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It’s time to give marked-to-market taxation a try

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A few weeks ago, U.S. Sen. Ron Wyden unveiled the Senate Finance Committee’s proposal for a so-called Billionaires Income Tax. Under the proposal, the publicly traded stock holdings of billionaires (along with other tradeable assets held by billionaires) would be marked to market each year, meaning that billionaires would be taxed on the gains on these assets, as well as be entitled to deductions for losses, regardless of selling these assets.

According to a preliminary estimate by the Joint Committee on Taxation, the proposal would raise $557 billion over 10 years. The proposal also would dramatically improve the fairness of the income tax, given that a large portion of the economic income received by billionaires takes the form of untaxed appreciation in the value of traded assets.
This income is ripe for taxation. Billionaires can easily reap the benefits of untaxed asset appreciation by borrowing against these assets, which can then be spent on consumption or used to create more wealth. Moreover, the increased wealth caused by this untaxed appreciation produces intangible benefits to billionaires in the form of prestige, power and security benefits.

For decades, tax scholars and analysts have debated the virtues and drawbacks of marked-to-market or accrual taxation. Most would probably agree that marked-to-market taxation would improve the economic efficiency and equity of the income tax system.

But there are the serious administrative concerns of valuing assets and ensuring that taxpayers have the liquidity to pay taxes irrespective of selling assets. A marked-to-market tax on publicly traded assets, however, should not raise valuation difficulties. And applying this tax only to billionaires should not create liquidity issues for these taxpayers — they should be able to borrow funds to pay taxes, or at worst, sell some of their vast holdings.

There are also concerns that a marked-to-market tax may be unconstitutional, if it is not viewed as an income tax for purposes of the 16th Amendment and is considered a direct tax that would require apportionment among the states based on population. The U.S. Supreme Court likely would need to decide this thorny issue, but there appear to be solid arguments that a marked-to-market tax would pass constitutional muster.

While imposing taxation on non-cash gains sounds strange, the Internal Revenue Code currently contains rules that do just that. Although limited in nature, marked-to-market taxation is imposed
on dealer securities as well as certain options, futures contracts
and currency contracts.

More broadly, taxpayers who hold original issue discount (OID)
bonds are required to include in income the OID that accrues
annually on the bonds, irrespective of selling the bond or receiving
any payments. And on the deduction side, taxpayers are permitted
depreciation deductions on most business or investment assets
without regard to selling the assets.

Besides creating needed revenue and improving the fairness of
the income tax system, the Billionaires Income Tax can serve as
an important test for a possibly broader application of marked-to-
market taxation. Implementation issues concerning valuation and
taxpayer liquidity, as well as attempts at avoiding the tax, can be
studied and evaluated in a limited setting.

Moreover, the Billionaires Income Tax may provide an opportunity
for resolving the constitutionality of marked-to-market taxation.

Success on these fronts may eventually lead to a greater use of
marked-to-market taxation, which in turn can result in an income
tax system that is more efficient and more equitable. Furthermore,
a broad application of marked-to-market taxation could either
obviate or render less important a significant portion of the Internal
Revenue Code, and thus has the potential for greatly simplifying
the tax law.

In addition to its current benefits, the Billionaires Income Tax can
serve as an important first step in this larger endeavor.

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