5 Considerations For Implementing A 70% Marginal Tax Rate

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January 10, 2019

Recent comments from Rep. Alexandria Ocasio-Cortez, D-N.Y., have sparked a debate about imposing a 70 percent marginal tax rate on income exceeding $10 million as a way to bring in additional revenue to fund various government programs.

Here, tax experts puzzle through the logistics of reimposing high marginal tax rates to raise revenue.

Distinguish Total Top Tax Rate From Top Federal Tax Rate

Ocasio-Cortez told CNN's Anderson Cooper during an interview Sunday that over 40 years ago, high-income earners were taxed at rates as high as 60 percent to 70 percent. However, it is important to distinguish the top total marginal tax rate — the highest rate that is incurred on each additional dollar and includes federal, state and local income taxes — from the top marginal income tax rate, which is just the federal income tax rate, according to Gillian Brunet, an economics professor at Wesleyan University.

“I think one distinction that’s been getting a lost in the discussion in the media is that all of the academic literature have talked about the total tax,” she said. “At one point, historically, the top income tax rate has more or less been a good proxy for top total on taxes because of deductibility of state taxes … but that’s not totally true anymore.”

Recent items such as the Tax Cuts and Jobs Act's $10,000 deduction cap on state and local taxes and the Affordable Care Act’s 3.8 percent surcharge for Medicare in 2010 have created a gap between the total tax rate and the federal income tax rate, Brunet explained. These two items impose extra marginal costs on the wealthy, she said.

The ACA’s 3.8 percent surcharge is called the net investment income tax, or NIIT, and is imposed by Section 1411 of the Internal Revenue Code, which applies the tax to individuals earning over $200,000 and to married filing jointly taxpayers earning over $250,000.

On that same note, the Tax Foundation in October said the benefits of the SALT deduction “overwhelmingly go to high-income earners.” Those in the top 1 percent would reap more than half of the total benefits if it was repealed, according to another study by the Tax Policy Center.

Both the $10,000 SALT cap and NIIT add to the marginal tax rate faced by the wealthiest households, which changes the relationship between the top marginal income tax rate and the top marginal total tax rate. They are no longer as close together as they were in the 1950s and 1960s, Brunet said.

The difference between a top total marginal tax rate and the top marginal income tax rate has implications, in that a federally imposed marginal tax rate would not need to be in the 70s to reach an overall top marginal rate of that level, as suggested by some economic literature, but instead should be between 55 percent and 60 percent, Brunet said.

“The federal rate would top out at about 55 to 60 percent,” she said. “It’s been driving me crazy because a lot of news stories haven’t expressed the difference.”

Evaluate Taxation on Capital Gains

Taxable income rates in 2019 vary from 10 percent to as high as 35 percent. However, short-term and long-term capital gains are taxed at a lower rate, and the discrepancy between the rates would need to be addressed. Otherwise, taxpayers would simply look for ways to shift income to invest in assets subject to the lower capital gains' rates.

It is important to first look at what income actually is when it is above $10 million, said Nicole Kaeding, director of federal projects at the conservative-leaning Tax Foundation.

“For most individuals that have income at that level, it’s not wage income; it’s business income or it’s capital gains,” she said. “And that means that that income is flexible. It can be massaged in the sense that … because we only tax when a gain is realized, the investor controls whether or not that tax would be due.”

Kaeding said if Congress does impose a high marginal income tax rate, there would be a large problem with realization under the current capital gains tax structure.

Steve Wamhoff, director of federal tax policy at the Institute on Taxation and Economic Policy, suggested a higher marginal tax rate should be carried out along with eliminating the different tax structure for capital gains. Doing so would eliminate that benefit for the wealthy, he said.

“We know the benefit for the break of capital gains goes to the richest 1 percent,” he said, noting that a 2013 Congressional Budget Office report on tax expenditures found that 68 percent of the capital gains and dividends preference goes to the wealthiest.

Wamhoff said adjusting taxation on capital gains could bring in a huge amount of revenue. While some right-leaning groups may argue that raising tax rates on capital gains would make people decide to realize those gains less often, his response was that if you do many reforms together, it will block a lot of the exits.

Study Academic Research

Erin Scharff, a professor at the Arizona State University Sandra Day O'Connor College of Law, told Law360 she thought it was funny that people are thinking of Ocasio-Cortez's remarks as a plan. She said that it's just a comment about how to think about tax policy, and that it would be fruitful to look at academic literature to better understand marginal rates.

"It's hard to critique in detail a 10-word comment. That being said, I think it's an idea worth pursuing," she said. "There's significant economic analysis that supports the idea that higher marginal rates are both effective at raising significant amounts of income for the U.S. by very prominent, very good economists. And that literature suggests it will not create massive disincentives to work for a living or invest and build the American economy."

Scharff said raising marginal tax rates would raise revenue. The idea floating around that tax rates are constantly too high and disincentivizing investment and labor is just not true, she said. The U.S. can in fact consider policy with significantly higher rates, she added.

However, Kaeding cited a 2017 paper that found that even though the 70 percent marginal tax rate would be ideal, the effective tax rate still would be around 40 percent, which remains close to the current tax rate.

"Between 1950 and 1959, the top 1 percent paid an average tax rate of 42 percent, and that included federal, state and local taxes, and at that point the highest marginal tax rate was 91 percent," Kaeding said. "In 2014, the most recent data we have, the average tax rate was 36.4 percent. So we've gone from a top rate of 91 percent to 37 percent and the effective tax rate has only fallen by 4 percent."

Ryan Bourne, who occupies the R. Evan Scharf Chair for the Public Understanding of Economics at the Cato Institute, told Law360 the policy debate is being distorted somewhat by implying a new higher marginal tax rate would be like going back to the economic growth from the 1950s, when the rates actually paid by rich people then were lower due to deductions, exceptions and loopholes available at the time.

"These models are very static and can understate how tax rates affect entrepreneurship and human capital accumulation, which can have big consequences for economic growth," he said.

Examine Business Taxes, Estate Policies

Lower tax rates for corporations and pass-through entities, as well as estate strategies where assets can be transferred to heirs to avoid taxation, are areas ripe for examination in the marginal tax rate discussion because wealthy earners can use them to move money to be taxed at lower levels if higher rates are imposed.

"What Ocasio-Cortez never suggested [is] that just raising the top marginal rate is the only thing Congress can do and everyone can go home. She understands that there are lot of other things

Congress has to do," Wamhoff said. "It's entirely reasonable to say we need a lot of revenue and a good place to start is to look at loopholes and get more revenue from high-revenue people."

Wamhoff suggested examining estate laws and eliminating the rule that exempts capital gains for assets left to heirs. He also proposed getting rid of other special tax breaks, such as the new deduction for pass-through businesses. Otherwise, people can figure out how to qualify and claim that 20 percent deduction, he added.

Kaeding agreed that under the current tax system, people will likely try to reclassify income as business income because the corporate tax rate is 21 percent, which is much lower than the proposed 70 percent marginal rate.

But she said funding an expansion of government programs would require more than just taxing the rich.

"The higher you raise that individual tax rate, the higher the marginal rate is, the higher the incentive is to shelter," Kaeding said. "If they're honest about the cost of those proposals, they'll realize that they need to have tax increases that are much broader than those on the quote-unquote 'rich.'"

Consider a Value-Added Tax

Other media commentary has focused on tax policies in Scandinavian countries, which have very generous programs, but also have high taxes, according to Kaeding.

"If you look at the Scandinavian countries that have these very generous programs that are referred to, these are countries that have very large value-added taxes, high payroll taxes," she said. "And in Denmark, the highest marginal tax rate of 60 percent starts at 1.2 times average income. That would be like us having a 60 percent tax rate at about $57,000 of income."

Wamhoff told Law360 that in a look at other countries in the Organization for Economic Cooperation and Development, the U.S. is one of the lowest-taxed compared to economic output and that the country still needs to find more revenue.

One solution could be exploring the possibility of adding a value-added tax, known as a goods and services tax based on the growing value of a product or service at each stage of production. Schraff said it could be another way to raise revenue and should be part of the marginal tax rate conversation.

She told Law360 that increasing the U.S. government debt can't last forever and those debts somehow have to be paid.

"How Scandinavian countries fund [their programs] is interesting; there are lots of tax analysts who think a VAT is a brilliant idea," she said.