stability of the economy through effective regulation; the rule of law and its attendant protections of property rights; infrastructure to bring products, consumers, and workers to market; and, a healthy, educated workforce that can efficiently produce desirable goods. Rampant inequality between workers and holders of capital undermine each of these features of our economy.

### **Tilting tax policy to investors over workers violates basic principles of fairness and should be rejected whole cloth.**

A fair tax rate on investment income will also require cleaning up the realization rules under our current tax code. These realization rules allow investors to control the timing of tax liability, sometimes avoiding taxes altogether by holding assets until death or simply borrowing against the value of their assets. But fixing these challenges should not delay the immediate change to our tax rates. We can easily fix the tax rate differential on capital first, and to the extent we see capital lock-in effects in specific industries or asset types, policymakers can address lock-in as it arises.

#### **Policy proposals:**

- Amend IRC § 1, so that tax rates on capital gains are the same as tax rates on labor income;
- Amend IRC § 1, so that tax rates on qualified dividends are the same as tax rates on labor income; and
- Repeal basis step-up in death under IRC § 1014 and treat basis in assets transferred at death under carryover basis rules provided for assets transferred as gifts under IRC § 1015.

## C. END WITHHOLDING INEQUALITY BETWEEN INVESTORS AND WORKERS

Tax rates are not the only form of inequality between business income and wage income. Our tax administration also privileges holders of capital over wage earners through the asymmetric design of federal tax remittance. Under current law, employers withhold income tax liability from workers' paychecks, leaving it up to workers to modify their allowances or claim a refund at the end of the year. Holders of capital—whether receiving dividends, interest payments, or distributions from a trust or partnership—generally do not have income tax withheld by the party distributing funds. This mismatch in withholding rules, which allows delayed remittance for holders of capital, is unjustified. It is another example of how today's tax code is skewed to serve investors over workers.

The appeal of withholding as a mechanism for revenue collection is twofold: First, the agent responsible for withholding tax from another's income will face consequences for failure to withhold without enjoying the benefits of under-withholding, thus improving tax compliance; second, withholding dampens the salience of taxpaying, reducing impact on tax morale and tax noncompliance. Withholding is distinct from third party reporting, where the Internal Revenue Service (IRS) is informed by a third party of a potential tax liability but remittance is not required by the third party. Third party reporting is the primary means by which holders of capital have distributions reported to the IRS. The compliance rates for withholding are higher than the compliance rates for third party reporting.<sup>20</sup>

It is time to close the gap between tax remittance of labor income, where taxes are typically withheld, and tax remittance of income paid to investors, where taxes generally are not withheld. We should reject our remittance status quo by making withholding the default form of remittance for pass-through income earned through S Corps, LLCs, and partnerships. This approach could also be broadened to distributions from trusts and payments of dividends or interest. Under this new proposal, trusts would be the withholding agents for their beneficiaries, partnerships would be withholding agents for partners, LLCs would be withholding agents for members, and corporations would be withholding agents for dividends distributed to shareholders. And just like wage withholding, to the extent that investment income is over-withheld, an investor can apply for a refund for the balance at the end of the year.

Expanding withholding would help improve our annual tax gap of \$450 billion—the estimated revenue that would be collected if we had full compliance with the tax laws already on the books.<sup>21</sup> According to the IRS, “the net misreporting percentage for income amounts subject to substantial information reporting and withholding is 1 percent, for income amounts subject to substantial information reporting but not withholding is 7 percent.”<sup>22</sup> Expanded withholding also satisfies basic fairness principles of a common compliance burden for labor and capital income. Additionally, withholding by pass-through entities would shed light on the unclassifiable partners and circular flow of funds identified by the Treasury Department as compromising 35 percent of pass-through income.<sup>23</sup>

### **Policy proposals:**

- Amend IRC Subchapter K, so that a partnerships’ tax matters partner is the income tax withholding agent for distributions from the partnership to partners at a fixed rate of 30 percent;
- Amend IRC Subchapter J, so that fiduciaries serve as withholding agents for both the grantors and beneficiaries of trusts at a fixed rate of 30 percent;
- Amend IRC § 311 to make corporations withholding agents for dividends at a fixed rate of 30 percent, modeled after backup withholding under IRC § 3406 and withholding required of foreign shareholders in non-FATCA compliant jurisdictions; and
- In each of the new withholding regimes, allow investors to apply for a refund for any amount over-withheld, just like workers must apply for a refund for wage income that is over-withheld. Since most investors already file a tax return annually, this should not create a substantially new filing burden.

## **D. TAX DYNASTIES MORE EFFECTIVELY THROUGH FEDERAL WEALTH AND TRANSFER TAXES**

The harrowing accumulation of wealth in the pockets of the few, simultaneous with the decline in marginal tax rates on the income of billionaires, has been at the expense of the many: massive deficits getting pushed to future generations; exorbitant student loan interest rates used as profits to subsidize falling government investment; slashed access to Medicaid and Veterans Affairs benefits; concentrated political power of economic elites. These are only a few of the consequence of a low- to no-taxed plutocracy.

Removing passive holders of capital, and, in particular, hoarders of capital, from their tax policy pedestal creates entirely new revenue sources. Rentiers who profit from passive investments inherited from others should not enjoy tax-free luxuries. Under current law, however, billionaires can achieve tax-free consumption by borrowing against their assets to gain liquidity without income tax liability on their debt-financed purchases.<sup>24</sup> While consumption taxes are one option to quelling tax-free aristocracy, a federal wealth tax offers a more direct solution without folding in low- and middle-income taxpayers. A federal wealth tax also removes the incentives for, and current scale of, dynasties and wealth hoarding. Additionally, a wealth tax can be blended with our current income tax structure by setting income tax rate brackets based on net worth.

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Taxpayers are already familiar with wealth taxes in the form of property taxes. Every state and the District of Columbia have property taxes, though the rates vary.<sup>25</sup> Many traditionally conservative states also have capital stock taxes. This annual, low-rate tax (below 1 percent) on capital stock applies at the firm level to the net worth of businesses.<sup>26</sup> While the constitutionality of a federal wealth tax has a checkered legacy dating back to the Supreme Court's *Pollock* decision in 1895, the constitutional limitations on federal wealth taxes are less conclusive than commonly assumed, and a federal wealth tax is likely viable without constitutional amendment.<sup>27</sup>

Beyond adopting new direct taxes on wealth, the income tax can also be strengthened to address tax abuses by the rich. Wealthy individuals should no longer be allowed to enjoy the political cachet of purported charitable contributions that are, in fact, only tax avoidance schemes. Donor advised funds (DAFs) allow the wealthy to claim all the tax advantages of charitable contributions before even a penny has been spent on a charitable cause. Unlike private foundations, these funds have no payout requirements and have become an attractive vehicle for billionaires to reduce income tax liability while posturing as philanthropists.<sup>28</sup> DAFs further compound current levels of inequality by preserving the political influence of the wealthy and stymying calls for federal wealth taxes.

Transfer taxes are also an opportunity to deter dynastic wealth—a growing feature of our economy that vests political power in the few who inherit at the expense of everyone else. By improving the tax treatment of transferred fortunes, in addition to taxing the accumulation of wealth prior to bequests, our tax code can help restore our democracy. First, weak rules for trust arrangements allow the wealthy to easily evade the estate tax. These can and should be fixed. Second, shifting the estate tax to the heirs of a fortune rather than the deceased would improve the political palatability of today's tax treatment of dynasties. Under current federal law, an estate tax is applied to assets held by the deceased above a shockingly high exemption amount. Under an inheritance tax, tax liability would be determined by the value of the amount received by the living, encouraging donors to divide their fortunes since tax liability is assessed on the amount of advantage passively received. A federal reform could be modeled off of the states that already have an inheritance tax, including Iowa, Maryland, New Jersey, and Pennsylvania.

From taxing wealth directly, to removing income tax advantages to the wealthy, to improving how we tax the transfer of wealth, our tax code can remove the political advantages granted to the barons of our new Gilded Age.

### **Policy proposals:**

- Continue to treat income as the taxable base, but apply tax rates based on wealth rather than income to better reflect ability to pay,<sup>29</sup> or enact federal net worth tax inspired by the capital stock taxes in Southeastern states, with a rate of .25 percent on net worth of individuals based on the median rate across 16 states who apply such a tax to businesses;
- End the sham of DAFs, which allow the wealthy to avoid both income and estate tax liabilities, by repealing relevant portions of IRC § 4966;
- Modify transfer tax rules for grantor-retained annuity trusts;<sup>30</sup> and
- Replace the estate tax on decedents with an inheritance tax on heirs.<sup>31</sup>

## II. Revive Regulatory Potential of the Taxing Power

The use of tax policy as a regulatory device under current law relies almost exclusively on one side of the ledger: We give away tax subsidies for behavior that Congress finds favorable, but we rarely add additional tax liability to predatory or undesirable activities. This section describes opportunities to increase costs for activities that undermine progressive policy priorities, while simultaneously raising much-needed revenue.

### A. END TAX SUBSIDIES FOR MONOPOLY

The United States has entered a new era of market concentration, putting taxpayers at the mercy of rent seekers for basic necessities, such as food, utilities, health insurance, and financial services.<sup>32</sup> Unchecked market concentration increases prices for consumers, decreases product innovation, depresses worker bargaining power, and undermines our democratic institutions, among other concerns. While the federal tax code is a key policy lever for shaping the competitiveness of our economy, tax policy has been relatively ignored as a driver of current levels of market concentration—and as a possible remedy to it. For example, proposals to revise our corporate reorganization rules have been standalone proposals disconnected from concerns about competitive markets.<sup>33</sup> Many proposed interventions to monopoly power also ignore tax policy.

Multiple tax incentives for monopoly exist under current law. Tax-free reorganizations allow one company to acquire another company without the IRS recognizing any gain from the sale. Shareholders of the acquired firm defer all gain until a later sale of their newly acquired stock. To the extent that there is a time value of money, the deferred tax liability subsidizes acquisitive mergers that use stock as consideration. Tax preferences for debt also subsidize the enormous acquisition costs that accompany merger activity. While TCJA placed new limits on interest expense deductions, the deductibility of interest expense for acquisitive mergers could be eliminated altogether.

Congress should remove tax incentives for market concentration by reforming tax-free reorganization rules, extending tax claw-backs for post-spin off acquisitions under current device period limitations, and capping interest deductions for leveraged acquisitions. New taxes on monopolies are also necessary to address existing levels

of market concentration, since removing current incentives won't undo past merger activity. Excess profits taxes have consistently been used to tax returns to capital that exceed normal returns. These excess returns suggest unearned windfalls or coercive profiteering. In the past, companies that leveraged wartime demands in steel were subject to excess profit taxes in steel. Such excess profit taxes could be applied to firms whose market concentration surpass statutory benchmarks.

## Policy proposals

- Repeal acquisitive reorg-rules under IRC § 368, so that all stock deals are taxable. Merger activity is already taxed for cash and asset deals, so this removes distortionary tax planning, while also removing tax incentives for merger activity;
- Amend IRC § 163(j) to cap interest deductions for debt used on acquisition costs. Cap could be limited to a flat dollar amount, so that smaller firms can still rely on the deduction and only the more problematic transactions would be impacted;
- Codify and extend device period limitations under IRC § 355, so that spin-offs cannot be easily reacquired without tax liability; and
- Modernize excess profits tax to tax monopoly firms' windfall profits. Eligibility requirements for the tax could include the percent of market share that the company holds in its industry.

## B. EMBRACE THE TAXING POWER OF FEDERAL AGENCIES TO DETER UNWANTED BEHAVIOR

The Internal Revenue Code is not the only available means for using federal taxes to improve market outcomes. Federal agencies also have various statutory authority to impose taxes that would internalize costs on market participants that are otherwise passed on to citizens without consequence for those responsible. For example, taxing authority is available under the Clean Air Act, Clean Water Act, the Securities Exchange Act, and the Occupational Safety and Health Act.<sup>34</sup> Agencies may also be better positioned to impose Pigouvian taxes than the current gridlock of Congress.

## Policy proposals:

- The Office of Management and Budget (OMB) should conduct a review of each executive branch agency's statutory authority to impose Pigouvian taxes; and
- The Environmental Protection Agency (EPA), Securities and Exchange Commission (SEC), and Department of Labor (DOL) should assert trial rounds of Pigouvian taxes to test constitutionality of underutilized taxing powers.

## C. END TAX PREFERENCES FOR MULTINATIONALS RELATIVE TO DOMESTIC BUSINESSES

Offshoring has ravaged much of our country and continues to contribute to staggering levels of inequality. This is partially due to disastrous trade policies that rewarded shareholders over workers, but our tax code has also fueled rust belt blight. Both before and after TCJA, our code has offered preferential tax rates to companies who stuff profits and jobs overseas. Correcting the failures of our international tax policies is not just about new revenue, it is also about restoring opportunity across our economy. Tax preferences for multinationals at the expense of domestic workers and domestic competitors must end.

**Correcting the failures of our international tax policies is not just about new revenue, it is also about restoring opportunity across our economy.**

First, today's international tax agenda should prioritize overhauling our bilateral tax treaties, with a presumption that leaving a treaty is preferable to tweaking it until proven otherwise. Our current tax treaty network has enabled double non-taxation of multinational firms, who can use treaty benefits to minimize tax in multiple jurisdictions.<sup>35</sup> There is also minimal credible evidence that these tax treaties have led to an increase in direct investment that otherwise would not occur but for the treaty.<sup>36</sup> Tax treaties also stand outside traditional tax reform opportunities given the idiosyncrasies of treaty ratification—a lag in responsiveness that allows tax planners an added advantage in the inevitable whack-a-mole of tax enforcement.<sup>37</sup>

Second, the tax rates included in TCJA to address cross-border profit shifting by multinationals should be increased, so that effective tax rates for foreign-source income are not preferential compared to tax rates on domestic business. Local firms cannot compete against rivals who are able to lower their costs through international tax planning, and the tax code should not be rewarding outsourcing of economic activity to foreign jurisdictions through tax advantages. TCJA's base erosion and anti-abuse tax rate (BEAT) should be increased and the 50% deduction allowed against global intangible low-tax income (GILTI) should be repealed.

Third, we should empower the public to hold multinational companies accountable for tax dodging by requiring country-by-country (CbC) tax reporting to be made public.<sup>38</sup> Companies are already preparing CbC reports for tax authorities, but public disclosure would allow advocates to hold companies accountable for their international tax schemes. It might also build political will to improve tax enforcement or, if necessary, new tax legislation.

### **Policy proposals:**

- Overhaul U.S. approach to double tax treaties by beginning with a presumption against remaining in a tax treaty unless compelling evidence to simply reform;
- Increase TJCA BEAT rate and repeal the 50% GILTI deduction, so effective tax rates on foreign-source income commensurate with U.S.-source income of domestic firms; and
- Require public disclosure of CbC reporting by multinationals.

## III. Restoring Civic Identity Through Taxpaying

Taxpaying is a civic act that shapes a citizen's relationship to her government. Taxpaying is also a point of civic pride amongst many individuals who view their contributions as entitling their political voice. This section elaborates on the policy proposals that result from viewing taxpaying as an opportunity to improve taxpayer perceptions of government and empower civic participation.

### A. STREAMLINE TAX FILING

Negative tax filing experiences further alienate taxpayers from the federal government. Despite being required to file taxes, taxpayers are thrown into a confusing and expensive tax filing process. One survey found that taxpayers spend, on average, 17 hours on their taxes.<sup>39</sup> The IRS's own estimate is 13 hours.<sup>40</sup> The difficulty of tax filing has been to the enormous financial benefit of tax filing preparation companies. National tax preparation chains charge an average of \$400 for returns claiming the Earned Income Tax Credit (EITC).<sup>41</sup> The expensive and time-consuming tax filing process erodes confidence in government and skims off much-needed tax benefits to private companies. Fortunately, the difficulty of tax filing can be easily remedied.

Under current law, individual wage data is submitted to the Social Security Administration for collection of withholding liabilities, then shared with the IRS. The IRS also receives third-party reporting of withheld taxes from employers. These data could be pre-populated on the tax returns provided to tax filers earning wage income. Pre-population of tax returns could be further expanded to additional categories of third-party reporting, such as 1099 income. The IRS could also provide all taxpayers with a free, online tax filing software. This software could be piloted with federal employees, including military personnel, and expanded to broader access over time.

The history of IRS discretion over tax filing also plots a new path for what could be done in the absence of new legislation to amend the tax code. For example, during the early advent of third-party reporting, wage earners below a certain income threshold merely needed to send in a copy of their W-2 to the IRS rather than fill out a tax return. The IRS has also been directed by Congress to develop procedures for a return-free filing, an obligation that has gone unfulfilled.<sup>42</sup> Whether in partnership with Congress or pursued independently, tax filing could be both cheaper and easier for American taxpayers.

## Policy proposals:

- The IRS should provide all individual income tax filers a free, online public platform for electronic filing. Taxpayers should still be able to elect private return preparers if they choose, but this should not prevent all filers from access to a free, publicly maintained tax filing platform online;
- The IRS should pre-populate federal income tax returns with information the agency already has on file about a taxpayer's liability. This should first be piloted with wage data and then expand to data from prior returns (e.g., number of dependents) and other third-party reported information (e.g., 1099 income); and
- The IRS should pilot return-free filing with federal employees, including military personnel, who elect to participate.

## B. IMPROVE TAX DATA TRANSPARENCY TO ROOT OUT RACIAL DISCRIMINATION IN TAX POLICY

The U.S. Treasury receives over \$1.5 trillion in individual income tax revenue per year from 150 million tax returns.<sup>43</sup> Many of these income tax filers also receive federal benefits through their tax returns, including the EITC and the mortgage interest deduction. One estimate of these benefits is that nearly one third of all social safety net spending in the U.S. is made through our tax code.<sup>44</sup> Substantial benefits are also meted out through our tax laws outside traditional safety net spending, such as preferential tax rates on investment income through lower capital gains rates.<sup>45</sup>

Despite our vast reliance on tax policy to distribute public benefits, federal tax data do not include basic descriptive statistics on race and ethnicity. The IRS, Treasury, and Joint Committee on Taxation have omitted race and ethnicity from the statistical analysis of tax data for over a century. These omissions are exceptional relative to other areas of public policy where federal data on race and ethnicity are readily available, such as student achievement or health care exchange enrollments.

Colorblind tax data prevent voters, elected officials, and tax administrators from knowing where tax dollars come from and where tax expenditures are spent. Colorblind tax data also impede both the identification and remedy of racial inequality in the design, execution, and impact of tax policy. We have substantial reason to believe that racial inequality is embedded in the design of our tax code and that there is a longstanding, disparate distribution of tax benefits by racial group. For example,

preferential tax rates on qualified dividends inures to only a small subset of taxpayers, as does the mortgage interest deduction.<sup>46</sup> Tax data transparency would expose racially targeted tax preferences and allow both policymakers and advocates to root out racial inequality in the design and administration of federal tax policy. Tax administrators should also be able to certify to the public that tax enforcement actions, such as audits, settlements, and collections, do not vary by the race or ethnicity of a taxpayer.

## **Tax data transparency would expose racially targeted tax preferences and allow both policymakers and advocates to root out racial inequality in the design and administration of federal tax policy.**

### **Policy proposals:**

- Expand tax questions on non-tax surveys, so that survey data include superior tax information without requiring the IRS to ask about race or ethnicity. For example, the Annual Social and Economic Supplement of the Current Population Survey, conducted by the Census Bureau, or the Survey of Consumer Finances, conducted by the Federal Reserve, could include all items from the 1040;
- Set quotas for tax data analysis on race and ethnicity at the Statistics of Income Division of the IRS. This could be done through a proportion of full-time equivalent staff hours going towards research that includes race and ethnicity; a minimum number of academic partnerships that will include race and ethnicity in the data analysis; or a number of annual data publications to include race and ethnicity. The IRS could also explicitly integrate research priorities on race and ethnicity into the standards for evaluating applicants seeking to partnership with the IRS for data access;
- Amend 13 USC 9 to allow de-identified Census data to be used for statistical purposes by the U.S. Treasury Department and amend IRC Subtitle F to clarify that all data received from the Census is for statistical purposes only and cannot be used for individual tax assessment;
- Issue an Executive Order specifying the application of Title VI of the Civil Rights Act of 1964 to tax expenditures administered by the U.S. Treasury Department; and
- Require the IRS Commissioner to document, in consultation with Office of the Taxpayer Advocate and the Department of Justice (DOJ) Office of Civil Rights, that tax enforcement actions do not vary by race or ethnicity. This analysis should include IRS Chief Counsel settlement rates and amounts.

## C. REVIVE FEDERAL TRUST FUNDS AT SCALE OF NEW DEAL

The popularity of a tax can be tied to the popularity of the public good that the tax finances.<sup>47</sup> To the extent that government at large is untrustworthy or unpopular, a tax financing the federal government at large also becomes all the more unfavorable. The estate tax, for example, is imposed on vanishingly few taxpayers and also funds diffuse federal expenditures. The gas tax is paid by a much broader base of taxpayers and funds the Highway Trust Fund. Calls to repeal the estate tax are routine; gas tax repeal is nearly absent from the U.S. political agenda. While the vested interests in repealing the estate tax are surely part of this political priority, estate tax repeal has traction because the costs of repeal are hidden from the public—they have little confidence that public dollars are put to use in ways that they value. This makes it far easier to ignore, or even celebrate, the consequences of reduced federal tax revenue.

A new commitment to public trust funds would improve the transparency of taxpaying by revealing to taxpayers how their contributions will be spent. Public trust funds that finance popular public goods can also improve the popularity of the tax used to fund them. Taxpayers are more likely to express pride in their own contributions when they agree with how tax dollars are spent. A new era of public trust funds paired with popular expenditures could reinvigorate support for investment in public institutions.

While some of the taxes that fund trust funds receive legitimate criticisms as regressive taxes, such as the gas tax, trust funds can achieve redistribution goals in multiple ways. First, distributions from the trust fund can counteract regressive features of tax liability. For example, although payments to the Social Security trust fund are regressive (in that they phase out for higher income taxpayers), payments to beneficiaries, by substantially subsidizing low-income contributors relative to high-income ones, are progressive. Trust funds also need not be based on user fees. For example, a financial transaction tax could be dedicated to an affordable housing trust fund or a universal family leave trust fund. The political constituencies who would mobilize to protect the longevity of the trust fund are thus distinct from those remitting payments to the fund.

### Policy proposals:

- Pair new tax proposals with new trust funds that fund targeted, equal opportunity initiatives at the scale of the New Deal. These trust funds could be financed through such new taxes as a financial transaction tax, a carbon tax, or a federal wealth tax.

# Conclusion

If economic inequality is undermining our democracy, then tax policy is the most direct instrument we have to repair it. By undoing current levels of inequality, our tax code helps fulfil the promise of equal political voice and equal opportunity for all. To do this, progressives must be willing to move beyond loophole closers to assert a new, affirmative vision for tax policy. This report offers such a vision—one that puts workers before holders of capital, revives the regulatory potential of tax policy, and treats taxpaying as a civic act. Together, these proposals can help restore our democracy.

# Endnotes

- 1 For example, *tax relief, tax cuts, and loophole closers* are organizing themes across past presidential budget proposals (available here: [https://www.treasury.gov/resource-center/tax-policy/Pages/general\\_explanation.aspx](https://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx)) and presidential platforms (available here: <https://www.hillaryclinton.com/issues/a-fair-tax-system/>). This is distinct from expanding the tax base through a new federal wealth tax or ending preferential tax rates on passive income.
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- 3 Ganesh Sitaraman, *The Crisis of the Middle-Class Constitution: Why Economic Inequality Threatens Our Republic* (2017).
- 4 This is not to say that all spending proposals must satisfy arcane budget rules that treat capital expenditures as revenue losers that require offsets. Rather, these tax proposals simply recognize that borrowing is only one component of financing a progressive agenda and that new tax revenue will also be part of any sustainable, long-term federal budget outlook.
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- 6 Revenue Act of 1861, 12 Stat. 292.
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