Testimony on Vermont H. 827 – An Act Relating to
Applying Personal Income Tax to Unrealized Gains

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Thank you for inviting me to testify before you today. It has been my privilege help design H. 827–an Act for applying Vermont's personal income tax to unrealized gains based on mark-to-market principles—along with my coauthors, Professor Brian Galle of Georgetown Law and Professor Darien Shanske of the University of California—Davis, School of Law. This Act builds on years of our work helping to design related tax reform proposals for California, Illinois, and New York, and for the federal government, especially President Biden's proposed Billionaire Minimum Income Tax Reform, and advising on other similar reform proposals for other states. This proposal builds on successful forms of taxation implemented around the world (including wealth taxes levied at the province or canton level in Spain and Switzerland) and anti-abuse rules that have successfully been implemented by the U.S. federal government (especially the Passive Foreign Investment Company, or "PFIC", rules).

Tax experts have long considered the realization requirement to be the '"Achilles heel'" of the income tax because it creates so much uncertainty and complexity in the tax law."[1] As my co-authors and I have explained in prior scholarship, "under a realization regime taxpayers include gains or losses in taxable income only when the taxpayer sells or otherwise disposes of an asset. Individuals who make most of their money through investments thus get to choose when to pay tax. In combination with other unfortunate U.S. rules, one of these options is 'never.' The result is evident in recent news stories reporting that many of America's wealthiest

[1] *See* Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization, in Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* 112, 132-33 (Paul L. Caron ed., 2d ed. 2009) (quoting William D. Andrews, *The Achilles Heel of Income Taxation*, in Taxation for the 1980's (Walker ed., 1983)).

individuals, such as Jeff Bezos, have reported taxable incomes lower than those of the [IRS] agents who audit them."[2]

Because of the realization requirement of the federal income tax, research finds that multi-millionaire taxpayers are able to completely escape income tax on over three-quarters of their investment income.[3] As my co-authors and I have explained in prior scholarship, "This failure of our existing tax system to adequately reach wealth or investment income creates a host of problems, including harm to economic growth, harm to the administrability of the entire tax system, harms related to holding back historically disadvantaged groups of Americans, and the more general but especially insidious harms of making our tax system ineffective at addressing the problems of rising inequality."[4]

These problems are even worse in states like Vermont that rely heavily on a realization based income tax (as compared to at the federal level). For taxpayers who build up substantial wealth in Vermont in the form of unrealized gains, benefitting from Vermont's services and protections while doing so, it is easy to completely escape Vermont's income tax under current law simply by moving to another state before selling appreciated assets. The research on taxpayer mobility generally finds that tax-induced mobility is very small or even negligible.[5] But an exception to this is when taxpayers can escape state-level estate or income taxes by moving out of state in their retirement years or just before death for massive tax savings.[6]

H. 827 would erase these perverse incentives and tax gaming opportunities that currently plague Vermont's income tax by taxing unrealized gains gradually over time as they accrue within Vermont and protecting Vermont's claim to gains that were accrued within Vermont so that taxpayers could not escape Vermont tax on these gains by moving out of state. Attached to his document are two Appendixes. The first—Appendix A—is a Section-by-Section Explanatory Document for Vermont H. 827, primarily written by my co-author, Professor Galle.

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[2] Brian Galle, David Gamage, & Darien Shanske, *Solving the Valuation Challenge: The Ultra Method For Taxing Extreme Wealth*, 72 DUKE L. J. 1257, 1262 (2023).
[3] 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, 501-02 (2022).
[4] Galle et. al, *supra* note 2, at 1260-61.
[5] *See* Appendix B, Part III.
[6] *Id*.

The second—Appendix B—is a draft Article that my co-authors and I have written to explain the general case and operation of reforms like Vermont H. 827. This draft Article is currently being submitted to law journals for review and eventual publication.

I look forward to answering your answering your questions today.

Sincerely,

David Gamage

Appendix A

Section by Section Explanatory Document for Vermont H. 827 – An Act Relating to Applying Personal Income Tax to Unrealized Gains

This bill proposes to apply income tax to 50 percent of the unrealized gain or loss of a taxpayer's assets. This treatment would only apply to individuals with a net worth of $10,000,000.00 or greater. The bill would cap the amount of unrealized gains subject to taxation at ten percent of the worth of a taxpayer's net assets in excess of $10,000,000.00 in a tax year.

Section 1 contains the bulk of the operative language for the bill, beginning with new section 5601.

Section 5601
Defines key terms used throughout the bill. Select terms include:

> (4) Phase-in cap amount. Ten percent of the taxpayer's net assets in excess of $10 million. Later provisions of the bill limit annual taxable gains to this amount.
> (6) Resident individual. Includes full- and part-year residents, as well as individuals who held that status within the previous four years. Later provisions of the bill impose tax on all residents, but with reductions for individuals who have been residents for less than four of the previous four years.

Section 5602
Sets out the basic operation of a mark-to-market tax on individuals with high net worth.

> (a) Requires Vermont residents to include 50% of the built-in gain or loss in their assets in their taxable income for the year, as if all assets had been sold for fair market value on the last day of the year. This additional taxable amount cannot exceed the phase-in cap amount (ten percent of the taxpayer's net assets in excess of $10 million).
> Example: Taxpayer A holds asset X with value $25 million and basis $15 million, and asset Y with value $25 million and basis $30 million. Taxpayer A is personally liable on debts of $30 million. Taxpayer A has mark-to-market gains on asset X of $10 million and mark-to-market losses on asset Y of $5 million. A's phase-in cap amount is 10% of ($25m + $25m - $30m), or $2 million. Thus, A will include $2 million in income, as that is the lesser of 50% of their net gain ($2.5 million) or the cap amount ($2 million).
>
> In addition, subsection (a) provides that if mark-to-market losses in a year exceed gains, those excess losses do not reduce taxable income, but instead must be carried forward to a later year to be used against subsequent mark-to-market gains. If losses are carried forward for more than two years, they become refundable against prior mark-to-market gains.
>
> (b) To ensure that built-in gains are not taxed twice, and that built-in losses are not taken into account more than once, this section provides for basis adjustments to assets

subject to mark-to-market treatment. Taxpayers reduce their basis in built-in loss assets by 50% of the built-in loss. For built-in gain assets, the taxpayer increases their total basis by the amount of gains they actually recognize–that is, the lesser of 50% of total built-in gains or the cap amount, plus any gains that were offset with built-in losses. This basis increase is assigned pro rata among all the built-in gain assets in proportion to their amount of built-in gain at year-end. A simple step-by-step method for making this adjustment is included at the end of this summary document.

(c) Requires Vermont residents to file forms for calculating the tax under the bill, or alternately declaring that their net assets are under $10 million.

(d) Grants credits for tax paid to another state on built-in gains accumulated while the taxpayer was resident elsewhere.

Section 5603
Details additional calculations for determining how much of a taxpayer's gains are taxable in Vermont.

(a)&(b) Phases tax liability in for new Vermont residents and out for departing residents. The amount otherwise due is reduced by the share of time, over the prior four years, in which the taxpayer was not a full-time, part-year, or temporary resident. For example, an individual who has resided in Vermont two years out of the last four would include in income only 2/4 or 50% of their mark-to-market gains (i.e., ¼ of their built-in gains).
(c) Allows taxpayers to reduce their tax if they can show, by clear and convincing evidence, that the computation of parts (a) and (b) overstates the gains that occurred while resident in Vermont. Students are presumed not to accumulate any gains while full-time Vermont students.
(d) Requires taxpayers to show their basis in any assets by clear and convincing evidence.
(e) Defines how debts and other liabilities affect the taxpayer's net worth, for purposes of calculating the phase-in cap and reporting requirements applicable to taxpayers with net worth in excess of $10 million. To reduce tax avoidance, certain liabilities do not reduce net worth, including debts owed to related parties or otherwise not negotiated at arms' length. Nonrecourse debts only reduce net worth to the extent of the value of property securing the debt. Future payments that are uncertain to occur also do not reduce net worth.
(f) Severability clause. This section provides that if any part of the bill is found unconstitutional, the rest should remain in force. Also provides a fall-back rule in the event section 5603(a) is found unconstitutional.

Section 5604
Describes how assets should be valued, and certain additional details for select categories of property interests, such as trusts and retirement accounts.

(a) Defines fair market value as the price an asset would sell for in a sale by a willing seller to a willing, informed, buyer.

(b) Restricts certain common valuation discount techniques by providing that FMV shall not take into account any feature of a property that was added with a significant purpose of reducing its appraised value. To limit excessive discounts for minority control rights and similar common techniques, the value of a partial interest must always be at least the pro rata value of the whole asset.
(c) Provides rules for valuing specific categories of assets.

(1) Publicly-traded assets are valued at their market price.
(2) Assets held through a sole proprietorship are treated as if held directly by the owner.
(3) Interests in other (non-public, non-sole proprietorship) business entities. For simplicity, taxpayers can exclude up to $1 million in business assets for both reporting and tax liability purposes. For interests above that amount, businesses are presumed to be valued at the sum of their GAAP book value plus 7.5 times GAAP earnings. The value of the taxpayer's interest is their ownership percentage times this amount. Taxpayers must file forms reporting these pieces of information. The ownership percentage is presumed to be at least the taxpayer's share of voting or other control rights. If taxpayers can show (by clear and convincing evidence) that either of these presumptions substantially overstates the value of their interest, they can submit a qualified appraisal instead, as described more below. In addition, to account for situations where taxpayers may lack liquid assets to pay current tax, or lack enough information to determine book value, taxpayers can always elect to attach business assets to an optional deferral account ("ODA"), as also described below, rather than including them as taxable in the current year. (Briefly, the ODA allows taxpayer to wait until an asset is sold to determine its value and pay tax, but in that event the taxpayer pays an interest charge reflecting the value of the resulting tax deferral).
(4) Real estate. For simplicity, taxpayers can exclude up to $1 million in real estate assets for both reporting and tax liability purposes. For interests above that amount, taxpayers can include the most recent equalized grand list value, or submit a qualified appraisal where the published value would substantially overstate fair market value. Again, to mitigate liquidity and valuation concerns, taxpayers can also choose to attach the property to an optional deferral account instead.
(5) Trusts. Vermont resident trusts are taxed as individuals, but with no phase-in or phase-out for changes in residency. Trusts do not receive their own $10 million phase-in cap amount or $1 million exclusions for sub-categories such as real estate. Instead (and subject to certain anti-abuse rules), an individual who contributed property to a trust can assign a portion of their own exemption to the trust. In this way, a trust neither increases nor decreases the total exemption

amount available to an individual. Vermont residents who are vested beneficiaries of a non-resident trust must treat their vested share of the trust assets as their own, and must attach those assets to an optional deferral account so that Vermont can collect interest on taxes deferred during the period the assets accumulated value in trust. For simplicity, however, an individual can exclude up to $1 million of trust-held assets for both reporting and tax liability purposes. There are no special provisions for charitable or split-interest trusts, so these follow the general rules applicable under the Vermont income tax.

(6) Retirement savings and deferred compensation. Qualified pensions and IRAs are exempt, except that Roth accounts are taxable to the extent that the taxpayer holds more than $1 million in aggregate in Roth-type accounts (for example, a taxpayer with $1.1 million in Roth accounts would include $100,000 towards their net worth, and 9% (1/11) of the annual accumulations in the accounts would be subject to mark-to-market treatment). Non-qualified deferred compensation, such as so-called "supplemental executive retirement plans," would generally be taxable if the individual is fully vested.

(7) Receivables. Receivables are generally subject to mark-to-market treatment, but regulatory authority is granted to exempt receivables that are unlikely to be collected or result in taxable income.

(8) Miscellaneous assets. Again, for simplicity, taxpayers can exclude up to $1 million in the aggregate of all other classes of property, such as art, collectibles, vehicles, and personal property. These miscellaneous assets are valued at their purchase price, if within the last ten years, adjusted for inflation and depreciation. Older assets must be appraised once every ten years, and then similarly adjusted for inflation and depreciation. Alternately, taxpayers can choose to attach an asset to an optional deferral account, in effect waiting until the asset is sold to determine its value.

Section 5605.

Rules for optional deferral accounts. In general, an ODA is a contract between the taxpayer and Vermont in which, in exchange for delaying the taxation of an asset until its sale, taxpayer pays additional interest at the time of sale, and also makes estimated withholding payments upon any partial liquidation of the asset (such as receipt of dividends from a business entity).

(a), (b) Makes the ODA a binding contract in which the taxpayer agrees to make annual reports to Vermont, pay all tax due, and be subject to personal jurisdiction of the State until the contract is resolved. Thus, Vermont may still collect deferred tax liabilities due under an ODA after a taxpayer is no longer a Vermont resident.

(c) Limits taxpayers to one ODA, although a given ODA may have any number of assets included.

(d) Requires taxpayers who attach assets to an ODA to report the new assets, any existing assets already attached to the ODA, and the respective bases of the assets.
(e), (g) Requires taxpayers to report material distribution transactions, which generally include any withdrawal of money, property, or other value from assets attached to the ODA, except where ordinary and necessary for maintaining or improving the value of the asset.
(f), (g) Imposes a withholding tax on material distributions from an ODA-attached asset. Each year, the taxpayer tracks Vermont's withholding percentage for each asset attached to an ODA. The withholding percentage begins at the top individual income tax rate, and increases each year by that rate, times an estimated average investment return, times one minus the percentage at the beginning of the year. In effect, this measures the expected share of the asset's value that will be payable in tax at the time the ODA is resolved. When taxpayer receives a material distribution, they multiply the withholding percentage by the amount of the distribution (e.g., the amount of a dividend received or gross proceeds from partial sale of their equity interest), and include that amount (or, if greater, the amount that would otherwise have been taxable under the income tax, such as in the case of a distribution taxed as a dividend) in their taxable income. This amount is later credited (with interest) against any tax due at sale. Taxpayers are responsible for reporting the sum of these withholding amounts annually. Assets distributed in kind take a fair market value basis.
Example. In 2025, Taxpayer B elects to attach their equity interest in Business Z to an ODA. The initial withholding percentage is 8.75%. Assume that the expected average appreciation rate announced by Vermont for the year is 10%. In 2026, Taxpayer B increases the withholding percentage to 8.75% + (8.75 * .10 * (1-.0875)) = 9.55%. In 2027, Taxpayer B receives a dividend of $10 million. Taxpayer B includes 9.55% * $10 million = $955,000 in income for 2027, as this amount is greater than the $875,000 ordinary Vermont income tax due on the dividend payment.
(h) Because of the great importance of personal borrowing in common strategies to permanently eliminate income tax for wealthy individuals, the bill also treats certain loan transactions as significant distributions triggering withholding tax obligations. In general, any individual who has an open ODA, and who receives loan proceeds, must treat the proceeds as a significant distribution. However, for this purpose, each taxpayer can ignore the first $1 million of personal indebtedness. In addition, personal-residence indebtedness, as defined in federal tax law (generally, this includes home mortgages of up to either $750,000 or $1 million, as well as up to $100,000 of certain home equity loans, depending on when the home was purchased and certain other details), is not counted. Taxpayers who repay their loans prior to resolving the ODA can get refunds of tax paid as a result of this withholding.
(*i*) An ODA is resolved either when the taxpayer sells all the remaining assets attached, or optionally at any earlier time.
(j) When the ODA is resolved, the taxpayer must include in tax 50% of the previously-untaxed gains in the attached assets. If the ODA is resolved at a time other than the sale of all the attached assets, the taxpayer must submit a qualified appraisal (described below) for any unsold assets. In addition, the taxpayer must pay an interest charge,

representing the time value of the deferred tax due on the assets. In the event the Vermont Tax Commissioner does not issue its own method for determining the interest amount, the statute provides a simple formula for determining the appropriate interest charge, in which interest is imposed at the average rate of return of the assets attached to the ODA. This computation is intended to minimize any economic incentive to defer tax. Basis recovery for assets sold prior to resolution is deferred until resolution, but interest is also awarded (using the same formula) for any withholding payments, minimizing any net economic cost to the taxpayer from delaying basis recovery. There is also a procedure for taxpayers to attempt to show that this method does not reasonably achieve the goal of allowing deferral while making taxpayers reasonably indifferent to the timing of tax payment, and allowing adjustments in that case.

(k) Decedent's estates remain liable for assets attached to an ODA.

Section 5606.
Appraisals. Allows taxpayers to submit an appraisal every ten years, and in intervening years to rely on the most recent appraisal, adjusted for inflation and depreciation, as well as for any withdrawals from, or contributions or improvements to, the property. Requires appraisers to submit a copy of the appraisal to the Department of Taxes. Instructs the Commissioner of Taxes to adopt rules for appraisals modeled after the federal qualified appraisal rules applicable to in-kind charitable gifts. In general, those provisions require certain key details to be included with an appraisal, impose education and experience requirements for qualified appraisers, and prohibit appraisal fee arrangements based in part on favorable tax outcomes for the client, among other details.

Section 5607.
Administration.

(a) Indexes exemption and exclusion amounts for inflation.

(b) Sets the default expected rate of appreciation at the applicable federal rate plus 300 basis points, unless otherwise determined by the Commissioner of Taxation.

(d) Authorizes the Commissioner to adopt rules necessary to carry the bill into effect, including specifying additional reporting requirements for taxpayers or third parties.

Section 2 and **Section 3** make conforming edits to the Vermont definition of taxable income.

Section 4 allows taxpayers to make payments on any additional tax due in the first effective year of the bill over the following three years, subject to an additional interest charge of 7.5%.

Section 5 makes the bill effective for the 2025 tax year.

Appendix B

Draft Article

Though Money Moves: Taxing the Wealthy at the State Level

Brian Galle*

David Gamage†

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Draft of January 15, 2024

Abstract

It's widely understood today that inequality is a major social problem that in turn contributes to other crises. By most accounts, tax systems are supposed to be our engines of equality. Yet in today's United States, state and local tax systems mostly do the opposite: they take a greater percentage of the resources of the poor and middle class than of the rich.

Perhaps surprisingly, the traditional view among fiscal policy experts has been that this state of affairs is correct. In this standard account, only national governments should impose progressive or redistributive taxes. While acknowledging that there would be advantages to redistributive state taxation if it could be done efficiently, many experts worry that taxing the wealthy at the state level would drive taxpayers to move to a neighboring jurisdiction with lower rates, resulting in greater economic distortions and potentially little or no additional tax revenue. Similarly, politicians and advocates have opposed recent state efforts to tax the wealthy by arguing that such taxes will drive away the rich.

This Article argues that this traditional view is misguided. Recent evidence finds that relatively few wealthy households actually move in response to changes in tax policy. On the other hand, the location of taxable income—the place where wealth is legally subject to claims of the state—is quite responsive to tax rates, due to a bevy of now-standard forms of tax gaming that we detail.

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‡ Professor of Law, University of California, Davis, School of Law. The authors gratefully acknowledge thoughtful comments from ….

This distinction is highly significant because while physical relocations are hard to prevent, and indeed are good for a healthy federalism, the shifting of taxable income across borders has some ready legal solutions. As we detail here, a key feature of most state tax-avoidance schemes is the exploitation of the realization rule, the tax principle that imposes tax on appreciated property only when it is sold. States can greatly undercut this tax avoidance by instead imposing wealth or "mark-to-market" taxes on assets as they appreciate. Thus, critics of state wealth tax efforts have things exactly backwards: rather than mobility making wealth taxes self-defeating, wealth taxes are what can counter tax-avoidance mobility.

Accordingly, we outline here how a truly progressive state tax system could operate. Building on earlier work, we show that standard critiques of wealth and mark-to-market taxes, such as that they would struggle to tax hard-to-value assets, are actually easy to design around. We additionally explain other anti-avoidance rules that address some of the common techniques used by the wealthy to avoid state tax, such as trusts, partnerships, over-stuffed retirement accounts, and private foundations. With these new anti-avoidance tools available to states, we argue, the standard economic account shifts to favor truly progressive state tax systems.

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INTRODUCTION

By most measures today's America is more unequal than it has been for a century or more.[1] Despite a nominally progressive federal tax system,

[1] *E.g.*, Emmanuel Saez & Gabriel Zucman, *The Rise of Income and Wealth Inequality in America: Evidence from Distributional Macroeconomic Accounts*, 34 J. ECON. PERSPS. 3, 10–11 (2020) (measuring wealth inequality); Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data*, 131 Q. J. ECON. 519, 551–54 (2016) (same); William G. Gale, John Sabelhaus, & Samuel I. Thorpe, *Measuring Income Inequality: A Primer on The Debate*, BROOKINGS COMMENTARY, December 21, 2023 ("the preponderance of evidence suggests that income inequality has increased"), available at https://www.brookings.edu/articles/measuring-income-inequality-a-primer-on-the-debate/.

the wealthiest tend to pay significantly less in federal taxes than the merely affluent.[2]

It might be thought that Americans just don't mind this inequality, but that is not so. Not only do Americans dislike inequality, they want to do something about it. Large majorities of respondents in most surveys want to raise taxes on the rich, and would support measures such as new taxes on the wealth of mega-millionaires and billionaires.[3]

Federalism is part of the problem. By most accounts, taxation is the most effective tool for distributive justice.[4] Yet nearly all state tax systems actually worsen inequality.[5] Indeed, even nominally progressive state tax systems tend to do even worse than the federal government at taxing the very wealthy. And this is not a small side-note to overall national

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[2] *E.g.*, Greg Leiserson & Danny Yagan, *What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?*, THE WHITE HOUSE, September 23, 2021, https://www.whitehouse.gov/cea/written-materials/2021/09/23/what-is-the-average-federal-individual-income-tax-rate-on-the-wealthiest-americans/; Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options* 4–8 (Sept. 11, 2019) (unpublished manuscript), https://ssrn.com/ abstract_id=3452274; Jessie Eisinger, Jeff Ernsthausen, & Paul Kiel, *The Secret IRS Files: Troves of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, Pro Publica (June 8, 2021), https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax

[3] *E.g.*, Pew Research Center, *Top tax frustrations for Americans: The feeling that some corporations, wealthy people don't pay fair share*, Apr. 7, 2023, https://www.pewresearch.org/short-reads/2023/04/07/top-tax-frustrations-for-americans-the-feeling-that-some-corporations-wealthy-people-dont-pay-fair-share/.

[4] LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 123–36 (2008).

[5] MEG WIEHE ET AL., THE INSTITUTE ON TAXATION AND ECONOMIC POLICY, WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES (6th ed. 2018), https://itep.sfo2.digitaloceanspaces.com/whopays-ITEP-2018.pdf; *see also* Johannes Fleck et al., *Tax and Transfer Progressivity at the US State Level*, manuscript at 3–4 (Sept. 12, 2021) (finding that even accounting for progressive state spending, state fiscal systems do not reduce inequality).

progressivity, as states bring in one-third of all national revenues.[6] Why has federalism been such a failure in the domain of progressive taxation?

A standard story advanced by opponents of progressive taxation is that wealthy residents would flee states that tried to tax them.[7] Even among academic economists, one can find claims that only the federal government can effectively redistribute income from the rich to the poor, so that states should instead rely on relatively regressive revenue sources such as sales or property taxes.[8]

Even ignoring the data and focusing just on normative arguments, these claims neglect some key counterpoints.[9] Sharp differences in who pays tax between the states and the federal government can distort the entire federalist structure by creating incentives to devolve policy downward. Wealthy Americans who want to escape progressive federal tax can lobby for "decentralized" government, even for policies where national approaches would make much more sense, because decentralized policies funded through regressive state taxes won't cost them as much. In addition, the basic logic of federalism—its potential for citizens to shop for the policies that best suit

[6] Saez & Zucman, *supra* note 1, at 18.
[7] *E.g.*, David Brunori, *State Personal Income Taxes in the Twenty-First Century*, *in* THE FUTURE OF STATE TAXES 191 (David Brunori ed., 1998); TAX NOTES STATE, *Wealth Taxes and America Divided*, Mar. 27, 2023, https://www.taxnotes.com/special-reports/legislation-and-lawmaking/wealth-taxes-and-america-divided/2023/03/24/7g760; Aimee Picchi, *A national wealth tax has gone nowhere. Now some states want to tax the ultra-rich*, CBS NEWS MONEYWATCH, Jan. 20, 2023, https://www.cbsnews.com/news/wealth-tax-in-8-states-california-new-york-connecticut-washington-illinois/; Arthur Laffer and Stephen Moore, *The Hotel California Wealth Tax*, WALL. ST. J., Mar. 5, 2023.
[8] WALLACE E. OATES, FISCAL FEDERALISM 143–44 (Edward Elgar 2011) (1972); Robin Boadway & Jean-François Tremblay, *Reassessment of the Tiebout Model*, 96 J. PUB. ECON. 1063, 1063–64 (2012); *see* Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1406–08 (2004) (summarizing literature).
[9] We detail these points in Part II, *infra*.

their preferences, and for subnational governments to operate as laboratories of democracy—applies as much or more to preferences for distribution as to other policies. Without access to progressive taxation, state efforts to reflect their citizens' preferences may be badly limited.

Equally importantly, though, the argument that states just can't tax the rich is wrong on at least one key fact, or at least is greatly exaggerated. Studies both of progressive taxes generally and of wealth taxes in particular find that on net, there is relatively little physical migration response to higher taxes, even among the wealthiest.[10] News accounts tend to highlight the occasional billionaire relocation, such as Jeff Bezos's new home in Miami,[11] speculating often without evidence that such moves are for tax reasons, while typically failing to note that empirical research finds that tax-induced migration has overall comparatively small consequences for tax revenues.[12]

This is not to say that people do not move across state lines. They do, and especially so in their retirement years, when relocations from more expensive (and often colder) states to lower-cost (and often warmer) states may become especially attractive. Relocations to states in the Southeast and Southwest have been particularly growing in recent years. Yet relative land and housing prices imply that Americans are still willing to pay large premiums to live in states like California and New York, at least during their pre-retirement years. Overall, Americans choose whether and where to relocate for a variety of interconnected reasons. The empirical literature finds that state-level tax policies are a relatively minor factor. As we will explain, there are some limitations and caveats to this empirical literature, and we ultimately urge caution in interpreting the implications of the literature.

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[10] We review this evidence in Part III.A, *infra*.

[11] Mike Ives, *Jeff Bezos Says He is Leaving Seattle for Miami*, N.Y. TIMES, Nov. 3, 2023.

[12] *But see* Jonathan Levin, *Texas Move is About Politics, Not Taxes*, WASH. POST, Mar. 30, 2023.

Nevertheless, despite the many statements to the contrary by politicians and the media, there is ultimately no empirical support for the claim that state-level progressive taxation would induce sufficiently large numbers of people to move to make these policies impractical or self-defeating.

Why, then, have states mostly failed to take advantage of the opportunities to implement progressive taxes? Our answer is that although people themselves don't seem to move much for tax reasons, money does.[13] Just as multi-national businesses have mastered the art of "stateless income" taxed by no jurisdiction,[14] the American rich have developed a wide range of tax-gaming moves that allow them to accumulate and even spend vast wealth that lies beyond the reach of their home state. Julie Roin aptly labels this phenomenon "exploitative mobility."[15] Mobility is generally not a bad thing; it becomes exploitative when taxpayers "can extract benefits from one jurisdiction while escaping some of the costs of providing those benefits."[16]

The tools to exploit mobility of money (as opposed to of natural persons) are many.[17] There is in fact an entire industry that self-consciously provides such techniques.[18] In many cases, no exotic planning is necessary. For example, Washington State's richest man parks most of the income

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[13] We develop this argument in Part III.B, *infra*.
[14] Edward D. Kleinbard, *Stateless Income*, 11 FLORIDA TAX REV. 699, 701–05 (2011).
[15] Julie Roin, *Changing Places, Changing Taxes: Exploiting Tax Discontinuities*, 22 THEORETICAL INQUIRIES L. 335, 378 (2021).
[16] *Id*. at 378.
[17] *See, e.g.*, Richard Rubin, *Wealthy New York Residents Escape Tax with Trusts in Nevada*, BLOOMBERG BUS. WK. (Dec. 18, 2013), http://www.businessweek.com/news/2013-12-18-wealthy-n-dot-y-dot-residents-escape-levy-with-trusts-in-Nevada-taxes, *archived at* http://perma.cc/ K5CC-JCGV (noting wealth planners describe state income taxes as "a huge issue" and reporting that New York state alone loses $150 million annually to just one of these techniques).
[18] Evan Osnos, *The Getty Family's Trust Issues*, THE NEW YORKER, Jan. 16, 2023; *see also, e.g.*, Andrew Bernell, *Eight Ways to Save Taxes When Selling A Business*, Century Park Wealth Management, https://www.centuryparkwm.com/eight-ways-to-save-taxes-when-selling-a-business/.

derived from his inventions inside a corporation (a little venture called Microsoft, maybe you've heard of it). Microsoft itself in turn exploits rules for multi-national firms to report most of its income in Ireland and other tax havens.[19]

Behind nearly all of these tax-avoidance games is one simple concept, the so-called "realization rule."[20] That's the income-tax principle that only requires taxpayers to include profitable investments in income at the time the property is sold, and not before.[21] It's a handy simplifying convention for an income tax, making it easier to know what a property is worth.[22] But it unlocks a vast array of tax-minimization strategies at the federal and state levels.

At the federal level, the realization rule enables a series of tax-planning strategies often labeled as "*buy, borrow, die*."[23] Wealthy taxpayers don't sell their appreciated assets and thus defer paying income tax during their lives, and then they completely escape their deferred tax responsibilities upon death thanks to another provision of the income tax (known as stepped-up basis).[24] When it comes to state-level taxes, wealthy taxpayers need not even wait until death, as *buy, borrow* … and then eventually move to a state

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[19] Paul Kiel, *The IRS Decided to Get Tough Against Microsoft. Microsoft Got Tougher*, PROPUBLICA, Jan. 22, 2020, https://www.propublica.org/article/the-irs-decided-to-get-tough-against-microsoft-microsoft-got-tougher.
[20] *See infra* Part III.B.
[21] Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 11–13 (1992).
[22] Edward Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 879–89 (1997).
[23] Edward J. McCaffery, *Taxing Wealth Seriously*, 70 TAX L. REV. 305, 306 (2017).
[24] 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, 500–05 (2022).

like Florida or Texas (where there is no income tax) suffices to escape deferred state-level tax responsibilities.[25]

Take Elon Musk, as one of many examples.[26] Musk built most of his wealth as a resident of California, benefitting from the services and protections offered by California while doing so. But because Musk did not take much salary or sell much stock while living in California, he paid minimal California income tax.[27] He instead borrowed to finance his investments and to pay for his lavish consumption, without paying much tax to California.[28] Now, assuming that Musk has actually moved to Texas (as he claims), he can completely escape California's income tax on most of the wealth that he built up while he was a California resident.[29]

The Musk example is in some ways unusual because he (apparently) actually moved, but in many ways it is typical because he was able to accumulate great wealth for years in California without paying taxes commensurate with his wealth. This is because his great wealth mostly consists of appreciated stock. Thus, because of the realization rule, it was easy for Musk to avoid taxes in California. Only after having benefitted from the realization rule did Musk actually leave.

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[25] *See, e.g.*, Kathleen Wright, *The Long Arm of California Stretches Even Farther*, 107 TAX NOTES STATE 435, 435 (Jan. 30, 2023) ("The sourcing rules for income from intangibles have been one of the best tax planning tools for nonresidents of California.").

[26] Tom Maloney et al., *Elon Musk's California Exit Can Save Him $2B in Taxes*, BLOOMBERG NEWS, Nov. 29, 2021, https://www.bloomberg.com/news/articles/2021-11-29/how-much-tax-does-elon-musk-save-by-moving-to-texas-and-selling-tesla-stock#xj4y7vzkg.

[27] *Id.*

[28] *Id.*

[29] Laura Davison, *Musk's Move to Texas May Yield Big Savings on Tesla Sale*, BLOOMBERG NEWS, Apr. 29, 2022, https://www.bloomberg.com/news/articles/2022-04-29/musk-s-2020-texas-move-may-yield-big-tax-savings-on-tesla-sale#xj4y7vzkg.

In this manner, realization-based income taxes create perverse incentives for taxpayers who build up great financial wealth within states with substantial income taxes (like California) to wait until after they eventually move out of state before they realize those financial gains. These perverse incentives could be eliminated, or at least greatly alleviated, by reforming the design of state-level taxes.

We will explain how it is relatively straightforward, using modern tax administration principles, including information reporting, to collect a progressive tax without relying on the realization rule. Indeed, with our economist colleague Emmanuel Saez, we have helped to author bills in California[30] and Washington[31] to impose an annual wealth tax on individuals with extremely high net worth (over $50 million in the California proposal and over $250 million in the Washington State proposal), and bills in New York[32], Illinois[33], and Vermont[34] to collect income tax from similarly very wealthy households when their assets increase in value, whether or not sold. We also have helped to pen Sen. Elizabeth Warren's federal wealth tax bill,[35] and the bill implementing Pres. Biden's "billionaire minimum income tax," which like the New York, Illinois and Vermont bills would impose tax on the very rich as their assets appreciate.[36] Tax mavens call this latter approach a "mark to market" tax.[37]

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[30] Assemb. B. 310, 2021–22 Reg. Sess. (Ca. 2021). For a more complete description, see Brian Galle, David Gamage, Emmanuel Saez, & Darien Shanske, *The California Tax on Extreme Wealth (ACA 8 and AB 310): Revenue, Economic, and Constitutional Analysis*, https://ssrn.com/abstract
_id=3924524.
[31] SB 5486 (Wa. 2023).
[32] S. 8277B/A. 10414 (NY 2021).
[33] HB 3475 (Ill. 2021).
[34] DR 24-0617 (VT 2024).
[35] S. 510, 117th Cong. § 2901(b) (2021).
[36] *See* H.R. 8558, 117th Cong. (2022).
[37] David Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 95–96 (1999).

Wealth and mark-to-market taxes of these sorts would go a long way towards solving the states' taxable-income mobility problem. Under a residence-based wealth or mark-to-market income tax, a wealthy individual in New York or California would pay tax as their wealth grew, regardless of whether that wealth was accumulating inside a multi-national corporation, a South Dakota trust, a complex multi-tiered partnership, or any of the dozen other supposedly out-of-state places the rich now move their money. If a wealthy taxpayer has been paying tax on their income accrued within a state while a resident, then their moving does not pose the same threat to the integrity of state tax systems.

Thus, recent critics of these new state tax proposals have gotten their arguments exactly backwards. They claim that states cannot impose wealth or mark-to-market taxes on the rich because the wealthy are mobile.[38] But in fact, a primary purpose and function of these taxes is to reduce merely paper capital mobility, allowing it to be taxed at the state level. Once capital is appropriately being taxed, physical relocations would generally serve the positive goals described in the federalism literature.

To be sure, critics also have other arguments, such as the common refrain that it is too hard to implement taxation without the realization rule because it would be too difficult to measure a taxpayer's net worth.[39] We have set out elsewhere a detailed explanation of how successful systems in other countries, such as the Swiss wealth tax (itself imposed not at the national but at the "canton" or Swiss state level) have approached this issue.[40] There we also explain how using a few modest administrative improvements, such as allowing governments to collect payment in the form of notional equity claims

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[38] *See* sources cited *supra* note 7.
[39] *See* Tax Notes State, *supra* note 7 (collecting valuation complaints from tax experts).
[40] Brian Galle, David Gamage, & Darien Shanske, *Solving the Valuation Challenge: The ULTRA Method for Taxing Extreme Wealth*, 72 DUKE L.J. 1257, 1274–80 (2023).

against a portion of the taxpayer's assets, can solve valuation and liquidity concerns.[41]

In this Article we extend that work to show how our proposed solutions to the valuation challenge also help states to overcome some of their own administrative obstacles. For instance, we'll explain how the notional equity claim helps a state to make sure it can still take a taxpayer to court to collect an outstanding tax debt, even after the taxpayer (or their money) has moved somewhere that would otherwise be outside the personal jurisdiction of the state's enforcement efforts.

In addition, we outline other design considerations for architects of a state wealth or mark-to-market tax. For example, we propose that instead of a strict binary definition of "residency" that would subject a resident's full wealth to state tax, states should instead tax only a portion of the wealth of new and departing residents, to reflect the fact that the state's claim on these assets is less than total, but also greater than zero. In the case of a mark-to-market tax, we offer recommendations for how to manage the ways in which the revenues from such a tax would swing up and down with the business cycle, such as by spreading out the taxation of gains (and refunds for losses) over multiple years.

We also consider state-specific rules for trusts, pensions, family foundations, and gifts, all of which currently feature prominently in common state-level tax avoidance strategies. For example, we propose reforms for states to tax large pension and retirement accounts of the very wealthy, such as Peter Thiel's infamous billion-dollar IRA. There is little policy reason why states should add further benefits on top of federal exemption for these savings, and we explain how state wealth taxes, in particular, would allow states to sidestep federal statutory limits on the taxation of pension accounts.

[41] *Id.* at 1297–1313.

In short, we argue that the central objection to progressive state taxation is really not a theoretical or normative argument, but instead a practical question about whether and how states can effectively tax mobile capital. We then dig into this practical problem and show how, using a combination of tools and approaches tested around the world plus some new innovations we propose, it can be overcome. With this practical barrier removed, the case in favor of significant state taxes on the rich becomes convincing, at least with respect to the states where supermajorities of voters say that they want more progressive taxation of the wealthy. State-level progressive tax reforms can help to reflect local preferences for distributional fairness, prevent serious distortions to the political economy of federalism, and, by offering smaller-scale experimental proofs of concept, can help to advance the national project of progressive taxation.

I. Fiscal Federalism and State-Level Taxation in the United States

In this Part we offer some important background theory on fiscal affairs in a federation, and an overview of U.S. arrangements. The main takeaway we emphasize is that under conventional analysis, progressive state taxation is self-defeating because taxpayers will move away in response. If this problem could be overcome, however, theory suggests that there are important benefits to subnational progressivity.

A. The Standard Story

Fiscal federalism is an economic framework for figuring out which level of government—assuming we have a federation with both national and distinct sub-national governments—should carry out any given governmental task.[42] Usually this prescription involves balancing competing considerations.[43] For instance, when there is significant popular disagreement about the details of a policy, fiscal federalism would generally favor assigning that policy task to state and local governments, so that governments can pursue diverse solutions and citizens can opt for the government that matches their preferences.[44] On the other hand, there is a strong argument that policies where there are significant externalities or spillovers across borders should be nationalized, to help ensure that the policymaker takes all the impacts of its policies into account.[45]

Traditional models of fiscal federalism tend to support allocating all progressive taxation to the federal government.[46] The idea is that, because wealthy residents can move from one state to another more easily than they can leave the country entirely, the federal government has a comparative advantage at taxing the wealthy.[47] This is not to say states can't collect taxes or redistribute at all; many taxpayers may be tied or drawn to a given state, whether by business needs, family, or a fondness for snowshoeing, permitting states to make claims on them up until the value of those ties becomes strained.[48] When state-level taxation causes wealthy residents to leave for

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[42] OATES, *supra* note 8, at xvii.
[43] Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120, 1120 (1999).
[44] *Id.* at 1122–23; McConnell, *supra* note **Error! Bookmark not defined.**, at 1493–95.
[45] McConnell, *supra* note **Error! Bookmark not defined.**, at 1495; Richard B. Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy*, 86 YALE L.J. 1196, 1215–16 (1977).
[46] *See* sources cited *supra* note 8.
[47] Stark, *supra* note 8, at 1394.
[48] Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563, 571–72, 601 (1983). For more discussion, see Brian Galle, *Is Local Consumer Protection Law a Better Redistributive Mechanism Than the Tax System?*, 65 N.Y.U. ANN. SURV. AM. L. 525, 532–34 (2009).

other states, the literature calls this "horizontal distortions" or "horizontal externalities": a state that sets a low tax rate in effect imposes fiscal pressure on its neighbors to lower their own rates.[49]

As we have explained in prior scholarship, "[d]ue to these horizontal distortions, the 'classic theoretical result' of the fiscal federalism literature is that both distribution policy and the taxation of mobile capital are best left to the federal rather than the state governments."[50] We further explained that "[t]he rationale for this result is that state governments carrying out these activities generate all of the same problems as when the federal government does so, in addition to inducing horizontal distortions related to economic activity being relocated to other states."[51]

These observations lead some commentators to argue that the federal government should take on most or all progressive taxation and then fund state governments with grants or other forms of "revenue sharing."[52] This is not just an abstract thought experiment: revenue sharing is an important feature of the fiscal systems in Canada and other countries.[53]

At the same time, the literature recognizes that there would be serious costs to depriving states of the ability to deploy progressive tax systems. Voters in different states might have different tastes for distributive fairness

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[49] Bev Dahlby, *Fiscal Externalities and the Design of Intergovernmental Grants*, 3 INT'L TAX & PUB. FIN. 397, 398 (1996).
[50] David Gamage & Darien Shanske, *Tax Cannibalization and Fiscal Federalism in the United States*, 111 N'WESTERN UNIV. L. REV. 295, 302 (2017).
[51] Gamage & Shanske, *supra* note 50, at 302*; see also* David Schleicher, *The City as a Law and Economic Subject*, 2010 U. ILL. L. REV. 1507, 1511-12; Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility's Place in Optimal Taxation*, 63 NAT'L TAX J. 843, 850 (2010).
[52] Dahlby, *supra* note 49, at 408–10; David Wildasin, *Income Redistribution in a Common Labor Market*, 81 AM. ECON. REV. 757, 768 (1991).
[53] Kirk J. Stark, *Rich States, Poor States: Assessing the Design and Effect of a U.S. Fiscal Equalization Regime*, 63 TAX L. REV. 957, 957 (2010).

and progressivity.[54] Beyond differing state preferences, there are also likely divergent state capacities to engage in redistribution.[55] States that are home to valuable economic and amenity aggregations (think California and New York) should be able to impose more progressive taxes than states without such aggregations—and, in fact, they do so.[56]

It would therefore improve democracy and efficiency to permit different states to pursue varying tax policy goals.[57] In addition, commentators often argue that state-level experiments with different forms of taxation can generate helpful lessons both for other states and for the federal government and can thereby help overcome political and administrative obstacles to enacting welfare-enhancing policies.[58] State-level experiments with early income taxes played a key role in paving the way for the federal government to successfully enact the modern federal income tax in 1913.[59] Redistribution may also be a local or club good best provided at the local level.[60]

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[54] John R. Brooks, *Fiscal Federalism as Risk-Sharing: The Insurance Role of Redistributive Taxation*, 68 TAX L. REV. 89, 114–15 (2014); *see* Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267, 1296, 1301 (2013) (arguing that varying local preferences justify state control over tax policy choices).
[55] Stark, *supra* note 53, at 962–65.
[56] David R. Agrawal & Kirk Stark, *Will the Remote Work Revolution Undermine Progressive State Income Taxes?*, 42 VA. TAX REV. 47, 54 (2022); *see* Kevin Milligan & Michael Smart, *An Estimable Model of Income Redistribution in a Federation*, 11 AM. ECON. J.: ECON. POL'Y 406, 412 (2019) (modeling optimal degree of state redistribution when states vary in fiscal resources).
[57] Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 828 (2012).
[58] Mason, *supra* note 54, at 1304–05; David Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2641 (2005).
[59] AJAY MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE 185–241 (2013).
[60] Brooks, *supra* note 54, at 116. *But see* Stark, *supra* note 46, at 1408 (noting that redistribution may have significant spillovers that would justify federal provision).

Some prior authors (including some of us) have therefore proposed hybrid systems in which the federal government uses grants, or designs its own tax system, to entice state governments to impose fewer externalities on one another, thereby freeing up states that prefer more progressive tax systems to do so without being undercut by their neighbors.[61] For example, matching grants or tax deductions can reward states for raising revenue.[62] Some of these tools may not even be intentional; the federal government might simply be indifferent to "vertical" externalities in which states are able to increase their own revenue by reducing the federal tax base.[63]

But these hybrid options have important limitations. The Supreme Court has said that federal grants cannot "coerce" states into compliance,[64] and it seems likely that a grant system large enough to push states to adopt an entire new tax system, such as a progressive income tax, would raise constitutional questions under that doctrine.[65] Although shifting some of a state's tax pain to the federal government can be an effective way of encouraging the state to impose tax, it also means that the state has sharply diminished incentives to choose an efficient tax,[66] to the point that some

[61] OATES, *supra* note 42, at 65–75; Brian Galle & Jonathan Klick, *Recessions and the Social Safety Net*, 63 STAN. L. REV. 187, 210 (2010); *Darien Shanske, How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 VA. TAX REV. 413, 462–63 (2012). For recent empirical estimates of the optimal federal policy, see Milligan & Smart, *supra* note 56, at 422–28.
[62] Stark, *supra* note 46, at 1393.
[63] Gamage & Shanske, *supra* note 50, at 336–52.
[64] Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2602 (2012).
[65] *See* Michael J. Graetz & Jerry L. Mashaw, *Constitutional Uncertainty and the Design of Social Insurance: Reflections on the Obamacare Case*, 7 HARV. L. & POL'Y REV. 343, 363–64 (2013) (making this point about unemployment insurance taxes). *But cf.* Ruth Mason, *Federalism and the Taxing Power*, 99 CAL. L. REV. 975, 1008–35 (2011) (arguing that federal tax incentives should face lesser constitutional constraint than conditional spending limits do).
[66] Galle & Klick, *supra* note 61, at 208–09; Barry R. Weingast, *Second Generation Fiscal Federalism: The Implications of Fiscal Incentives*, 65 J. URB. ECON. 279, 285 (2009).

states may even be enacting taxes that are on the wrong side of the Laffer Curve (i.e., are losing money on net), once the costs to both states and the federal government are taken into account.[67] State fiscal needs often vary with the business cycle, but federal support rarely matches this pattern, or at best does so only with a damaging lag.[68]

Ultimately, then, our read of the current literature is that states should mostly not impose progressive taxes, but that this conclusion depends on an empirical question about the extent of taxpayer mobility.[69] If the voters in some states believe that the federal government is not doing enough to combat inequality through tax policy (and polling suggests that a supermajority of voters in many states do in fact believe this),[70] then theories of fiscal federalism support state-level progressive tax reforms. But on the other hand, the literature holds, taxpayer mobility makes these taxes so inefficient that the benefits are not likely to be worth the cost. Fully assessing this is partially an empirical question, as it matters whether horizontal distortions are likely to be small or large.

The fact that the case against state progressive tax depends on whether in fact tax revenues move easily across states is key to our argument. In Part III, we explain that the empirical ligature generally finds relatively small horizontal distortions in the form of wealthy people moving

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[67] Gamage & Shanske, *supra* note 50, at 331–34.
[68] Super, *supra* note 58, at 2650.
[69] *See* Roger H. Gordon & Julie Berry Cullen, *Income Redistribution in a Federal System of Governments*, 96 J. PUB. ECON. 1100, 1103, 1108 (2012) (stating that assignment of redistribution depends on balancing of mobility costs against other benefits); *cf*. Milligan & Smart, *supra* note 56, at 429 (finding that optimal fiscal decentralization depends on balance of horizontal and vertical externalities).
[70] *E.g.*, Taylor Orth, *Most Americans support raising taxes on billionaires*, YOUGOV, Oct 4, 2022, https://today.yougov.com/topics/politics/articles-reports/2022/10/04/most-americans-support-raising-taxes-billionaires (reporting that twice as many respondents support as oppose).

in response to taxation. By contrast, horizontal distortions in the form of moving money to escape taxation can be quite large. Crucially, though, we will argue that with wise design, and some innovations we propose, state governments have the tools to reduce these forms of distortions. If we are right about that, then the case for progressive state tax systems is much stronger.[71]

B. The Modern Fiscal Picture

To further set the stage for our arguments, it's worth noting that modern American fiscal arrangements don't look much like what the fiscal federalism literature calls for.[72] On the tax side, things are somewhat in line with theory.[73] State-level tax systems have become increasingly regressive—today mostly exacerbating inequality rather than combatting it.[74] States have largely abandoned the general taxes on wealth that they imposed throughout the 19th Century.[75] Local governments do impose taxes on real property, but these turn out to be relatively regressive.[76] Moreover, modern wealth and modern inequality are mostly tied to financial assets, not bricks and mortar.[77]

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[71] *See* Slemrod, *supra* note 51, at 851, 855 (arguing that tax system design can reduce capital mobility, making it more likely that it is optimal to tax capital).
[72] For a helpful overview, see Brooks, *supra* note 54, at 102–09.
[73] Stark, *supra* note 46, at 1390.
[74] *See* WIEHE ET AL., *supra* note 5.
[75] Glenn W. Fisher, *The Changing Role of Property Taxation*, *in* FINANCING STATE AND LOCAL GOVERNMENTS IN THE 1980S 37, 50–51 (Norman Walzer & David L. Chicoine eds., 1981).
[76] Fleck et al., *supra* note 5, at 8–9, 18; *see* Darien Shanske, *Revitalizing Local Political Economy Through Modernizing the Property Tax*, 68 TAX L. REV. 143, 178 (2014).
[77] Congressional Budget Office, *Trends in the Distribution of Family Wealth, 1989 to 2019*, at 28 (Sept. 2022), https://www.cbo.gov/publication/58533.

As to the spending side, we think two facts stand out. First, states and local governments have extensive fiscal responsibility to provide frontline government services, particularly public education.[78] The US spends about 3% of GDP on K-12 education, slightly more than the OECD average.[79] However, across the OECD, central governments provide 55% of funding,[80] where the federal government in the U.S. provides 8%.[81] Put another way, education funding makes up about one-third of state expenditures.[82]

Secondly, states have huge responsibilities for safety-net programs and other efforts to fight recessions.[83] Over 40% of states' expenditures go to public-welfare programs such as Medicaid, Temporary Assistance for Needy Families, and Supplemental Security Income, which are funded through a mix of state and federal dollars.[84] By design, these safety-net responsibilities increase during a downturn.[85] Unemployment insurance benefits are paid for by state taxes, although backstopped by federal funds during recessions.[86]

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[78] Katherine A. Baicker, Jeffrey Clemens, & Monica Singhal, *The rise of the states: U.S. fiscal decentralization in the postwar period*, 96 J. PUB. ECON. 1079, 1081–82 (2012).
[79] https://data.oecd.org/eduresource/public-spending-on-education.htm
[80] OECD (2017), *The Funding of School Education: Connecting Resources and Learning*, OECD Reviews of School Resources, OECD Publishing, Paris, https://doi.org/10.1787/9789264276147-en at 61.
81 Melanie Hanson, *U.S. Public Education Spending Statistics*, EDUC. DATA INITIATIVE (Aug. 2, 2021), https://educationdata.org/public-education-spending-statistics.
82 *State and Local Expenditures*, URB. INST. (2011), https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/state-and-local-expenditures.
[83] *See* Baicker et al., *supra* note 78, at 1082.
84. *Id.* This percentage only relates to state-level expenditures.
85 *See, e.g.*, David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 760 (2010).
[86] Josh Bivens et al., *Reforming Unemployment Insurance: Stabilizing a System in Crisis and Laying the Foundation for Equity*, ECON. POL'Y INST. 32–33 (June 2021),

Fiscal federalism generally holds that subnational units should not be given these kinds of large counter-cyclical spending responsibilities and, if they are, then the central government should race in to help.[87] Among other reasons, states do not internalize any economy-boosting or -sapping effects of their spending decisions for other states.[88] Public education is a partial example of this issue, as it does not make a lot of sense to lay off lots of teachers every time there is a recession, yet that is often what states do. States also cannot easily save for recessions or borrow during them.[89]

In short, modern arrangements in the U.S. are a bit of a puzzle. Why do we engage in so much safety-net and redistributive spending at the state level and below? Perhaps policy makers believe that progressive state spending can make up for regressive financing. Or perhaps regressive financing is exactly the point. We consider those two possibilities in the next Part.

II. Why Should States Tax the Rich?

Before exploring the empirics of tax mobility, we want to pause to add what we think are some new additional arguments for progressive state taxation. Specifically, we argue that state progressivity is essential to what we call "federalism neutrality," that it can't be replaced by other forms of progressivity, and that it is perhaps encouraged by unique federal constitutional constraints. We think it's worthwhile to put all the arguments

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https://files.epi.org/uploads/Reforming-Unemployment-Insurance.pdf [https://perma.cc/ZHZ3-35BR].

[87] Super, *supra* note 58, at 2648–50.

[88] Brian Galle, *The American Rescue Plan and the Future of the Safety Net*, 131 YALE L.J. F. 561, 568 (2021).

[89] Super, *supra* note 58, at 2609–11.

on the table, because again fiscal federalism is a balancing of competing considerations. If the arguments for state progressivity are stronger, we should be willing to tolerate more inefficiency or horizontal distortions in order to achieve it.

A. Federalism Neutrality

In our view, the modern fiscal arrangements we described in Part I.B. are a symptom of a serious structural problem, which we believe progressive state taxation would help to cure. Why do we give so much spending responsibility to states, when that responsibility makes little sense from a policy perspective?

While of course government choices are complex and have many causes, some of which may simply be path dependence, we argue that an important potential contributor is the U.S. failure to maintain what we call "federalism neutrality." A fiscal system is “federalism neutral” in our definition when voters and businesses are indifferent to whether policies are funded at the national level or instead by state or local governments. That is, political players have no reason to think that they will pay more or pay less based on which government is imposing the tax.

Federalism neutrality is potentially critical to efficient government. Suppose that under fiscal federalism criteria it would be highly inefficient to assign responsibility for some policy, such as aid to needy families, to states. But suppose also that powerful political interests calculate that their share of the cost of that policy will be much lower if states collect the tax. As a matter of political economy, then, federations should strive to achieve fiscal arrangements under which there are not likely to be large and systematic differences in the distribution of tax burdens between federal and sub-national tax systems.[90]

But large and systematic differences in tax burdens is exactly what the U.S. fiscal system has achieved. The federal tax system is far more progressive than state and local systems, particularly at the top of the income distribution.[91] States struggle to tax business income.[92] We contend that this misalignment incentivizes wealthier interests and corporations to push for policy to be devolved to state and local governments, in the expectation that the less-progressive and more porous revenue systems there will greatly lighten the tax cost for those interests.

B. Spending is No Substitute

Next, we argue that states should be able to redistribute through their tax systems, rather than having to rely on alternatives such as progressive spending policies. It might be argued that even if state taxes are flat or regressive, states could make up for that by targeting their spending to poorer households, so that taken as a whole state policy is progressive.[93] To

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[90] *But see* Kirk Stark, *The Federal Role in State Tax Reform*, 30 VA. TAX REV. 407, 437 (2010) (arguing that progressivity of state tax systems should be "left to state political choice"). We might be more inclined to agree with Prof. Stark's argument if we thought that state political choices reflected actual preferences of state voters, as opposed to constrained choices shaped heavily by structural factors that lean against progressivity.
[91] Daniel J. Hemel, *Federalism as a Safeguard of Progressive Taxation*, 93 N.Y.U. L. REV. 1, 10–14 (2018).
[92] Michael J. McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, 25 ST. TAX NOTES 931, 944–45 (2002).
[93] *See* EDWARD KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY 335–71 (proposing this approach for governments generally). *But see* Stark, *supra* note 46, at 1424–25 (noting some legal constraints on state ability to

the contrary, states with more progressive taxes have historically also had the more progressive spending,[94] but we want to at least consider the possibility that this trend could be reversed.

The main problem with this approach is that any means-tested spending program is just another tax system under a different name. If each additional dollar you earn causes you to lose twenty cents, it doesn't matter much whether that loss is a higher tax or instead a smaller amount of benefits received.[95] For the person who is being taxed or receiving the benefit, their decision about whether to move in order to keep their twenty cents is the same.[96] Indeed, there is a large literature on the extent to which mobility constrains states from providing more generous safety-net programs.[97]

One place where taxing and spending in fact differ is in the populations they reach. It is likely very difficult for spending programs to make important distinctions among relatively wealthy households.[98] In theory, government benefits could be designed to phase out in a way that would give smaller benefits to billionaires than mega-millionaires, and so on. But government

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differentiate services by income); Super, *supra* note 58, at 2617–40 (describing structural features of state spending that make redistributive programs less effective).

[94] Roy Bahl, Jorge Martinez-Vasquez, & Sally Wallace, *State and Local Government Choices in Fiscal Redistribution*, 55 NAT'L TAX J. 723, 737 (2002).

[95] Wildasin, *supra* note 52, at 767.

[96] *See* Henrik Kleven, Camille Landais, Mathilde Munoz, & Stephanie Stantcheva, *Taxation and Migration: Evidence and Policy Implications*, 34 J. ECON. PERSP. 119, 122 (2020).

[97] A classic cite here is Paul E. Peterson & Mark Rom, *American Federalism, Welfare Policy, and Residential Choices*, 83 AM. POL. SCI. REV. 711, 725 (1989). For more modern reviews, see Jan K. Brueckner, *Welfare Reform and the Race to the Bottom: Theory and Evidence*, 66 S. ECON. J. 505, 514-18 (2000); Lucas Goodman, *The Effect of the Affordable Care Act Medicaid Expansion on Migration*, 36 J. POL'Y ANAL. & MGMT. 211, 213 (2017).

[98] *See* Isaac Martin & Monica Prasad, *Taxes and Fiscal Sociology*, 40 ANN. REV. SOC. 331 (2014).

benefits are such a tiny share of household income for those families that these phaseouts would be almost meaningless to them.[99] Taxes, of course, do not have that constraint, and so tax systems are likely much more effective at addressing inequality between the mega-rich and everyone else.

Tax and spending programs also differ in their administration. Administering several parallel tax systems is not just expensive, it also interferes with other important goals. We know now that the complexity and "hassle" of government programs is a major obstacle to their efficacy, especially when the target population is relatively less educated.[100] Adding means-testing or other tools for targeting spending to select populations will often require more paperwork and more complexity, and thus will arbitrarily deny benefits to many deserving households. This problem is especially serious during recessions, when the government's capacity to process paperwork shrinks and the households who lose out are the ones we most want to get the money.[101]

Lastly, shifting redistribution over to spending programs doesn't help much with the federalism-neutrality problem. Reducing or shifting the benefits from a program are mostly an externality for the interests that want to shift policies to the state level to shift their tax bill. That is, moving school lunches off the federal budget and onto state ledgers would predictably save high-earners money, even if states respond by phasing out meal money for wealthier families.

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[99] *See* Saez & Zucman, *supra* note 1, at 22.

[100] Richard Domurat et al., *The Role of Behavioral Frictions in Health Insurance Marketplace Enrollment and Risk: Evidence from a Field Experiment*, 111 AM. ECON. REV. 1549, 1550–51 (2021); Barak A. Orbach, *Unwelcome Benefits: Why Welfare Beneficiaries Reject Government Aid*, 24 LAW & INEQUALITY 107, 116–26 (2006).

[101] Galle, *supra* note 88, at 566–67.

Overall, we think the current condition of U.S. fiscal federalism supports a potentially powerful case for reform. Regressive state financing contributes to overall inequality, and may be driving the decision to allocate so much safety-net spending responsibility to states. And this spending consequently does little to counteract many important dimensions of inequality.

III. On the Mobility of Wealthy People and of their Money

We have argued so far that there are good reasons for states to pursue progressive tax reforms, but is that a realistic goal? A key argument against progressive taxation at the subnational level, and especially against taxing the very wealthy, is that taxes could drive the rich away. For example, when California was debating a tax hike on its higher-bracket households in 2011, the California Senate minority leader quipped: "Nothing is more mobile than a millionaire and his money."[102]

He was half right. In this Part, we argue that while there are some significant practical obstacles to progressive state-level taxation, out-migration of wealthy residents themselves should probably not be a primary consideration—but with some caveats and cautionary notes that we will explain further below.[103] While some millionaires do sometimes move after states raise taxes, others move in, and perhaps new entrepreneurs rise to take their place. The empirical literature simply does not support the claim that wealthy peoples' movement decisions are highly responsive to taxation.

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102 Kevin Yamamura, *Plans to "Tax the Rich" Hold Risks and Rewards for California*, SACRAMENTO BEE, Dec. 27, 2011.

103 We provide support and elaboration for all of the statements in the introduction to this Part in the following text.

Money, on the other hand, is much more portable. We sketch a few of the many ways in which wealthy individuals can readily shift their taxable income across state borders to minimize their tax burdens, and show how these opportunities help to explain some of the observed empirical findings on the impact of progressive wealth or income taxes. Importantly, we subsequently explain in Parts IV and V how state governments can use tax reform solutions to combat the ways in which money can currently move to escape state-level taxation. In other words, we argue that the movement of money is not an inherent limitation on state-level taxation, but rather should be understood as mostly just a design problem.

A. On the (Non-)Mobility of Wealthy People

By nearly all accounts, the recent empirical literature does not support claims that migration of wealthy people poses a substantial constraint on states' taxing capacity. As John R. Brooks explained in 2014, the evidence that migration substantially limited subnational redistribution was then weak, and data in the last decade has strongly confirmed that view.[104] For example, a thorough review of the evidence commissioned by the U.K. government concluded in 2022 that "actual migration responses are small."[105] In other words, although people do move, their decisions as to whether and where to move do not appear to be heavily influenced by tax considerations.

We will not here repeat the work of these thorough literature reviews, but rather will explain just a few important points and some especially relevant

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[104] Brooks, *supra* note 54, at 117–19.

[105] Arun Advani & Hannah Tarrant, *Behavioural responses to a wealth tax*, 42 FISCAL STUDIES 509, 531 (2021); *see also* Arun Advani, David Burgherr, & Andy Summers, *Taxation and Migration by the Super-Rich*, Warwick Economics Research Papers No. 1427, at 15–18 (Sept. 2022) (reporting "close to zero" international mobility response of the wealthy in response to U.K. tax changes).

studies. Because most of the literature has focused on existing realization-based income taxes (along with business taxes and the like), the research on Spain's recent experience with subnational wealth taxes is especially interesting for the purposes of this Article. Prior to 2008, when it was suspended for two years, the Spanish wealth tax was mostly levied and administered in a uniform manner across different regions of Spain, meaning that moving from one region to another would not have had substantial tax consequences for migrating residents.[106] This changed with the reintroduction of the wealth tax in 2011, after which different regions began enacting substantially different tax rates and exemptions. Notably, Madrid effectively abolished its regional wealth tax (establishing an effective zero percent tax rate), whereas other regions in Spain levied progressive wealth tax rates ranging from 0.16 percent to 3.75 percent.[107]

As the leading academic study of the effects of the Spanish wealth tax explains, the tax savings of moving from a region with a higher wealth tax rate to Madrid "are sizeable."[108] This is because a number of regions in Spain levy top wealth tax rates much higher than those that have been proposed for state-level wealth tax reforms in the U.S. For instance, compare the top 1.5% rate of California's proposed wealth tax or the top 1% rate of Washington State's proposed wealth tax with the top rates in higher-tax Spanish regions of 2.75% in Catalonia or 3.75% in Extremadura.[109] Depending on certain assumptions, these Spanish rates can impose an economic burden

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[106] David R. Agrawal, Dirk Foremny, & Clara Martínez-Toledano, *Wealth Tax Mobility and Tax Coordination* 36–37 (March 2022), https://ssrn.com/abstract=3676031.
[107] Cristina Enache, *Spain Is Doubling Down on Poor Tax Policy*, TAX FOUNDATION, April 10, 2023 *https://taxfoundation.org/spain-wealth-tax-windfall-tax/*. For further explanation of variation in wealth tax rates across Spanish regions from 2011 through 2015, *see* Agrawal et al., supra note 106, at 41.
[108] Agrawal et al., *supra* note 106, at 5.
[109] *Wealth Tax in Spain: Exact Percentages and How to Reduce It*, BALCELLS, https://balcellsgroup.com/wealth-tax-in-spain/.

comparable to a capital-gains tax of upwards of 60%, triple the U.S. federal rate.[110]

Yet despite these relatively high top rates levied in these regions and the large tax savings that can thus be achieved from moving from one of these high-tax regions to Madrid, the study finds that mobility responses are relatively small as compared to the revenues raised by Spain's wealth tax.[111] Specifically, the study finds that regions other than Madrid only lose about 5% of the potential revenue that would otherwise have been raised from their wealth taxes due to mobility responses, plus an additional loss of 2.5% of personal income tax revenues.[112] Thus, although these mobility responses are measurable and significant, they do not greatly undermine the revenue-raising potential of Spain's subnational progressive taxes.

Moreover, the study finds that "nearly all tax-induced mobility is driven by the salient zero-tax region of Madrid."[113] Despite the quite significant tax rate differentials among regions other than Madrid, the study found negligible tax-induced mobility between these regions.[114]

Other studies of tax-induced migration responses find similar results. Consider a study of California's 2012 tax hike on millionaires, authored by two economists at the conservative Hoover Institute, Rauh and Shyu,[115] a study that has been trumpeted by many opponents of progressive state-level

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[110] Advani & Tarrant, *supra* note 105, at 520–21.
[111] Agrawal et al. , *supra* note 106, at 5.
[112] *Id.* at 2.
[113] *Id.* at 23.
[114] *Id.*
[115] Joshua Rauh & Ryan Shyu, *Behavioral Responses to State Income Taxation of High Earners: Evidence from California*, __ AM. ECON. J.: POL'Y __ (forthcoming 2023), [*https://ssrn.com/abstract=3461513.*](https://ssrn.com/abstract=3461513)

tax reforms.[116] This study finds dramatically larger responsiveness of wealthy taxpayers to California's 2012 tax hikes than what is found in most other studies in the literature,[117] yet only a small portion of this responsiveness is due to taxpayers leaving California, with over ninety percent of the reported responsiveness instead arising from reductions in taxable income by taxpayers who remain in California.[118] The authors note that there are a number of possible mechanisms that could explain how taxpayers remaining in California were able to reduce their reported taxable incomes, including "labor supply effects, offshoring to other countries, shifting of sales of pass-through businesses to other states under California's single sales apportionment rule, and shifts to forms of compensation for which taxation is deferred."[119]

In other words, most of this reported responsiveness may be a result of taxpayers moving their money so as to escape tax, as we discuss further below. Looking just at migration responses, the study found that California only lost about 4.2% of the revenue that would otherwise have been raised from its tax hikes due to taxpayers leaving the state.[120]

Thus, although both the study of Spain's wealth taxes and the study of California's 2012 income tax hikes find mobility responses that are measurable and significant, the migration responses reported by both studies are relatively small as compared to the revenue-raising potential of the taxes being studied. Moreover, neither Spain's wealth tax nor California's income tax has implemented the reform measures we propose in Part IV to mitigate

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[116] *E.g.*, Editorial, *California's Tax-the-Rich Boomerang*, WALL STREET JOURNAL, Oct. 21, 2019, https://www.wsj.com/articles/californias-tax-the-rich-boomerang-11571697967.
[117] Rauh & Shyu, manuscript at 5.
[118] *Id.* at 51 (explaining that of the 55.6% loss of revenue from taxpayer responsiveness only 4.2% was due to out-migration).
[119] *Id. at 53.*
[120] *Id. at 51.*

migration responses. As we will explain, implementing these reforms would likely have further alleviated the migration responsiveness (or at least the revenue loss from the migration responsiveness).

Looking to the literature more generally, in our view the most convincing study is one from 2016, based on confidential IRS data on the universe of million-dollar earners in the U.S. from 1999 to 2012.[121] The authors of that study concluded:

> The most striking finding of this research is how little elites seem willing to move to exploit tax advantages across state lines in the United States. Millionaire tax flight is occurring, but only at the margins of statistical and socioeconomic significance….[M]illionaires are not very mobile and actually have lower migration rates than the general population.[122]

There are some sub-categories of the rich who do seem to be more apt to move in response to tax. "Super-star" inventors who hold multiple patents tend to relocate to low-tax places more than the general population does, as do European soccer players and some entertainers.[123] These are logical exceptions, because they all are populations that move far more even than other wealthy individuals, and represent earners whose ability to bring in

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[121] Cristobal Young, Charles Varner, Ithai Z. Lurie, & Richard Prisinzano, *Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data*, 81 AM. SOC. REV. 421, 426 (2016).
[122] *Id*. at 439.
[123] Ufuk Akcigit, Salome Baslandze, & Stephanie Stantcheva, *Taxation and the International Mobility of Inventors*, 106 AM. ECON. REV. 2930 (2016); Henrik Kleven, Camille Landais, & Emmanuel Saez, *Taxation and International Migration of Super-stars: Evidence from the European Football Market*, 103 AM. ECON. REV. 1892, 1903–12 (2013); Enrico Moretti & Daniel J. Wilson, *The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists*, 107 AM. ECON. REV. 1858 (2017).

money is relatively unattached to any one place.[124] Patent-holders are most mobile, for instance, when they already work for a multi-national business and have an alternative workplace ready to relocate to.[125] In contrast, most revenue is deeply embedded in a community: workers, customers, and suppliers cannot easily be uprooted, and it is difficult to manage a successful business from afar.[126] Studies that have examined the question indeed find that business owners are considerably less mobile than other millionaires, particularly while still in their working years.[127]

A Swiss study did find somewhat higher migration responses than the others we have surveyed, finding that claimed relocations cost about $.22 of every potential dollar that would have been collected without any moves.[128] But that was the result of tax differences between two adjacent, relatively tiny (total population: 1.5 million) German-speaking cantons, connected by Switzerland's famously extensive and efficient public transit.[129] In the U.S.

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[124] For example, Kleven et al. find that football players are two to four times more responsive to tax rates than other Danes. Kleven et al., *supra* note 123, at 1913 & Fig. 4. Moretti and Wilson note that star inventors are three times more mobile than other professionals, *supra* note 123, at 1865.

[125] Akcigit et al., *supra* note 123, at 2935.

[126] Young et al., *supra* note 121, at 425; *see* Kleven et al., *supra* note 96, at 120; *see also* David Schleicher, *Stuck! The Law and Economics of Residential Stagnation*, 127 YALE L.J. 78, 113–49 (2017) (describing set of legal and structural factors reducing American mobility).

[127] Young et al., *supra* note 121, at 428; *see* Advanti & Tarrant at 531 (noting that elasticity of relocation is highly sensitive to ease of mobility); Joshua Rauh, *Taxes, Revenue, and Net Migration in California* at 43 Fig. 1 (Dec. 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4037764 (showing that nearly all of the relocation response to the 2012 California tax change was among near-retirees).

[128] *See* Marius Brulhart, Jonathan Gruber, Matthias Krapf, & Kurt Schmidheiny, *Behavioral Responses to Wealth Taxes: Evidence from Switzerland*, 14 AM. ECON. J: POLY 111 (2022) at [22, 36] (reporting a revenue elasticity of -.92, with 24% of that caused by (reported) migration).

[129] *See id*. at 20–21; Advani & Tarrant, *supra* note 105, at 516 (making this point about the Swiss study).

context, researchers find some tax responsiveness in border regions and cross-state metro areas, but only incrementally so.[130] It is thus worth cautioning that our conclusions about the limited impact of interstate mobility do not necessarily apply when considering metro areas sitting at the boundaries of a higher-tax state and a much lower-tax state, so that taxpayers could just move neighborhoods to escape some tax while remaining in the same general region.[131] But we view these as exceptions that are consistent with our general conclusions: for the most part, the empirical literature finds relatively small migration responsiveness of wealthy taxpayers to taxation.

Moreover, there is evidence that a good portion of this supposed "migration" is actually fake.[132] Infamously, tax authorities struggle to know where taxpayers really live, as it can be challenging to verify whether a beach house or pied-a-terre is really a primary residence, or vice-versa.[133] In Spain, for instance, researchers estimated that four-fifths of all claimed relocations to Madrid were likely bogus.[134] That is, much or even most of the measured mobility responses to the Spanish wealth tax was likely a result of taxpayers with second homes in Madrid fraudulently claiming to have moved their principal residence to Madrid without actually having done so.[135] These sorts

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[130] Young et al., *supra* note 121, at 437–39.
[131] Because most states tax compensation earned in the state, no matter the residence of the earner, these cross-border tactics would largely only serve to reduce investment earnings.
[132] *See* Agrawal et al., *supra* note 106, at 56–57; Advani & Tarrant, *supra* note 105, at 531.
[133] Aaishah Hashmi, *Is Home Really Where the Heart Is? State Taxation of Domiciliaries, Statutory Residents, and Nonresidents*, 65 TAX LAW. 797, 803–17 (2012); Edward A. Zelinsky, *Defining Residency for Income-Tax Purposes: Domicile as Gap-Filler, Citizenship as Proxy and Gap-Filler*, 38 MICH. J. INT'L L. 271, 274–78 (2017).
[134] Agrawal et al., *supra* note 106, at 56–58; Advani & Tarrant, *supra* note 105, at 531.
[135] Agrawal et al., *supra* note 106, at 57–58.

of fraudulent "paper" forms of migration could potentially be prevented with stronger auditing and enforcement policies.[136]

Similarly, in the U.S. studies, many of the "migrations" observed by researchers involve changes from full to part-year residency, a change that can bring major tax benefits (as we detail more below).[137] Of course, tax fraud reduces revenues, just as real relocations do, but the policy implications of fake moves are quite different from their real counterparts. For example, tax authorities have had considerable success in some jurisdictions in cracking down on bogus relocations,[138] whereas we likely would not want to (and perhaps constitutionally could not) constrain real moves.

We acknowledge, however, that mobility responses to tax depend on the total tax enforcement environment. In a world where fake moves are easy or, as we argue below, it is very easy to move money without physical relocation, taxpayers may have little incentive to relocate. Tighter enforcement on these other margins might result in more actual relocations.[139] But available evidence is reassuring on this front. Enforcement crackdowns in Norway, for instance, did not result in any measured increase in real relocations.[140] And, as we will argue, the tax rewards to moving are much smaller if common abusive techniques are curtailed.

[136] Advani & Tarrant, *supra* note 105, at 524; *see* Bertrand Garbinti et al., *Tax Design, Information, and Elasticities: Evidence from the French Wealth Tax*, NBER Working Paper No. 31333, at 4–5 (June 2023) (describing French taxpayer responses to information reporting reforms).
[137] Rauh & Shyu at 30.
[138] *See* Advani & Tarrant at 524 (describing Norwegian enforcement efforts).
[139] Advani & Tarrant, *supra* note 105, at 512.
[140] Advani & Tarrant, *supra* note 105, at 524.

B. *E Pur Si Muove*[141]: On the Mobility of Money

While wealthy taxpayers themselves do not appear to be especially mobile, their reported taxable income and wealth often is.[142] As evidence of fake relocations itself suggests,[143] taxpayers often find it easier to escape tax through tax-gaming and tax-planning strategies than through real changes in their behavior.[144] This accords with the widely-accepted view that "capital," or the combination of business and investment assets is more "mobile" than humans.[145] Profits and losses are intellectual concepts, not natural things. They do not exist in any one place, but instead arise through a series of transactions between parties who may be far apart from one another. Thus, law must impose somewhat arbitrary rules to tie any given bit of profit to a particular taxable location.[146] Often the result is that it is relatively easy for taxpayers to tweak relatively unimportant features of their transactions to change the law's arbitrary assignments.[147]

When it comes to taxing peoples' income, the most important of these arbitrary rules is the concept of realization. As we noted in the Introduction,

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[141] *See* Mario Livio, *Did Galileo Truly Say "And Yet It Moves"? A Modern Detective Story*, SCIENTIFIC AMERICAN blog, May 6, 2020, https://blogs.scientificamerican.com/observations/did-galileo-truly-say-and-yet-it-moves-a-modern-detective-story/.
[142] Kleven et al., *supra* note 96, at 133.
[143] *See supra* notes 132–138 and accompanying text.
[144] David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 387–98 (2015).
[145] *E.g.*, Roger H. Gordon & James R. Hines, Jr., *International Taxation*, *in* 4 HANDBOOK OF PUBLIC ECONOMICS 1935 (Alan J. Auerback & Martin Feldstein eds., 2002); Kleven et al., *supra* note 96, at 133.
[146] Stephen E. Shay, J. Clifton Fleming, & Robert Peroni, *"What's Source Got to Do With It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 83–84 (2002); Slemrod, *supra* note 51, at 845–46.
[147] Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 177–78, 180–98 (2008).

the realization rule is the feature of most global income taxes providing that taxpayers only have to include profitable investments in their income at the time those assets are sold.[148] Although the rule makes some sense as an easy way for tax systems to determine the value of a taxable asset,[149] it also has the effect of arbitrarily assigning taxing rights to the jurisdiction where a taxpayer happens to live when they sell their property.[150]

Realization can easily be gamed to avoid state income taxes.[151] For instance, as Julie Roin has recently explained,[152] imagine that Elon's stock increases in value from $0 to $100 billion while he lives in California, but he never sells it. He then moves to Texas, where the tax rate is zero. If Elon sells his shares while in Texas, he will never pay income tax to California (or any other state) on the $100 billion in appreciation he enjoyed. The reverse is also true: if someone plans to permanently relocate to a high-tax state, they have the option to sell appreciated property before moving, to take advantage of their pre-move lower rates.[153] Thus, even if there is no net loss of population from higher state taxes, it is still possible that states could lose a great deal of revenue from mobility. Departures will tend to take their taxable gains with them, while new arrivals will not bring any in.

Taxpayers don't even have to move permanently to exploit this strategy. They can relocate (or claim to) for one year, sell, and then move

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148 *See, e.g.*, I.R.C. § 1001(b).
149 Zelinsky, *supra* note 22, at 879–89. For more discussion of the policy plusses and minuses of the realization rule, see Galle et al., *supra* note 40, at 1268–73.
150 *See* Shay et al., *supra* note 146, at 137–38, 144.
151 Galle et al., *supra* note 40, at 1285, 1315.
152 Roin, *supra* note 15, at 346.
153 This strategy has some tradeoffs. In general, a benefit of the realization rule is that it gives taxpayers the option to delay sales, capturing the time value of their unpaid taxes, *see generally* J.B. Chay, Dousung Choi, & Jeffrey Pontiff, *Market Valuation of Tax-Timing Options: Evidence from Capital Gains Distributions*, 61 J. FIN. 837 (2006), and in the U.S. also escaping tax entirely if they die while holding the appreciated asset.

back if they want, assuming they can convince state tax authorities their move was genuine.[154] This greatly lowers the subjective cost of tax avoidance, as it minimizes the time taxpayers have to spend in the less-desirable location.[155] Accordingly, researchers find that the location of taxable estates is highly responsive to effective state tax rates:[156] the wealthy person can move in late retirement years or even just before their expected end, making it relatively easy to shop for a preferable tax rate.[157]

Realization and its close cousins also lie behind numerous other state-tax reduction strategies. For instance, another relatively simple tactic is to gift appreciated or income-producing assets to relatives in low-tax states.[158] This is far superior to earning the income in high-tax states, then transferring to the relative later. Gifts are not "realization events" in the American tax system,[159] so the transfer entirely eliminates any tax that might have been imposed by the transferor's home jurisdiction.[160] Some commentators note that this strategy could trigger federal transfer (i.e., gift

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[154] *Cf.* N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2225–26 (2019) (describing a version of this strategy).

[155] We're not passing judgment on low-tax states here; we just mean that by definition the taxpayer must prefer the high-tax state in some sense, otherwise they would have already moved to the low-tax one.

[156] *See* Enrico Moretti & Daniel J. Wilson, *Taxing Billionaires: Estate Taxes and the Geographical Location of the Ultra-Wealthy*, NBER Working Paper No. 26387, at 19–23 (Sept. 2020); Jon Bakija & Joel Slemrod, *Do the Rich Flee From High Tax States? Evidence from Federal Estate Tax Returns*, NBER Working Paper No. w10645, at 4, 24–25, 34 (Jul. 2004) (finding that estate tax influences reported, though not necessarily real, location of estates, but that "the welfare cost and revenue-loss from any tax-induced migration would be small").

[157] Advani & Tarrant, *supra* note 105, at 532; Moretti & Wilson, *supra* note 156, at 23 (reporting that effect of state estate taxes rises sharply with old age).

[158] John Buckley, *Transfer Tax Repeal Proposals: Implications for the Income Tax*, 90 TAX NOTES 539, 540 (2001)

[159] Treas. Reg. § 1.1001-1(e).

[160] Jonathan G. Blattmachr & Mitchell M. Gans, *Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 90 TAX NOTES 393, 396–98 (2001).

and estate) taxes,[161] but that outcome has long been fairly easy to avoid for aggressive planners,[162] and was further de-fanged by 2017 changes to increase the gift-tax exemption to more than $10 million.[163] Since the transfer tax is not imposed on transfers for fair market value, the aggressive move is to "sell" the transferred assets to relatives, often at very low prices that the parties will nonetheless maintain are fair market value.[164] Many planners use trusts for this purpose,[165] both because of favorable Tax Court and IRS rulings,[166] and perhaps on the expectation that the presence of the trustee adds a veneer of independence to the deal.

Trusts further amplify this basic strategy by allowing wealthy individuals to move assets to low-tax states even if they don't (yet) have any relatives there they want to give money to.[167] Many states tax trusts based on

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[161] *See id.*; Jay A. Soled, *Reassigning and Assessing the Role of the Gift Tax*, 83 B.U. L. REV. 401, 410, 412 (2003) (suggesting gift tax might mitigate income shifting generally). More technically, it results in gift tax, which is (roughly speaking) the tax imposed on wealthy households when they transfer property during life rather than at death.

[162] Soled, *supra* note 161, at 423 (noting the many improvements that would be needed for gift tax to effectively constrain income shifting); *see* Jay A. Soled & Mitchell Gans, *Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do To Curb Aggressive Transfer Tax Techniques*, 78 TENN. L. REV. 973, 975–86 (2011) (describing strategies for avoiding gift tax).

[163] Mitchell Gans, Kaestner *Fails: The Way Forward*, 11 WM. & MARY BUS. L. REV. 651, 657 (2020).

[164] *Id.*; *see* Dwight Drake, *Transitioning the Family Business*, 83 WASH. L. REV. 123, 173–77 (2008) (describing sale of owners' stock back to the family business as a form of "estate freeze").

[165] *See* Drake, *supra* note 164, at 180–83.

[166] *See* Walton v. Comm'r, 115 T.C. 589, 603 (2000) (rejecting IRS regulation that had limited use of annuity payments to grantor); Soled & Gans, *supra* note 162, at 988–90.

[167] Gans, *supra* note 163, at 656; *see* Peter Spero, *State Taxation of Trusts*, 46 ESTATE PLANNING 20, 20 (2019) ("A common use of out-of-state trusts is the avoidance of taxation of income by the state in which the settlor resides.").

where the trust is managed, not where its money originated.[168] If the transferor (called the grantor or settlor in trust lingo) gives up certain elements of control, they can easily shift taxation of trust assets elsewhere.[169] There is currently a split between state supreme courts over whether it would even be constitutional for a state to tax a trust based only on where the grantor lived.[170] And once the grantor passes, trust funds can often grow free of any tax, even if the eventual beneficiaries live in a high-tax state.[171] Here again, this loophole has a constitutional source, as the Supreme Court recently held that states cannot tax trusts based only on the residency of a beneficiary who isn't currently entitled to receive funds from the trust.[172] More complex trust strategies, such as charitable remainder trusts, offer even more possibilities.[173]

Partnerships and limited liability companies also provide an, ahem, wealth of planning options. Probably the simplest example is that partners and LLC members can store a great deal of unrealized value inside the entity, then claim that value upon sale of their equity interest.[174] Partnership sales (and sales of LLC's, which are generally taxed as partnerships) are

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[168] Jonathan G. Blattmachr & Martin M. Shenkman, *State Income Taxation of Trusts: Some Lessons of* Kaestner, 29 J. MULTISTATE TAX'N & INCENTIVES 20, 22–23 (2019).
[169] Grayson M.P. McCouch, *Adversity, Inconsistency, and the Incomplete Nongrantor Trust*, 39 VA. TAX REV. 419, 420–24 (2020).
[170] Gans, *supra* note 163, at 671–74.
[171] Jeffrey Schoenblum, *Strange Bedfellows: The Federal Constitution, Out-of-State Nongrantor Accumulation Trusts, and the Complete Avoidance of State Income Taxation*, 67 VAND. L. REV. 1945, 1950 (2014).
[172] N.C. Dep't of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust, 139 S.Ct. 2213, 2221 (2019); *see* Gans, *supra* note 163, at 656–66.
[173] Paul D. Callister, *Charitable Remainder Trusts: An Overview*, 51 TAX LAW. 549, 559 (1998).
[174] Kathleen K. Wright, *Planning Opportunities in Taxation of Nonresident Partners*, 2 J. MULTI-STATE TAX'N 244, 249 (1993).

typically "sourced" to the state of residence at the time of sale,[175] so if the sale happens after the partner has retired to a low-tax state, the high-tax state loses out on all the stored value.[176]

How do partnerships and LLCs store value? They could buy and hold appreciating property, of course. But another common route is for the retiring partner to sell off the valuable reputation, customer lists, and other intangibles associated with their business (think of the sale of a used-car business or a dental practice).[177] A good share of these assets are in actuality a product of the partner's "sweat equity" or labor, not a classic investment.[178] In theory, labor income is supposed to be taxed in the place where the labor happened,[179] but by converting their labor into an increase in the value of their partnership, then moving, partners escape that rule. Partnership tax rules also routinely grant partners large deductions in early years at the price of income in later years or at sale; partners who move to a low-tax state

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[175] Carolyn Joy Lee, Bruce P. Ely, & Dennis Rimkunas, *State Taxation of Partnerships and LLCs and Their Members*, 19 J. MULTISTATE TAX'N & INCENTIVES 8, 17 (2010); Michael W. McLoughlin & Walter Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box*, 8 ST. & LOCAL TAX LAW. 1, 30 (2003). That is, states for the most part do not apply any analogue to I.R.C. § 751 and § 864(c)(8), which (roughly speaking) recharacterize sales of a partnership interest as sale of the underlying assets. *See* Emily Cauble, *Taxing Selling Partners*, 94 WASH. L. REV. 1, 21–23, 26 (2019). But California has a version of the FIRPTA provision, I.R.C. § 897(g), taxing sales of partnerships that hold U.S. real estate. Cal. Rev. & Tax Code §25125(d) (allocating portion of partnership sale proceeds to California, based on share of partnership tangible assets or other business factors in California).

[176] States probably have constitutional authority to apply a different rule, *see* McLoughlin & Hellerstein, *supra* note 175, at 19, but as we note below it is unlikely that anti-abuse rules would have much bite. *See infra* notes 176–183.

[177] *See* Edward Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208, 229 (2017) (offering the example of a celebrity restaurant owner).

[178] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 44 (2008).

[179] Mitchell A. Kane, *A Defense of Source Rules in International Taxation*, 32 YALE J. REG. 311, 336–37 (2015).

can escape this deferred-tax obligation.[180] While state anti-abuse rules are possible,[181] and some do exist,[182] even federal auditing of partnerships is essentially toothless; it would be naïve to believe states are at all effective on this front.[183]

Taxpayers can avoid state tax even more effectively with corporations, although sometimes there is an offsetting federal disadvantage. While partnerships and some corporations "pass through" their annual income to their owners, a so-called "C Corporation" (named for its subchapter of the tax code) is treated as a separate taxpayer. Equity owners only pay tax on the corporation's profits when they sell (or otherwise dispose of) their stock, or when they get dividends. Both of these are discretionary, particularly in the case of a C-Corp that is controlled by just a few shareholders who can thus choose when to issue any dividend. Therefore, it is simplicity itself to store value inside a corporation: the owners simply leave the profits in the corporation's bank account, and don't sell their shares or take dividends.[184] They can easily borrow against the value of their stock if they need spending money.[185] States generally tax corporations based on where their sales are, not where their owners are, so often the entity's overall rate will be lower than the owners', and frequently close to zero for multi-national firms.[186] If

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[180] See JAMES REPETTI, WILLIAM LYONS, & CHARLENE LUKE, PARTNERSHIP INCOME TAXATION 76–106 (7th ed. 2023) (describing the deferral system); Andrew Monroe, *Saving Subchapter K*, 74 BROOK. L. REV. 1381, 1403 (2009) (same).
[181] *See* Roin, *supra* note 15, at 361–62.
[182] *E.g.*, N.Y. Codes, Rules & Regs. §3-13.3(a)(3).
[183] Monroe, *supra* note 180, at 1382.
[184] Leo N. Hitt, *Rethinking the Obvious: Choice of Entity After the Tax Cut and Jobs Act*, 16 PITT. TAX REV. 67, 98 (2018); Mary LaFrance, *The Separate Tax Status of Loan-Out Corporations*, 48 VAND. L. REV. 879, 881–82 (1995).
[185] David Kamin, David Gamage, Ari Glogower, Rebecca Kysar & Darien Shanske, *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1448 (2019); Hitt, *supra* note 184, at 98.
[186] Alexander Arnon & Zheli He, Penn-Wharton Budget Model, *Effective Tax Rates on U.S. Multinationals' Foreign Income Under Proposed Changes by House Ways and*

the owners' home state would impose any tax on the corporation's income, there are an assortment of common planning techniques to "strip" the income out and send it to another corporation owned by the same people, but taxable only in a tax haven such as Delaware, Liechtenstein, or Ireland.[187]

While there is a federal cost to the C-Corp strategy, that cost got much lower in 2017, when Congress slashed the corporate tax rate from 35% to 21%.[188] At a minimum, the strategy is appealing for owners who were likely to form a C-Corp anyway, such as those who hope to go public or are funded by private equity.[189] In theory, there are very old federal rules that are supposed to impose penalty taxes on corporations that are used to accumulate excess profits or serve as "personal holdings companies."[190] But those rules are in desuetude—we could find only three cases applying them more recently than 1989, and one since 2000.

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It is worth reemphasizing that we do not consider mobility in and of itself to be a problem. Quite the contrary, and consistent with most of the

Means and the OECD, Sept. 28, 2021, https://budgetmodel.wharton.upenn.edu/issues/2021/9/28/effective-tax-rates-multinationals-ways-and-means-and-oecd.

[187] *See* Swain, *supra* note, at 385–86.

[188] Because distributed corporate profits are taxed at lower capital-gains rates, whereas pass-through income from an active business taxed as a partnership would typically be ordinary income, the federal tax disadvantage to a C-Corp is smaller than it might appear. And particularly for multi-national entities that can drive their effective federal rates to 10.5% (or lower), the C-Corp can be appealing. But there is still a net disadvantage for many businesses.

[189] *See* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738 (1994) (explaining why PE firms prefer C-Corps for their portfolio companies); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 175–84 (2004) (same).

[190] I.R.C. §§ 531, 541; *see* Calypso Music, Inc. v. Comm'r, T.C. Mem. 2000-293, at *2 (2000).

literature on fiscal federalism, we favor a system in which people can freely move to whichever jurisdictions offer them their most preferred packages of tax-funded benefits and other amenities along with paying the tax costs of funding those benefits.[191]

Rather, the problem in our view is what Julie Roin has labeled "exploitative mobility"—that is, when taxpayers "can extract benefits from one jurisdiction while escaping some of the costs of providing those benefits."[192] If a taxpayer decides not to move to a jurisdiction with tax policies that are too progressive for their tastes, we would not consider this to be exploitative mobility, but rather just the normal operations of fiscal federalism. Alternately, a taxpayer who has earned substantial income and wealth in State A in which she resides and has also fully paid taxes on this income and wealth is not engaging in exploitative mobility if they relocate, because this income and wealth was taxed as it was accrued. Instead, we think reform efforts should be focused on taxpayers who benefited from the amenities provided by State A, but engaged in tax planning (such as the schemes we discussed above)[193] so as to never pay much tax to State A.

Ultimately, just as we argue that there are good reasons for states to pursue progressive tax reforms, there may also be good reasons for states to limit the rates or aggressiveness of such reforms. We caution here that our assessment that the empirical literature does not find large migration responsiveness from existing forms of progressive taxation is not dispositive as to all possible futures.[194] If a state were to shut down all of the ways in

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[191] Schleicher, *supra* note 51, at 86–106.
[192] Roin, *supra* note 15, at 378.
[193] Part II.B. *supra*.
[194] As the maxim goes, past performance does not guarantee future results. Also, it takes time for empirical studies to fully take account of more recent developments. For instance, it could be that changing technology or COVID-induced social changes or other developments might result in greater mobility responses than what the empirical literature has found for the past. Further, when it comes to evaluating the

which money moves to escape tax—implementing the reforms we propose in Parts IV and V—and especially if the state were to then hike its tax rates well above existing or historical levels, then this might well produce larger migration responsiveness (though it also might produce less, as although it will be harder to escape tax without moving, the tax rewards to moving will also be smaller). With those cautions in mind, we think it prudent that both California's and Washington State's proposed wealth tax reforms would levy top rates well below the top rates currently being levied in many regions of Spain.[195]

A comprehensive evaluation of all of the factors that states should consider in deciding the top rates for progressive tax reforms is beyond the scope of this Article. In this Part, we have aimed more modestly just to explain why the existing empirical literature does not support claims that migration of people themselves is a primary obstacle to progressive tax reforms at even relatively low rates. Instead, we have argued that the primary obstacle is the movement of money. We thus next explain, in Parts IV and V, how states can solve the exploitative mobility problems associated with the movement of money.

IV: Addressing Exploitative Migration with Wealth Tax or Mark-to-Market Reforms

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behaviors of individual members of the super-rich, the number of such people may be too small to analyze effectively with empirical methods, and yet some of these super-rich may be so wealthy that their individual mobility decisions may have significant tax revenue implications even apart from any larger trends. Overall, again, we urge caution in interpreting the implications of the empirical literature.

[195] Note 109 and accompanying text *supra*; *see also* Julie Zauzmer-Weil, *Billionaires in Blue States Face Coordinated Wealth-Tax Bills*, WASH. POST, Jan. 17, 2023, https://www.washingtonpost.com/business/2023/01/17/wealth-taxes-state-level/.

As we have explained, we do not consider mobility to be a problem in and of itself. Instead, this Article is concerned only with "exploitative mobility."[196] It is now worth further subdividing exploitative mobility into two subcategories that we will label as "exploitative migration" and "exploitative money moves." Exploitative migration is when taxpayers physically relocate in a manner that extracts benefits from one jurisdiction while escaping that jurisdiction's tax costs. Exploitative money moves are when taxpayers do not physically relocate but rather just move their money to escape their resident jurisdiction's tax costs. This Part explains how states can use wealth tax or mark-to-market reforms to address exploitative migration. The next Part will then explain reforms that states can implement to address exploitative money moves.

Exploitative migration typically begins with taxpayers accruing income and wealth in states with relatively progressive but realization-based income tax systems (e.g., California and New York), benefitting from the services and benefits provided by those states, but without paying much tax to those states because the taxpayers' incomes come mostly in the form of unrealized gains. Then, the taxpayers relocate to a state without an income or wealth tax (e.g., Texas or Florida), or with much lower-rate or much less-progressive taxes, prior to selling their appreciated assets or otherwise triggering tax on their unrealized gains. Through these steps, the taxpayers can escape income tax in their state of initial residence, the state in which they accrued their income and wealth while benefitting from that state's services and benefits.

In this Part, we discuss two sets of options for solving this exploitative migration problem. First, a straightforward state-level wealth tax could partially solve this problem even without any further refinements. This is because the base of a wealth tax is a taxpayer's net worth, with no need to wait for assets to be sold. However, wealth taxes are inherently backward-

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[196] Roin, *supra* note 23, at 378.

looking in that wealth is built up over a period of time and then taxed periodically—economists often say that wealth taxes are assessed on a stock measure, whereas income taxes are assessed on a flow measure.[197]

To illustrate, imagine if Lucky Taxpayer won a $100M lottery ticket in year one while living in New Delaware, a state. Under an income tax, Lucky would have $100M of income in that year and then would have no further income in subsequent years unless there were subsequent gains—so that all of the income would be subject to income tax in ND, even if the Lucky were to relocate to another state in a subsequent year. By contrast, under a wealth tax, Lucky would have $100M of wealth in the first year and also in each subsequent year (assuming for simplicity that there were no subsequent changes in their wealth). Thus, if ND levied an annual wealth tax, and if Lucky remained in ND, then Lucky would owe wealth tax to ND in both the first year and in each subsequent year. But if Lucky instead left ND at the end of that first year, then they would only owe a single year of wealth tax to ND, despite that the wealth was accrued entirely while Lucky was a ND resident.

Because wealth taxes are inherently backward-looking in this fashion, we argue that residency tests for purposes of wealth tax assessments should similarly be backward looking. Specifically, we propose that residency for purposes of wealth tax assessments should be phased both in and out, symmetrically, over a period of multiple years. We explain this proposal further in Section A below.

The second set of options for solving the exploitative migration problem is mark-to-market reforms. The primary cause of exploitative migration is realization-based state income taxes, so mark-to-market reforms

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[197] Greg Leiserson, *Taxing Wealth*, *in* TACKLING THE TAX CODE: EQUITABLE AND EFFICIENT WAYS TO RAISE REVENUE 89, 91 (Jay Shambaugh & Ryan Nunn eds., 2020).

could solve this problem straightforwardly by taxing gains as they accrue without waiting for the sale of assets or other similar "realization events."[198] However, there are a number of design issues and potential obstacles with implementing straightforward mark-to-market reforms at the state level. We discuss some options for resolving these issues in Section B below. We also discuss in Section B how state-level wealth tax reforms might be integrated with mark-to-market reforms as an alternative approach for solving the exploitative migration problem with respect to state-level wealth taxes.

For both wealth tax and mark-to-market reforms, the primary administrative and implementation challenges concern valuation and liquidity issues. Many opponents of such reforms have argued that valuation and liquidity issues are so severe as to make these forms of taxation infeasible, especially at the state level.[199] In Section C below we explain how either wealth tax or mark-to-market reforms can be implemented so as to mostly resolve valuation and liquidity issues.

Beyond just addressing exploitative migration, either wealth tax or mark-to-market reforms can also go a long way towards mitigating exploitative money moves. For instance, in the case of business entities such as partnerships and corporations, the value of any entity owned in part by an in-state taxpayer would be subject to wealth or mark-to-market taxation, no matter where it's located. Any wealth stashed inside the entity would thus be subject to tax, no matter where the entity is legally located.[200] However, additional reforms and anti-abuse rules are needed to more fully address the problem of exploitative money moves, as we detail in Part V.

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[198] *See* Roin, *supra* note 15, at 346–57 (suggesting mark-to-market taxation can reduce exploitative mobility).

[199] Jéanne Rauch-Zender, *Wealth Taxes and America Divided*, 107 TAX NOTES STATE 1153, 1155–56, 1168 (2023).

[200] *See* Mark Gergen, *How to Tax Capital*, 70 TAX L. REV. 1, 5–6 (2017) (noting that a wealth-type tax on securities would largely eliminate profit-shifting and use of tax havens).

A. Proposing Phased Residency Rules for State-Level Wealth Taxes

A foundational legal and normative principle of multijurisdictional taxation is that the jurisdiction in which wealth or income is accrued should have the priority claim of taxing that wealth or income.[201] In a world of perfect information and ignoring administrative and compliance costs, this principle might imply that state-level wealth taxes should employ tracing rules so that each jurisdiction would only tax wealth that was accrued within that jurisdiction, so that wealth earned before entering and after leaving is exempt.

To ground the intuition for why, consider Mark Zuckerberg, who built his fortune (from Facebook/Meta) as a resident of California, taking advantage of California's services and benefits in doing so. If California were to levy a wealth tax and then Zuckerberg were to move out of state, we would consider it to be an inappropriate result if California were to consequently have no claim on taxing Zuckerberg's wealth that was accrued within California. Conversely, imagine if Jeff Bezos were to move to California either just before or after California levied a wealth tax. Bezos built his fortune (from Amazon) as a resident of Washington State. We would thus consider it to be an inappropriate result if California were to tax all of Bezos's wealth upon his becoming a resident.

Although this tracing approach has normative philosophical appeal, it would be excessively cumbersome to implement in practice.[202] And even if

[201] Mitchell Kane & Adam Kern, *The Use and Abuse of Location-Specific Rent*, 76 TAX L. REV. __, manuscript at 10 (forthcoming 2023).
[202] Andrew Appleby, *No Migration Without Taxation: State Exit Taxes*, 60 HARV. J. LEG. 55, 92–93 (2023).

record-keeping could be simplified, because money is fungible, such tracking would likely prove incoherent in practice. Consider if a taxpayer won the lottery in State A, then moved to State B and invested those lottery winnings in growth stocks, then moved to State C and sold some of those stocks to buy real estate. What portion of that real estate value should be attributed to each state?

But something like the binary approach of current law, in which all realized investment income is taxed to the residence state, regardless of when that investment wealth actually accrued, is not satisfying either. While administratively simpler than tracing, it departs very far from the normative principle of assigning taxing rights to the state that hosted the taxpayer while their wealth accumulated.[203] And because it is easily manipulable, and causes large swings in tax outcomes, it is a highly inefficient rule.[204] Thus, several commentators have recently proposed "sliding scale" or partial-residency systems for income taxes, in which taxpayers split their income among multiple jurisdictions, even for items that have not traditionally been divided that way.[205] A full discussion of all options and their comparative advantages and disadvantages is beyond the scope of this Article.

Instead, we will just explain an approach that we call phased-residency rules, an approach that we incorporated in the proposed wealth tax reform for California (that we designed and drafted along with the economist Emanuel Saez and other collaborators)[206] and in the pending mark-to-market

[203] *Id.* at 61–63; David Elkins, *A Scalar Conception of Tax Residence for Individuals*, 41 VA. TAX REV. 149, 174–76 (2020).
[204] *See* Edward Fox & Jacob Goldin, *Sharp Lines and Sliding Scales in Tax Law*, 72 TAX L. REV. 237, 292–95 (2020).
[205] *Id.*; *see* Appleby, *supra* note 202, at 93–94; Elkins, *supra* note 203, at 178–85; Edward A. Zelinsky, *Apportioning State Personal Income Taxes to Eliminate Double Taxation*, 15 FLA. TAX REV. 533, 553–56, 572–81 (2014); *see generally* David Gamage & Darien Shanske, *A New Theory of Equitable Apportionment*, 85 STATE TAX NOTES 267 (2017).
[206] Galle et al., *supra* note 30.

bill in Vermont.[207] We argue that this phased-residency rules approach is greatly superior to the binary approach in terms of accurately and fairly attributing wealth among jurisdictions while still being practically implementable and without imposing excessive administrative or compliance costs. The phased-residency rules approach also substantially mitigates the exploitative migration problem.

The essence of the phased-residency rules approach is to gradually phase in residency status for wealth-tax assessment purposes for new residents over a multi-year period and to symmetrically phase out residency status over the same number of years for former residents who have migrated out of the state. Thus, for example, the California wealth tax reform bill uses a four year phase-in and phase-out period, so that new residents migrating to the state would only have a fourth of their net worth attributed to California for wealth tax assessment purposes in the first full year of residence, rising to half in the second year, three-quarters in the third year, and with the taxpayers' entire net worth only being attributed to California in the fourth year. [208] Symmetrically, a former resident migrating out of California would still have three-quarters of their net worth attributed to the state in the first year after their move, lowering to half in the second year, a quarter in the third year, and then with none of their net-worth being attributed to California in the fourth and subsequent years following their out migration.

Partial-residency rules for wealth taxes shouldn't face any serious legal challenge. The general rule of state taxation is that intangible wealth and income of persons is sourced to (that is, taxed in) each person's state of residence. However, as the Supreme Court has made clear, granting the resident state taxing rights to all of the income from intangible investments

[207] Brian Galle, David Gamage, & Darien Shanske, *Vermont Mark-to-Market Tax: Section by Section Summary*, Jan. 2, 2024.
[208] A.B. 259 (Cal. 2023) (proposing to enact a new Cal. Rev. and Tax. Code section 50313).

is just a tradition grounded in administrative convenience; there is no reason such income cannot be apportioned or split amongst multiple states if it can be reasonably sourced to particular jurisdictions.[209] Thus, appropriately, the Court has allowed the intangible income of a corporation to be apportioned,[210] and has ruled similarly with respect to corporate franchise taxes.[211] Indeed, the origin of these apportionment rules and the related "unitary business" principle was with respect to property tax disputes, which are a form of partial wealth tax.[212] Furthermore, tracing rules have actually been used in some circumstances, such as with respect to stock options, so that a taxpayer earning certain forms of stock options while residing in California will be taxed on the exercise of those stock options even if and after the taxpayer has migrated to another state.[213]

We view the choice of a four-year phase-in and phase-out period to be conservative, a deliberate choice to err on the side of having a shorter period for a novel reform proposal. We think a strong case could be made that the period should be substantially longer. That said, at some extreme lengths, we think there would be due process concerns caused by the compliance burdens

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[209] *See generally* Amanda Parsons, *The Shifting Economic Allegiance of Capital Gains*, 26 FLA. TAX REV. __ (forthcoming 2023), https://ssrn.com/abstract=4152114; Wei Cui, *Taxation of Non-Residents' Capital Gains*, *in* UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES 107 (Alexander Trepelkov, Harry Tonino & Dominika Halka, eds, 2d ed. 2015).
[210] Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980).
[211] Ford Motor Co. v. Beauchamp, 308 US 331, 336, 60 S. Ct. 273 (1939).
[212] *See generally* WALTER HELLERSTEIN, STATE TAXATION § 11.05[1]. And there is ample precedent that a state can tax all of a resident's *intangible* wealth, not just income. Curry v. McCanless, 307 U.S. 357, 368 (1939). For worldwide income, see Oklahoma Tax Comm'n v. Chickasaw Nation, 515 U.S. 450 (1995). Tangible wealth located in another state cannot be taxed. Frick v. Pennsylvania, 268 U.S. 473, 488-492 (1925). For critique of this distinction, see Boris Bittker, *The Taxation of Out of State Tangible Property*, 56 YALE L.J. 640 (1947).
[213] *See* Shail P. Shah and Campbell McLaren, *California's 'Long Range' Taxing Scheme: Taxation of Nonresident Equity-Based Compensation*, TAX NOTES STATE, Jan. 24, 2022, p. 351. The key regulation is at Cal. Code Regs. tit. 18, § 17951-5(b).

in later years. Recognizing that the Due Process Clause is often conceived of as containing a kind of fairness gut check, we thus think that (say) a hundred-year apportionment rule, though perhaps defensible for taxpayers whose wealth accumulated long ago, would likely offend this rough sense of fairness. We therefore chose four years for a measurement period not because there is any literature we have identified as to the "best" timeframe to consider the relative contributions of a state to accumulations of great wealth, but rather because four years is the statute of limitations in California.[214] That is, Californians already seem to accept that their tax affairs with a state that they have physically left might not be completely finished for four years. And so that is the intuition as to fairness that we are using to guide the phase-in and phase-out periods.

Also, although this would add to the complexity somewhat, it may be desirable to just use the phase-in and phase-out rules as a rebuttable default presumption to be accompanied by equitable apportionment rules, so that either taxpayers or a state could argue with respect to specific fact patterns that less or more of a taxpayer's wealth should be attributed to the state.[215] In a sense, the combination of a multi-year phase-in and phase-out period and equitable apportionment rules would be implementing a limited form of tracing system for scenarios in which such tracing is practical and administrable and only using the phased-residency approach as the default and for scenarios in which tracing is not practical or administrable.

Also note that state income tax systems already use an approach similar to phase-in and phase-out rules for residency, although only for allocating

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[214] For a deficiency assessment. RTC 19057(a). Interestingly, the FTB has 20 years to collect a liability. RTC 19255(a).

[215] *See* Gamage & Shanske, *supra* note 205. This is the approach of the Vermont bill. *See* Galle et al. *supra* note 207, at 2.

income between states when a taxpayer moves partway through the year.[216] This one-year period is appropriate for income taxes, because again income taxes are assessed on a flow measure. By contrast, because wealth taxes are assessed on a stock measure and so are inherently backward-looking, we have argued that the residency test for wealth tax assessment purposes should also be backward looking.[217] Overall, although our proposed phased-residency rules approach is by no means perfect—we are aiming only for rough justice—we view it as a substantial improvement over the binary approach.

B. Implementing State-Level Mark-to-Market Income Tax Reforms

As we explained in Part II.B., taxpayers exploit the realization rule to shift business and investment earnings to low-tax places. That might not matter for our example of Lucky, the lottery winner, whose entire $100M would be subject to ND's income tax, even if they moved to another state in a subsequent year, because income taxes are assessed on a flow measure and because the entire $100M of lottery winnings would be realized and recognized in the year in which the award was won. But the majority of super-wealthy Americans earn their wealth and income not through lottery tickets, but rather through investment, entrepreneurship, or finance.[218] For sure, some super-wealthy Americans do earn most of their wealth and income in the form of wages and salaries that—like the lottery winnings—are treated as realized and recognized in the years in which those wages and salaries are earned. But this is the minority case; the majority of the wealth

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[216] For discussion of the complex factual analysis that goes into assessing tax residence, see Daniel P. Kelly, *Deferred Compensation—Delayed But Not Forgotten*, 27 J. MULTI-STATE TAX'N 14, 17–19 (2017).
[217] See *also* Adams Exp. Co. v. Ohio State Auditor, 166 U.S. 185, 224 (1897).
[218] 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, 499 (2022).

and income of super-wealthy Americans is accrued in forms that our income tax rules treat as unrealized gains.[219]

We explained at the outset of this Part that the straightforward solution is to reform income taxes so that economic gains are taxed as they accrue, instead of waiting for sale or other realization events. Here we note a few additional design considerations for implementing the mark-to-market solution.

First, such mark-to-market reforms involve substantially higher administrative and compliance burdens as compared to realization-based income taxes. In order to limit the extent to which taxpayers with limited resources and tax advice face these burdens, these proposals can be crafted so that they would only apply above some high thresholds for income or wealth. For instance, the proposed New York State Billionaire Mark-to-Market Act would only apply to taxpayers with net-worth in excess of a billion dollars, and the proposed Illinois Extremely High Wealth Mark-to-Market Tax Act would only apply to taxpayers with net-worth in excess of fifty million dollars.[220]

Another set of issues concerns volatility in asset prices and the related challenges of refunding losses if a taxpayer pays tax on accrued gains in earlier years (after the asset prices increase) but with the gains then disappearing in subsequent years (because the asset prices decrease). To address these issues, two of us have previously proposed an approach that we called "phased mark-to-market".[221] The essence of this approach is to treat all gains as realized in each year of assessment, but then to treat a percentage of those realized gains as unrecognized (i.e., not included in taxable income).

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[219] *Id.* at 501-02.
[220] *See supra* notes 33 & 34.
[221] David Gamage and Darien Shanske, *Phased Mark-to-Market for Billionaire Income Tax Reforms*, 176 TAX NOTES FEDERAL 1875 (2022).

For instance, a federal-level reform proposal that we co-designed based on this approach, the *Babies Over Billionaires Act*,[222] would annually deem realized all gains in traded assets but then would only recognize (i.e., impose immediate tax on) thirty percent of those deemed-realized gains. The next year another thirty percent could be included in income, and so on. If the taxpayer's assets lose money the next year, that loss could offset any older, unrecognized gains.

With only a percentage of deemed-realized gains being recognized (and thus subject to tax) in any assessment period, the volatility of the tax assessments would be greatly reduced, as the taxation of gains produced by market fluctuations would be spread over time. This is important at the state-level because balanced budget constraints can create problematic fiscal volatility if tax revenues vary too much with economic cycles, creating numerous harms, so spreading out tax revenues across boom-and-bust economic cycles mediates these harms.[223] Spreading out the recognition of gains over time and across economic cycles also greatly reduces the likelihood and prevalence of the need to refund losses, which is important both politically and to reduce administrative and compliance costs.[224]

For a state-level mark-to-market reform, this approach of combining full deemed-realization with partial non-recognition can be implemented in a manner that further mitigates the exploitative migration problem. The key is to make the partial non-recognition an elective taxpayer option. In order to take advantage of partial non-recognition of their deemed-realized gains, taxpayers would have to agree that they would continue to report and make payments on the unrecognized balance. Those obligations would continue

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[222] H.R. 7502, introduced by U.S. Rep. Jamaal Bowman, D-N.Y., in April 2022.
[223] David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CAL. L. REV. 749, 754–91 (2010).
[224] Gamage & Shanske, *Phased Mark-to-Market*, *supra* note 221, at 1877.

regardless of whether the taxpayers remain in the state or migrate out of the state.[225]

Finally, because the phased-residency rules approach we propose for wealth tax reforms does not completely solve the exploitative migration problem, and because there is some possibility that the courts might not uphold our proposed approach, there are advantages to integrating wealth tax and mark-to-market income tax reforms. Specifically, a state considering implementing either a wealth tax reform or a mark-to-market income tax reform may wish to do both while then making the wealth tax payments creditable (and refundable) against the mark-to-market payments.

To illustrate, imagine if Betty Billionaire has net-worth of a billion dollars, of which half—five hundred million—is unrealized gains. Further imagine that Betty's state of residence implements a wealth tax with a 1% rate along with a mark-to-market reform with a 15% rate (with both reforms applying to taxpayers with net-worth above fifty million dollars), and with the wealth tax creditable against the mark-to-market tax. In year one, Betty would owe mark-to-market tax of $75 million (15% of $500M)[226] and wealth tax of $10 million (1% of $1B), but the wealth tax obligation would be creditable against the mark-to-market obligation for a net tax liability of $75 million. If Betty subsequently left the state, she would eventually no longer owe wealth tax to the state.[227] But under the combined approach, her incentive to exit is lessened. Each year she stays and pays wealth tax, she would earn an offsetting credit against her prior mark-to-market bill. Departure would only save her net tax liability to the extent her future

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[225] *Id.* at 1878.
[226] Under the phased mark-to-market approach we recommend, Betty could (and probably would) elect to treat the majority of these deemed realized gains as unrecognized, but this we ignore this in our example above for simplicity.
[227] This would occur in the first full year following migration under the binary approach, or gradually over a period of years under our proposed phased-residency rules approach.

wealth tax obligations had she remained in the state would have exceeded her mark-to-market tax payments.

C. Addressing Valuation and Liquidity Challenges

Critics of wealth and mark-to-market reform proposals often argue that valuation and liquidity problems make them impossible to implement.[228] Even some supporters raise these concerns.[229] That is, the critics argue that it is too hard to know what a taxpayer's assets are worth before they are sold, and that before sale some taxpayers may not have cash to pay any tax. These critiques typically fail to mention the century-long history of broad-based wealth taxes among the U.S. states.[230] In any event, we have written extensively elsewhere about how to address these complaints, building on an earlier literature describing so-called "retrospective" tax systems.[231]

Briefly, we think the best solution is a combination of notional equity interests with improved techniques for appraising an asset's true value. At the time tax would be due, taxpayers who own illiquid or hard-to-value assets can give the government an IOU instead of cash. Taxpayers then pay off the IOU when the asset is ultimately sold, and pay interest on the original tax debt at the asset's internal rate of return. To streamline accounting and administration, the interest charge is calculated simply by awarding the government a proportional but non-voting share in the taxed asset (hence "notional equity" interest), so that algebraically the government's interest

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[228] Natasha Sarin, Lawrence Summers & Joe Kupferberg, *Tax Reform for Progressivity: A Pragmatic Approach*, *in* TACKLING THE TAX CODE, *supra* note 197, at 317, 344; *see* TAX NOTES STATE, *supra* note 7 (collecting valuation complaints from tax experts).
[229] *See, e.g.*, Roin, *supra* note 15, at 349–50.
[230] Fisher, *supra* note 75, at 50–51.
[231] Galle et al., *supra* note 40, at 1297–1309.

will always grow or shrink at the same rate as the asset itself. Taxpayers who want to avoid this system can opt for a more traditional appraisal, but on terms that are more favorable to the taxing authority than under current practices.

This approach also helps states to solve the problem of how to implement a retrospective system at the state level. Retrospective systems generally impose tax at realization, plus an additional interest charge to account for the time value of money.[232] But before our proposal, it was unclear whether a state could successfully tax a former resident whose wealth appreciated during their residency but who realized those gains somewhere else, often in a place where the state lacked personal jurisdiction over the taxpayer.[233] Under prevailing personal-jurisdiction precedents, though, the States have jurisdiction to collect debts in the courts of other states.[234] Thus, if a state takes the trouble of getting its tax lien reduced to a judgment in its own courts and then follows the procedures of the Uniform Enforcement of Foreign Judgments Act[235] then it can enforce its judgments in the courts of another state. Forms of this Act have been passed in forty-nine states.[236] To be sure, states apparently do not typically go to this much trouble, but they do sometimes,[237] and the stakes relating to the extremely wealthy indicate that they should.

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[232] Schizer, *supra* note 153, at 1596–97; Leiserson, *supra* note 197, at 105, 112.
[233] Schoenblum, *supra* note 171, at 1995.
[234] Milwaukee County v. M.E. White Co., 296 U.S. 268, 277, 279 (1935).
[235] *See generally* C. Joseph Lennihan, *Cross-Border Collection Of State Tax Assessments: A Primer*, 19 J. MULTISTATE TAX'N & INCENTIVES 8 (2009).
[236] *See id.*; *see also* http://www.uniformlaws.org/Act.aspx?title=Enforcement%20of%20Foreign%20Judgments%20Act.
[237] There are a number of cases involving New York trying to enforce judgments in Florida. *See, e.g.*, New York State Com'r of Taxation & Fin. v. Hayward, 902 So. 2d 309, 310 (Fla. Dist. Ct. App. 2005).

The notional equity interest, we argue, is indistinguishable from other collectable debts. In order to ensure future collections, the California and Vermont proposals have a belt and suspenders approach, going beyond the enforceability of the deferred tax liability. As with our phased mark-to-market proposal, taxpayers that chose to defer payment must agree to the state's jurisdiction to collect payment of their liability in the future or else be denied the privilege of using deferral.[238]

Crucially, this is not a novel approach, which indicates it is well within the capacity of state tax administrators. In response to a similar challenge, many states give nonresident limited partners or shareholders of a limited liability corporation ("LLC") a choice: either consent to jurisdiction[239] (and to future information-reporting requirements for updating the state tax authorities), or else the entity must withhold for the nonresident partners.[240] Of course, the existence of an enforceable[241] threat of a continued tax obligation to their former state may also incentivize taxpayers to just opt for appraisal and immediate payment.[242]

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[238] Galle et al., *supra* note 40, at 1315–16.
[239] Charles W. Rhodes & Cassandra Burke Robertson, *A New State Registration Act: Legislating a Longer Arm for Personal Jurisdiction*, 57 HARV. J. LEGIS. 377, 400 (2020) ("The Supreme Court has long acknowledged that non-resident defendants can consent to personal jurisdiction, which, when given in accordance with the Constitution, waives other potential constitutional challenges to the state's adjudicative power.") (citing cases).
[240] *See, e.g.*, CAL. REV. & TAX. § 18633.5 (stating that limited liability corporations and limited liability partnerships must pay a tax on distributive share of California income if the nonresident does not consent to jurisdiction); Bruce P. Ely & William T. Thistle, II, *An Update on the State Tax Treatment of LLCs and LLPs*, 94 TAX NOTES STATE 319 (2019) (listing nonresident partner-withholding state tax treatment for each state).
[241] Galle et al., *supra* note 40, at 1312–13, 1316.
[242] *Id.* at 1307–09.

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In sum, wealth and mark-to-market taxes can significantly constrain exploitative migration by taxing wealth as it accumulates, rather than allowing taxpayers to pack it away and haul it to a tax haven. With thoughtful design, these systems can also allocate taxing rights to the places with the strongest claims on them, mitigate practical problems related to debt collection and rebates, and readily assign value even to hard-to-value assets.

V. Addressing Exploitative Money Moves

We have argued that reforming tax systems away from the realization rule can help states tax the wealthy more effectively. Yet while wealth tax or mark-to-market reforms would reduce opportunities for tax planning, some would still remain. In this Part we consider options states might pursue in shutting down these strategies. Again, our main objective is not to work out every detail, but instead to show that there are plausible solutions to these major tax-minimization efforts, and thus that the project of taxing the wealthy at the state level is worth pursuing.

A. Income-Splitting and Non-charitable Gifts

A standard tax-planning issue that looms larger when borders are easier to cross is what tax lawyers call "income splitting" or "income shifting."[243] Briefly, the idea is that a family or other group of close-knit

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[243] For an overview, see Brant J. Hellwig, *The Supreme Court's Casual Use of Assignment of Income Doctrine*, 2006 U. Ill. L. REV. 751, 766–85

taxpayers may not care much which one of them holds legal title to an asset. A parent might be planning to share some their wealth with their children anyway; an unmarried couple might expect that each will share everything the other owns; or the lone shareholder of a small business may exercise the legal right to claim the business's assets. In all these cases, the taxpayers can and often do arrange their affairs so that income is reported by the lowest-taxed member of the group. For example, parents who want to help their children buy a new house might gift taxable interest-bearing bonds to the kids instead of cash.[244] That way, the interest is taxed at the children's (presumably) lower tax rate.

This strategy can be super-charged at the state level. Income shifting is only moderately effective at minimizing federal taxes, because as the higher earner transfers more taxable income to the lower earner, the lower earner's marginal tax rate rises.[245] At the state level, of course, earners in high-tax states can shift income to loved ones or controlled entities in low-tax states without limit, and can even shift taxable income to those with higher incomes (but lower tax rates). Further, most wealth tax or mark-to-market reform proposals build in large exemption thresholds, so that each additional taxpayer that wealth can be shifted to adds another, say, $50 million in exemptions.[246]

As a result, existing tax rules aimed at limiting income shifting are too weak to constrain aggressive state tax planning. With certain statutory exceptions, we currently tax income to the taxpayer who exercises real control over the source of the income, regardless of legal formalities.[247] Determining "control" can be a complex and fact-intensive question, and so is

[244] Helvering v. Horst, 311 U.S. 112, 114 (1940).
[245] *See* Schoenblum, *supra* note 171, at 1949 (making this point about income-shifting with trusts).
[246] *See* Advani & Tarrant, *supra* note 105, at 524.
[247] James Edward Maule, *Gross Income: Tax Benefit, Claim of Right, and Assignment of Income*, BNA Portfolio 502-4th, §§ IV.B.1.b.(1)(a), IV.B.3.b.(2).

costly for tax authorities to investigate, litigate, and prove.[248] Perhaps the rule is good enough for the more modest role it plays in limiting federal income-shifting,[249] but we doubt it can realistically constrain more strongly motivated state tax planners. Further, by definition it cannot prevent income shifting in cases where the taxpayers intend (or are indifferent to) changes in control, such as when parents actually want their children to have a new house or take over the family business. Other federal income-tax rules against income shifting, such as an extra tax on investment earnings by children under eighteen, are little more than speedbumps.[250]

Some experts have argued that the more important planning obstacle to these kinds of transactions is the separate federal tax on gratuitous transfers, but as we mentioned earlier it too is fairly easy to sidestep.[251] For donors who don't want to pay gift or estate tax, there is always the sale for "fair" market value.[252]

Given taxpayers' powerful incentives to shift income and the ease with which these arrangements can be entered into, we would argue for strong presumptions or even bright-line rules treating gifted property as still the property of the transferor, at least for some period of time after the gift.[253] For example, a state statute could provide that any asset transferred by a taxpayer to a related party is treated as still taxable to the transferor (or presumed to be controlled by them, unless taxpayer can show otherwise), but that the taxable amount is reduced by the value of any consideration paid at

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[248] *Id.* §IV.A.; for extensive examples, see *id.* § IV.B.1.b.(1)
[249] For a skeptical account, see Soled, *supra* note 161, at 417–20.
[250] Samuel D. Brunson, *Grown-Up Income Shifting, Yesterday's Kiddie Tax is Not Enough*, 59 U. KAN. L. REV. 457, 482–83 (2011).
[251] *See* Blattmachr & Gans, *supra* note 160, at 396.
[252] *See* sources *supra* note 165.
[253] *Cf.* 26 U.S.C. § 2036 (treating assets held by trust in which grantor still retains an interest as still within the taxable estate of the grantor).

the time of transfer.[254] Both wholly gratuitous and below-market transfers would then both be at least partly taxable to the original owner. This approach does have some constitutional questions, which we detail in the next subsection.

While this might at first seem strong medicine, we would argue it is effectively just a variation on the standard tax-policy decision about whether to tax married couples as a unit or as separate individuals. Modern tax systems strive to impose tax based on a taxpayer's "ability to pay."[255] The argument for taxing married couples as one taxpayer is based on the idea that the couple's spending decisions are made jointly, or at least that each partner's spending decisions are highly influenced by the other's, so that it is incoherent or at least difficult to say that one partner has a different ability to pay than the other.[256]

The ability-to-pay argument, if it's persuasive, isn't clearly limited to married individuals, but instead could extend to any group of people who closely share resources and take one another's well-being into account.[257] Where to draw the exact line is a tradeoff, with equity and efficiency on one side and on the other the administrative difficulty of identifying non-marital relationships that reflect a shared ability to pay.[258] As we've said, in the

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[254] An alternative solution would be to track such transfers using the notional equity interest concept we described earlier, and to presume that all spending by recipient was a distribution from that interest.
[255] Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 401 (2005).
[256] Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1392–95 (1975); *see* Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 348–58 (1994) (considering both shared control and shared consumption as rationales for joint taxation of married couples).
[257] *See* Bittker, *supra* note 256, at 1398–99.
[258] *Cf. id.* at 1399 (considering administrative costs of identifying correct taxable groups). We recognize that in some circumstances there may also be arguments other than administrative cost against taxing households as a collective.

unusual context of state taxes on the wealthy, it would be easy for some families that in fact share resources to achieve a much lower tax rate than others, resulting in both inequity and inefficient expenditures of resources on tax planning. Accordingly, we'd argue that it makes sense to tax each wealthy family roughly the same, regardless of whether some families happen to have children who live in low-tax states, or just have more children who can claim a $50 million exemption amount. Achieving this goal is worth some additional administrative expense. That is especially the case where the transferor demonstrates, by the fact that they have transferred the asset, that the transferee's well-being is important to them, so that taxing the transfer is in effect taxing based on the well-being of the transferor.

B. Trusts

Trusts replicate all the state planning strategies offered by gifts, but with greater flexibility, and the benefit of generous IRS rulings that often allow for even better estate and gift tax results.[259] Unfortunately, courts have interpreted the U.S. Constitution in ways that tend to limit state options for taxing trust assets. In its 2019 *Kaestner* decision, the Supreme Court held that it would violate due process for a state to tax a trust based only on the fact that a potential future beneficiary of the trust resides in the state.[260] The possibility of future benefit was not a sufficient "definite link" or "minimum connection" to the taxing state.[261] To meet that standard, the Court held, the state must show that "the resident ha[s] some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset."[262] That rule allows wealthy families to place

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[259] *See supra* notes 168–173.
[260] N.C. Dep't of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust, 139 S.Ct. 2213, 2221 (2019).
[261] *Id.* at 2220.
[262] *Id.* at 2222.

unlimited value in trusts in low-tax jurisdictions where they can grow free of any state tax, for enjoyment by later generations.[263] Beneficiaries can likely even borrow for their current enjoyment against these funds tax-free, while living in high-tax states.[264]

Additionally, as we noted earlier, there is a division between state supreme courts over whether states can impose tax on a trust based on the residence of the grantor. While older decisions have upheld that authority, the Minnesota Supreme Court ruled in 2018 that the Due Process Clause prevents Minnesota from taxing a trust, where the state asserted that the fact the trust was established during the grantor's life in Minnesota served as a sufficient in-state connection to tax the trust indefinitely.[265] The Minnesota Supreme Court's position would likely also imply that our proposal to tax gifts in the state of the gift giver would similarly raise due process concerns.

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[263] We agree with Prof. Gans that while states could likely include the value of vested trust benefits as part of the wealth of an in-state taxpayer, it is uncertain whether that approach would satisfy *Kaestner* with respect to unvested beneficiaries. Gans, *supra* note 163, at 667–70. Older cases do suggest that states could at least determine the in-state person's tax bracket based on the out-of-state trust, *cf*. Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717, 734, 768–69 (2020) (citing Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 576 (1895)) (making this point for business income) but if this option were pursued very aggressively (say, with special brackets applying to in-state wealth to replicate the tax burden that would apply if the trust wealth were directly taxable) it would probably invite modern courts to carefully reconsider those precedents.

[264] While the Court held open the possibility that a state might be able to reach trusts whose in-state beneficiaries borrow against trust assets, *see Kaestner*, 139 S.Ct. at 2223 & n.9 (noting possibility of basing taxing jurisdiction on beneficiary's right to assign assets, as would be necessary in a loan secured by trust assets), as a practical matter money is fungible. Thus, it will typically be hard for a state to show that an individual with significant resources borrowed against any particular asset.

[265] Fielding v. Comm'r, 916 N.W.2d 323, 330–32 (Minn. 2018); *see* Gans, *supra* note 163, at 671–74. For detailed consideration of the law before 2018, although one we think is obsolete in light of later Commerce Clause developments, see Schoenblum, *supra* note 171, at 1969–89.

We suggest that basing tax on the grantor or gift-giver's continuing control or influence over the transferred assets could avoid this question. As Mitchell Gans has observed, *Kaestner* cited with approval earlier cases upholding state taxation based on continuing control by the grantor.[266] And before Congress developed a refined regime for trust taxation, the U.S. Supreme Court held that taxation of trust income could turn on (at least for federal law purposes) "actual command over the property taxed."[267] That rule, the Court would later explain, was necessary to prevent income splitting: so that "what is in reality one economic unit cannot be multiplied into two or more."[268] We believe the Court would recognize similarly that states may, consistent with the Due Process Clause, take into account the economic reality that a seemingly out-of-state cache is actually part of the wealth of an in-state resident.[269] Further, we think the Court would allow states to do so based on practical reality, as it did in the federal income-tax context, not the formalities of trust documents.[270]

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[266] Gans, *supra* note 163, at 683–87 (citing Kaestner, 139 S.Ct. at 2222 & n.7.).
[267] Corliss v. Bowers, 281 U.S. 376, 378 (1930); *see* Curry v. McCanless, 307 U.S. 357, 370–71 (1939).
[268] Helvering v. Clifford, 309 U.S. 331, 334–35 (1940).
[269] *See T. Ryan Legg Irrevocable Trust v. Testa*, 75 N.E.3d 184, 197–98 (2016) (holding that Ohio grantor's control over non-Ohio trust gave Ohio jurisdiction to tax trust assets) (citing *Curry*, 307 U.S. at 370–71); Blattmachr & Shenkman, *supra* note 168, at 28. *But see* Schoenblum, *supra* note 171, at 1994 (arguing that a New York law treating some incomplete grantor trusts as grantor trusts under state law would be unconstitutional because the trust would not have "physical presence" in New York) (citing Robert L. McNeil, Jr. Trust *ex rel.* McNeil v. Commonwealth, 67 A.3d 185, 192–198 (Pa. Commonw. Ct. 2013)). The Supreme Court has since essentially eliminated the physical presence requirement. South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2092 (2018); *see* Spero, *supra* note 167, at 25 (suggesting that states will likely broaden trust taxation to take advantage of elimination of physical presence requirement).
[270] *See Clifford*, 309 U.S. at 336–37 (holding that "all considerations and circumstances" are relevant to question of who is taxable on trust income, not "mere formalism").

A control-based test could likely capture most potentially abusive or tax-avoiding transfers. States could place the burden on donors to show that they don't retain any meaningful influence over assets transferred to trusts or related parties, perhaps based on the federal rules for "complete terminations of interest" in intra-family transfers.[271] This would reflect the basic facts that transfer is itself an exercise of control,[272] that family members are often indifferent about which family member has legal title,[273] and that trust administrators compete for the right to manage trust assets, giving transferors considerable implicit influence over the administrator.[274] Even if the grantor does not retain formal control, they will retain significant influence over the trustee based on their ability to direct additional assets to the trustee, a fundamental economic concept known as "staged financing."[275]

Taxing later generations after the grantor dies often requires a different technique,[276] but states can get there by tweaking a tool already in use in California. Once a grantor has passed, a family might use out-of-state trusts to allow assets to grow free from state tax until heirs need the funds.[277]

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[271] I.R.C. § 302(c)(2). We note that most litigation in the complete termination of interest context is over an inexplicable exception for continuing creditor interests, *see* Drake, *supra* note 164, at 175 (citing I.R.C. § 302(c)(2)(A)(i)), so we would recommend omitting that provision.
[272] *See* Helvering v. Horst, 311 U.S. 112, 117 (1940).
[273] *Clifford*, 309 U.S. at 335–36.
[274] At a minimum, any control rule should treat a trust as "related" to the grantor if one or more of the trustees is related to them, which somewhat unbelievably is not currently a feature of federal law. *See* Soled & Gans, *supra* note 254, at 422–24.
[275] Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1464 (1995). For evidence that living donors exercise greater control over entities they have funded, see Brian Galle, *The Quick (Spending) and the Dead: The Agency Costs of Forever Philanthropy*, 74 VAND. L. REV. 757, 782–90 (2021).
[276] In some cases, though, states might treat contingent beneficiaries as though they were in control of the trust, such as where the beneficiary is consulted on or consents to trustee decisions. *See* Gans, *supra* note 163, at 687.
[277] Schoenblum, *supra* note 171, at 1950.

California's "throw-back tax" (which gets a brief, seemingly approving, shout-out in *Kaestner*)[278] tries to address this problem by imposing California tax on a trust in the year when a beneficiary "vests," or becomes entitled to, the trust assets.[279] The throwback tax imposed is not only for the year of vesting, but also for any prior years when the beneficiary lived in California, on the plausible assumption that effectively the beneficiary was enjoying the trust's accumulating wealth in those earlier years, such as by spending non-trust wealth in reliance on the future trust distribution.[280] The problem is that the throwback is relatively easy to dodge, since it triggers only if the beneficiary is living in California in the year of vesting.[281] If the beneficiary moves to Nevada, vests, then moves back to California, there is no throwback. A more sensible version of the rule would simply impose throwback liability in years when a beneficiary resides in California, regardless of when vesting occurred.[282]

C. Pensions and Retirement Savings

The U.S. tax system already offers high-earning individuals an assortment of tax-favored tools for stashing money away until retirement

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[278] 139 S.Ct. at 2225 n.13.
[279] Cal. Rev. & Tax. Code Ann. § 17745(b); *see also* N.Y. TAX LAW § 612(b)(40) (imposing a similar throwback tax in New York).
[280] *See* Spero, *supra* note 167, at 34 (discussing how throwback tax relates to beneficiaries' benefits from living in taxing state).
[281] *See* Schoenblum, *supra* note 171, at 1991 (describing the year-of-vesting rule). *But cf.* Evan Osnos, *The Getty Family's Trust Issues*, THE NEW YORKER, Jan. 16, 2023 (describing family's efforts to establish legal facts sufficient to show they were living in Nevada when they preferred to live in California).
[282] Of course, an improved rule would also close other blatant loopholes, such as the electing small-business trust scheme. *See* F. Ladson Boyle, Jonathan Blattmachr, & Mitchell Gans, *Planning Opportunities with ESBTs: Saving State and Local Income Taxes*, 129 J. TAX'N 20, 21 (2018) (recommending the ESBT for high-wealth clients).

age, and yet Congress and creative tax planners are steadily inventing new ones.[283] States should decouple themselves from most of these overly-generous policies. Most commentators have assumed that a federal statute, adopted in 1996, bars states from taxing retirement savings,[284] but in fact state wealth and mark-to-market tax systems would not raise any issues under the federal law. We'll now explain these points in a bit more depth.

Our focus here is not on the standard 401(k) and individual retirement arrangements available to most earners, but instead on the specialized benefits claimed by the very highest earners.[285] For example, many executives accrue large sums in "nonqualified" deferred compensation plans, so called because they are not bound by the relatively low contribution limits that are supposed to apply to plans that qualify for tax benefits under ERISA.[286] Yet even though these plans do not meet ERISA's requirements, they still grant the executive unlimited tax deferral.[287] This technique is not limited to executives at large companies; any self-employed person (or group of persons, such as physicians or lawyers) can pay out business profits to themselves in the form of a nonqualified but tax-favored "pension" instead of salary or dividend.[288] Partners in private equity funds get similar deferral

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[283] *E.g.*, Terry LaBant, *For Snowbird Tax Savings, Avoid Homing Pigeon Instincts*, 43 ESTATE PLANNING 11, 14 (2016). *See* Michael Doran, *The Great American Retirement Fraud*, manuscript at 8–15, 31–64 (Dec. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3997927.
[284] *See, e.g.*, Roin, *supra* note 15, at 368.
[285] For brief overviews of these “qualified” retirement savings, see Brendan S. Maher, *Regulating Employment-Based Anything*, 100 MINN. L. REV. 1257, 1268–70 (2016); Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Trees in Its Proper Season*, 67 OHIO ST. L.J. 347, 360–63 (2006).
[286] David I. Walker, *The Practice and Tax Consequences of Nonqualified Deferred Compensation*, 75 WASH. & LEE L. REV. 2065, 2068 (2018).
[287] *Id.* at 2081.
[288] Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise To Pay*, 89 MINN. L. REV. 1092, 1134–37 (2004); *see* LaFrance, *supra* note 184, at 889–90 (noting that self-employed individuals can create shell corporations for this purpose).

benefits (plus others) from being paid with a "profits interest" rather than cash.[289] If impatient to spend their funds, the entrepreneur or partner can then borrow against the deferred payments without income-tax consequence.[290]

Even if this system of generous retirement benefits for the wealthy had some plausible justification, states still should not follow along. For instance, while courts have said that the difficulty in valuing deferred compensation requires deferred taxation, our ULTRA mechanism easily solves that problem.[291] Another standard explanation of retirement benefits, at least those available to middle-income earners, is to overcome the public's tendency to save too little.[292] These subsidies arguably conserve overall government expenditures in the long run, if we think that those who fail to save would otherwise be supported through public programs.[293] This rationale does not support additional state retirement benefits, because under-saving by higher earners doesn't likely vary much from state to state and so is best solved by federal policy.[294] Yet if states exempt retirement contributions from their own income tax, they are adding to the marginal incentive for savings.[295] And indeed, states did attempt to impose income tax on the retirement earnings of former residents, but Congress prohibited that approach in the 1996 statute we mentioned.[296]

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[289] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–4 (2008).
[290] Edward J. McCaffrey, *The Death of the Income Tax (Or, the Rise of America's Universal Wage Tax)*, 95 IND. L.J. 1233, 1263–54 (2021).
[291] Galle et al., *supra* note 40, at 1328–30.
[292] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 498–99 (7th ed. 2007).
[293] *Id.*
[294] Admittedly, the fiscal externality from retirement savings is larger in states with more generous safety-net programs. But this probably isn't an argument to encourage savings by families who have more than $50 million.
[295] Mason, *supra* note 54, at 1340–41.
[296] Roin, *supra* note 15, at 368 (citing Pub. L. No. 104-95 (1996) (codified as 4 U.S.C. § 114)).

State wealth and mark-to-market statutes are not meaningfully constrained by the federal limit on state retirement taxes. The federal law only prohibits states from imposing tax on the retirement *income* of non-residents.[297] Nothing prevents the state from treating funds held in a retirement account, or in the form of a partnership profits interest, as part of the taxpayer's wealth, or from imposing mark-to-market taxes on growth in the value of those funds during the taxpayer's working years. Federal law gives states broad authority to define "resident," and so would likely be compatible with our proposal for phased residency.[298]

We emphasize that this is an approach aimed only at the deferred earnings of those very wealthy households who would be the subjects of wealth or mark-to-market taxation. ERISA preempts states from taxing the ERISA-qualified savings held by most middle-class earners,[299] and we suspect that taxing retirement savings for lower- and middle-earning households would be politically infeasible, even if economically defensible. States might, though, close abusive loopholes in qualified accounts, such as the infamous claim by Peter Thiel and others that they can legally hold billions in Roth accounts whose annual contributions are limited to five figures.[300]

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[297] *See* Pub. L. No. 104-95, 4 U.S.C. § 114(a).
[298] *See* J. Brian Knopp, *New Federal Statute Bars States from Taxing Pension Income of Nonresidents*, 6 J. MULTI-STATE TAX'N 68, 71 (1996) (noting that statute provides that residency is determined under state law).
[299] 29 U.S.C. § 1144(a).
[300] Justin Elliot, Patricia Callahan, & James Bandler, *The Lord of the Roths: How Tech Mogul Peter Thiel Turned a Retirement Account for the Middle Class Into a $5 Billion Tax-Free Piggy Bank*, PRO PUBLICA, June 24, 2021, https://www.propublica.org/article/lord-of-the-roths-how-tech-mogul-peter-thiel-turned-a-retirement-account-for-the-middle-class-into-a-5-billion-dollar-tax-free-piggy-bank Justin Elliot, Patricia Callahan, & James Bandler, *The Lord of the Roths: How Tech Mogul Peter Thiel Turned a Retirement Account for the Middle Class Into a $5 Billion Tax-Free Piggy Bank*, Pro Publica, June 24, 2021,

D. Charity

Charitable and other tax-exempt organizations present several policy challenges for state taxes on the wealthy. Family foundations, for example, have been a key tool for dodging taxes in Europe,[301] and though the U.S. regime is less porous it does have important holes that are especially wide at the state level.[302] The U.S. tax system has generally relied on a separate body of law, the law of charitable organizations, to police these kinds of abuses,[303] but it is likely states cannot depend on that as an effective backstop to expanded state taxes on the wealthy. States should also consider the extent to which new taxes on wealth or capital earnings would affect how or how much donors give to charity.

Charities can be surprisingly effective tax shelters. A standard planning technique exploits the fact that the IRS allows a charity to pay "reasonable" compensation and reimbursable expenses to its employees and board members, even if those individuals are the same people who donated money to the charity.[304] A small charity whose board is controlled by a donor's family can simply hire the family members to run the charity, paying them hundreds of thousands of dollars annually in the aggregate.[305] Indeed, as one

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https://www.propublica.org/article/lord-of-the-roths-how-tech-mogul-peter-thiel-turned-a-retirement-account-for-the-middle-class-into-a-5-billion-dollar-tax-free-piggy-bank.

301 OECD TAX POLICY STUDIES, TAXATION AND PHILANTHROPY 103–06 (2020).

302 *See* Brian Galle & Ray Madoff, *The Myth of Payout Rules: Where Do We Go From Here?*, *in* GIVING IN TIME 235 (Ray Madoff & Benjamin Soskis eds. 2022) (describing use of private foundations for federal tax minimization).

303 Galle, *supra* note 275, at 794–95.

304 *See* Galle & Madoff, *supra* note 302, at 235.

305 Ray Madoff, *The Five Percent Fig Leaf*, 17 PITT. TAX REV. 341, 346–47 (2020).

of us has calculated, among the smallest private foundations, more than half of the charities' annual expenditures are these kinds of administrative expenses.[306]

Because contributions to a charity are not a realization event, donors who fund their family charity with appreciated assets can get a quadruple tax benefit: no tax on the appreciated gains, no tax on subsequent investment gains while the assets are held by the charity, no estate or gift tax on the transfer of the assets, and a charitable contribution deduction in the full (untaxed) value of the assets as the cherry on top.[307] In effect, the charity enables the tax-free purchase of millions of dollars' worth of annuities, or annual payments that continue until the death of the beneficiaries. But, even better than a standard annuity, the salary payments can move from the original donor to their heirs, and then so on in perpetuity. And this can be a highly tax-efficient method for transferring a stream of payments from a high-tax jurisdiction (say, where the family business was operated) to a low-tax jurisdiction (say, where the family retires).

Of course, the success of this strategy depends on how stringently tax officials enforce limits on "reasonable" payments. Over the last decade or so, regulatory oversight of U.S. charities has become notoriously lax.[308] Even more problematically, state wealth or mark-to-market taxes would put increased pressure on the IRS to enforce its rules. The higher the tax on investment income, the greater would be donors' incentives to exploit tax-

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[306] Galle & Madoff, *supra* note 302, at 235.
[307] MYRON S. SCHOLES ET AL., TAX PLANNING AND BUSINESS STRATEGY 485–502 (5th ed. 2016).
[308] *See* Jasper Craven, *There's Never Been a Better Time to be a Scammy Nonprofit*, THE NEW REPUBLIC, Aug. 29, 2022, https://newrepublic.com/article/167244/theres-never-better-time-scammy-nonprofit; Maya Miller, *How the IRS Gave Up Fighting Political Dark Money Groups*, PROPUBLICA, Apr. 18, 2019, https://www.propublica.org/article/irs-political-dark-money-groups-501c4-tax-regulation.

exempt entities. Even if donors' primary goal really is charitable works, taxes on capital encourage donors to shift investment funds to charitable control, so as to allow the donation to grow tax-free.[309] This in turn creates temptations for the donors, or the agents they hire to manage the charity, to take advantage of charitable resources for their own purposes.[310] We should not expect the federal authority to calibrate its enforcement effort, tools, and priorities to serve as an effective backstop for state policy.

Accordingly, states should strongly consider taxing some assets that are nominally held by charities as though they were still owned by donors or those related to their donors, at least for donors who would be subject to wealth or mark-to-market taxation. In effect, the same rules we proposed for trusts could apply to charities as well. States could presume that donated assets are still under the sway of the donor, unless the donor can establish otherwise. For example, a state could presume that a charity that pays compensation to its major supporters (or their relatives) is under their control. Board members who donate to a private foundation should be taxed as though they still directly owned the donated assets, because in actual fact they continue to exercise influence over those funds, even if as a technical matter the funds belong to the charity. States should also aim to counter incentives to hold assets longer inside charities by requiring "pay out" over relatively short periods.[311]

Again, as with trusts, we think such treatment reflects economic reality and good tax policy. Control over resources is an aspect of ownership, even if those resources are used for good social purposes.[312] The traditional policy

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[309] Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 287-88, 306–08 (2011).
[310] Galle, *supra* note 275, at 768–69.
[311] *Id.* at 769–70, 790–93.
[312] John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 661 (2001); Miranda Perry Fleischer, *Theorizing the*

argument for pretending otherwise—that is, for allowing charities to be tax exempt, and for granting a deduction for charitable contributions—is to stimulate production of positive externalities by the charity.[313] That is, both giving money to charitable causes and buying a yacht are "consumption," or spending that satisfies the spender's subjective preferences, but in order to encourage the former, we provide that form of consumption with extra tax benefits.[314] The question for states is whether there is any reason to provide additional tax benefits when the federal government is already subsidizing charitable activity. Perhaps the best argument for state-specific incentives for giving is that tastes for public goods might vary from place to place, or the marginal return on investments in public goods might be higher in some places than others.[315]

But there are better ways of making this connection. Tax deductions for charity tie the level of the state's support with the tax rate imposed on wealthy donors, when there is no necessary connection between those two. New taxes on extreme wealth, if they included deductions for charitable contributions (in the case of the mark-to-market tax) or exemption for charity-owned wealth (in the case of a wealth tax),[316] would greatly increase the state's subsidy for charity, even though it is unlikely that the social returns to charity would happen to also be spiking at that moment. In

Charitable Tax Subsidies: The Role of Distributive Justice, 87 WASH. U. L. REV. 505, 517 (2010).

313 Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397 (1988).

314 *Id.*

315 Galle, *supra* note 57, at 821–22.

316 A wealth tax cannot have a meaningful charitable contribution deduction. In a wealth tax, all money spent before the end of the year is removed from the tax base, so that effectively all consumption, whether given to charity or otherwise, is deductible. But exempting charity-owned assets from an annual wealth tax would still be quite valuable, and would encourage donors to shift assets to charitable control.

addition, state charitable dollars might flow mostly out of state.[317] States that want to support charity without tying the value of the subsidy to their tax system have other excellent options, such as the government matching grant method employed in the U.K.[318]

For similar reasons, states should decline to follow the federal lead on so-called "split-interest trusts," or trusts where one beneficiary is a charity but others are heirs of the grantor. These can offer significant tax savings, including providing a vehicle for moving assets out of state without paying gift tax. Commentators think these trusts provide minimal benefit for charity while taking significant sums from the Treasury.[319] Given that the case for more traditional and more effective state-level tax subsidies is already tenuous, it is difficult to see why states would want to pour in yet more money. States should not provide split-interest trusts with treatment any different than what is available for other trusts.

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Although state taxpayers currently have a long menu of exploitative money moves available for minimizing their tax bills, we have argued in this Part that states also have good counter-options to the most important of these modern strategies. In combination with a wealth tax or mark-to-market reform, these reforms should substantially curtail taxpayers' ability to readily shift their taxable incomes from place to place.

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[317] The Constitution prohibits states from favoring charities that provide in-state benefits. Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 583–95 (1997).
[318] Miguel Almunia et al., *More Giving or More Givers? The Effects of Tax Incentives on Charitable Giving in the U.K.*, 183 J. PUB. ECON. 104114, at 3 (2020).
[319] Wendy Gerzog, *Toward a Reality-Based Estate Tax*, 57 B.C. L. REV. 1037, 1058–59 (2015).

Conclusion

We have argued that the conventional wisdom on state taxation of the wealthy is mistaken. Standard accounts assume that because redistributive taxes would drive the tax base to other places, meaningfully progressive state taxes are impractical, and especially that wealth or mark-to-market taxes aimed at the rich would be self-defeating. To the contrary, we have argued that, by removing the opportunities to exploit realization rules, wealth and mark-to-market taxes are exactly what would make truly progressive state taxation viable, especially if those big reforms were accompanied by other policies to close the most important remaining loopholes. With these fixes in place, families could continue to move from place to place, as a healthy federalism likely requires, but exploitative legal maneuvers to relocate taxable income would no longer be commonplace.

We think these insights should be valuable to several different sets of policy makers. To be sure, progressive state taxation may not be to every state's taste. But for states where voters desire lower inequality, and where on balance progressive taxes could improve welfare, our proposals may be key to achieving voters' preferences. We also have suggested that enabling state-level progressivity is likely important to the long-term health of our federation. Thus, our arguments should additionally be of interest to federal lawmakers, and offer them potential reasons to further encourage, rather than block, state progressivity efforts. For instance, some commentators suggest that the federal deduction for state and local taxes encourages state progressivity.[320] Our analysis thus may be central to the ongoing debates over whether to renew limits on that deduction.[321]

Finally, we suspect that state-level experiments with new tools for implementing progressive taxation—like those we propose in this Article—will be needed to pave the way for these reforms to be adopted more widely. Just as early state-level income tax reform efforts led to the enactment of the modern federal income tax in 1913,[322] efforts for state-level wealth tax or mark-to-market reforms could lead to these proposals eventually being adopted nationally.

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[320] Stark, *supra* note 8, at 1417–22; *see* Galle & Klick, *supra* note 61, at 223–35 (reporting evidence that SALT deduction is correlated with higher safety-net spending and personal income-tax revenue).
[321] Howard Gleckman, *Buckle Up. 2025 Promises to Be An Historic Year in Tax and Budget Policy*, TAXVOX, July 7, 2023, https://www.taxpolicycenter.org/taxvox/buckle-2025-promises-be-historic-year-tax-and-budget-policy.
[322] Note 59 and accompanying text *supra*.