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ESSAY

EXPLODING WEALTH INEQUALITIES: DOES TAX POLICY PROMOTE SOCIAL JUSTICE OR SOCIAL INJUSTICE?

PHYLLIS C. TAITE*

[I]t is a cruel jest to say to a bootless man that he ought to lift himself by his own bootstraps.¹

INTRODUCTION²

In reviewing tax policy as a whole, our current system is grossly imbalanced. Although the structure of the U.S. taxing system is labeled as a progressive system, the reality is that our system, in operation, is a regressive taxing system.³ The benefits and treasures of tax policies

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1. Martin Luther King Jr., Speech at National Cathedral, Washington D.C., Remaining Awake Through a Great Revolution (Mar. 31, 1968).

2. This Essay was originally submitted as part of: *Stuck in Forward? Debt, Austerity and the Possibilities of the Political*, ClassCrits VI Workshop presented by Southwestern Law School Law Review, November 15-16, 2013, and sponsored by The Baldy Center for Law & Social Policy at SUNY Buffalo and UC Davis School of Law. The full symposium published by Southwestern Law School Law Review is forthcoming. See 43 SW. L. REV. (forthcoming 2014).

3. Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 HOW. L.J. 319 (2010).

On paper, progressive rates can appear dramatic. At times, the highest marginal rate has risen to 90% of taxable income. Working solely from the statute as written, progressive rates seem ideal for downward wealth redistribution; but the dramatic appearance of rates on paper are just part of the story.

Progressive rates are applied to ordinary income, including income from wages,

flow to those of greater wealth while those with less wealth squarely shoulder the burdens of raising revenue. Tax policies that have shaped the tax structure and economic climate overwhelmingly favor the wealthy, propertied taxpayers.

These tax policies work in concert to contribute to the wealth and income inequality that disadvantage the poor and middle class in favor of the wealthy. While there is current and past discourse on wealth and income inequality, and impact of the same, as well as discussions of multiple causes of wealth and income inequality, there is little discussion on how various tax policies work together as a common force to perpetuate income and economic inequality. This Essay will briefly discuss how some tax policies work in concert to systematically shift wealth to the wealthiest taxpayers. This social arrangement is counter to what many would perceive as social justice. Social justice requires that those who are of greater means and receive greater benefits of tax policy should be responsible for a greater weight of the tax burdens.

This Essay will focus on tax preferences and estate tax policy, as well as identify inequities and propose solutions to reform the taxing system into a more progressive system. By making adjustments to current policies, the tax code can be used to reduce the massive wealth and income disparity that currently exists.

Part I of this Essay will define social justice and outline the general parameters used to promote social justice through the tax code as applied to the tax topics discussed in this Essay. Part II of this Essay focuses on the home mortgage interest deduction, capital gains exclusions from the sale of a home, and the estate tax and how these policies perpetuate income and wealth inequality. Part II of this Essay will also discuss wealth and income inequality by determining benefits of wealth and measured burdens and responsibilities that should attach to ensure the preservation of social order to achieve social justice as applied to each tax policy discussed. This Essay will further discuss proposed limitations that should be placed on these tax subsidies and defined benefits and burdens that should attach for the benefits received from these tax subsidies. Part III of this Essay will provide the conclusion.

but a lower rate applies to income from the sale of capital assets, such as stocks, bonds, and real estate. Progressive rates are more public than real because as income and wealth rises, sources of taxable income shift from wages to capital gains. This shift in the source of income moves most wealthy people out of the high progressive rates on ordinary income and into the lower tax rates on capital gains. The result is that, as income rises, tax rates actually fall.

Id. at 324 (citations omitted).

I. SOCIAL JUSTICE “DEFINED”

When discussing issues of wealth and income inequality, the discussion inherently turns to a discussion of what is fair, equitable, and bears the most resemblance to justice. The discourse is saturated with the frustrations of the 99% and their demands for “justice.” As I read various articles discussing the different aspects of the current economic climate, the overarching question in my mind remains, “what is justice?” John Rawls indicates, “[j]ustice is the first virtue of social institutions, as truth is of systems of thought.”⁴ If we adopt his premise, then justice is fundamental to ensuring social order and social justice should be an aspiration of a modern society.

In my quest to define justice, I realized the principles of justice are very elastic and any definition would change as the situation changed. For example, the top wealth earners might define justice as everyone paying a flat tax based on a percentage of income such that everyone has the same burden no matter the income. On the other hand, the lowest wealth earners might view justice as requiring the top wealth earners to shoulder the entire tax burden for the country because they have more discretionary income to absorb the responsibility.

Therefore, rather than attempting to define justice, I looked to Rawls for a proposed set of principles that may be dictated by various social arrangements to achieve social justice.⁵ The social arrangement that is closest to what I would define as social justice, in the context of income inequality, would reform tax policy to distribute benefits and burdens to the appropriate members of society based on a benefits/burden model.⁶

Before settling on these principles of justice, Majorie Kornhauser discusses another type of justice she described as distributive justice.⁷ She explains that distributive justice is foundationally derived in the principles of liberty and equality.⁸ Liberty and equality are equally

4. JOHN RAWLS, *A THEORY OF JUSTICE* 3 (Harvard Univ. Press rev. ed. 1999) (1971).

5. *Id.* at 4 (“A set of principles is required for choosing among the various social arrangements which determine this division of advantages and for underwriting an agreement on the proper distributive shares.”).

6. *Id.* (“These principles are the principles of social justice: they provide a way of assigning rights and duties in the basic institutions of society and they define the appropriate distribution of the benefits and burdens of social cooperation.”).

7. Marjorie E. Kornhauser, *Equality, Liberty, and a Fair Income Tax*, 23 *FORDHAM URB. L.J.* 607 (1996).

8. *Id.* Professor Kornhauser admits that, while there are different meanings associated with the terms liberty and equality and that they conflict with each other, Americans still embrace these terms. Although the context in which she makes the assertion is to endorse the concept of a mildly progressive hybrid income-consumption tax, the overall concept is

elastic as justice. Nonetheless, she tackled the issues in the context of tax policy by using efficiency to determine the tax base and equity to determine the tax rates.⁹ The concepts of liberty and benefits can be melded through rights associated with property ownership. A taxpayer is free to choose whether he or she purchases or invests in certain property. Once purchased, the taxpayer would be responsible for such property unless or until the person is no longer the owner.

The commonality between the Rawls and Kornhauser theories is equity. If I use the Rawls theory as a model and apply it to tax policy, equity could be achieved by allocation of tax burdens placed on the parties to a social contract. Under Kornhauser's theory, equity can be achieved by allocating "just tax rates," and she provides different theories and methodologies to reach these "just tax rates."¹⁰ While equality and equity are difficult to quantify because they have different meanings depending on the situation, equity is foundationally based on the notion of ownership interest or stake in property rights.

As applied to tax policy, justice may be achieved based on a two-pronged approach. First, these concepts may be seamlessly translated to burdens and duties under our tax system. These burdens and duties should be allocated based on a person's station in life such that as more wealth is accumulated or as income increases, then, correspondingly, more responsibility (tax liability) should be assigned. Conversely, if the taxpayer is lower on the income and wealth hierarchy, then as the taxpayer's income or wealth is reduced the less responsibility (tax liability) should attach.

applicable to other areas.

9. *Id.* at 609 ("In the tax field the battle between liberty and equality—often characterized as one between efficiency and equity—occurs primarily in two fundamental areas: choice of the tax base and choice of a rate structure.").

10. *Id.* at 611.

The method of determining whether a tax is just depends on whether that justness can be determined independently of the justness of the pre-tax wealth distribution. There are two possible situations. In the first, the justness of the tax is independent of the justness of the pre-tax wealth distribution. Consequently, a just tax is simply one that distributes fairly the tax burdens—the revenues of which will be used to provide approved public goods—and will not disturb the pre-tax distribution. Redistribution of income is not a permissible tax function under this view.

Conversely, in the second situation, the justness of a tax is related to the justness of the pre-tax distribution. Consequently, the tax may serve a re-distributive function in addition to its role as a collection vehicle to fund governmental duties.

Under this second situation the determination of a just tax is a two-step process. First, one must determine whether the existing distribution of goods is just.

The second step then distributes the burden of taxation.

Id. (footnote omitted).

Second, “just rates” should be implemented to re-assign greater responsibility of rate revenue to taxpayers with the greatest wealth. In this Essay the target rates are those associated with the estate tax.¹¹ Based on this two-pronged approach, the taxing structure would move towards a progressive structure. Assigning the burden determines who will pay more based on wealth or income and adjusting rates determines how much they will pay. In other words, if achievable, the ever-elusive ideal progressive tax system would achieve social justice.

In order for these principles to work, it is fundamental that benefits are defined and measurable burdens are matched with those benefits. Once the benefits and burdens are determined, the social contract must be honored by all parties to the contract. The contract is clearly breached when a party has more social and/or political power and they use such influence to change the rules or change the spirit of the rule.

Our taxing system is the perfect example of a program structured on the principle of progressivity, but that progressivity is consistently undermined with a change in the rules or policies that undermine the spirit of progressivity. Tax preferences, which primarily benefit the upper income taxpayers, have undermined the progressive nature of the taxing system.¹² Tax preferences have changed the seemingly progressive taxing system into a regressive taxing system.

By changing the rules and introducing tax preferences, Congress has contributed to the illusory nature of the progressive tax structure.¹³ In order to bring social justice to the tax code, reform is necessary to reallocate burdens and reduce wealth and income inequalities that have resulted from years of a regressive taxing system. By reforming tax policy and reallocating the burdens of our taxing structure to those of greater means and greater ability to pay, Congress could set the path for bringing social justice to tax policy.

11. *See infra* Part II.

12. Moran, *supra* note 3, at 319.

13. While there is no formal evidence of an agreement for a progressive tax system, the fact that rates on ordinary income increase as income increases would seem to so indicate implicitly. Even so, it is still an illusion because taxpayers at the upper income level have other sources of income that may cause their overall taxable income to be significantly reduced. *See generally* Moran, *supra* note 3, at 319.

II. PERPETRATORS OF INCOME AND WEALTH INEQUALITY

A. *Mortgage Interest Deduction*

1. How Mortgage Interest Deduction Contributes to Income and Wealth Inequality

The mortgage interest deduction (MID) is another provision that is well debated. One of the primary reasons for opposition is the fact that the MID is one of the most expensive tax expenditures for the government. In addition to being expensive, another reason for such debate is that the MID is unique because the deduction is permitted to taxpayers without offsetting income associated with the property.¹⁴ Typically, tax-deductible interest is associated with the production of income, and personal homes do not produce income. Interest associated with personal property is ordinarily not deductible and personal debt interest deductions were, in large part, eliminated in the Tax Reform Act of 1986.¹⁵

The MID is unique in its personal nature but is only available if the taxpayer itemizes his tax return. The MID permits a homeowner to deduct interest paid on a mortgage for up to two qualified residences for each taxable year that a taxpayer itemizes his or her tax return deductions.¹⁶ While the Tax Reform Act of 1986 eliminated the deduction for personal interest for most personal debt in an effort to reduce tax expenditures, the most expensive of personal debt interest—the MID—remained deductible.

One of the reasons attributed to permitting the MID to remain, despite the personal nature of the property, was because of the belief that the MID promoted homeownership. An article written by Professor Roberta Mann explores the MID to determine whether the government should promote homeownership and whether the MID is indeed effective

14. William A. Fischel, *The Evolution of Homeownership*, 77 U. CHI. L. REV. 1503, 1509 (2010) (“The imputed rent on owner-occupied housing is an untaxed source of income for homeowners.”) (citing James R. Follain and Lisa Sturman Melamed, *The False Messiah of Tax Policy: What Elimination of the Home Mortgage Interest Deduction Promises and a Careful Look at What It Delivers*, 9 J. HOUSING RES. 179, 180 (1998) (“[T]he main component of the subsidy to owner-occupied housing is the failure to tax gross implicit rental income earned by owner-occupants.”)).

15. Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986* (1987), available at <http://www.jct.gov/jcs-10-87.pdf>; see also Memorandum from the Office of Chief Counsel Internal Revenue Service to Anne Ronholm (Nov. 1, 2011), available at <http://www.irs.gov/pub/irs-wd/1201017.pdf> (noting that personal interest became nondeductible under section 163(h) as added by the Tax Reform Act of 1986 (Pub L. 99-514, 100 Stat. 2246)).

16. I.R.C. §§ 163(h)(2)(D), 163(h)(3) (2013).

for promoting homeownership.

Professor Mann cited sources that indicate homeowners may be better citizens than renters because homeowners are more likely to be involved with the political process, neighborhoods, schools and the economy.¹⁷ It is generally accepted that our government has used tax policy to promote certain social behavior. Generally speaking, if tax policy is influential in guiding positive taxpayer behavior then it stands to reason the government would prefer to continue to influence such behavior.

The problem, as previously mentioned, is the MID is extremely costly and the majority of the taxpayers do not receive the benefit of the MID deduction. Those in the middle and lower end of the income spectrum are the people the government should seek to encourage because the people in the upper income levels are likely to become homeowners without an incentive. The driving force for taxpayers in the middle to lower income levels is affordability.

If the government seeks to encourage more homeownership then finding a way to make homes more affordable is the best way to increase homeownership rates. In some ways the MID is thought to drive up the cost of housing, thereby creating a situation that makes homeownership less likely for the masses, i.e. those taxpayers in the middle to lower income levels. If this is true, the cost of the MID is at the expense of the majority of Americans who may or may not be homeowners.

Professor Mann also briefly discussed the argument that homeownership is an investment and therefore the expenses should be deductible.¹⁸ This argument is problematic because if we treat the home as an investment, then the deduction should be limited by the amount of the investment income, as with all other investments.¹⁹ In such case, the deduction allowed should be zero because personal homes usually do not generate investment income.

These are examples of the special treatment afforded the MID and how the MID is a conduit to shift wealth to wealthier taxpayers. This assertion is evidenced by the fact that this is the only deduction that permits a deduction for interest on personal property up to one million dollars.²⁰ It is also evidenced by the fact that the deduction is not specifically limited based on the income level of the taxpayer.²¹

17. Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1354 (2000).

18. *Id.* at 1357.

19. I.R.C. § 1411 (2013).

20. § 163.

21. *Id.*

Another factor perpetuating systematic wealth shifting is the ability to deduct the mortgage interest on a second home. The justifications for the MID are more transparent when considering the ability use the MID to deduct the interest paid on a second home. Permitting the MID on a second home is clearly designed to benefit the upper income taxpayers because most Americans can barely afford one home. Keep in mind homeownership rates are already highest at the highest income levels so the incentive to purchase justification is not persuasive as good tax policy.²²

In 2008, the homeownership rate for taxpayers earning greater than or equal to the median family income was more than 82% percent, while homeownership rates for taxpayers earning less was below 52%.²³ Since homeownership rates are already high for the taxpayers earning more than \$100,000 the MID operates more like a reward than an incentive.

Just as telling is the tax savings from the MID based on household income. A National Tax Journal article by James Porterba and Todd Sinai provided information on the age, household income, and tax savings from the MID.²⁴ Households with incomes of \$250,000 or more, and an age range of 25-35 received the largest tax savings, almost \$8,000.²⁵ As taxpayers at this income level increase in age, the tax savings steadily declines to just under \$6,000 by the age of sixty-five.²⁶ After the age of sixty-five, the tax savings decline to approximately \$1,500.²⁷ Taxpayers with household income between \$125,000-\$250,000 had tax savings of approximately \$3,500 between the age of 25-35 with a decline to approximately \$1,000 by the age of sixty-five.²⁸

Based on this research the taxpayers receiving the greatest tax benefits are those with the highest household income and these same taxpayers have the highest homeownership rates. In order to use tax policy to shift some tax benefits of homeownership back to the median to low income households, homeownership and the tax benefits must be

22. See generally DEAN STANSEL & ANTHONY RANDAZZO, REASON FOUND., UNMASKING THE MORTGAGE INTEREST DEDUCTION: WHO BENEFITS AND BY HOW MUCH?, (Policy Study 421) 7 (2013), available at http://reason.org/files/mortgage_interest_deduction_2013_update.pdf.

23. U.S. CENSUS BUREAU, RESIDENTIAL VACANCIES AND HOMEOWNERSHIP IN THE FOURTH QUARTER 2013, at 10 (2014), available at <http://www.census.gov/housing/hvs/files/qtr413/q413press.pdf>.

24. James M. Poterba & Todd Sinai, *Revenue Costs and Incentive Effects of the Mortgage Interest Deduction for Owner-Occupied Housing*, 6 NAT'L TAX J. 531 (2011).

25. STANSEL & RANDAZZO, *supra* note 22, at Figure 4.

26. STANSEL & RANDAZZO, *supra* note 22, at Figure 4.

27. STANSEL & RANDAZZO, *supra* note 22, at Figure 4.

28. STANSEL & RANDAZZO, *supra* note 22, at Figure 4.

attainable.

2. The Proposal

The MID should be reformed to generate additional funds for the government and to also create policies that encourage homeownership at all levels and to reverse aspects of the MID that work to shift wealth to the upper income taxpayers. Homes often represent the greatest asset owned by the taxpayer family. Therefore, the ability to deduct up to one million dollars is an opportunity to seriously reduce tax liability for the upper income taxpayers and shift wealth.

In order to facilitate homeownership at the lower income levels, affordability is the key to encouraging middle to lower income taxpayers to purchase. Tax policy changes will be more effective if tax assistance is targeted towards reducing the costs of homeownership for households in the median to low income levels. The necessary reforms to make homeownership more affordable and accessible are: (1) offering a one-time refundable home buying tax credit, (2) keeping interest rates low, and (3) limiting the MID to taxpayers with modified adjusted gross income (MAGI) of \$85,000 for single taxpayers (\$170,000 for married filing jointly). In doing so, taxpayers will be cognizant of the amount of debt they are undertaking and will be less likely to spend more on a house than they can afford and the government has an opportunity promote social justice through tax policy.

One way to reduce the cost of homeownership is by reinstating the First Time Homebuyer Credit. For taxpayers who bought homes between 2008 and 2010, a First Time Homebuyer Credit was available as a tax credit to assist with acquisition costs and to encourage home buying. The first version, Housing and Economic Recovery Act of 2008 (HERA), was implemented in 2008 and provided a \$7,500 loan that was repayable over a fifteen year period and limited the credit to taxpayers based on their modified adjusted gross income (MAGI).²⁹ The second version of the credit, American Recovery and Reinvestment Act of 2009 (ARRA), provided a refundable \$8,000 tax credit without the obligation to repay and the same MAGI limitations for taxpayers as HERA.³⁰

29. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008), available at <http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf>. The credit began to phase out for single taxpayers with a MAGI of \$75,000 and completely phased out at \$95,000. For married taxpayers, the credit phased out with a MAGI of less than \$170,000.

30. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009), available at <http://www.gpo.gov/fdsys/pkg/BILLS-111hr1enr/pdf/BILLS-111hr1enr.pdf>.

The 2009-2010 credit, Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA), extended the \$8,000 credit but limited the credit to homes purchased for \$800,000 or less and expanded the credit to include taxpayers with higher MAGIs and to repeat homebuyers.³¹ These different homebuyer programs were enacted to deal with the housing crisis from the Great Recession.

It is interesting to note that the different models and methods to find a solution to the housing crisis did not include the MID, in current or modified form. Indeed, the MID would not offer much of a solution. The primary problem for the foreclosure crisis was predatory lending programs that caused a substantial number of taxpayers to lose their homes because of those predatory lending practices.³²

Also, in reviewing history, spikes in home purchasing rates coincide with times when interest rates were low.³³ It would be fair to say that interest rates and limited temporary tax assistance provides just as much incentive, if not more incentive, to encourage taxpayers to purchase a home than the MID. The costs associated with reducing interest rates and providing limited assistance would be substantially less than costs associated with the MID.

In order to shift the wealth back towards the middle to lower income taxpayers, the MID should be reformed to set income limitations and reinstate the First Time Homebuyer Credit implemented under ARRA with a few modifications. Specifically, the MID should be modified to provide a refundable credit up to \$6,000 to qualified taxpayers. Qualified taxpayers would be limited to those earning MAGI of less than \$170,000 for married taxpayers filing jointly and \$85,000 for single taxpayers.

The First Time Homebuyer Credit from ARRA should be reinstated but also include a sliding scale for the tax benefit. Instead of flat credit, the credit should be based on the cost of the home. The credit should be ten percent of the purchase price up to \$6,000. On the first tax return, the taxpayer would be permitted to claim the First Time Homebuyer

31. Workers, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984, available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ92/pdf/PLAW-111publ92.pdf>.

32. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xvii (2011) (concluding that the financial crisis was avoidable primarily by the warning signs that were present due to the "explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices . . ."), available at <http://gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

33. U.S. CENSUS BUREAU, *supra* note 23, at 5; see also FREDDIE MAC, 30-YEAR FIXED-RATE MORTGAGES SINCE 1971 (2014), available at <http://www.freddiemac.com/pmms/pmms30.htm>.

Credit or the MID, whichever provided the greater benefit.

The proposed changes do not specifically include the wealthiest but those taxpayers still have tax benefits associated with homeownership. When they sell their home, a married couple may exclude up to \$500,000 from the capital gains associated with the sale.³⁴ Since most middle to lower income taxpayers would not likely own homes that would bring these substantial gains, this subsidy is clearly intended to benefit the wealthier taxpayers.

By reinstating the First Time Homebuyer Credit and modifying the MID, the current tax breaks from the MID that flow primarily to the wealthy will be cut off and the shift will then support taxpayers in the middle to lower income quintile. In addition, the government will gain more revenue by limiting the preference such that the wealthiest taxpayers will have a higher tax responsibility.

The exclusions associated with the sale of the home still provide enough incentive and benefits to the wealthier taxpayers to purchase a home. By implementing the proposed policy changes, the government will have greater resources to reduce the deficit and provide a more balanced approach to promote social justice in tax policy.

B. *Estate Tax*

1. How the Estate Tax Contributes to Wealth Inequality

The estate tax permits the wealthiest taxpayer to transfer great, sometimes massive, wealth to their family members. As applied, the estate tax shifts wealth and contributes to wealth concentration by not taxing property and people who have been historically taxed on such property. The discussion will include how the estate tax has been used to encourage wealth concentration and policies that should be reformed to achieve social justice.

There have been many changes to tax policy that have affected wealth shifting but for the purpose of this Essay I focus on three that caused the greatest impact in the recent history.³⁵ The Taxpayer Relief Act of 1997 (TRA 1997) brought about annual incremental increases that started at \$625,000 and the increases were scheduled to reach \$1,000,000 by 2006.³⁶ The exclusion increases, scheduled to occur

34. I.R.C. § 121 (2013).

35. For a more in depth discussion on reforming the estate and gift tax, see Phyllis C. Smith, *Change We Can't Believe in ... or Afford: Why the Timing is Wrong to Reduce the Estate Tax for the Wealthiest Americans*, 42 U. MEM. L. REV. 493 (2012).

36. DAVID JOULFAIAN, U.S. DEPT. OF THE TREASURY, *THE FEDERAL ESTATE TAX: HISTORY, LAW, AND ECONOMICS 2-5* (2013), available at <http://papers.ssrn.com/sol3/papers>

under TRA 1997 after 2001, were preempted by even more increases under the Economic Growth and Tax Reconciliation Relief Act of 2001 (EGTRRA)³⁷ Even with the increases in exemption amounts, the number of estate tax returns filed increased from an estimated 109,000 in 1998 to 122,000 by 2001.³⁸

EGTRRA, also known as the Bush Tax Cuts, called for increases from \$1,500,000 in 2004 up to \$3,500,000 in 2009 and a total repeal for 2010.³⁹ Most tax experts believed Congress would act prior to 2010 to avoid the repeal.⁴⁰ Congress failed to pass any provisions prior to 2010 to address the looming sunset provisions. Because of this failure, there was no estate tax for the year 2010.

The repeal resulted in a windfall for the wealthy, especially the top wealth earners.⁴¹ The appropriate response by Congress should have been an increase in estate tax rates or reduced exclusions amounts in order to raise revenue to make up for the loss, particularly since there had been so many years of estate tax breaks for the wealthy. Instead, Congress, via the 2011 Economic Stimulus Package (ESP), reduced the estate tax rates to the 45 percent and reduced the applicable exclusion amounts for estate and gift tax to approximately \$5 million dollars.⁴² While the ESP was enacted as a temporary solution, the permanent transfer tax solution has made a progressive tax structure even more elusive.

In 2012, the American Tax Payer Relief Act passed and the \$5.12 million exemption amount became the unified transfer tax exemption amount and the highest marginal rate was 40%.⁴³ In the face of the increasing exclusion amounts and the historically decreasing rates, the amount of revenue to the government decreases and the amount of wealth concentrated in the hands of the wealthiest increases. The wealth

.cfm?abstract_id=1579829; NONNA A. NOTO, ESTATE AND GIFT TAX REVENUES: PAST AND PROJECTED, CONGRESSIONAL RESEARCH SERVICE 1 (2007), available at http://assets.opencrs.com/rpts/RL34142_20070824.pdf; see also Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of the Internal Revenue Code).

37. See JOULFAIAN, *supra* note 36.

38. See JOULFAIAN, *supra* note 36.

39. Economic Growth and Tax Reconciliation Relief Act of 2001, Pub. L. No. 107-16, §501(a), 115 Stat. 38, 69.

40. See Meggie Orgain, *Death Comes to Us All, But Through Inheritance, the Rich Can Get Richer: Inheritance and the Federal Estate Tax*, 4 EST. PLAN. & COMMUNITY PROP. L.J. 173, 185 (2011).

41. See Smith, *supra* note 35, at 514.

42. See American Recovery and Reinvestment Act of 2009, Pub L. No. 111-5, 123 Stat. 115, amended by Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub L. No. 111-312, 124 Stat. 3296.

43. See American Taxpayer Relief Act of 2012, Pub L. No. 112-240, Stat. 2318.

disparity is now more unequal than ever and unless something changes, there is a risk that it will be irreversible. For instance, in non-home wealth, the top twenty percent owns more than ninety-five percent of the wealth.⁴⁴

To address these tax benefits received by the wealthiest, an equal and opposite burden should attach if the goal is to operate under the principles of equity, as proposed by this Essay. Because of the years of revenue loss through the high exclusion amounts, a low exclusion amount should be implemented to offset those benefits. An appropriate exclusion amount should consider revenue potential and balance that against the decedent's rights and obligations to take care of his or her family.

Therefore, the applicable exclusion amount should be reduced \$3.5 million as implemented under EGTRRA.⁴⁵ Also, estate tax rate should increase to 55% from the current 40%. Providing greater opportunity to concentrate wealth does not contribute to social justice, but instead perpetuates wealth inequality. These proposed changes move us towards shifting the responsibility and burden to taxpayers with the highest wealth and steps closer to social justice.

2. How Marital Portability Contributes to Wealth Inequality

I.R.C. section 2010 permits marital portability of the unused exclusion amount from the first-to-die spouse to be used by the surviving spouse.⁴⁶ With this provision, a married couple would have the opportunity to transfer even more wealth to their children or other beneficiaries if the second spouse's estate is larger than the first spouse's estate. This is one of the most egregious inequities associated with the estate tax.

The marital deduction for transfer taxes was introduced by Congress in 1948 to address the inequities associated between married couples in community property states versus separate property states.⁴⁷

44. Paul L. Caron & James R. Repetti, *Occupy the Tax Code: Using the Estate Tax to Reduce Inequality and Spur Economic Growth*, 40 PEPP. L. REV. 1255, 1260 (2013); Boston College Law School Legal Studies Research Paper No. 280; U. of Cincinnati Public Law Research Paper No. 13-02.

45. Economic Growth and Tax Reconciliation Relief Act of 2001, Pub. L. No. 107-16, §501(a), 115 Stat. 38, 69.

46. I.R.C. § 2010(c)(4) (2013).

47. PATRICK FLEENOR, TAX FOUND., A HISTORY AND OVERVIEW OF ESTATE TAXES IN THE UNITED STATES 7 (1994), available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/f7c34848582a114133f90711b50b9a3a.pdf>.

The one important change in estate tax law that occurred in this period dealt with the different treatment of property in community and noncommunity property states.

At the time of implementation, the marital deduction was 50% of the estate.⁴⁸ To further address the inequities between community property states and separate property states, the TRA 1976 raised the marital deduction for estates to the higher of \$250,000 or 50% of the estate.⁴⁹ After the implementation of the Economic Recovery Tax Act of 1981 (ERTA 1981), the unlimited marital deduction was born.⁵⁰

With changes over the years to bring horizontal equities to marital estates, it seemed the shortfall in revenue was warranted to permit the use of the full marital estate by both parties. As long as the property is transferred to the surviving spouse within the limitation of section 2056, the tax on the entire marital estate is not due until the death of the surviving spouse.⁵¹ Because the motivation for the increasing levels of the deductions were to provide both spouses the full use of all marital property before taxation, there have been few criticisms of the deduction.

Professor Wendy Gerzog provides criticism of the marital deduction, referring to the deduction as “the largest destroyer of that revenue stream” because of the foregone revenue otherwise collectable by the transfer taxes.⁵² She elaborates by showing the estate tax returns for 2009 alone reveal this deduction costs the government \$62 billion in foregone revenue because 97% of estates with surviving spouses reported marital deductions.⁵³ This makes the marital deduction one of

Community property states treat the property held by married persons as one estate. The property of a married couple in noncommunity property states is treated as two estates. This effectively doubles the benefit of the unified credit and graduate rate schedule for persons in noncommunity property states. In an effort to correct this situation, Congress in 1948 created a marital deduction for estate and gift tax purposes. It also allowed spouses to “split gifts” between themselves to third parties. This effectively doubled the exemption amount available and allowed for potentially lower rate schedules.

Id.

48. DAVID JOULFAIAN, U.S. DEP’T OF TREASURY, OTA PAPERS, THE FEDERAL GIFT TAX: HISTORY, LAW, AND ECONOMICS 4 (2007), available at <http://www.irs.gov/pub/irs-soi/11pwcompenaddgift.pdf>.

49. FLEENOR, *supra* note 47, at 8 (the gift tax marital deduction also increased to 100 percent of the first \$100,000 and 50 percent of the amount over \$200,000).

50. FLEENOR, *supra* note 47, at 9.

51. I.R.C. § 2056 (2013).

52. Wendy C. Gerzog, *The New Super-Charged PAT (Power of Appointment Trust)*, 48 HOUS. L. REV. 507, 508 (2011) (“While controversial, the purpose of transfer taxes is to break up wealth concentrations and to collect at least a modicum of revenue. The marital deduction, currently unlimited in amount, is the largest destroyer of that revenue stream.”).

53. *Id.* at 509.

Regarding the estate tax returns filed in 2009, ‘97 percent of the estates of married decedents, and 43 percent of estates overall, reported deductions for marital bequests, for a total of \$62 billion. Only 10 percent of estates with a marital bequest owed estate tax.’ That means that there has been and likely will continue to be what

the largest tax subsidies codified in the tax code.

Still, Professor Gerzog's challenge is primarily aimed at the allowance of the unlimited deduction for the decedent's spouse's estate without the decedent having to provide the surviving spouse with a real ownership interest, not so much about the unlimited deduction specifically.⁵⁴ In that regard, the unlimited marital deduction has received great deference because there is a willingness to forgive the revenue loss if the surviving spouse is the recipient of the property, or has unrestricted use of the property.

The same deference should not be afforded to the marital portability provisions. Marital portability refers to the ability of a surviving spouse to take advantage of the unused exemption amount from a decedent spouse's estate to transfer more to someone other than the surviving spouse. Beginning in 2011, as a result of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, surviving spouses now have the right to make an election to use the unused exemption amount from their decedent spouse's estate.⁵⁵

(4) Deceased spousal unused exclusion amount.

—For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term 'deceased spousal unused exclusion amount' means the lesser of—

(A) the basic exclusion amount, or

(B) the excess of—

(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.⁵⁶

There were two purposes that are inextricably attached to the marital deduction. First, the marital deduction was designed to place surviving spouses in separate property states in parity with surviving

is not an insignificant loss of current revenue because of this deduction.
Id. (footnote omitted).

54. *See id.* Professor Gerzog focused her critique and discussion on the fact that an unlimited marital deduction should not be permitted for a QTIP trust because ownership of the property ultimately passes outright to someone other than the surviving spouse. She proposed the power of appointment trust and other methods as better alternatives to qualify for the unlimited marital deduction. As such, there is some deference to the unlimited marital deduction even with her acknowledgement that billions of dollars in revenue are lost as a result of its unlimited nature.

55. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 3303, 124 Stat. 3296, available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ312/pdf/PLAW-111publ312.pdf>.

56. *Id.*

spouses who live in community property states.⁵⁷ Second, the marital deduction intended to provide full use of the marital property to both spouses by taxing the property at the death of the second spouse.⁵⁸ When reconciling the purposes of the marital deduction with the purposes of the estate tax, to raise revenue and curtail wealth concentration, there is no inconsistency. The portability provisions change that. The primary, if not sole function, of the portability provision is to permit more wealth transmission to persons other than a surviving spouse.⁵⁹ As such, portability is another form of shifting more wealth to the already wealthiest households.

This is further evidence of tax policy that contributes to wealth inequality without a benefit to the government or public at large. Ideally, the marital deduction would be permitted to benefit the surviving spouse and the remaining marital property would be taxed at the death of the surviving spouse. Any part of the tax exclusion available to a decedent at his death should be used at his death.

By permitting the use of the first-to-die spouse's unused exemption amount, the provision further contributes to wealth concentration and wealth inequality. This is another example of tax policy being used to permit the wealthy to enjoy the benefits of ownership and transfer of ownership without the attendant tax burden. As such, the marital portability provisions perpetuate wealth inequality and moves us further away from social justice.

3. The Proposal

The increasing exemptions and marital portability have provided a greater method of shifting wealth to the wealthiest taxpayers. The estate tax has historically been used to provide additional revenue to the government, but since 2001 the estate tax burden has been systematically reduced.⁶⁰ The exclusion level for the estate tax should be reduced to

57. Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 EMORY L.J. 871, 882 (1999) ("In 1948, in an attempt to create parity between couples living in common law and community property states, Congress adopted the marital deduction.").

58. Jonathan G. Blattmachr, Austin W. Bramwell & Diana S.C. Zeydel, *Portability or No: The Death of the Credit Shelter Trust?*, 118 J. TAX. 232, 234 (2013).

59. Marc S. Bekerman, *What Portability Means to Trust and Estate Professionals*, PROB. & PROP., Sept.-Oct. 2009, at 39, 39 ("These bequests can either be to beneficiaries who do not qualify for the marital or charitable deduction (that is, to a beneficiary who is neither a spouse nor a qualifying charity) or to a qualifying beneficiary in a nonqualifying form (that is, to a trust for the benefit of a spouse or charity that does not qualify under the Internal Revenue Code for the applicable deduction).").

60. See Smith, *supra* note 35, at 512.

\$3.5 million as it was in 2009 pursuant to EGTRRA. There was no real policy justification for the increase from \$2 million to \$3.5 million and even less of a justification for the increase to \$5 million.

Ideally, the applicable exclusion amount should be reduced to \$3.5 million and the highest marginal rate should increase to 45%. In the history of the estate tax there has been only one instance in which the exclusion amount was reduced; therefore, it is highly unlikely there will be a reduction now.⁶¹ If the political support is not available to reduce the exclusion amount, then an alternate solution is to increase the highest, marginal rate to 55%. The rate increase is justified to offset the substantial increase in the exclusion amount and to place a higher burden on the wealthiest taxpayers.

In the past, the highest marginal rate for the estate tax has been as high as 55% at a time when the economy was not operating under a tremendous deficit.⁶² In order to address the foregone revenue from years of reducing estate tax liabilities, the estate tax should be reformed to raise more revenue and shift higher burdens of raising revenue to the wealthiest taxpayers. Increasing the highest marginal rate for the estate tax is necessary to achieve these goals.

Another part of the solution to addressing wealth inequality is to abolish the marital portability provisions. While most estate planners love the marital portability provisions for postmortem planning, this is still another method of shifting great amounts of wealth to the descendants of the already wealthiest taxpayers. The justification for the marital deduction makes sense because it permits both members of the marital unit to fully benefit from the marital assets. Marital portability is less justified because the clear beneficiary of the portability provision is not the surviving spouse.

If the first-to-die spouse did not have enough assets to use his or her entire exclusion amount, then the remaining unused amount should vanish at his or her death. If the necessary political support for an abolishment is not available, then an alternate solution is to limit the marital portability amount to 50% of the applicable exclusion amount less the amount used by the first spouse's estate. Therefore, assuming \$5 million as the applicable exclusion amount, if the first spouse to die only used \$1.5 of his or her own exclusion, the surviving spouse would

61. Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 FLA. TAX REV. 875, 897 (2010). The applicable exclusion amount was reduced to \$50,000 (from \$100,000) pursuant to the Revenue Act of 1932, to address the financial crisis caused by the Great Depression.

62. FLEENOR, *supra* note 47, at 10.

have an additional \$1 million under the marital portability provisions.⁶³

With these changes to the estate tax, the tax burden is shifted back towards the wealthiest taxpayers and necessary steps towards social justice are made. With years of tax policy benefitting the wealthiest taxpayers, it is long past the time to reallocate the burden of tax liability to the wealthiest taxpayers.

CONCLUSION

In conclusion, tax policies should be used to promote certain social behaviors taking social justice into consideration. In doing so, tax policies should be implemented in a balanced way that provides benefits to taxpayers across the income spectrum. As currently comprised, tax policies overwhelmingly favor the wealthy. It is time to shift tax policies toward the middle and lower income taxpayers to provide an opportunity to rebuild taxpayers in the middle and lower income demographics.

Home ownership is an admirable goal for everyone, and the government should use tax policy to benefit homeowners across the board. The current policies do not benefit all homeowners, only a small percentage, but still cost the government billions. In addition, the same wealthier taxpayers also benefit from the tax exclusion when they sell these homes at a gain. It is time to take a more balanced approach to providing benefits through tax policy.

By reforming the current policies and placing limitations on both the amount of the deduction and who qualifies to take the deduction (or credit), more taxpayers will benefit from the MID, thereby tipping the scales to place more of the tax burden on the wealthier taxpayers. Since the wealthier taxpayers have benefitted from these policies for the last 100 years, it is long past the time for the wealthiest to assume more of the tax burden.

The current estate tax policies are more generous to the wealthy than ever. With proper planning, married taxpayers may pass more than \$10 million to their descendants tax free, so it is unnecessary to provide additional estate tax breaks. The marital portability provisions are designed solely to reduce the tax liability of the wealthiest, thereby

63. In other words, the first spouse used \$1.5 million of the \$5 million exclusion available. As a result, there was \$3.5 million remaining in unused exclusion from the first spouse. When the second spouse's estate seeks to claim the remaining unused amount, the estate would be limited to \$2.5 million. Since the first spouse's estate used \$1.5 million then only \$1 million remained as a portable amount for the second spouse. If the first spouse's estate used \$3 million, then no amount would be available to the surviving spouse's estate.

shifting more wealth to the wealthiest. With the increased exclusion amount and portability provisions, a rate increase is necessary to bring some semblance of balance.

It is time to reform tax policy to bring more social justice to the tax code. Years of using the tax code to shift wealth to the wealthiest must end. The middle-income taxpayers have shouldered the burden of raising revenue long enough. It is time to swing the pendulum and shift the burden back to the wealthier taxpayers, transforming our current tax system from one resembling social injustice to one more closely resembling policies based in social justice.