Capital Gains Tax Reform: Conceptual and Practical Considerations

Introduction

The question on how capital should be taxed has prompted academic and political discussions for years. Current law taxes capital gains upon realization and sets the long-term capital gains tax rate substantially lower than the short-term capital gains and ordinary income tax rates. Given the resulting tax deferral opportunity and special low rate, it faces increased scrutiny for benefitting the very wealthy earning more from capital than labor. One prominent policy proposal, “mark-to-market,” presents an alternative: it would tax capital gains as they accrue annually, as opposed to waiting until the assets are sold and the gains are realized.

The current tax system raises an urgent need for reform because it is flawed and outdated in several ways. It has not generated much growth. Keeping the long-term capital gains tax rate low has mixed effects on saving, investment, and gross domestic product (GDP). The recent fundamental changes in the structure of the United States economy, most notably the growing financial and technology sectors, have sharply increased capital’s share of national income and thus warrant a corresponding upward tax rate adjustment. At the same time, due to the expanding budget deficit and public debt, public finances are in poor shape now and are expected to be worse amid economic uncertainty. By effectively continuing to subsidize capital, the existing tax system is cutting off an importance source of revenue. It also worsens inequality by providing tax advantages and tax shelter opportunities for the wealthy, who own most capital assets. Furthermore, it generates efficiency losses and the lock-in effect, where firms and individuals forego investment opportunities and instead hold on to their capital assets until realization or death.

By taxing all capital gains every year instead, mark-to-market could solve the related problems head on, but it remains politically and technically unfeasible as it stands now. Calling to abruptly shift away from the long-standing realization rule and singling out the wealthy to be taxed alienates certain political groups and lacks bipartisan support integral to effective implementation and compliance with the associated legislative changes. The contemplated arrangement coupling accrual taxation of tradable assets with retrospective taxation of non-tradable assets needs to address valuation, distortion, and administration complications. Mark-to-market requires early rudimentary valuations of certain private assets when their values are inherently or deliberately left undetermined. The proposed methodologies have yet to adequately capture the private asset valuation complexities. The arrangement could create new distortions and arbitrages when it potentially renders private assets more attractive and valuable and people shift away from owning public assets. On the other end, the government could incur considerable rulemaking and enforcement costs to combat such taxpayer efforts.

In the meantime, Congress could tackle two action items as groundwork for a successful transition to mark-to-market. First, it should reframe political messaging and positioning to stress that mark-to-market reform benefits all because it improves economic efficiency and growth. The reform could promote capital mobility and market transparency and raise substantial revenues for the government. Second, Congress should set the capital gains tax rate to be higher or equal to the ordinary income tax rate. As capital constitutes a greater share of national and individual income and does not necessarily carry higher risk relative to labor, it could be taxed more. The tax rates are not fixed and could certainly change again as contemplated before in 1986 and 2010 with bipartisan backing. Congress should set the rate within in the range of 28–37% because going over the current ordinary income tax rate of 37% could be counterproductive. While working toward developing and implementing a well-functioning, accrual-based system taxing capital gains, these items are the essential prerequisites to the reform and should and can be addressed now.

Part I provides background on what constitute capital assets and gains and how they were taxed in the past and are taxed now. It then discusses why current law needs to reform by assessing its effects on growth, revenue, equity, and efficiency. Part II examines the mark-to-market alternative's features, advantages, and disadvantages and finds that this alternative should not be implemented in a premature manner. Part III argues that two action items, setting proper political messaging and positioning and raising the capital gains tax rate to adjust for economic realities, should be accomplished first.

I. Background

A. How are Capital Gains Taxed?

Net capital gains (gains minus losses) are included in federal taxable income and result from the sale or exchange of certain property (e.g., stocks, businesses, real estate, collectibles, and art) defined as capital assets in the Internal Revenue Code.[1] They are distinguished from ordinary income that includes wages, interest income, and business income.[2] Currently, capital gains are realized and taxed in the year when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus commissions and the cost of improvements, less

[1] The Internal Revenue Code (I.R.C.) § 1221. Capital assets are property subject to certain exceptions, such as business inventory, accounts receivable, copyrights, and literary compositions.
[2] I.R.C. §§ 64, 1231(b) (defining ordinary income as "any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)"); Corn Products Refining Co. v. Comm'r, 350 U.S. 46, 52 (1955) ("Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss . . . the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly.").

depreciation.[3] Capital losses occur when an asset is sold for less than its basis.[4] Gains and losses are not adjusted for inflation.[5]

The tax rate depends on both the amount of time the asset was held and the taxpayer's tax bracket. Capital gains and losses are classified as short-term if the asset was held for a year or less or long-term if the asset was held for more than one year.[6] Short-term capital gains are taxed as ordinary income at rates up to 37% and long-term capital gains are taxed at lower rates up to 20%. Taxpayers with modified adjusted gross income above certain amounts ($200,000 for singles and heads of household, $250,000 for married couples filing jointly and qualifying widowers with dependent children, and $125,000 for married couples filing separately) are subject to an additional 3.8% net investment income tax (NIIT) on short- and long-term capital gains.[7]

Capital gains and ordinary income tax rates have been in constant flux for more than 100 years.[8]

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[3] *Topic No. 409 Capital Gains and Losses*, INTERNAL REVENUE SERV. (Feb. 11, 2020), https://www.irs.gov/taxtopics/tc409.

[4] I.R.C. § 1001; Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991); Helvering v. Horst, 311 U.S. 112 (1940).

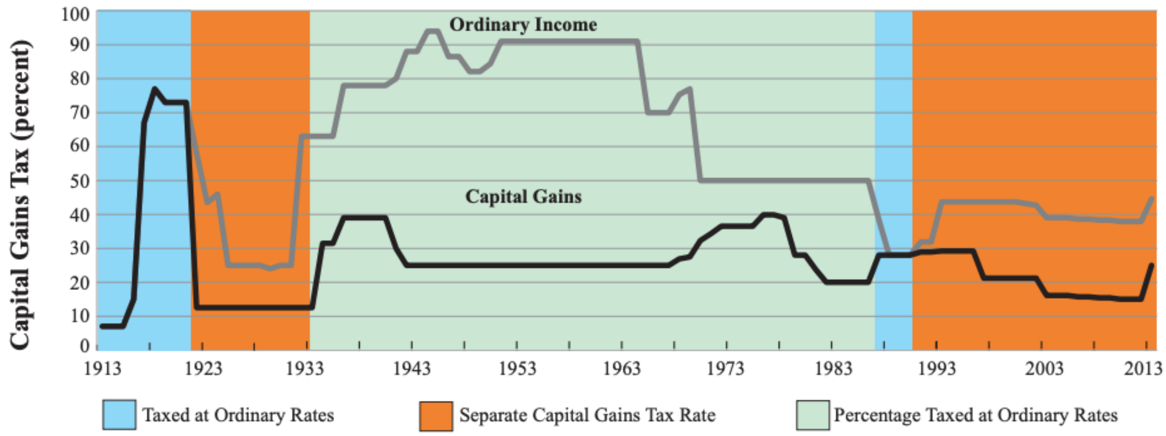
[5] Grace Enda & William G. Gale, *How Could Changing Capital Gains Taxes Raise More Revenue?*, BROOKINGS UP FRONT (Jan. 14, 2020), https://www.brookings.edu/blog/up-front/2020/01/14/how-could-changing-capital-gains-taxes-raise-more-revenue/.

[6] I.R.C. § 1222.

[7] I.R.C. §§ 1(h)(1)(D), 1411(c)(1).

[8] Ajay K. Mehrotra & Julia C. Ott, *The Curious Beginnings of the Capital Gains Tax Preference*, 84 FORDHAM L. Rev. 2517 (2016); *see also* J. COMM. ON TAXATION, 112th CONG., JCX-72-12, PRESENT LAW AND BACKGROUND INFORMATION RELATED TO THE TAXATION OF CAPITAL GAINS, at 17–18, 19–23 tbl.3 (2012), https://www.jct.gov/publications.html?func=startdown&id=5172 (showing that since 1921, Congress has, on several occasions, also adjusted the holding period tied to capital gains taxation).

Figure 1. Capital Gains and Ordinary Income Tax Rates, 1913–2013[9]



From the inception of the federal income tax in 1913 until 1921, capital gains and ordinary income were taxed at the same rate. In 1922, Congress established a separate tax rate for capital gains and taxed them at 13%, much below the 58% top ordinary income tax rate. Then in 1934, Congress differentiated short- and long-term capital gains, based on varying holding periods with the former taxed at the ordinary income tax rate and the latter taxed at a lower rate. The Tax Reform Act of 1986 cut the top rate on ordinary income from 50% to 28% and set the ordinary income and long-term capital gains tax rates the same from 1988–90.[10] Starting in 1991, however, Congress reestablished the long-term capital gains tax preference. It initially raised the top rate on ordinary income to 31%, while leaving tax rates on capital gains unchanged. Enacted at the end of 2017, the Tax Cuts and Jobs Act (TCJA) raised the ordinary income tax rate to 37%. The Act retained the preferential tax rate on long-term capital gains adjusting down to 20%.[11]

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[9] Roberton Williams, *Tax Rates on Capital Gains*, 95 TAX NOTES 251 (2012), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/1001583-Tax-Rates-on-Capital-Gains.PDF.

[10] *Id.*

[11] *How are Capital Gains Taxed?*, URBAN-BROOKINGS TAX POL'Y CTR (2018) [hereinafter *Capital Gains*, URBAN-BROOKINGS], https://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed.

B. Why Should We Reform Current Law?

Current law giving the substantial tax preferential treatment for capital gains over ordinary income necessitates reform because it contributes little to economic growth, adds to budget deficits, widens income inequality, and creates efficiency losses.

i. Economic Growth

Saving and Investment

Empirical research shows conflicting results regarding whether the reduction in long-term capital gains tax rates led to meaningful impacts on economic growth.[12] The main rationale for such preferential tax treatment stems from the concern that taxing capital gains reduces the incentive to save and invest and thus deters growth.[13]

Recent studies, however, indicate a capital gains tax rate reduction likely has a negative overall impact on national saving, the sum of public and private saving.[14] The rate reduction appears to decrease public saving because it reduces tax revenues and increases a budget deficit.[15] The rate reduction increases the after-tax return of investments in businesses, stocks, bonds, and other financial instruments. This change in the rate of return has two offsetting effects on private saving. The substitution effect has individuals willing to save more because they now prefer to substitute current consumption for future consumption. At the same time, the income effect allows

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[12] Chris W. Sanchirico, *Do Capital Income Taxes Hinder Growth?* (U. of Pa. Law Sch. Inst. For Law & Econ., Wharton Pub. Pol'y Initiative, Research Paper No. 13-6, Feb. 22, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222843; Eric Toder & Kim Rueben, *Should We Eliminate Taxation of Capital Income, in* TAXING CAPITAL INCOME 126–27 (Henry J. Aaron et al. eds., 2007).
[13] Scott Eastman, *Evaluating Mark-to-Market Taxation of Capital Gains*, TAX FOUND. (Dec. 17, 2019), https://taxfoundation.org/mark-to-market-taxation-of-capital-gains/.
[14] THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R40411, THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION 5–6 (June 18, 2010), https://fas.org/sgp/crs/misc/R40411.pdf.
[15] *Id.* at 11.

them to save less to maintain their desired target level of income. Consequently, the rate reduction may have little or no effect on private saving.[16]

Although some argue that lower capital gains taxes promote entrepreneurship and innovation, others disagree. The extent to which entrepreneurs take tax considerations into account remains unclear because private equity and venture capital in large part are supplied by pension funds, endowment funds, foreign investors, and other entities not subject to the capital gains taxes.[17] Furthermore, not enough evidence connects longer corporate stock holding periods to more investments in long-term assets, including research and development.[18]

Capital and Labor

By rendering long-term capital even cheaper relative to labor and incentivizing taxpayers to characterize ordinary income as long-term capital gains, the tax rate differential between the two growth inputs (setting the top marginal tax rate on long-term capital gains of 23.8%, much lower than the top marginal tax rate of 40.8% on labor income) distorts resource allocation decisions.[19] Capital gains taxes thus affect growth in another way given that demand for capital and labor is interrelated and their allocation decisions determine national and individual firm output.[20] Generally, an increase in capital share of income accompanies a decrease in labor share.[21]

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[16] *Id.*
[17] JANE G. GRAVELLE, CONG. RESEARCH SERV., 96-769, CAPITAL GAINS TAXES: AN OVERVIEW 5–6 (Mar. 16, 2018), https://fas.org/sgp/crs/misc/96-769.pdf.
[18] *Id.*
[19] Len Burman, *Mitt Romney's Teachable Moment on Capital Gains*, FORBES (Jan. 18, 2012), https://www.forbes.com/sites/leonardburman/2012/01/18/mitt-romneys-teachable-moment-on-capital-gains/#1d18a4e7a4e1 ("Virtually every individual income tax shelter is devoted to converting fully taxed income into capital gains. If you can transform $10 million of wages into gains, you can save over $2 million. With that kind of payoff, there is a whole industry devoted to inventing schemes to generate current deductions to shelter the wages and ultimately recoup it years later as lightly taxed gains.").
[20] Developed by Robert Solow in 1957, the growth accounting equation is as follows: GDP Growth = Capital Growth x (Weight of Capital Contribution) + Labor Growth x (Weight of Labor Contribution) + Technological Progress.
[21] Steve Roth, *Capital's Share of Income is Way Higher than You Think*, EVONOMICS (May 18, 2018), https://evonomics.com/capitals-share-of-income-is-way-higher-than-you-think.

Several factors, including the expanding financial services industry, new automation technology, union decline, and market consolidation, increased the capital share.[22] The Bureau of Labor Statistics estimates that, although the labor share had already started to decrease in the 1960s, three-fourths of the entire post-1947 decline occurred between 2000 and 2016 from 63.3% to 56.7%.[23] Yet, between 2003 and 2010, the long-term capital gains tax rate was kept at 15%, the lowest rate since the Second World War. In contrast, the ordinary income tax rate ranged from more than 90% in 1945 to still fairly high 37% now.[24] The growing capital share of national income relative to labor share calls for a corresponding increase in the capital gains tax rate. One recent study found that the rate correction could raise employment by 5.9%, the labor share by 0.5 percentage point, and overall welfare by 0.6%.[25] The current rate remains far too low and induces capital bias and use away from the optimal level.[26]

Another adverse effect is that the current arrangement based on the rate differential creates tax avoidance and inconsistencies. Executive compensation may be shifted from salaries to stock options.[27] Also, firms could characterize labor as capital. One loophole involves carried interest

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[22] James Manyika et al., *A New Look at the Declining Labor Share of Income in the United States* (McKinsey Global Institute, Discussion Paper, May 2019) [hereinafter *Declining Labor*, McKinsey Global Institute], https://www.mckinsey.com/~/media/mckinsey/featured%20insights/employment%20and%20growth/a%20new%20look%20at%20the%20declining%20labor%20share%20of%20income%20in%20the%20united%20states/mgi-a-new-look-at-the-declining-labor-share-of-income-in-the-united-states.ashx; David Rotman, *How Technology is Destroying Jobs*, MIT TECHNOLOGY REVIEW (June 12, 2013), https://www.technologyreview.com/s/515926/how-technology-is-destroying-jobs/.

[23] *Labor Share of Output has Declined Since 1947*, U.S. BUREAU OF LABOR STATISTICS (Mar. 7, 2017), https://www.bls.gov/opub/ted/2017/labor-share-of-output-has-declined-since-1947.htm; *see also* Michael D. Giandrea & Shawn Sprague, *Estimating the U.S. Labor Share*, U.S. BUREAU OF LABOR STATISTICS (Feb. 2017), https://www.bls.gov/opub/mlr/2017/article/estimating-the-us-labor-share.htm.

[24] Hungerford, *supra* note 14.

[25] Daron Acemoglu et al., *Does the U.S. Tax Code Favor Automation* (NBER, Working Paper No. 27052, 2020), https://www.brookings.edu/wp-content/uploads/2020/03/Acemoglu-et-al-Conference-Draft.pdf.

[26] *See* Paul Krugman, Opinion, *Profits Without Production*, N.Y. TIMES (June 20, 2013), https://www.nytimes.com/2013/06/21/opinion/krugman-profits-without-production.html.

[27] *See* Roth, *supra* note 21 ("Little of Jeff Bezos'[s] and Bill Gates's wealth, for instance, came from wages, salaries, and benefits—what the IRS classifies as 'earned' income. It came from owning stock. But you can still say it's ultimately a result of their labor—their work, smarts, and effort.") (quotations omitted).

and allows certain private equity, venture capital, and hedge fund managers to get taxed at the long-term capital gains rate on service compensation paid to them in the form of a share of their investors' profits.[28]

ii. Revenue Inadequacy and Federal Deficit

In light of the growing federal budget deficit, capital gains taxes represent one important source of government revenue. In 2019, taxes from capital gains constituted about 11% of individual income tax revenues, totaling $193 billion or 0.9% of GDP.[29] Reducing the capital gains tax rate reduces tax revenues.[30] The federal government currently has serious financing needs. The Congressional Budget Office projects that the federal budget deficit will reach $1.0 trillion and 4.6% of GDP in 2020 when it averaged 1.5% of GDP in the past 50 years.[31] The Government Accountability Office notes that the current federal fiscal path, where debt is growing faster than GDP, is unsustainable.[32] An excessively high budget deficit could affect growth and welfare. If interest rates rise, the government could devote an increasing share of tax revenues to debt payments.[33] Critical programs, such as Social Security and Medicare, could lose necessary

[28] Typically, these managers receive both a management fee, a percentage of the value of the assets they manage, and a performance fee, a share of the gains they have generated for their clients. The latter is called carried interest. David Kamin, *Capital: Paths to a Fairer and Broader U.S. Tax System* 14–15 (Washington Center for Equitable Growth, Aug. 2016), https://equitablegrowth.org/wp-content/uploads/2016/08/081016-kamin-taxing-capital.pdf; Chris W. Sanchirico, *Taxing Carried Interest: The Problematic Analogy to "Sweat Equity*," 117 TAX NOTES 239 (2007).

[29] CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2020 TO 2030 (2020) [hereinafter CBO BUDGET PROJECTIONS], https://www.cbo.gov/system/files/2020-01/56020-CBO-Outlook.pdf.

[30] Hungerford, *supra* note 14.

[31] CBO BUDGET PROJECTIONS, *supra* note 29.

[32] U.S. GOVT. ACCOUNTABILITY OFFICE, ACTION IS NEEDED TO ADDRESS THE FEDERAL GOVERNMENT'S FISCAL FUTURE (2020) [hereinafter 2020 GAO REPORT], https://www.gao.gov/assets/710/705327.pdf.

[33] Jared Bernstein, *The Deficit Hasn't Smothered Growth. So Why Can't We Keep Partying on Credit?*, WASH. POST (Nov. 20, 2019), https://www.washingtonpost.com/outlook/2019/11/20/deficit-hasnt-smothered-growth-so-why-cant-we-keep-partying-credit/.

funding.[34] Accordingly, adjusting the current rate scheme and removing the long-term gain preferential rate could enhance tax revenues.

iii. Distribution Skewed to Higher Income

Higher-income taxpayers disproportionally benefit from the existing capital gains tax scheme. They own most of capital assets, realize most of capital gains, and pay most of capital gains taxes at the preferential rate. For the top 0.001%, wages and salaries constitute less than 10% of their income, while capital gains and dividends taxed at preferential rates make up 71% with business income accounting for the remainder.[35] The Joint Committee on Taxation estimates that 91% of 2019 total long-term capital gains in Adjusted Gross Income (AGI) for all taxpayers attributes to those with more than $200,000 of income.[36]

Figure 2. Distribution of Selected Sources of Income in 2019 (Projected)[37]

Income Category [1]	Number of Returns [2] (Millions)	Wages	Long-Term Capital Gains in AGI	Dividend Income	Interest Income	Schedule C Income	Schedule E Income
		$ Billions	$ Billions	$ Billions	$ Billions	$ Billions	$ Billions
Less than $10,000	17.2	37.0	0.3	0.5	0.3	6.8	-0.5
$10,000 to $20,000	17.6	157.5	0.5	0.9	0.4	31.6	-0.1
$20,000 to $30,000	19.6	268.2	1.3	1.6	1.0	19.1	0.5
$30,000 to $40,000	16.5	306.1	2.0	2.5	1.5	12.9	0.9
$40,000 to $50,000	14.3	341.9	2.3	3.2	1.7	10.1	2.8
$50,000 to $75,000	27.8	919.5	9.1	11.2	5.5	20.9	7.3
$75,000 to $100,000	17.3	803.4	12.2	13.2	6.0	18.9	7.9
$100,000 to $200,000	31.1	2,563.6	59.6	51.9	17.2	68.4	50.6
$200,000 to $500,000	10.3	1,783.3	109.7	63.8	17.4	87.4	136.9
$500,000 to $1,000,000	1.3	487.7	84.9	37.3	9.3	44.3	127.9
$1,000,000 and over	0.7	666.2	700.7	120.2	50.4	58.9	499.3
Total, All Taxpayers	173.7	8,334.3	982.8	306.1	110.7	379.4	833.5

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. ci izens living abroad. Categories are measured at 2019 levels.
[2] Includes nonfilers, excludes dependent filers and returns with negative income.

[34] 2020 GAO REPORT, *supra* note 32 (finding that net interest costs are projected to increase to 7.2% of GDP by 2049 and become the largest category of spending exceeding Medicare spending as a share of GDP in 2041, Social Security spending as a share of GDP in 2044, and total discretionary spending as share of GDP in 2049).
[35] Lily L. Batchelder & David Kamin, *Taxing the Rich: Issues and Options* (Sept. 11, 2019).
[36] *See* J. COMM. ON TAXATION, 116th CONG., JCX-9-19, OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2019 (2019), https://www.jct.gov/publications.html?func=startdown&id=5172.
[37] *Id.* at 36 tbl.A-9.

Capital income goes primarily to very wealthy taxpayers and the tax preference for capital gains mainly benefits them.

iv. Efficiency Losses and Lock-in Effect

Because capital gains are taxed only upon realization and at lower rates when assets are held longer, owners tend to retain their assets and contribute to this "lock-in" effect. The effect generates efficiency losses when they hold suboptimal portfolios with inappropriate risk or diversification, or forgo investment opportunities offering higher expected pre-tax returns.[38] Even with relatively low tax rates for capital income, taxpayers maintain sizeable unrealized capital income. The top 1% of wealth holders possess on average $4,670,000 of capital gains that they have yet to realize, while those in the 50th to 59th percentile of net worth report only $27,000.[39] Furthermore, taxpayers incur transactional costs to structure around realization events, and the government incurs administrative costs developing and enforcing complex tax laws to prevent such abuses.[40] The current regime based on realization and bifurcating between short- and long-term capital gains tax rates distorts allocation of investment and prevents flow of capital to where it would be most productive. As owners will hold onto capital assets for longer than socially ideal to lower their effective tax rate, lock-in effectively subsidizes underperforming assets.[41]

The Code's another related provision, step-up basis at death, increases the incentive to lock in capital gains.[42] A taxpayer inheriting a capital asset could eliminate taxes altogether by holding it until death. The cost basis of the transferred asset receives a "step-up" in basis to the asset's fair

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[38] Hungerford, *supra* note 14, at 4.
[39] FED. RES. SYS., SURVEY OF CONSUMER FINANCES (SCF) (2016), https://www.federalreserve.gov/econres/scfindex.htm.
[40] Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 355, 383–92 (2004).
[41] Enda & Gale, *supra* note 5.
[42] I.R.C. § 1014.

market value at the time of the inheritance. The heir does not get taxed on the increase in value that occurred before the inheritance (such as during the life of the decedent). When selling the asset at a later time, the heir only owes capital gains taxes on the increase in the asset's value since inheriting that asset.

Adversely interacting with this provision, current law taxing only realized capital gains and long-term capital gains at the lower, preferential rate therefore has not improved growth, revenue, equity, and efficiency.

II. Mark-to-Market

In response, some propose a shift from the current realization system to an accrual system instead. Specifically, the related "mark-to-market" proposal has gained much traction and would impose taxes on the value of an asset annually, not when the asset eventually gets sold.

A. How Should We Reform?

Under mark-to-market, a taxpayer values all capital assets every year and either pays tax on the gain or deducts the loss. Such system offers many advantages. It could raise significant revenues estimated to be $180 billion per year.[43] Another study estimates $1.7 trillion over ten years even when limiting to the top 1% of households and assuming a 15% avoidance rate.[44] It could raise most of this revenue from the wealthy, as they own more capital assets. It could also eliminate the lock-in effect and tax deferrals because taxpayers would no longer be incentivized to reduce tax liability based on the timing of the sale of property.

[43] Jane G. Gravelle, Mark-to-Market Taxation of Capital Gains, Conference on Taxing Capital Income: Mark-to-Market and Other Approaches, Tax Policy Center (Nov. 15, 2019), at 6, https://www.taxpolicycenter.org/sites/default/files/mark-to-market_taxation_of_capital_gains.pdf.
[44] Batchelder & Kamin, *supra* note 35, at 13.

i. Valuation

Valuation is the key to mark-to-market reform. Publicly-traded securities and real estate are relatively easy to value given their functioning markets with adequate comparable sales data. Their valuation could incorporate the existing schemes on securities taxes[45] and state and local property taxes, respectively.[46] The main difficulty concerns how to treat non-tradable assets (e.g., private businesses, artworks, and goodwill and other intangibles) that lack readily available and reliable valuations.[47]

In arguing that complete accrual taxation is possible, scholar Fred Brown suggests that the Internal Revenue Service (IRS) adopt sophisticated computer models to value all assets.[48] Yet, primarily concerned about tax collection and compliance with limited resources, the IRS is currently not suited to originate such technology incorporating some cutting-edge valuation methods tailored to different private assets or carrying out infrastructure changes on a mass basis.[49]

Thus technically limited to partial accrual taxation, one approach couples accrual taxation of tradable assets with retrospective taxation of non-tradable assets. For the latter, a "look-back charge" rule, in compensating the government for the deferral, taxes these assets upon realization

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[45] Some financial instruments, such as securities and futures and currency contracts, are taxed mark-to-market. *See e.g.,* I.R.C. § 475 (requiring dealers in securities to value certain securities held at year end, by treating the securities as sold for fair market value on the last business day of the year).

[46] *How Do State and Local Property Taxes Work?*, URBAN-BROOKINGS TAX POL'Y CTR (2018), https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-property-taxes-work (discussing how different states assess property values for federal tax purposes).

[47] Batchelder & Kamin, *supra* note 35, at 15 (finding that publicly-traded assets represent only about one-fifth of assets held by the top 1%); Howard Gleckman, *Don't Try to Mark to Market Capital Gains. Tax Unrealized Gains at Death Instead*, FORBES (Nov. 21, 2019), https://www.forbes.com/sites/howardgleckman/2019/11/21/want-to-tax-the-rich-dont-mark-to-market-capital-gains-tax-unrealized-gains-at-death-instead/#63158a1363ad ("[P]rivately held businesses—a significant share of the wealth of the richest Americans—are notoriously hard to value.").

[48] Fred B. Brown, "*Complete" Accrual Taxation*, 33 SAN DIEGO L REV. 1559, 1613–59 (1996).

[49] NAT'L TAXPAYER ADVOCATE, 1 ANNUAL REPORT TO CONGRESS 2019 (2019) [hereinafter 2019 NTA REPORT], https://taxpayeradvocate.irs.gov/Media/Default/Documents/2019ARC/ARC19_Volume1_MSP_03_IRSFUNDING.pdf (identifying the lack of the IRS funding as one of the most serious problems and notes that the IRS currently does not have sufficient resources to provide quality service).

but assesses as though they had accrued gains between the time they were acquired and sold.[50] Some characterize capital gains deferred as an interest-free loan from the government and design look-back formulas that approximate the interest the taxpayer should have paid on that loan.[51] This interest rate approach, however, relies on various assumptions and may not translate well to complex situations. The interest rate is *assumed* to reflect market conditions during the period of deferral but probably will reflect instead the conditions at the time of the sale. This rate is *assumed* to reflect the riskiness of the particular taxpayer's credit, but a uniform interest rate likely will apply to everyone. Moreover, the investment is *assumed* to have appreciated by a constant amount without reference to what actually happened.[52] Others propose another methodology of the look-back rule. It is instead based on the asset's yield and sets an investment's post-tax yield equal to its pre-tax yield reduced by the tax rate.[53] The tax due at realization would be the difference between the investment amounts calculated using the two yield numbers.[54] This approach could be less accurate if the investment has multiple payoffs though.[55] Both approaches could result in either undertaxation or overtaxation.[56]

Another partial approach relies on prospective taxation or expected return. One model imposes tax as if assets are earning an assumed return (e.g., the risk-free rate), regardless of how

[50] David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).
[51] Alan J. Auerbach, *Retrospective Capital Gains Taxation* (NBER, Working Paper No. 2792, 1988), https://www.nber.org/papers/w2792.pdf; Cynthia Blum, *New Role for the Treasury: Charging Interest on Tax Deferral Loans*, 25 HARV. J. ON LEGIS. 1 (1988).
[52] David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. Rev. 1594, 1597–98 (1998).
[53] Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L REV. 45 (1996).
[54] *Id.* at 46 (If the taxpayer invests $1,000 at a 10 percent pre-tax yield, the investment will grow to $2,718 in ten years. If the investment were sold then, the tax should be an amount that would leave the taxpayer with $1,916, which is the proceeds of $1,000 invested for ten years at 6.5 percent. The difference of $802 is the proper amount of tax to compensate for the effects of deferral. This tax should be compared with the tax of $601 that would be imposed under the current system, which is obtained by applying the 35-percent tax rate to the nominal gain of $1,718. The extra $201 is what compensates for the privilege of deferring the tax until sale.").
[55] *Id.* at 86–92.
[56] Schizer, *supra* note 52, at 1597–98.

the assets are actually performing. Differences between the actual and assumed returns are resolved when taxpayers sell the assets. They either pay more tax on the excess of the actual return over the assumed return or claim a deduction for the excess of the assumed return over the actual return).[57] Scholar Mark Gergen devises a mixed regime incorporating the discussed methods for assets with different trading costs: assets with low trading costs are taxed under mark-to-market, assets with moderate trading costs are taxed under a retrospective asset-specific method, and assets with high trading costs are taxed under the prospective asset-specific or expected return method.[58]

Different valuation methods address private assets. Each, however, introduces its own blend of rule, compliance, and transactional complexity and necessitates refinement.

ii. Exemptions, Capital Losses, and Pre-Enactment Gains and Losses

In addition to valuation, mark-to-market's main design features cover exemptions, capital losses, and pre-enactment gains and losses.

Exemptions

Targeting wealthy taxpayers, some proposals incorporate income- or asset-based exemptions.[59] For example, Senator Elizabeth Warren has proposed the mark-to-market tax regime, where the highest income 1% of households pays tax on any increase in the value of their

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[57] Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 733–40 (1992).

[58] Mark P. Gergen, *The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return and Retrospective Taxation*, 49 TAX L. REV. 209 (1993).

[59] Batchelder & Kamin, *supra* note 35, at 18; Greg Leiserson & Will McGrew, *Taxing Wealth by Taxing Investment Income* 7–8 (Washington Center for Equitable Growth, Sept. 2019), https://equitablegrowth.org/taxing-wealth-by-taxing-investment-income-an-introduction-to-mark-to-market-taxation/.

assets over the course of a year even if they do not sell those assets.[60] Senator Ron Wyden has taken the similar approach for those with incomes of $1 million and assets of $10 million.[61]

Capital Losses

Another major component is capital losses. For tradable assets, the mark-to-market system again works well—gains could be immediately taxable and losses could be immediately deductible. The system could follow the treatment applicable to losses when traders elect mark-to-market accounting.[62] Gains and losses from all securities or commodities held in connection with a taxpayer's trading business are treated as ordinary income and losses though, not as capital gains and losses.[63] For non-tradable assets, their gains and losses are taxed on the realization basis and remain as capital gains or losses. Ordinary and capital losses receive different tax treatment under current law. An ordinary loss is fully deductible in the year the loss is incurred.[64] A capital loss is subject to an annual deduction limit of $3,000 and any excess may be carried to future years.[65] The two asset types' loss timing and character differences complicate how to treat losses and set the appropriate deduction limit and carryover period.

Pre-Enactment Gains and Losses

A mark-to-market system also needs to answer the question on how current unrealized gains and losses at the time of enactment should be treated. If mark-to-market applies only to gains and losses arising *after* the effective date, the result will be a hybrid system that actually exacerbates the lock-in effect for many existing capital assets because taxpayers will not realize

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[60] Howard Gleckman, *How Should We Tax the Rich*, URBAN-BROOKINGS TAX POL'Y CTR (Sept. 10, 2019), https://www.taxpolicycenter.org/taxvox/how-should-we-tax-rich.
[61] S. COMM. ON FIN., TREAT WEALTH LIKE WAGES (2019), https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.
[62] I.R.C. § 475(f).
[63] I.R.C. § 475(d)(3).
[64] I.R.C. §§ 165, 65.
[65] I.R.C. §§ 1211, 1212.

gains and losses to avoid transactions triggering tax liability in the new regime. In contrast, if mark-to-market then attempts to extend back to gains and losses incurred *before* the effective date, the asset basis adjustment addressing built-in gains and losses must follow and invokes a valuation reset and overhaul largely for non-tradable assets even before they are realized.

Despite the compelling advantages of raising substantial revenues and promoting a more efficient and equitable tax system, current mark-to-market proposals have still much room for development when various driving components, including valuations and other adjustments on exemptions, capital losses, and pre-enactment gains and losses, remain unresolved.

B. What are Challenges and Limitations?

The new mark-to-market reform also presents some practical challenges and limitations.

i. Lack of Political Feasibility

Mark-to-market reform faces several political roadblocks. Realization is convenient and simplicity has political appeal. Path dependence means resistance to overturning the realization rule. Some find that far too much infrastructure remains and depends on this rule.[66] Some raise the reliance argument that taxpayers have arranged their affairs with the expectation that the rule will remain in place.[67] Furthermore, the reform's strong redistributive rhetoric could alienate economically and politically powerful groups and makes difficult to gain bipartisan support and compromise necessary for the associated legislative changes to withstand administration changes and promote effective compliance. (For one, the TCJA managed to pass with the majority backed by one party, but now its various provisions could be reversed just as quickly.) To no surprise, wealthy taxpayers subject to more taxes would make up the most vocal opposition. Although their

[66] Schenk, *supra* note 40, at 374–77 (observing that some may find repeal setting off a political "firestorm").
[67] *Id.* at 375.

current positions remain unsettled,[68] some politicians and corporations favored lower capital gains tax rates in the past.[69] Other defenders could include closely-held business owners, farmers, and homeowners.[70] While such considerations concern more value judgments and politics, they nonetheless cannot be ignored when any meaningful and lasting policy change requires wide political support.

ii. Valuation

As discussed above, private asset valuation is the fundamental problem. Determining a reliable value on these assets is incomplete work in part due to the lack of market data and transparency. Various financial institutions, including regulators, investment banks, in-house corporate finance departments, private equity firms, and hedge fund firms (investing in derivatives and other complex financial instruments) may be more apt to come up with solutions for improving valuation methodology and reporting.

Despite the subsequent call by some to encourage more companies and assets to be subject to public information disclosure and access, it may not be desirable to induce businesses and individuals to provide their information and firm up valuations early on when those should be strategic economic decisions best left to them.[71] Some largest valuation premiums for private investments derive from compensating for these information deficiencies. The market and demand for private investments always exist because profit opportunities and big premiums come from

[68] Evan Vucci, *Trump Rules Out Indexing Capital-Gains Taxes to Inflation 'at This Time*,*'* WALL ST. J. (Sept. 11, 2019), https://www.wsj.com/articles/trump-again-mulls-capital-gains-tax-cuts-11568210829.
[69] Mehrotra & Ott, *supra* note 8, at 2519 (noting that corporations and financial institutions played an integral role in establishing in the first capital gains tax preference in 1922 and continued to advocate for a low rate in the 1930s and 1940s).
[70] Schizer, *supra* note 52, at 1601–09.
[71] *Cf.* Hillary A. Sale, *Disclosure's Purpose*, 107 GEO. L.J. 1045–69 (2019) ("The goal of the regulatory approach is to promote strong and healthy markets, which, in turn, enable growth and innovation. To achieve that goal, the regime charges corporate players . . . with responsibility for both the quality and quantity of disclosures, where quality concerns affirmative required disclosures and quantity concerns any additional disclosures needed to ensure completeness.").

these high-risk, high-return assets.[72] To illustrate, by nature, venture capital and angel investor valuation of start-up companies lacking profits and track record involves more assumptions. Especially in early funding rounds, the numbers are based on a company's prospective, not actual or historical performance. These numbers reflect more of the company's potential, based on presumed profitability and workability of an idea. The valuation work thus has high fluctuation and is more about building investor interest and premium until a formal price quote is created upon sale.[73]

Requiring early rudimentary valuations through taxes could be even more problematic because it then requires examining second-order effects that are even harder to foresee and measure. Arguably, valuation exercises prior to realization are less meaningful and taxing based on these numbers is trickier, raising problems surrounding the tax base amount calculation and revenue volatility. What mark-to-market reform effectively does is to impose price tags on all capital assets when some asset values are inherently or deliberately left speculative and undetermined. Perhaps later in the business cycle, these start-ups will decide to go public eventually to get more capital and expand their consumer and investor base.[74] The exceptions are large, closely-held companies that retain their private status.[75] The reform, if done prematurely, could invokes resistance from

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[72] MCKINSEY & COMPANY, THE RISE AND RISE OF PRIVATE MARKETS (2018), https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/the%20rise%20and%20rise%20of%20private%20equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx ("Private asset managers raised a record sum of nearly $750 billion globally . . . . Investors' motives for allocating to private markets remain the same, more or less: the potential for alpha, and for consistency at scale.").

[73] Some valuation factors considered for very early-stage rounds include "initial traction by the company," "progress towards a minimally viable product," and the consideration "whether the company is 'hot' and being pursued by other investors." Mike Sullivan & Richard D. Harroch, *A Guide to Venture Capital Financings for Startups*, FORBES (Mar. 29, 2018), https://www.forbes.com/sites/allbusiness/2018/03/29/a-guide-to-venture-capital-financings-for-startups/#14ca2cbe51c9.

[74] *Id.*

[75] *See e.g.*, *America's Largest Private Companies*, FORBES (Nov. 6, 2008), https://www.forbes.com/2008/11/03/largest-private-companies-biz-privates08-cx_sr_1103intro.html#2fb491105ccb (identifying Koch Industries and Cargill as large companies that maintain their private status).

those who see it potentially adding to the already high macroeconomic and market volatility and stifling activities of businesses and the financial sector.

iii. Market Distortions and Arbitrage Opportunities

Current proposals based on partial mark-to-market solutions would create new distortions and arbitrage opportunities. The bifurcated and different tax treatment of tradable and non-tradable asset is the underlying cause altering market and actor behavior.[76] Individuals and businesses take taxes into account in arranging their affairs. They determine how much cash to hold to pay taxes and make investment decisions treating taxes akin to operating costs affecting the net rate of return.[77] On the one hand, gains on tradable assets are taxed based on objective values every year. On the other hand, gains on non-tradable assets are taxed based on fungible or presumed amounts deferred until realization. The two tax treatments would make non-tradable, especially volatile, assets more attractive and valuable. When taxpayers' budget and ability to pay remain constant, they would likely shift away from tradable assets to non-tradable assets. As a result, individuals may own more non-tradable assets, and businesses may go or stay private for tax reasons.[78] In addition, taxpayers would incur planning and transaction costs to put these plans in place.[79] This part accrual- and realization-based arrangement could introduce new economic and market distortions.[80]

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[76] Cunningham & Schenk, *supra* note 57, at 749 (recognizing possible unplanned advantages for certain investments and inefficient allocation of capital).
[77] Schenk, *supra* note 40, at 362.
[78] Batchelder & Kamin, *supra* note 35, at 15, 18.
[79] *Id.* at 9.
[80] Brown, *supra* note 48, at 1606 ("[A] part accrual, part retrospective tax system would not just create a bias for more volatile nonpublicly traded interests over less volatile ones; such a system also would create a tax bias for investing in nonpublicly traded interests in general over publicly traded ones. The significant tax discontinuity created by a bifurcated system could in turn lead some companies to avoid publicly traded status. Consequently, the economic efficiency benefits that would be realized by equalizing the effective tax rates on publicly traded stock likely would be offset, to an extent, by inefficiencies created as a result of the generally more favorable treatment accorded nonpublicly traded business interests.").

iv. Administrative Complexity and Costs

Dividing assets among different tax regimes would also add to administrative complexity and costs. As discussed earlier, valuation is feasible for publicly-traded assets with regularly quoted prices. In contrast, valuation is difficult and costly for assets that do not regularly trade and is subject to varying methodologies and taxpayer manipulation.[81] In fact, taxpayers have a greater incentive to get valuation wrong than right.[82] The government would be at a disadvantage because taxpayers have most of the relevant information and an interest in not revealing it.[83] Furthermore, the IRS currently lacks the valuation and audit capacity. It has severe resource constraints, while it continues to take on vastly expanded responsibilities. Between fiscal years 2010 and 2019, the IRS had its budget cut by 20.4% after adjusting for inflation.[84] The IRS deals with antiquated technology, a smaller workforce, and an increasing workload.[85] The audit rate for the top 1% was reported to be only 1.6% for the tax year 2018.[86] Rare audits mean that most of the IRS assessment and collection operate based on taxpayers' self-reported information. Even when wealthy individuals and businesses they own get audited, they could hire sophisticated lawyers and accountants and devise effective tax avoidance strategies to prevail against the

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[81] Schizer, *supra* note 52, at 1594 ("[M]onitoring the accuracy of these appraisals would be daunting. In the absence of comparable sales, appraisers generally rely on what are at best approximations, typically based on subjective assumptions."); Thomas L. Evans, *The Evolution of Federal Income Tax Accounting—A Growing Trend Towards Mark-to-Market?*, 67 TAXES 824, 825 (1989), ("[A]nnual estimates of market values . . . would be extremely subjective in nature, costly to make, and the source of innumerable disputes between taxpayers and the IRS.").
[82] Schenk, *supra* note 40, 367–68.
[83] *Id.*
[84] 2019 NTA REPORT, *supra* note 49, at 23.
[85] *Id.*
[86] Paul Kiel, *It's Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%*, PROPUBLICA (May 30, 2019), https://www.propublica.org/article/irs-now-audits-poor-americans-at-about-the-same-rate-as-the-top-1-percent.

government.[87] Due to the information asymmetry and low audit risk, taxpayers may become non-compliant.[88] Under the new regime, these adverse behaviors tied to realization taxation remain, but the IRS would be administering at least two different tax arrangements covering tradable and non-tradable assets. The government would thus incur substantial rulemaking and enforcement costs to combat taxpayer efforts on both fronts.[89] The following administrative burden of developing and reviewing valuations and enforcing compliance exhaust the public resources and political capital needed to carry out what could be done now using the workable infrastructure in place.[90]

The political resistance, valuation limitations, market and tax distortions, and administrative and compliance challenges constitute setbacks for mark-to-market reform.

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[87] Jesse Eisinger & Paul Kiel, *The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well.*, PROPUBLICA (Apr. 5, 2019), https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits.

[88] For these wealthy taxpayers, liquidity is not an issue. Schenk, *supra* note 40, at 362–63 ("We should not assume that those who hold illiquid assets necessarily would have liquidity problems if those assets were valued annually. Some taxpayers could borrow against an appreciated asset, and those investing in financial capital. could maintain a diversified portfolio that provided liquidity or cash. It seems likely that the vast majority of those holding significantly appreciated collectibles, for example, also would have liquid assets (or would surely do so on the adoption of accrual taxation). Shareholders in closely held corporations usually would have access to cash as well.").

[89] *See* Natasha Sarin et al., *Tax Reform for Progressivity: A Pragmatic Approach*, in TACKLING THE TAX CODE: EFFICIENT AND EQUITABLE WAYS TO RAISE REVENUE 322 (Jay Shambaugh & Ryan Nunn ed., The Hamilton Project, 2020) (finding that, between 2011 and 2013, the IRS failed to collect more than $380 billion in taxes per year and could use more funding).

[90] *See Tax Reform and the Tax Treatment of Capital Gains: Joint Hearing Before the H. Comm. on Ways and Means and the S. Comm. on Fin.*, 112th Cong. 112–29 (2012) (statement of David H. Brockway, Partner, Bingham McCutchen, LLP), https://www.finance.senate.gov/imo/media/doc/CHRG-112jhrg80843.pdf ("[I]t is highly unlikely that you will find it possible to have comprehensive tax reform with a top rate below 30 percent without raising the capital gains rate close to 30 percent or probably, once you are in the neighborhood, to 30 percent or less—whatever the top ordinary incomes rate is, 25 percent, 28 percent. Therefore, I tend to view the capital gains issue in the context of tax reform as a gating issue.").

III. First Steps

The paper proposes two immediate action items—reframing political messaging and positioning and equalizing capital gains and ordinary income tax rates—as groundwork for a successful transition to mark-to-market.

A. Reframing Political Messaging and Positioning

The first action item requires reframing political messaging and positioning to stress economic problems affecting *all* taxpayers. Currently policy proposals to first or disproportionately address inequality over other relevant ones. The following prioritization and rhetoric based on redistribution have the right intentions but will fall short on execution. To put it simply, this approach is not sensible: it alienates and pressures the "haves" to give up their wealth when they, in fact, possess considerable political and economic resources needed for the reform to move forward.[91] Public support and participation include wealthy or conservative individuals, industry professionals (including those representing corporate and closely-held business interests), politicians, and academics.[92]

In this regard, efficiency and growth, other important principles of this reform, should be emphasized in order to secure the requisite political capital.[93] The suggested message is as follows. Proper capital gains tax reform (for example, establishing a fully functioning mark-to-market

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[91] Peter K. Enns et al., *The Power of Economic Interests and the Congressional Economic Policy Agenda* (Washington Center for Equitable Growth, July 2016), https://equitablegrowth.org/working-papers/the-power-of-economic-interests-and-the-congressional-economic-policy-agenda/ (observing that these interests could shape the congressional agenda because members of Congress are reliant on the support of economic interests to achieve their goals).

[92] *Id.* at 5 ("[I]n capitalist democracies the issues that these firm managers and capitalists taken together, what we call upper class interests would like to see addressed are more likely to receive attention from policy making institutions, while issues that threaten their core interests are less likely to be considered.").

[93] The Enns study argues that in order to receive resources from certain interests, Congress must "signal" its support for these interests by discussing the economic problems that most concern them. The study found that that upper-class interests prioritized deficit while lower-class interests prioritized inequality and that both classes cared about growth. *Id.* at 8, 15–16.

system) benefits all because it improves economic efficiency and growth. It facilitates capital mobility by minimizing the lock-in effect. It enhances public revenues and reduces budget deficits. It, however, does not necessarily increase individuals' tax burden and discourage private economic activities because broadening the tax base could allow for lower tax rates. Sending such message illustrates that the intended effect could be achieved without setting against a particular group and generating their skepticism upfront and non-compliance later.

B. Equalizing Capital Gains and Ordinary Income Tax Rates

Next, capital gains should be taxed at the rate same as or closer to ordinary income. Recall that the current rate differential is substantial: the top ordinary income tax rate is 37%, but the top long-term capital gains tax rate is only 20%.[94] Even without an elaborate analysis, the differential magnitude suggests a strong incentive to earn income in form of long-term capital gains, not wages or short-term capital gains. Equalizing or lessening the gap between the capital gains and ordinary income tax rates and removing the long- and short-term capital gain distinction reduce distortions and arbitrage possibilities associated with capital/labor, capital asset type, rate, and timing differentials.[95]

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[94] *IRS Provides Tax Inflation Adjustments for Tax Year 2020*, INTERNAL REVENUE SERV. (Nov. 6, 2019), https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2020.

[95] *Fair and Equitable Tax Policy for America's Working Families: Hearing on S. 1130, H.R. 1840, S. 1999. H.R. 2834, and H.R. 3221 Before the H. Comm. on Ways & Means*, 110th Cong. (2007) (statement of C. Eugene Steuerle, Senior Fellow, The Urban Institute) [hereinafter STEUERLE STATEMENT] https://www.urban.org/sites/default/files/publication/47071/901112-Tax-Reform-Tax-Arbitrage-and-the-Taxation-of-quot-Carried-Interest-quot-.PDF ("Tax arbitrage opportunities are created and enhanced when Congress establishes differential rates of taxation for certain types of income. Some of these differentials work off of the requirement that income be realized before it is taxed . . . others work off of such differentials as capital gains versus ordinary income . . . . The tax arbitrage opportunities the tax system creates reduce national income and product, encourage too much production of some items and too little of others, shunt many talented individuals into less productive and sometimes nonproductive activities, and add substantially to the debt and other financial instruments in the economy. But when money gets invested for tax rather than economic reasons, the economy gets too much widget making and too little carpentry . . . . As a result, most tax theorists, whether liberal or conservative, Republican or Democrat or independent, believe that reducing and removing differentials helps promote a more vibrant and healthy economy, no matter what level of progressivity or revenues Congress sets.").

i. Potential Drawbacks

One major pushback reflects the view that the same tax treatment cannot be extended to sources fundamentally different in nature or character.[96] Some favor relatively lower capital gains tax rates on the ground that capital income incorporates risk. Others add that capital gains should not be taxed at all because they are not supposedly income.[97] They say that any increase in value of capital is merely a "paper gain" reflecting non-recurring and temporary price changes.[98] Their observations are as follows. Ordinary income is usually guaranteed. If one works a certain amount of time, one is legally entitled to the pay offered when one took the job. In contrast, capital gains involve risk and are not guaranteed. One could invest money and lose it all. If a country wants investors to invest, it cannot tax their resulting capital gains the same as the incomes of people whose incomes were guaranteed in advance when they took the job.[99] That way is not the only way of looking at these sources though. If thinking in terms of pay on an annual or longer-term basis, ordinary income could be deemed riskier. One may any day lose one's job due to sickness, age, etc., and most employment contracts are at-will.[100] Conversely, capital income could be

[96] Another complication involves pass-throughs that this paper does not address. The equalizing treatment would have to get refined because different types of labor income are taxed differently as well. Following the TCJA, owners of unincorporated businesses taking their labor compensation in the form of business profits pay a lower rate than high-earning professionals, such as doctors, lawyers, accountants, and independent consultants. I.R.C. §§199A, 1202(e)(3).
[97] Lawrence H. Seltzer, *Capital Gains and the Income Tax*, 40 AM. ECON. REV. 209 (1950) ("The traditional concept of income includes only more or less regular and recurring receipts, or, in any event, only those that are more or less expected. An occasional, sporadic gain or loss, especially if unsought and unexpected, does not function like income in guiding conduct or in determining the allocation of economic resources.").
[98] Schenk, *supra* note 40 at 377–83 ("The intuition is that returns based on market risk are ephemeral and should not be subject to tax so long as the taxpayer is in the market"); *cf.* Thomas Sowell, *Capital Gains Taxes*, CREATORS SYNDICATE (Oct. 2, 2001), https://www.creators.com/read/thomas-sowell/10/12/capital-gains-taxes; *see also* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 239 (W.D. Tex. 1988) (realization "reflects the public's general distrust of 'paper' gains and losses"), *aff'd*, 887 F.2d 593 (5th Cir. 1989); Tocco v. Tocco, 567 A.2d 303, 315 (Pa. Super. Ct. 1989) ("The tax laws illustrate the folly of attempting to equitably distribute a mere paper gain on an asset that is not present when the asset is sold."), *aff'd*, 590 A.2d 1255 (Pa. 1991).
[99] Sowell, *supra* note 98.
[100] Former U.S. Treasury Secretary Andrew Mellon advocated for a lower tax rate for ordinary income. ANDREW MELLON, TAXATION: THE PEOPLE'S BUSINESS 56–57 (1921) ("The fairness of taxing more lightly incomes from

deemed safer.[101] One example is income from certain financial instruments, such as dividends and sale proceeds from index funds held for years.[102] Another example is income from physical assets, such as rent received for leasing an apartment and proceeds received from selling a house or an artwork. The income stream itself may be volatile, but it is coming from the hard assets one owns.[103] In sum, this entailed assessment could go both ways to advocate for lower tax rates for capital or labor income, depending on how risk is defined and what time horizon is considered. Most people diversify income sources based on this exact reason. Besides, prices of capital and labor already bake in these differences and drive people's allocation decisions.

The path dependence and reliance arguments also do not work. The rates' historical fluctuations have not been motivated purely by economic logic but rather by political compromise and social experience.[104] The rates and the preferential treatment for long-term capital gains are not fixed and could change now if necessary.[105] In fact, specific bipartisan efforts were made recently before and could be revived.[106] In 2010, the Obama Administration formed bipartisan

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wages, salaries and professional services than the incomes from business or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; the income may be disposed of during a man's life and it descends to his heirs.").

[101] In his 1989 public finance treatise, political economist Henry Carter Adams instead found that "[pers]onal incomes such as wages, salaries, professional fees, undertakers' profits, and the like, are both terminable and uncertain, while rent and interest are by comparison considered perpetual and certain. HENRY CARTER ADAMS, SCIENCE OF FINANCE: AN INVESTIGATION OF PUBLIC REVENUES AND PUBLIC EXPENDITURES 357–38 (1898).

[102] Roth, *supra* note 21 ("Your stock portfolio or home value might go up this year but go down again next year. That's certainly true for any given year—or even three, five, or seven years. But over any longer period, household capital gains are very, very real income indeed. They deliver very real assets and net worth—wealth —onto household balance sheets, which individuals can easily swap for 'cash' when they want to spend, in our liquid financial system.") (quotations omitted).

[103] *Id.*

[104] Mehrotra & Ott, *supra* note 8.

[105] *Id.*

[106] U.S. DEPT. OF THE TREASURY, 1 TAX REFORMS FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 40 (1984) https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v1-1984.pdf ("The taxation of capital and business income in the United States is deeply flawed . . . . The tax law provides subsidies to particular forms of investment that are unfair and that seriously distort choices in the use of the Nation's scarce capital. The interaction of various provisions results in opportunities for tax shelters that allow

groups "charged with identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run."[107] They presented the Simpson-Bowles and Domenici-Rivlin plans that propose taxing capital gains (and dividends) as ordinary income at the top tax rate of 28%.[108] In addition to securing bipartisan backing, the subsequent legislation incorporating the new rates should avoid including sunset or contingency clauses because if taxpayers expect the change to be temporary, they retain their current realization behavior.

ii. Optimal Rate

The optimal rate should be set to at least 28% but not so high (beyond the current ordinary income tax rate of 37%) that it actually reduces tax revenue. The Joint Committee on Taxation and the Department of Treasury contemplate raising the capital gains tax rate to 30%.[109] The Urban-Brookings Tax Policy Center recommends 28%, not much higher than the current rate of 23.8% that includes the 3.8% NIIT.[110] The Laffer curve explains that increasing the rate beyond the optimal rate becomes counterproductive for raising revenue.[111] The more Congress raises taxes on capital gains, the more likely taxpayers will defer tax by holding on to assets, rather than realizing them. Enough deferral and reduction or elimination of their tax bill could be done by waiting until death to obtain a step-up basis on assets and using other tax planning strategies. The

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wealthy individuals to pay little tax, create the perception of a fundamentally unfair tax system, and further distort economic choices.").

[107] Exec. Order No. 13,531, 75 Fed. Reg. 7927 (Feb. 23, 2010) (to be codified at 3 C.F.R. pt. 100–02), https://www.federalregister.gov/documents/2010/02/23/2010-3725/national-commission-on-fiscal-responsibility-and-reform.

[108] *Domenici-Rivlin Debt Reduction Task Force Plan 2.0 Senator Pete Domenici and Dr. Alice Rivlin*, BIPARTISAN POLICY CENTER (Dec. 3, 2012), https://bipartisanpolicy.org/wp-content/uploads/2019/03/D-R-Plan-2.0-FINAL.pdf.

[109] Batchelder & Kamin, *supra* note 35, at 7.

[110] Gleckman, *supra* note 60.

[111] Batchelder & Kamin, *supra* note 35, at 7–8.

Congressional Budget Office estimates that increasing the capital gains rate by 2 percentage points generates about $70 billion and to the 30% optimal rate raises $200 billion in revenue.[112]

Conclusion

While recognizing the need for capital gains tax reform, this paper finds that the mark-to-mark design and implementation prompt additional development at least in the near-term. The proposal has yet to garner broad political support and work out valuation, market and tax distortion, and administration problems involving private assets. The paper identifies reframing political messaging and positioning and equalizing capital gain rates as the immediate, practical solutions and the key pieces of mark-to-market reform.

[112] CONG. BUDGET OFFICE, OPTIONS FOR REDUCING THE DEFICIT: 2019 TO 2028 (2018), https://www.cbo.gov/system/files/2019-06/54667-budgetoptions-2.pdf.