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Generations Winter 2023 - Do Wealth Tax Proposals Foreshadow a New Trend in Tax Policy?

Legislators in several states have recently proposed imposing annual wealth taxes on their residents. Wealth taxes are imposed on a person's net worth, including stocks, real estate and other investments. Although there are federal and state estate tax laws that impose tax as wealth moves from one generation to the next, the notion of imposing an annual wealth tax at the federal level has never gained traction. In what may be described as an act of frustration, state legislators and advocates in several Democrat-leaning "blue" states across the country have recently begun to promote such proposals.

On January 19, legislators from several states acting in concert—California, Connecticut, Hawaii, Illinois, Maryland, Minnesota, New York and Washington—introduced legislation that would raise taxes on their wealthiest residents. Lawmakers from these eight states working with the State Revenue Alliance represent an organization called "Fund our Future," whose slogan is "Make the wealthy pay what they owe" to "build a national movement for tax justice" and ensure "that the ultra-wealthy pay what they owe so all of us can thrive."

Last year, Massachusetts voters approved a "Millionaires Tax," which imposed a 4% surtax on income in excess of $1 million. The Millionaires Tax disrupted a flat rate tax system that had existed in Massachusetts for over a century, despite numerous concerted attempts to change to a progressive tax rate system. In the wake of the Massachusetts Millionaires Tax, state legislators in neighboring states New York and Connecticut proposed tax hikes of their own.

New York lawmakers introduced proposals that would impose an additional tax on dividends and capital gains for certain high-income taxpayers. Similarly, Connecticut representatives proposed increasing personal income tax rates, a surtax on net gain from the sale of capital assets for taxpayers in the two highest income brackets, and additional taxes on property, corporations and businesses with gross revenues over $10 billion.

Opponents of Connecticut's proposals point to the fact that Connecticut expects to enjoy a multibillion-dollar budget surplus in the current fiscal year. However, that argument did not carry the day in Massachusetts, where advocates of the Millionaires Tax convinced voters that a tax on the wealthy was the only way to bring in enough revenue to fund social programs like education in a year in which Massachusetts enjoyed a budget surplus significant enough to trigger an obscure state law that mandated tax refunds to Massachusetts taxpayers.

In addition to traditional revenue raisers such as marginal tax rate increases, the Fund our Future coalition also proposed wealth tax legislation that would impose taxes on unrealized asset appreciation. Suppose a taxpayer buys stock for $100 and the stock's value increases to $150 in the next year. Under general income tax principles, the taxpayer does not pay tax on the $50 of appreciation until the taxpayer sells the stock. However, many of the proposed wealth taxes would impose tax on the $50 of appreciation, even if the taxpayer did not sell the stock.

New York introduced Senate Bill 1570, which would do just that. Under this bill, taxable gain or loss would be recognized as if each taxpayer with net assets of at least $1 billion sold all of his or her assets for fair market value at the end of each year. Any net gain from these deemed sales would be included in the taxpayer's 2023 income up to a "phase-in cap" amount.

A week later, a California representative introduced Assembly Bill 259, which would impose a 1.5% wealth tax on Californians with net worth in excess of $1 billion and a 1% tax on Californians with net worth in excess of $50 million. Although California Governor Gavin Newsom said that this wealth tax is "not part of the conversation" and that Assembly Bill 259 will never become law, wealth taxes in general are clearly becoming a part of the national conversation.

One of the primary reasons that wealth taxes have failed to gain traction in the past is that any such tax would present significant challenges in enforcement and administration. A wealth tax must be applied as a "mark-to-market" system, meaning that taxpayers must assume a hypothetical sale of each asset for its fair market value on a particular date (usually December 31 of each year). This could impose hardships resulting from market fluctuations and could require taxpayers to obtain expensive appraisals for hard-to-value assets.

Wealth taxes could also create liquidity problems. When someone sells an asset for a gain, they receive proceeds from the sale and can use that money to pay the taxes owed on the sale. In a wealth tax regime, the tax is imposed with no reciprocal cash payment to foot the bill. This could force taxpayers to sell assets or borrow against assets to pay the tax.

States also have to wrestle with the fact that any increase to income taxes or introduction of wealth taxes could drive residents to move to other states. There are currently nine states that do not impose any income taxes at all, many of which border states in the Fund our Future coalition. In recent years, there has been a well-documented exodus of people from Connecticut, New York and Massachusetts to Florida, which does not impose any state income tax or estate tax on its residents.

If this trend continues, it will put high-tax states in the difficult position of balancing the perceived need for more tax revenue against the risk of shrinking the tax base if residents change domicile. Even if proposals like the wealth tax never pass a state legislature, the very fact that the tax was proposed could be enough to convince wealthy residents to move and could be a sign of things to come.

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