# *NOTES*

# TAXING "BORROW" IN "BUY/ BORROW/DIE"

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*The United States federal income tax contains a flaw: Because it reaches capital gains only after a "realization" event, it permits owners of highly appreciated assets to defer their tax liability by holding them and refusing to sell. Worse yet, easily available debt allows those owners to consume from their "unrealized" gains while continuing to defer tax. As Professor Edward McCaffery identified in 2012, consumption and deferral through secured borrowing, coupled with the stepped-up basis death benefit from section 1014 of the Internal Revenue Code, create an opportunity for individuals to avoid lifetime income tax and net estate tax. This strategy, known as "buy/borrow/die," contributes to consumption inequality and, by extension, America's growing wealth inequality.*

*In the tax literature, buy/borrow/die has served as a helpful hook for supporters of wealth taxes, mark-to-market income taxes, and the repeal of section 1014's stepped-up basis provision. But these three solutions merit some pragmatic concern, on the grounds that they are (to varying degrees) possibly unconstitutional, likely to be repealed, or publicly unpopular. Recognizing those practical obstacles should steer policymakers toward an incremental second-best solution: treating borrowing against appreciated collateral as a realization event. Embracing a "realization at borrowing" policy would reduce the availability of buy/borrow/die as a tax reduction strategy while sidestepping the hurdles that other proposed solutions must clear.*

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## Introduction

During the State of the Union on February 8, 2022, President Biden called for Congress to pass his Billionaire Minimum Tax because "no billionaire should pay a lower tax rate than a school teacher or a firefighter."[1] The claim that billionaires can pay rates lower than everyday Americans seems incredible under a progressive income tax, but it is true.[2] Using a straightforward set of tools, wealthy Americans can defer, reduce, and eliminate taxable income throughout their lives.

Today's tool of choice for tax elimination is the secured loan. By borrowing against appreciated assets, wealthy individuals can take advantage of the tax system's "realization doctrine," which generally requires an asset be sold or exchanged before its appreciation can be taxed.[3] They can then use their loan proceeds to pay their bills or

[1] President Joe Biden, State of the Union Address as Prepared for Delivery (Feb. 7, 2023), https://www.whitehouse.gov/briefing-room/speeches-remarks/2023/02/07/remarks-of-president-joe-biden-state-of-the-union-address-as-prepared-for-delivery [https://perma.cc/RF9F-3Z7E].

[2] IRS information published in a 2021 article revealed that Jeff Bezos, Elon Musk, Michael Bloomberg, Carl Icahn, and George Soros had each paid $0 in federal income tax in at least one year after 2005. Jesse Eisinger, Jeff Ernsthausen & Paul Kiel, *The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, ProPublica (June 8, 2021, 5:00 AM), https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax [https://perma.cc/AAP5-JP3C]. The same article developed a metric called the "True Tax Rate," which compares tax paid for a given year to the taxpayer's increase in wealth in the same year. *Id.*; *see also* Jeff Ernsthausen, Paul Kiel & Jesse Eisinger, *How We Calculated the True Tax Rates of the Wealthiest*, ProPublica (June 8, 2021, 4:59 AM), https://www.propublica.org/article/how-we-calculated-the-true-tax-rates-of-the-wealthiest [https://perma.cc/N3BS-TZT9]. ProPublica calculated that, between 2014 and 2018, Warren Buffett paid a True Tax Rate of 0.10%. *Id.* Jeff Bezos paid 0.98%. *Id.* Michael Bloomberg paid 1.30%. *Id.* And Elon Musk paid 3.27%. *Id.*

[3] *See* Joseph Bankman, Daniel N. Shaviro, Kirk J. Stark & Edward D. Kleinbard, Federal Income Taxation 230 (18th ed. 2019) ("In general, gain or loss resulting from a

amass more wealth as their portfolio continues to grow. For example, a financing proposal for Elon Musk's acquisition of Twitter filed with the Securities and Exchange Commission in April 2022 suggested that he would borrow $12.5 billion against Tesla shares to finance the acquisition.[4] While Musk ultimately secured higher amounts of equity financing and did not take the $12.5 billion loan,[5] the proposal demonstrates how secured borrowing can help wealthy individuals buy the things they want—even whole companies.

When taken to an extreme, a taxpayer refuses to sell until she has died, eliminating nearly all taxable income in a strategy known as "buy/borrow/die."[6] Since 2012, tax scholars have developed an interest in ending buy/borrow/die. They have generally focused on taxing the "buy" step by implementing a wealth tax or mark-to-market income tax,[7] or taxing the "die" step by repealing section 1014's stepped-up basis provision.[8] But these approaches are imperfect. They suffer from constitutional concerns, value loss due to political optionality, and meager public support.

By contrast, legal scholars have paid scant attention to taxing "borrow."[9] This Note offers the first comprehensive evaluation of a tax on secured borrowing to curb debt-powered tax deferral.

change in the value of an asset held by the taxpayer is not taken into account under the income tax until a 'realization' event occurs (such as sale).").

4 Twitter, Inc. Amendment No. 3 to Schedule 13D, Securities and Exchange Commission, April 20, 2022, https://www.sec.gov/Archives/edgar/data/1418091/000110465922048128/tm2213229d1_sc13da.htm [https://perma.cc/LYT2-H9LR]; Lauren Hirsch, *Elon Musk Details His Plan to Pay for a $46.5 Billion Takeover of Twitter*, N.Y. Times (Apr. 21, 2022), https://www.nytimes.com/2022/04/21/business/elon-musk-twitter-funding.html [https://perma.cc/UB68-FJEN] (disclosing the purchase of all outstanding Twitter common stock for a value of $54.20 by Elon Musk).

5 *See* Hyunjoo Jin & Chibuike Oguh, *Explainer: How Elon Musk funded the $44 Billion Twitter deal*, Reuters (October 28, 2022 9:25 AM), https://www.reuters.com/markets/us/how-will-elon-musk-pay-twitter-2022-10-07 [https://perma.cc/XEM5-TUBM].

6 Edward J. McCaffery, *Taxing Wealth Seriously*, 70 Tax L. Rev. 305, 306 (2017) ("By buying and holding assets that appreciate in value without producing taxable cash flows; borrowing to finance one's lifestyle; and holding on to their assets until death, the rich – those with capital – can avoid all income taxation.").

7 A wealth tax would use, as its base, a measure of the total value of the taxpayer's assets. A mark-to-market income tax, on the other hand, would only include net changes in the value of the taxpayer's assets in its base.

8 For more information on reforms to the "buy" step, see McCaffery, *supra* note 6, at 369–70. For reforms to the "die" step, see *id.* at 373–74.

9 Professor McCaffery briefly examined the "borrow" step in *Taxing Wealth Seriously*, focusing on the implementation of a progressive spending tax. *Id.* at 370–72. He mentioned this Note's proposal—expanding the set of realization events to include borrowing—in passing but believed that it would be infeasible. *Id.* at 370 ("Third, we could keep the realization requirement in place, but broaden the scope of realization events, specifically to include borrowing . . . but this would only create an incentive to design unsecured debt, or to use unappreciated property to secure debt.").

Part I introduces the problem of buy/borrow/die, its connection to consumption and wealth inequality, and three common proposals to fix it. Part II describes constitutionality, political optionality, and public support defects in the dominant solutions. Part III proposes a tax on secured borrowing as a solution to buy/borrow/die, evaluates it along the same criteria as the other solutions, and assesses its effectiveness against the problem. The Note concludes that policymakers should view treating secured borrowing as a realization event as a second-best solution to buy/borrow/die in recognition of practical obstacles that reduce the attractiveness of first-best solutions.

## I
## Introduction to Secured Debt Deferral

### A. *The Tax Treatment of Secured Debt*

The U.S. Federal Income Tax requires that a "realization event," often a sale, occur before a taxpayer must include an asset's growth in value in their income.[10] When a realization event occurs, the taxpayer "realizes" gain to the extent that the sale price of their asset exceeds their basis, a measure of investment often equal to the taxpayer's original acquisition price.[11] This "realization requirement" divides the set of possible transactions into two subsets: those which give rise to potential income and those which do not.

Borrowing against an appreciated asset is not treated as a realization event. A taxpayer must dispose of a capital asset before recognizing any taxable gain.[12] During the twentieth century, federal courts interpreted the Internal Revenue Code's definition of disposition to exclude secured borrowing.[13] The question appeared most squarely in *Woodsam Associates, Inc. v. Commissioner*, a canonical tax case decided by the Court of Appeals for the Second Circuit.[14] While *Woodsam* itself only

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10 Bankman et al., *supra* note 3, at 230.

11 26 U.S.C. § 1001 ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . ."). One might think of basis as a "running total" of investment into an asset. When a taxpayer acquires an asset, their basis in the asset is set at its cost. 26 U.S.C. § 1012. In many cases, basis remains constant as the taxpayer holds the asset. But additional monetary investment can increase basis under 26 U.S.C. § 1016, and return of capital can decrease basis. *E.g.*, Inaja Land Co. v. Comm'r, 9 T.C. 727, 735–36 (1947).

12 26 U.S.C. § 1001.

13 *E.g.*, Woodsam Assocs., Inc. v. Comm'r, 198 F.2d 357 (2d Cir. 1952); Comm'r v. Tufts, 461 U.S. 300 (1983); Crane v. Comm'r, 331 U.S. 1 (1947).

14 198 F.2d 357 (2d Cir. 1952). In *Woodsam*, a property owner named Wood purchased a home for roughly $300,000—$100,000 cash and $200,000 mortgage—and later borrowed an additional $200,000 after it had appreciated. *Id.* at 358. Years later, when the property was held by the taxpayer's closely-held corporation, her creditor foreclosed on the $400,000 mortgage.

binds the U.S. Tax Court and the courts of the Second Circuit, the view that loan proceeds are not income is universal in tax law.[15]

Because it is not a realization event, secured borrowing allows a taxpayer to choose when to pay tax on asset appreciation. Suppose Alice, a taxpayer, owns stock which she purchased for $1,000 and which is now worth $100,000. If Alice sells the stock today, she will realize $99,000 of capital gain. If she borrows $100,000 against the stock today, she will realize no gain. When she sells the stock to repay the loan, however, she will realize $99,000 of capital gain. By borrowing, taxpayers can defer realization until they repay. This Note refers to the power to defer realization by borrowing as "secured debt deferral."[16]

By choosing when to repay, taxpayers can reduce their overall tax liability.[17] The tax an individual owes on one dollar of income in a given year depends on a number of factors, including (1) the amount of other income the individual has in that year,[18] (2) the tax rate structure in that year,[19] and (3) whether the individual has capital losses or applicable deductions available

The IRS argued that the corporation should have included the excess of the mortgage over its basis, $100,000, in income *at the time of the foreclosure*. The corporation, in turn, argued that Wood should have included the excess in income *at the time of borrowing*. The Court of Appeals held that secured borrowing above basis was not included in the Internal Revenue Code's definition of "disposition," writing: "'Disposition,' . . . is the 'getting rid, or making over, of anything; relinquishment.' . . . Nothing of that nature was done here by the mere execution of the second consolidated mortgage; Mrs. Wood was the owner of this property in the same sense after the execution of this mortgage that she was before." *Id.* at 359.

15 *See* William D. Popkin, *The Taxation of Borrowing*, 56 Ind. L.J. 43, 43 n.1 (1980) ("Borrowed funds, *as we all know*, are not income.") (emphasis added); *see also* Dori Zinn & Jordan Tarver, *Are Personal Loans Taxable & Considered Income?*, Forbes (Mar. 29, 2021, 4:28 AM), https://www.forbes.com/advisor/personal-loans/are-personal-loans-taxable [https://perma.cc/8FPT-TGSM].

16 Although "buy/borrow/die" is likely the greater evil, secured debt deferral itself is a mechanism for the rich to avoid taxes. Even when taxpayers repay their loans before death, they may be able to harvest losses in a way that minimizes their eventual (nominal) tax burden. Taxpayers also pay a lower real tax rate by deferring because tax of $x is worth less in the future than it is today. *See generally* David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 N.C. L. Rev. 487, 502 (2022).

17 *See id.* at 487 ("Due to the realization doctrine and taxpayers' consequent ability to defer taxation of gains, taxpayers can easily minimize or avoid the taxation of investment income . . . .").

18 This is a consequence of progressive tax rates. Consider two taxpayers, Bob and Eve, who each earn $1,000 mowing lawns throughout tax year 2022. If Bob has $20,000 in other taxable income, he will pay $150 in tax on his lawnmowing pay. If Eve has $30,000 in other taxable income, she will pay $280 in tax on her lawnmowing earnings. *See generally* 26 U.S.C. § 1(c) (setting a 15% marginal rate on income up to $22,100 and a 28% marginal rate on income from $22,100 to $53,500).

19 Rate changes require comparisons between years. A tax-cutting Congress may reduce marginal rates by legislation, so that a taxpayer with equal taxable income in year one and year two will pay more tax in year one than in year two.

in that year.[20] By waiting to repay until circumstances favor realization, a taxpayer can offset the gain realized by selling their asset or simply owe less on that gain. Consider Bob, a taxpayer who owns $50,000 of Amazon stock with a basis of $1,000 and $20,000 of Meta stock with a basis of $20,000. Suppose Bob borrows $50,000 against his Amazon stock in year one and plans to repay. If Bob's Meta stock declines in value to $10,000 in year three, he could "harvest" a $10,000 loss by selling both Meta and Amazon stock in the same year. If he sells both holdings in year three, he will realize only $39,000 of gain ($49,000 from the Amazon sale, less $10,000 of loss from the Meta sale). Because Bob would have realized $49,000 of gain if he had sold in year one, he will have reduced his overall tax liability by deferring. Delaying tax into the future can be a powerful tool to avoid it altogether.

By deferring until death, taxpayers can eliminate their tax liability in full. When a taxpayer dies, their estate's basis in any capital asset increases to the asset's market value.[21] This rule is commonly known as "stepped-up basis." Because the Internal Revenue Code determines the gain realized on the sale of an asset by subtracting a taxpayer's basis from the amount received for the asset,[22] a sale at market value just after death will lead to no realized gain.[23] For example, suppose Bob bought a house for $50,000 in 2010, and that by 2022 the house had appreciated to a market value of $100,000. If Bob sold his house in 2022, he would realize $50,000 of gain.[24] If Bob died in 2022, and his executor sold the house shortly thereafter, the estate would realize no gain.[25] Although taxpayers can reduce their tax liability by deferring

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20 Taxpayers can offset their capital gains using capital losses and can deduct up to $3,000 of capital losses in excess of their capital gain. I.R.S. Topic No. 409, Capital Gains and Losses ("The term 'net capital gain' means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss for the year."); 26 U.S.C. § 1211(b) (allowing losses up to $3,000). They can also claim itemized deductions or the standard deduction to reduce their taxable income for the year. 26 U.S.C. § 63 (defining taxable income as gross income less either itemized deductions or the standard deduction).

21 26 U.S.C. § 1014(a) ("[T]he basis of property in the hands of a person acquiring the property or [who inherited the property] shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—(1) the fair market value of the property at the date of the decedent's death . . . .").

22 26 U.S.C. § 1001(a).

23 Because a taxpayer's basis in an asset they have inherited equals the market value of the asset when the prior owner died, the gain calculation (subtracting basis from sale price) yields $0 or nearly $0 of gain. Even if a taxpayer holds an inherited asset for decades, they will only be taxed on its appreciation since the death of the deceased.

24 When Bob purchased the house, his basis was set at its cost, $50,000. *See* 26 U.S.C. § 1012(a). When he sold it later, its sale price ($100,000) exceeded the basis by $50,000. This difference becomes the taxable gain. 26 U.S.C. § 1001(a).

25 Suppose Bob's son, Charlie, inherited the house. In Charlie's hands, the basis of the house would be $100,000. 26 U.S.C. 1014(a). So if Charlie sold the house for $100,000, the gain calculation would yield a gain of $0. 26 U.S.C. § 1001(a).

until favorable circumstances arise, they can eliminate it entirely by deferring until death and repaying their loans with stepped-up assets.[26] This strategy—to defer by borrowing until death and then avoid tax by selling assets with stepped-up bases—is known as buy/borrow/die.[27]

The power to minimize tax in life and avoid it in death contributes to consumption inequality. Because taxpayers do not realize income when they borrow, they can consume more by borrowing than they could by realizing income. Consider two taxpayers: Alice and Bob. Suppose Alice borrows $100,000 and Bob takes in $100,000 as salary. Assuming a 20% tax rate and no deductions or credits, Alice will have $100,000 after tax, while Bob will only have $80,000. The disparate treatment of loans allows Alice to consume $20,000 more than Bob. Secured debt deferral allows individuals holding appreciated assets to consume more than individuals who make their money as salary or by selling assets and realizing gain.

Secured debt deferral also accelerates wealth inequality in the United States. Taxpayers who defer can consume more after tax than their non-deferring neighbors. As a result, they can acquire even more wealth at a pace that exceeds that of ordinary income-earners. Professor Edward McCaffery acknowledged this problem in the paper that coined the phrase buy/borrow/die, writing:

> "Without the yoke of heavy taxation around their necks, the rich can get richer, while ever-greater burdens fall on workers, who struggle to save at all. Such a tax system would *predict*, from first principles, a world of unequal wealth, and of wealth inequality more severe than income inequality. [Thomas] Piketty demonstrates that we have such a world. Why not connect these dots?"[28]

Because the taxpayers for whom buy/borrow/die is a viable strategy already occupy the upper strata of wealth ownership, secured debt deferral allows increased concentration of wealth at the very top.

### *B. Three Common Solutions*

Discussions of buy/borrow/die and the deferral power of secured borrowing have emerged from the wealth and consumption tax

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26 Of course, a taxpayer that defers gain by borrowing will owe interest on their loan proceeds. As long as their interest totals to less than their tax savings, a taxpayer will benefit by borrowing to defer gain.

27 *See* McCaffery, *supra* note 6, at 319 ("Step three is to *die*: the last thing all of us will do on earth, however we plan.").

28 *Id.* at 329.

literatures.[29] As a result, three commonly proposed solutions to the strategy also belong to the wealth taxation world: a straightforward wealth tax, a mark-to-market income tax, and the repeal of stepped-up basis.[30]

A straightforward wealth tax would assess taxpayers based on the value of their assets at the end of each year.[31] For example, under a flat 10% total wealth tax, if Alice owns a house worth $300,000, a car worth $10,000, stock worth $5,000, and $25,000 cash, she will owe $34,000 at the end of the year. A legislature certainly could craft the wealth tax to hit only particular sources of wealth: One might imagine a world in which Alice only owes tax on her stock and cash holdings and so owes $3,000 at the end of the year. Secured debt deferral could not occur under a wealth tax because an asset's appreciation would be captured by the tax base.

A mark-to-market income tax would capture the *change* in a taxpayer's wealth during the year.[32] Consider again a flat 10% tax, but this time only on the difference between asset value on December 31 of the preceding value (the *mark*) and value on December 31 of the current year (the *market*). If Bob begins the year with $50,000 of stock and ends it with $60,000 of stock, he will owe $1,000 of tax on the $10,000 of gain he accrued during the year. A mark-to-market tax would end secured debt deferral: Even if Bob borrowed against his appreciated stock, he would owe tax on its appreciation.

Repealing section 1014's stepped-up basis rule would preserve unrealized gains for taxation after death. If Eve holds $100,000 of stock with a basis of $50,000 at death, for example, her estate's basis in the stock will be $50,000. When the estate (or its beneficiaries) sells the shares, it will realize gain to the extent the sale price exceeds $50,000. Ending the stepped-up basis provision of section 1014 would eliminate

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29 *See generally id.*; Ari Glogower, *Taxing Inequality*, 93 N.Y.U. L. Rev. 1421 (2018); David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 N.C. L. Rev. 487 (2022) (arguing that changes in law during deferral can undermine the eventual assessment and collection of tax).

30 Other solutions to the buy/borrow/die phenomenon exceed the scope of this Note. The tools used in Part II to evaluate the three chosen solutions, however, could be applied to additional solutions.

31 Thomas Piketty, Capital in the Twenty-First Century 665 (2014) ("To my mind, the objective ought to be a progressive annual tax on individual wealth—that is, on the net value of assets each person controls."); David Kamin, *How to Tax the Rich*, Tax Notes 122 (2015) ("The key problem . . . is the ability of high-income Americans to adjust their realization behavior. This can be avoided by . . . imposing wealth taxes on the entire corpus of wealth . . . .").

32 Daniel Hemel, *Taxing Wealth in an Uncertain World*, 72 Nat'l Tax J. 755, 757 ("A mark-to-market income tax would . . . require taxpayers to estimate the value of all their assets each year and (in the case of assets held year to year) pay a tax based on the value of those assets minus their value a year before.").

buy/borrow/die as a strategy but would not end secured debt deferral generally. Eve could still defer throughout her life, waiting to realize her gains until an optimal moment. If no such moment arises during Eve's life, her beneficiaries could carry on the deferral game in their lives.[33]

These are not the only solutions available to challenge secured debt deferral. Professor McCaffery and others have suggested implementing a progressive spending tax, for example, which might also reach deferred gains eventually.[34] But the wealth tax, mark-to-market income tax, and repeal of stepped-up basis have worked their way toward the center of buy/borrow/die discussion.

## II
## Flaws in Proposed Solutions

A common attribute unites the three common solutions to buy/borrow/die: Each is practically flawed. In a world with low information costs, an eager legislature, low likelihoods of repeal, and strong public support for taxes on capital, the solutions would be promising policy choices. But constitutional, administrative, and political realities will reduce their efficacy. This Part evaluates each of the three solutions against three criteria: constitutionality, political optionality, and public support.[35] Although individual solutions may fare well under one criterion or another, the Part describes a mixed bag of obstacles for each approach.

### *A. Constitutionality*

In a world where legal challenges to new policies are common, policymakers should be concerned by the possibility that a court will swiftly strike down their hard work on constitutional grounds. As they design policies, legislators should consider the likelihood that their creations will violate a constitutional provision. This is as true in tax law as in other areas.

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[33] Generally, the executor of a decedent's estate will pay their debts using assets in the estate before distributing the remainder to any beneficiaries. We could imagine a situation, however, in which both the lender and the heir remain bullish about the estate's portfolio after death. Such a situation might arise if the decedent held substantial equity in a booming business. If both the lender and heir believe they can earn more by having the heir assume all or part of the decedent's debt, they could negotiate to make that happen.

[34] McCaffery, *supra* note 6, at 370–72. For a more general introduction to the progressive spending tax, see Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 Yale L.J. 283, 345 (1994).

[35] The analysis in this Part draws inspiration from Professor Daniel Hemel's *Taxing Wealth in an Uncertain World*, 72 Nat'l Tax. J. 755, 757 (2019). While the structure of the analysis is similar, this Part aims to take a primarily external view of obstacles to solving "buy/borrow/die" and takes a different stance on some pragmatic concerns, particularly the constitutionality of mark-to-market taxation.

The Constitution divides taxes into two categories: those which must be apportioned among the states, and those which do not have to be apportioned.[36] If a tax must be apportioned, it must be paid by the states in proportion to their populations: California, at 11.953% of national population, would pay 11.953% of the total tax levied.[37]

Whether a tax is "direct" or not determines whether Congress must apportion it.[38] Before the Sixteenth Amendment took effect, Article I required Congress to apportion all "direct" taxes and capitations.[39] Other taxes could be levied without apportionment. The Sixteenth Amendment exempted the income tax, which had been ruled a direct tax, from apportionment.[40]

Taxes on personal property are direct taxes. When the Supreme Court struck down the fledgling income tax in 1895, it held that "[t]he power to tax real and personal property, and the income from both, there being an apportionment, is conceded; that such a tax is a direct tax in the meaning of the constitution has not been, and, in our judgment, cannot be, successfully denied . . . ."[41] While the Court's holding in *Pollock* with regard to income from real and personal property was superseded by the Sixteenth Amendment, the Court continues to view taxes on personal property as direct taxes.[42]

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36 The Constitution directs that "Representatives and direct Taxes shall be apportioned among the several States . . . according to their respective Numbers[.]" U.S. Const. Art. I, § 2, cl. 3. It further prohibits Congress from imposing any "direct" tax except by apportionment. U.S. Const. Art. I, § 9, cl. 4 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or enumeration herein before directed to be taken."). But it also grants to Congress the broad "Power To lay and collect Taxes, Duties, Imposts and Excises[.]" U.S. Const. Art. I, § 8, cl. 1. Because the Constitution grants Congress the power to impose "taxes" generally and places the apportionment constraint only on the subset of "direct" taxes, there exists a complement (which we can call the "indirect" taxes) that Congress can impose without apportionment.

37 U.S. Const. Art. I, § 2, cl. 3; U.S. Census Bureau, Table 1: Apportionment Population and Number of Representatives by State: 2020 Census. California's "apportionment population" under the 2020 Census is 39,576,757. Dividing by the total apportionment population, 331,108,434, yields an apportionment population percentage for California of 11.953%.

38 U.S. Const. Art. I, § 9, cl. 4 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or enumeration herein before directed to be taken.").

39 *Id.*

40 The Supreme Court held that the income tax was an unapportioned direct tax, and thus unconstitutional, in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). The Sixteenth Amendment, proposed in response to the *Pollock* decision and ratified in 1913, provides that "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

41 *Pollock*, 158 U.S. at 634 (holding that a statutorily imposed income tax Farmers' Loan & Trust paid on behalf of its stockholder was unconstitutional).

42 NFIB v. Sebelius, 567 U.S. 519, 571 (2012) (finding that the Patient Protection and Affordable Care Act of 2010's individual mandate operates as a valid income tax);

A straightforward wealth tax is a tax on personal property and thus likely a "direct" tax. A tax is "on personal property" if it is imposed simply because the taxpayer owns the property taxed.[43] Under a wealth tax, individuals would owe tax by reason of their ownership of valuable property. Taxation would not depend on any transactional or behavioral trigger. Thus, a wealth tax would most likely have to be apportioned among the states.

A "direct" wealth tax would have to be apportioned, but apportionment would kill a wealth tax. The distribution of population among the states is different from the distribution of wealth, so large, poorer states would pay much in tax while small, richer states would pay little.[44] For example, consider Texas and Virginia. As of the 2020 census, Texas's "apportionment population" was 29,183,290; Virginia's was 8,654,542.[45] Because of its relative population size, Texas would owe 3.372 times as much contribution to a national wealth tax as Virginia. But according to estimates from Census Bureau statisticians, the mean net worth in Texas is $1,220,117; in Virginia, it is $4,240,759.[46] Rough extrapolation from these values suggests that Virginia has 3% *more* cumulative wealth than Texas,[47] but an apportioned wealth tax would require it to pay less than one third of what Texas would pay. The mismatch between population and wealth distributions would cause a wealth tax to drain the pockets of individuals in states with wealth portions below their population portions.[48] It would also encourage

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Eisner v. Macomber, 252 U.S. 189, 218–19 (1920) (holding that a stock dividend paid as additional shares of stock is not taxable income).

43 *See Eisner*, 252 U.S. at 205 ("In [*Pollock*] . . . taxes [on returns from real estate and personal property] were held to be . . . direct taxes upon the property from which such income arose, imposed by reason of ownership . . . Congress could not impose such taxes without apportioning them among the states according to population . . . .").

44 *Cf.* Carl Davis, Emma Sifre, & Spandan Marasini, Inst. on Tax'n & Econ. Pol'y, The Geographic Distribution of Extreme Wealth in the U.S., (Oct. 13, 2022), https://itep.org/the-geographic-distribution-of-extreme-wealth-in-the-u-s [https://perma.cc/K6TH-TCAU] (describing the distribution among states of people with personal wealth over $30 million).

45 U.S. Census Bureau, Apportionment Population and Number of Representatives by State: 2020 Census (2020).

46 Rebecca Chenevert, Alfred Gottschalck, Mark Klee & Xingyou Zhang, *Where the Wealth Is: The Geographic Distribution of Wealth in the United States* (U.S. Census Bureau, Working Paper No. FY2016-129, 2017).

47 Simply multiplying the apportionment population by the estimated mean net worth suggests that the cumulative net worth of individuals in Texas is $35,607,028,244,930. The same calculation for Virginia yields a cumulative net worth of $36,701,826,877,378. These are by no means the true wealth bases in either state; rather, they serve to illustrate the point that population count is a poor estimator for wealth held by that population.

48 Suppose Congress asks the states to pay a combined tax amount equal to 10% of the national wealth and further mandates that states must collect the tax through a flat rate wealth tax. If a state's portion of national population equals its portion of national wealth (an "equals" state), the state can impose a 10% statewide wealth tax to raise the funds it owes.

wealthy individuals to congregate in small states, where apportionment would reduce tax rates.

Not all tax policy scholars agree that an unapportioned wealth tax would be unconstitutional.[49] Some agree with the Supreme Court's eighteenth and nineteenth century view of the Direct Taxes Clause: that direct taxes are those for which apportionment is reasonable.[50] Under this view, apportionment is a mechanism to reduce valuation uncertainty by using population to estimate the distribution of the tax base. If a tax could not be apportioned without adverse effects, it would not be direct.[51] Bruce Ackerman advanced this view in 1999,[52] relying on Supreme Court precedent from as early as 1796.[53] Under an apportion-when-reasonable rule, Congress would not need to prorate a wealth tax by state population because the distribution of wealth and distribution of people in the United States differ widely.

Even those scholars who believe a wealth tax need not be apportioned, however, acknowledge that the judiciary may feel differently.[54] Others still take the position that, regardless of how a "correct" interpretation of the taxing clauses would fall, the contemporary Supreme Court will almost certainly strike down an unapportioned wealth tax.[55]

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If a state's portion of national population exceeds its portion of national wealth (a "greater-than" state), it will have to impose a flat rate greater than 10%. If a state's portion of national population is less than its portion of national wealth (a "less-than" state), it can raise the tax it owes by imposing a flat rate below 10%. Taxpayers in the "greater-than" states will pay tax at a higher rate than those in "less-than" or "equal" states.

49 *See generally, e.g.*, Ari D. Glogower, David Gamage & Kitty Richards, Roosevelt Inst., Why a Federal Wealth Tax Is Constitutional (2021) (analyzing Supreme Court precedent to argue that an unapportioned wealth tax is constitutional); Dawn Johnsen & Walter Dellinger, *The Constitutionality of a National Wealth Tax*, 93 Ind. L.J. 111 (2018) (acknowledging that an effective progressive tax system is difficult, but not unconstitutional); John R. Brooks & David Gamage, *Taxation and the Constitution, Reconsidered*, 76 Tax L. Rev. 76 (2022); Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1 (1999) (arguing for the narrow construction of Article I's "direct tax" clause as it should not serve as a constitutional bar).

50 Hylton v. United States, 3 U.S. 171, 174 (1796) ("The rule of apportionment is only to be adopted in such cases where it can reasonably apply; and the subject taxed, must ever determine the application of this rule."); *see also* Ackerman, *supra* note 49, at 25 ("Only in 1895 did the Court depart from this unbroken line of precedent to strike down a federal income tax statute . . . .").

51 *Hylton*, 3 U.S. at 174.

52 Ackerman, *supra* note 49, at 20–25.

53 *Hylton*, 3 U.S. at 174.

54 Glogower et al., *supra* note 49, at 3("Would a federal tax on an individual's net wealth be a 'direct tax' subject to apportionment? This question cannot be answered with certainty since the scope of the term "direct tax" is innately ambiguous and indeterminate."); *id.* at 16 ("Of course, any particular justices on the Supreme Court at any particular moment in history could find grounds to invalidate an unapportioned wealth tax . . . .").

55 *See* Daniel Shaviro, *Would an Unapportioned U.S. Federal Wealth Tax Be Constitutional, and What Does That Mean?*, NYU Law and Economics Research Paper Series (Working

Because a wealth tax may, with some substantial likelihood, be enjoined within weeks of passage, it should be less desirable to policymakers.

Mark-to-market taxation also carries constitutional baggage. In order to tax annual appreciation, Congress would have to obliterate the realization requirement. If annual gains are not "income" under the Sixteenth Amendment until they are realized, however, Congress could not tax them except through an apportioned direct tax or an "indirect" tax.[56] Because an apportioned mark-to-market tax would face the same troubles as a wealth tax, the feasibility of a mark-to-market tax turns on whether the realization requirement stems from the Constitution or statute.

One point in favor of the constitutionality of unapportioned mark-to-market taxation is that a mark-to-market provision on the books has survived constitutional scrutiny in federal Courts of Appeals. Section 1256 of the Internal Revenue Code treats regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts held by a taxpayer at the end of the year as though they had been sold on the last day of the year.[57] A taxpayer challenged section 1256's constitutionality in *Murphy v. United States*, arguing before the Court of Appeals for the Ninth Circuit that the mark-to-market provision fell outside of the grant of power in the Sixteenth Amendment and should have been apportioned.[58] The Court of Appeals disagreed, holding that section 1256 falls "well within [Congress's] authority" to levy income taxes.[59] In 1999, the Court of Appeals for the Second Circuit also held that section 1256 counted as an income tax even though it did not require realization.[60]

But decisions endorsing the tax on section 1256 contracts generally rely on the doctrine of "constructive receipt" without answering the realization question. Constructive receipt allows Congress to tax income which, although it has not actually been reduced to possession, falls within the taxpayer's control.[61] For example, funds or property in a nonqualified deferred compensation plan are constructively received

Paper No. 23–25) (2023); Daniel J. Hemel & Rebecca Kysar, Opinion, *The Big Problem with Wealth Taxes*, N.Y. Times (Nov. 7, 2019), https://www.nytimes.com/2019/11/07/opinion/wealth-tax-constitution.html [https://perma.cc/3J3Z-ZESP].

56 *See supra* note 34.

57 U.S.C. § 1256(a)(1); *see also* § 1256(b)(1) (defining a "section 1256 contract").

58 992 F.2d 929 (9th Cir. 1993).

59 *Id.* at 931.

60 Greene v. United States, 185 F.3d 67 (2d Cir. 1999).

61 26 C.F.R. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time . . . .").

by an employee if the employee can trigger their distribution.[62] The Court of Appeals for the Ninth Circuit grounded its *Murphy* decision in constructive receipt. Section 1256 contracts could be cashed out by holders at the end of each market day. Because Murphy had a right to withdraw each day's appreciation, he had constructively received the contract's gain over the year.[63] In fact, the *Murphy* court expressly avoided the realization question.[64] The Second Circuit, likewise, relied on constructive receipt to justify its holding.[65]

Disagreement over the Tax Cuts and Jobs Act's Mandatory Repatriation Tax among judges of the Court of Appeals for the Ninth Circuit suggests that a constitutionally based realization requirement is not out of the question. The Mandatory Repatriation Tax requires owners in a controlling group of a foreign corporation to recognize, as income, a *pro rata* share of that corporation's profits from 1986 to 2018.[66] A contemporary challenge to the law, *Moore v. United States*, recently appeared before a three-judge panel at the Ninth Circuit, which unanimously held that it did not exceed Congress's taxing power. When the Court of Appeals denied a petition for rehearing en banc, four circuit judges dissented.[67] The dissent found a constitutional basis for the realization requirement in the Sixteenth Amendment, relying on the Supreme Court's holdings in *Eisner v. Macomber* and *Glenshaw Glass*.[68] As of the time of this writing, the Supreme Court of the United States has granted certiorari in *Moore v. United States* but has not issued a final decision. Nevertheless, some commentators have advanced the view that the case could be resolved on limited reasoning that does not squarely resolve the status of the realization requirement.[69]

Because cases supporting the constitutionality of mark-to-market taxation were actually decided on more traditional, realization-compatible

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62 *See generally* 26 U.S.C. § 409A.

63 *See Murphy*, 992 F.3d at 931 ("Section 1256 is premised on the doctrine of constructive receipt because the taxpayer who trades futures contracts receives profits as a matter of right daily.").

64 *Id.* at 931–32 ("We need not, and do not, decide the broader issue of whether Congress *could* tax the gains inherent in capital assets prior to realization or constructive receipt.").

65 *Greene*, 185 F.3d at 72–73.

66 26 U.S.C. § 945.

67 Moore v. United States, 53 F.4th 507, 507 (9th Cir. 2022) (Bumatay, J., dissenting) (joined by Judges Ikuta, Callahan, and Vandyke).

68 *Id.* ("[B]y dispensing with the realization requirement for income without offering any other limiting principle, we open the door to expansion of the federal taxing power beyond the limits placed by the Constitution. . . . Based on text, history, and precedent, our court erred in disregarding the realization requirement of the Sixteenth Amendment."). The *Moore* plaintiffs filed a petition for writ of certiorari at the Supreme Court in February 2023; the Court has not made a decision regarding the petition as of May 15, 2023.

69 *See* Daniel J. Hemel, *The Low and High Stakes of* Moore, Tax Notes (July 24, 2023).

grounds,[70] and because recent challenges to the taxation of unrealized gains have garnered originalist support,[71] policymakers should recognize that mark-to-market taxation carries non-negligible constitutional uncertainty. Even though mark-to-market taxes are less certainly troubled than a straightforward wealth tax, they are by no means out of the woods.

Unlike enacting a wealth tax or a mark-to-market income tax, Congress undoubtedly has the power to repeal section 1014. Section 1014 is a conscious exclusion of potential income. No part of the Constitution requires Congress to wipe out accrued gains at death. Additionally, section 1014 has been repealed twice before with no constitutional fanfare.

A constitutional analysis provides policymakers with justifications to prefer repealing stepped-up basis over a mark-to-market income tax, and to prefer a mark-to-market income tax over a wealth tax.

### *B. Political Optionality*

Suppose that each of the three policies could be passed and that courts would uphold them if challenged. The adopted solution would then have to weather political headwinds over time, primarily the possibility that a political party opposed to it would attempt repeal. An emerging understanding in tax scholarship suggests that future political trouble should shape the choices of policymakers ex ante, particularly when deferral is available. In their paper *Tax Now or Tax Never*, Professors David Gamage and John Brooks identify what they call the "political optionality benefit" of tax deferral.[72] Political optionality benefits reflect the potential for law to change in the future such that a deferring taxpayer will owe less nominal tax after deferral than in the present.[73] Under Gamage and Brooks's account, future-assessment policies (policies which permit deferral) are less attractive than current-assessment policies because political realities will undermine the future-assessment policies. Put differently, the possibility of repeal or amendment over time should change rational policymaker preferences.

A simple example illustrates the power of political optionality benefits to influence rational policymakers. Consider two policies: one which will charge Alice $100 today, and one which will charge her $100 in one year. Suppose that Congress will repeal either policy by the end

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70 Murphy v. United States, 992 F.2d 929, 931 (9th Cir. 1993); *Greene*, 185 F.3d at 72–73.

71 *Moore*, 53 F.4th at 507 (Bumatay, J., dissenting).

72 David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 N.C. L. Rev. 487, 495 (2022). Political optionality benefits are also referred to as "political uncertainty" in Daniel Hemel's *Taxing Wealth in an Uncertain World*. 72 Nat. Tax J. 755 (2019).

73 Gamage & Brooks, *supra* note 72, at 495.

of the year with probability 20%. Then under policy one, Alice should expect to pay $100, and under policy two, Alice should expect to pay $80. Because she expects to pay less under policy two, Alice should prefer policy two. The State, on the other hand, should prefer policy one because it offers a higher expected revenue. This is the core of political optionality: Policymakers interested in raising revenue should prefer immediate taxation over deferred taxation.[74]

Gamage and Brooks's analysis demonstrates that policymakers interested in taxing wealth should prefer to do so through a true wealth tax, rather than by taxing some deferrable proxy. Consumption is one such proxy: If all wealth will be consumed eventually, a consumption tax will eventually reach all wealth. But even if the assumption that all wealth will be consumed is true, the possibility of repeal or amendment reduces a consumption tax's expected revenue.[75] An immediate-assessment wealth tax does not face the same expected revenue reduction because wealth cannot be deferred past the end of any taxable year. All else being equal, Gamage and Brooks argue, policymakers should prefer an immediate-assessment wealth tax to a consumption tax.[76]

Political optionality benefits depend, however, on the target of taxation. If the goal is to tax wealth, any deferrable proxy for wealth (e.g., consumption or realized gains) is less appealing than taxing wealth immediately. If the goal of a set of policies is to tax wage income, what matters is the opportunity for taxpayers to defer wage income taxation. In a discussion focused on wage income, a tax on savings would be less appealing than the federal income tax, even if all income will eventually be saved.

Political optionality considerations weigh heavily against repealing stepped-up basis to prevent secured debt deferral. Repealing section 1014 would stop the elimination of accrued taxable gain at death. It does little, however, to ensure that lifetime appreciation is ever taxed. No policy commands estates to sell their decedent's assets and realize gains. Hypothetically, the child of a buy/borrow/die participant could continue to borrow as long as their assets continue gaining value. One might assume that eventually, whether one generation or ten after the original taxpayer purchased their assets, appreciation will end and someone will sell the assets. For each year that passes, however, the possibility that Congress will reinstate section 1014 reduces the government's expected revenue. By continuing to permit unchecked deferral, repealing stepped-up basis leaves significant political optionality benefits on the table.

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74 *Id.* at 521–22.

75 *See id.* at 541–44.

76 *Id.* at 492.

Even if stepped-up basis repeal were accompanied by a "realization at death" rule, taxpayers could still defer throughout their lives and gamble on the appearance of a wealth-friendly Congress. A taxpayer whose IPO goes extremely well at age twenty might suppose she has sixty years of political possibility ahead of her. If she believes a 1014-friendly party will win control of Congress during those six decades, she may choose to defer her gains by borrowing against her appreciated stock. Ex ante, the likelihood of either a return to stepped-up basis or the repeal of the retrospective capital gains tax reduces the appeal of repealing stepped-up basis to reach deferred gains.

History, as well as theory, supports disfavoring section 1014 repeal on account of political optionality. Congress has repealed stepped-up basis twice in the past fifty years.[77] The Tax Reform Act of 1976 amended section 1014 to provide a carryover basis rule.[78] Under the amended rule, a taxpayer's basis in an inherited asset would be the same as it was in the hands of the person who left it to them.[79] The change was short-lived. The Revenue Act of 1978 deferred the carryover basis rule until 1980.[80] In 1980, the Crude Oil Windfall Profit Tax Act repealed the rule altogether, reinstating the step-up regime.[81] In 2001, Congress tried again, removing step-up in basis for decedents starting in 2010 in order to satisfy the Byrd Rule.[82] Nine years later, just before the change had any effect, Congress repealed the carryover provisions from 2001.[83] If section 1014 were terminated once more, taxpayers may feel no compulsion to avoid death-based strategies: They have seen this before.

Wealth taxes and mark-to-market income taxes, on the other hand, fare well under a political optionality analysis. Either of these proposals would include what we currently call "unrealized gains" in the annual tax base. Because neither would allow deferral of realization, they do not lose value to political fluctuations. This is not to say they could not be repealed or defanged; they could. But taxpayers cannot dodge a wealth tax or mark-to-market income tax while waiting for eventual repeal or amendment. Thus, political optionality offers a reason to favor wealth

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77 *See id.* at 549–52.

78 Tax Reform Act of 1976, Pub. L. 94–455, § 2005, 90 Stat. 1520, 1872 (1976).

79 *Id.*

80 Revenue Act of 1978, Pub. L. 95–600, § 515, 92 Stat. 2763, 2884 (1978).

81 Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96–223, § 401, 94 Stat. 224, 299 (1980).

82 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16, § 541, 115 Stat. 38, 76 (2001). The Byrd Rule, contained in the Congressional Budget Act, prohibits Congress from including provisions that would increase the federal deficit beyond a specified window in any reconciliation bill. Nowadays, many taxpayer-friendly tax provisions "sunset," or go out of effect at a specified time, to eliminate the deficit effects of reconciliation bills.

83 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111–312, § 301, 124 Stat. 3296, 3300 (2010).

tax or mark-to-market income tax solutions to secured debt deferral over a repeal of stepped-up basis.

### *C. Public Support*

Public response to a policy solution influences both the likelihood that the solution will become law and the desirability of enacting it. As a practical matter, politicians rely on public support to win elections and take office. Even though contemporary political science suggests that only a select few citizens can influence policymaking, overwhelming opposition by one's constituents may pose electoral problems. Assuming politicians hope to stay in office, they should let public preference serve as some degree of guide to their policymaking behavior.

A reinvigorated line of thought in law and economics supports the idea that policy should reflect public preference. Tax policy scholarship often grows out of contemporary economics, with an aim of maximizing welfare. In a recent article, Zachary Liscow and Daniel Markovits argue that law and economics should engage with public preferences to build policy.[84] Behavioral economics, their argument contends, relies on assumptions about so-called "normative preferences"—neutral principles that serve as a benchmark for true behavior.[85] But because economists and legal scholars may not hold the same preferences as others, their work "risks merely enacting the policy preferences (or biases) of unrepresentative experts and thereby distorting policymaking."[86]

Because the public widely approves of the realization requirement, policymakers should disfavor using a mark-to-market income tax to end secured debt deferral. To implement a mark-to-market income tax, Congress would need to abandon the realization requirement altogether. Under a mark-to-market system, taxpayers would include their unrealized and realized gains alike in income at the end of the year. Recent evidence, however, suggests that the public widely approves of the realization requirement. In 2021, Professors Zachary Liscow and Edward Fox conducted a survey intended to evaluate public sentiment surrounding the realization rule.[87] Respondents opposed taxing unsold

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[84] Zachary Liscow & Daniel Markovits, *Democratizing Behavioral Economics*, 39 YALE J. REG. 1274, 1274 (2022).

[85] *Id.* at 1307.

[86] *Id.* at 1274; *see also* Jeffrey J. Rachlinski, *Nudges, Defaults, and the Problem of Constructed Preferences*, 72 DUKE L.J. 1731 (2023); Michael Hallsworth, *A Manifesto for Applying Behavioural Science*, 7 NATURE HUMAN BEHAVIOR 310, 312 (2023).

[87] *See* Zachary Liscow & Edward Fox, *The Psychology of Taxing Capital Income: Evidence from a Survey Experiment on the Realization Rule*, 213 J. PUB. ECON. (2022), https://www.sciencedirect.com/science/article/pii/S0047272722001165 [https://perma.cc/5MS4-LPU2].

stock gains 75% to 25%.[88] Overwhelming opposition to ending the realization requirement, Liscow and Fox contend, stems from a form of "mental accounting" in which unrealized gains are a fiction rather than a form of untaxed income.[89]

Although Liscow and Fox's main result focused on the taxation of unrealized appreciation through a mark-to-market system, Americans likely would not prefer a wealth tax. First, a wealth tax would also require Congress to eviscerate the realization rule.[90] Because taxpayers roundly oppose removing realization, they should oppose taxing unsold gains and a taxpayer's basis annually. Second, Liscow and Fox asked respondents about a close cousin of the wealth tax: state property taxes.[91] When asked if an appreciated home should be taxed at its market value or at its purchase price, taxpayers split: 51% preferred a valuation below market value.[92] Even in a wealth tax world, Americans would be uncertain about including unrealized gains in wealth.

Repealing stepped-up basis, on the other hand, garners substantially more support from the public. According to Liscow and Fox, 64% of respondents support taxing gains at death.[93] Congress may find it preferable, therefore, to repeal stepped-up basis rather than embracing either of the other solutions. Speculatively, this aspect of tax psychology may partially explain why repeal of section 1014 has, of the three solutions, come closest to enactment in recent years. President Biden included a repeal of the stepped-up basis provision, as well as a proposal to treat death as a realization event, in his Fiscal Year 2022 Green Book—an annual document laying out proposed revenue changes.[94] Widespread disapproval of mark-to-market and wealth taxation among citizens should give policymakers pause and enhance their relative disfavor to repealing stepped-up basis.

Constitutional concerns, political optionality, and public support analyses present a rocky road for common solutions to secured debt deferral and buy/borrow/die. Individual solutions succeed under some analyses and not others, but none pass each test with flying colors. A mark-to-market income tax, though it does not suffer from political optionality failings, runs counter to public sentiments about tax and carries some constitutional uncertainty. A wealth tax performs no better

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88 *Id.* at 2.

89 *Id.*

90 David Kamin, *How to Tax the Rich*, 146 Tax Notes 119, 122 (2015) ("Both [a wealth tax and mark-to-market income tax] overcome the realization barrier.").

91 Liscow & Fox, *supra* note 87, at 6.

92 *Id.*

93 *Id.* at 8.

94 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals 62 (2021).

on public support grounds and faces a more treacherous constitutional road, but likewise does not lose value to political optionality. Repealing stepped-up basis outperforms both the wealth tax and mark-to-market income tax on constitutionality and public support but would offer taxpayers extreme deferral windows in which to root for its reversal. In the absence of a clear path forward for any of the oft-discussed solutions, policymakers should contemplate alternatives which may fare better against constitutional and political headwinds.

## III
## Realization at Borrowing

### A. *Describing Realization at Borrowing*

To avoid the political, constitutional, and timing flaws inherent in other approaches to ending secured debt deferral, policymakers could consider an incremental solution. This Part proposes a targeted strike: treat the secured loan transaction as a realization event.

The design of a "realization at borrowing" rule flows from the logic of section 1001, which sets out the rule for determining gain from a disposition of a capital asset.[95] It requires taxpayers to recognize gain to the extent the disposition price exceeds their basis in the disposed asset.[96] When a taxpayer borrows against an appreciated asset, the natural substitute for disposition price is the face value of the loan. Substituting market value for the disposition price would create a valuation problem: Without a sale, taxpayers often do not know the true values of their assets.[97] By contrast, the value of the loan principal should be known at the time of the transaction. Comparing basis to market value would also create liquidity problems for taxpayers who do not have significant cash reserves.[98] The receipt of loan proceeds by the taxpayer, on the other hand, relieves any fear of liquidity problems in using the loan principal amount.

The logic of section 1001 also suggests that realization at borrowing should be accompanied by an increase in basis to offset future gains. The end goal of the realization requirement—as enshrined in section 1001—is to reach the difference in value between the sale price of an asset and a

[95] 26 U.S.C. § 1001.

[96] 26 U.S.C. § 1001(a). A taxpayer's basis for determining gain is determined, in turn, by 26 U.S.C. § 1011.

[97] Kamin, *supra* note 90, at 123 ("According to IRS estimates based on estate tax returns, about 50 percent of gross wealth held by those with a net value exceeding $2 million in 2007 . . . is held in assets not easily valued.").

[98] *See generally* Glen Loutzenhiser & Elizabeth Mann, *Liquidity Issues: Solutions for the Asset Rich, Cash Poor*, 42 Fiscal Stud. 651 (2021).

taxpayer's basis.[99] Without a basis increase, realization at borrowing would lead to a double taxation. For example, consider Eve, a taxpayer who purchased one share of stock in 2022 for $10 which is now worth $100. Under a realization at borrowing solution without a basis adjustment, if Eve borrows $50 secured by the share, she will realize $40 of income. When Eve sells her share a few years later to repay the loan, assuming it is then worth $150, she will realize $140 of income. Even though the stock will have appreciated by only $140, Eve will realize $180 of income between the borrowing and the sale. Instead, Eve should increase her basis to $50 after recognizing $40 of borrowing income. Then, after selling the share for $150, Eve will realize $100 of income for a total of $140—equal to the share's net appreciation.

Losses, however, should not be allowed when a taxpayer borrows an amount below their adjusted basis in the collateral. If borrowing below basis could trigger a loss, a realization at borrowing rule would open new doors for at-will gain deferral. Suppose Alice owns shares of Under Armour with a basis of $100 and fair market value of $600, and shares of Nike with a basis of $1,000 and fair market value of $1,000. Assume as well that Alice has held her Nike and Under Armour shares for more than one year. Alice hopes to sell her Under Armour stock in 2023. If she prefers to recognize her $500 of long-term capital gain in a later tax year, she could concurrently borrow $500 against her Nike shares and net the resulting loss (because $500 is less than her $1,000 basis) against her gain from the Under Armour sale.[100] Her $500 gain will be preserved by reducing her basis in Nike to $500. Allowing a loss to taxpayers who borrow below basis would only change the mechanism for gain deferral, rather than prohibit the deferral altogether.

As a design choice, secured borrowing should not be treated as a realization event when the collateral is an asset deployed in a trade or business. The primary sin of secured debt deferral is that it contributes to individual consumption inequality and, by extension, wealth inequality.[101] These problems do not necessarily map well onto businesses: They cannot consume in the individual sense, and their growth may promote economic wellbeing for varied stakeholders. Thus, it is harder to find a compelling reason to discourage secured borrowing in the business context. Applying realization at borrowing to business assets would also diminish the effect of other growth-promoting code provisions. For

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[99] 26 U.S.C. § 1001(a).

[100] *See* 26 U.S.C. § 1222(7) (defining net long-term capital gain as the excess of long-term capital gains over long-term capital losses in a given year). Note that this hypothetical supposes that the character of the borrowing loss would be the same as if Alice had sold the Nike shares for $500.

[101] *See supra* Section I.A.

example, consider a farmer who purchases a truck and expenses it as section 179 property.[102] Requiring that farmer to recognize gain whenever he borrows against the truck would work against the expensing provision: If the farmer plans to borrow against it within the same year as entering it into service, it eliminates the benefit of section 179 altogether. Because the rationale for opposing secured debt deferral is less apparent in the business context, and because realization at borrowing would work against existing expense provisions, realization at borrowing should not apply to loans taken against trade or business assets.

A realization at borrowing policy would put an end to secured debt deferral. The crux of secured debt deferral is that taxpayers holding unrealized gains can use loan proceeds to consume without realizing any gain.[103] If the loan proceeds could not be retrieved without a realization event, taxpayers could still borrow, but could not defer their gains by borrowing against their assets.

Because it would end secured debt deferral, realization at borrowing would also put a stop to buy/borrow/die using secured loans. Buy/borrow/die is secured debt deferral taken to an extreme: until after the taxpayer dies.[104] By taking away the power to defer at all, realization at borrowing would prevent buy/borrow/die well before death.

### *B. Realization at Borrowing Would Avoid the Problems of Other Solutions*

Policymakers should consider realization at borrowing among their menu of options because it is comparable, or relatively superior, to the three aforementioned solutions when measured against the practical obstacles of constitutional certainty, political optionality, and public support.

#### *1. Constitutionality*

The Constitution undoubtedly permits Congress to tax individuals when they borrow against appreciated assets without apportionment. Congress can tax income without apportionment.[105] It can also levy indirect taxes, such as duties and excises, without

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102 *See* 26 U.S.C. § 179 (allowing taxpayers to expense the cost of property used in a trade or business when the property is entered into service).

103 McCaffery, *supra* note 6, at 319 ("This gets us to a deep problem: *Consumption financed by debt is income-tax free*.").

104 *Id.* at 319–21.

105 U.S. Const. amend. XVI.

apportioning its revenue by population.[106] A tax on secured borrowing would fit within either power.

Congress can tax secured loan proceeds as "income" under the Sixteenth Amendment. Suppose the Sixteenth Amendment contains some type of realization requirement. The Supreme Court has held that "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion[]" fall within the Sixteenth Amendment's scope.[107] Secured loan proceeds clearly meet *Glenshaw Glass*'s standard. Borrowers turn over a combination of a promise to repay funds and a contingent property interest (the right to possess collateral) in exchange for some amount of money. Because borrowers receive funds that they can use to consume and that, before the loan, were locked into their collateral assets or their power to make promises, they have accessed wealth that would otherwise have been unavailable.

Leading decisions that hold loan proceeds are not realized income rely on statutory definitions of realization, not constitutional standards. In its influential *Woodsam* opinion, for example, the Court of Appeals for the Second Circuit acknowledged that, by borrowing rather than selling her property, Mrs. Wood "never 'disposed' of the property to create a taxable event *which Sec. 111(a) I.R.C. makes a condition precedent to the taxation of gain*."[108] Whether or not loans can be *constitutionally* taxed as income has not been reached.

Even if loan proceeds are not "income," Congress could tax them as an excise on the loan transaction. Article I enables Congress to levy "duties, imposts, and excises" without apportionment.[109] Since the Founding, federal courts have repeatedly afforded Congress an expansive construction of what counts as an indirect tax.[110] For example, the Court has permitted Congress to tax corporate income framed as an excise on the right to operate under a corporate charter.[111] Congress can tax transactions or processes other than ownership without apportionment under its original grant of power. Framed as an excise on the borrowing transaction, a realization at borrowing rule would certainly survive constitutional scrutiny.

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106 U.S. Const. art. I, § 8, cl. 1.

107 Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

108 Woodsam Assocs., Inc. v. Comm'r, 198 F.2d 357, 359 (2d Cir. 1952) (emphasis added).

109 U.S. Const. art. I, § 8, cl. 1.

110 *See, e.g.*, Flint v. Stone Tracy Co., 220 U.S. 107, 157 (1911) ("When the Constitution was framed, the right to lay excise taxes was broadly conferred upon the Congress."); Murphy v. United States, 992 F.2d 929, 930 (9th Cir. 1993) ("The power of Congress in levying taxes is very wide . . . ." (quoting Barclay & Co. v. Edwards, 267 U.S. 442, 450 (1925))).

111 *See Flint*, 220 U.S. 107.

Because treating secured borrowing as a realization event carries little to no constitutional uncertainty, it should be relatively more attractive than constitutionally uncertain alternatives. Specifically, policymakers should prefer realization at borrowing to a wealth tax or a mark-to-market income tax on constitutional grounds. Constitutional uncertainty reduces the appeal of a policy option: It reduces the expected return on political capital investment. Further, a high likelihood of invalidation leaves open the possibility that a court will answer a constitutional question in a way that cuts off other policy options.

### 2. *Political Optionality*

When considering policies that will end secured debt deferral, treating secured borrowing as a realization event has no political optionality problem. Political optionality problems arise when a policy permits taxpayers to wait it out and hope for amendment in the future.[112] Because taxing secured loans touches the very mechanism of deferral, taxpayers cannot hold off its effects and hope for repeal unless they refuse to use their wealth to consume at all.

The lack of deferral opportunity under a realization at borrowing rule puts it in the same optionality category as a wealth tax or a mark-to-market income tax. Policymakers should think of these three solutions as, all else equal, superior to a repeal of stepped-up basis for ending secured debt deferral strategies.

### 3. *Public Support*

Public support for relaxing the realization requirement in secured debt deferral circumstances is significantly higher than the general response.[113] Liscow and Fox report that 36% of respondents supported taxing a hypothetical individual when they borrowed $40,000 against home appreciation of $50,000.[114] While 36% is obviously not a majority, an 11% support increase over the pure realization rule response suggests that the public feels differently about unrealized gains when they are consumed rather than saved.

Heightened public support for relaxing the realization requirement in the context of secured debt deferral could justify policymakers in preferring a realization at borrowing solution over a wealth tax or a mark-to-market income tax. All else equal, we might expect

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112 Gamage & Brooks, *supra* note 72, at 495.

113 Liscow & Fox, *supra* note 87, at 13 ("We give a scenario in which the taxpayer borrows $40,000 against $50,000 of unsold stock gains and uses the money for personal expenses. Here, 36% prefer to tax the amount borrowed and consumed, even without a sale . . . .").

114 *Id.*

policymakers to support solutions that their constituents approve. Of course, support for repealing stepped-up basis exceeds support for any of the other solutions, including realization at borrowing. But just as in Part II, public support should not be a dispositive factor—constitutionality and political optionality should color policymakers' choice of solution as well. In the decision between repealing stepped-up basis and implementing a realization at borrowing scheme, political optionality should weigh heavily in favor of immediate-assessment through a realization at borrowing rule.

### *C. Would Realization at Borrowing Reach the Targeted Gains?*

Notwithstanding its relative success in analyses of public support, constitutionality, and political optionality, treating secured borrowing as a realization event may not be a perfect solution to income tax avoidance by the wealthy. The few commentators who have considered the approach in the past have noted two possible drawbacks.[115] First, wealthy individuals could avoid a secured borrowing tax by taking out unsecured loans.[116] Second, the tax on secured borrowing could be minimized by pledging excess collateral or unappreciated collateral to a loan.[117]

Taxing secured borrowing does create an incentive for taxpayers to borrow without security. To illustrate this, consider a taxpayer, Alice, who hopes to borrow $10,000. Suppose Congress has passed a flat income tax at a 10% rate and that Alice holds stock, worth $15,000, which she purchased for $5,000. If Alice borrows against her stock, realization at borrowing will cause her to realize some income and pay some tax. To end up with $10,000, Alice must borrow $11,250 and pay $1,250 in tax if she borrows with security.[118] If Alice borrows without security, however, she realizes no income and pays no tax. She can borrow $10,000 unsecured to end up with $10,000. Because she must take on additional debt and pay some tax if she pledges collateral, Alice will prefer unsecured debt if she were otherwise ambivalent between the two types of debt.

In a world with only tax considerations, the availability of unsecured debt would undermine a realization at borrowing rule. Non-tax considerations include, among other things, interest rates,

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115 McCaffery, *supra* note 6, at 370 ("[T]his would only create an incentive to design unsecured debt, or to use unappreciated property to secure debt."); *see also* Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 Tax L. Rev. 401 (1989).

116 McCaffery, *supra* note 6, at 370. Unsecured loans do not require the borrower to put up assets as collateral. Because realization at borrowing relies on the relationship between the collateral and loan principle, it would not translate well to an unsecured loan.

117 *Id.*

118 Generally, for a marginal rate $r$, final principal amount $p$, and collateral basis $b$, Alice must borrow $(p - rb)/(1 - r)$ dollars with security to end up with $p$ dollars in hand.

preferences between *in rem* and *in personam* claim rights, credit qualification requirements, and state or federal law concerning debts. If these considerations were equal between secured and unsecured loans, Alice, a rational taxpayer, would never choose to borrow with security. If all taxpayers switch to unsecured borrowing, the realization at borrowing rule would quickly become vestigial: it would bring in no revenue and prevent no deferral.[119]

But we live in a world filled with non-tax considerations which prevent or discourage individuals from borrowing without security. First, creditors often charge additional interest on unsecured loans to compensate for increased risk.[120] Instead of betting on the stability of an asset's value, unsecured creditors bet on the borrower's ability to repay the loan. Because creditors are less able to pinpoint the reliability of a borrower, they may charge higher interest rates (a mechanism for receiving some short-term return).[121] Over the life of a borrower—and recall that buy/borrow/die participants could borrow for decades—borrowing at a higher interest rate may generate significant costs and reduce the attractiveness of deferral.

Second, unsecured loans subject borrowers to personal liability if they fail to pay. A creditor who extends an unsecured or recourse secured loan can sue the borrower personally to recover unpaid debt upon default.[122] Unsecured loans always allow personal liability; secured loans only sometimes—a secured recourse loan allows the creditor to sue if the collateral is insufficient to cover the debt.[123] Other secured loans are nonrecourse loans: The creditor's recovery in case of default is limited to the value of the collateral.[124] Some borrowers prefer

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119 One could consider imposing a realization event on all borrowing, not just borrowing against collateral. But without referring to the borrower's basis in their collateral, it would be difficult to determine how much of an unsecured loan represents borrowing against otherwise untaxed appreciation. Further, to avoid taxing the borrower twice on the same appreciation, a tax on unsecured borrowing would have to be accompanied by either (a) a portfolio-wide basis adjustment or (b) a global loan repayment deduction, either of which would be difficult for individuals to administer.

120 *See* John D. Leeth & Jonathan A. Scott, *The Incidence of Secured Debt: Evidence from the Small Business Community*, 24 J. Fin. & Quantitative Analysis 379, 382 (1989) ("The borrower benefits through the lower interest rate on secured debt but suffers from the potential loss of collateral when the project's returns are low."); Yuk-Shee Chan & George Kanatas, *Asymmetric Valuations and the Role of Collateral in Loan Agreements*, 17 J. Money, Credit & Banking 84, 93 (1985) ("The benefit to [secured borrowers] of providing more collateral is the lower loan rate that will be offered . . . .").

121 *See* Leeth & Scott, *supra* note 120, at 382; *see also* Chan & Kanatas, *supra* note 120, at 93.

122 Kiah Treece, *Recourse Loans vs. Non-Recourse Loans*, Forbes (Aug. 12, 2020, 11:36 AM), https://www.forbes.com/advisor/loans/recourse-loans-vs-non-recourse-loans [https://perma.cc/52VG-7W6H].

123 *Id.*

124 *Id.*

nonrecourse loans to secured loans, so much so that they will pay higher interest rates to avoid recourse.[125]

Third, creditors may refuse to extend large lines of credit without security. As the size of a loan increases, lenders become more likely to require collateral.[126] Some lenders even publicize that they will not lend above a certain amount without security.[127] Even if some individuals would prefer to borrow without security despite the non-tax costs of doing so, banks might not be willing to lend to them.

All told, significant non-tax considerations push individuals to borrow with security. These considerations fuel present-day borrowing decisions, including why many known buy/borrow/die participants choose to borrow with security.[128] More study is necessary to determine the extent to which buy/borrow/die participants would transition to unsecured loans, but individual preferences around interest rates and personal liability for debt, as well as banks' unwillingness to lend large sums without security, suggest that the obstacles to such a switch are non-trivial.[129]

If secured borrowing were treated as a realization event, taxpayers could also minimize their liability by using high-basis assets as collateral. Under a realization at borrowing rule, a taxpayer would realize income when she borrows to the extent her loan principal exceeds her basis in the collateral.[130] If the taxpayer's basis were equal to the loan amount, she would realize no gain. For example, suppose Bob, a fictional taxpayer, purchased 1,000 shares of X Corp. for $1 each in 2020. By 2023, his shares have appreciated to $100 each. Bob hopes to borrow $1,000. If he borrows $1,000 against ten shares, he will realize $990 in income. If he borrows $1,000 against all 1,000 shares, however, he will realize no income at all. But borrowing against high-basis assets does not create the same consumption inequality and wealth inequality pressures that

125 David Glancy, Robert Kurtzman, Lara Loewenstein & Joseph Nichols, *Recourse as Shadow Equity: Evidence from Commercial Real Estate Loans* 2–3 (Finance and Economics Discussion Series 2021-079 2021), https://www.federalreserve.gov/econres/feds/files/2021079pap.pdf [https://perma.cc/GAT4-2242].

126 Alberto Franco Pozzolo & Banca d'Italia, Secured Lending and Borrowers' Riskiness 21 (2002) (finding larger loans more likely to be secured because they are considered riskier ex ante).

127 *See Personal Line of Credit Details and Benefits*, U.S. Bank (last visited May 27, 2023), https://www.usbank.com/loans-credit-lines/personal-loans-and-lines-of-credit/personal-line-of-credit.html [https://perma.cc/8WNM-DKZ9] (stating personal credit limit of $25,000).

128 *See* Eisinger et al., *supra* note 2.

129 If further research suggests that tax costs under the standard capital gains structure would categorically outweigh non-tax costs (and, thus, that taxpayers would switch to unsecured loans), policymakers could consider tailoring rates on secured borrowing gains. Such a solution would permit some deferral but would also raise revenue that is currently lost to tax-free borrowing.

130 *See supra* Section III.A.

borrowing against low-basis assets does—the problem with buy/borrow/die is that it permits consumption against deferred, unrealized gains, not just that it permits consumption without sale. Additionally, taxpayers may be less likely to borrow against high-basis assets than to sell them, because service on a large personal loan may exceed the tax cost of realizing a small amount of gain. Minimizing realized gain by pledging high-basis assets is therefore not a primary concern.

## Conclusion

Scholars and policymakers who have considered solutions to buy/borrow/die have primarily aimed at the "buy" step or the "die" step, drawn by prior interest in wealth taxation or a focus on political expedience. But attempts to curb "buy" carry constitutional and public support baggage, and the preeminent "die" solution trades efficacy against lifetime deferral for political ease. In short, practical obstacles render "first-best" solutions unattainable in our world.

Commentators have largely overlooked taxes on the "borrow" step. But as it turns out, a realization at borrowing regime occupies a middle-ground between the infeasibility of "buy" solutions and the inefficacy of the "die" solution. An evaluation of public support, constitutionality, and political optionality metrics reveals that a realization at borrowing policy would thread the needle of practical obstacles faced by "buy" and "die" solutions. A first-order analysis of a realization at borrowing policy also reveals that it would likely produce less avoidance through unsecured debt than previously expected. Policymakers interested in ending buy/borrow/die and turning toward "serious" taxation of the rich in America should, therefore, add realization at borrowing to their menu of possible solutions.