

Mark-to-Market Taxation of Capital Gains

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The Issue: How to Tax the Wealthy

- Increase Corporate Taxes
- Increase Rates at High End on Income from Business, Wages, Dividends, Capital Gains (including carried interest)
- Increase Estate Tax
- Wealth Tax, or
- Tax Capital Gains on an Accrual Basis

How to Impose Tax on Accruals

- Mark-to-Market for publicly traded assets
- Impose look-back method on other assets
- Provide exemption to exclude ordinary tax payers (lifetime and possibly annual exemption, similar to gift tax treatment)
- Make death a realization event with options for delayed payment with interest

The Simplest Lookback Method

- Decreases basis (i.e., increases taxable gain) in order to achieve the same net on a sale as if the tax had been paid on an accrual basis. Requires minimal information
- Variables: g = growth rate T = holding period S = sales price, B equals basis, t = tax rate B^* = new basis
- To determine the growth rate g : $B(1+g)^T = S$, or $g = (S/B)^{(1/T)} - 1$
- Find a value of B^* that will give you the same return as accrual. The gain on realization with the new basis is $S - t(S - B^*)$; the gain on accrual is $B(1+g(1-t))^T$
- Equate them substituting in for the value of g : $B(1 + ((S/B)^{1/T} - 1)(1-t))^T = S - t(S - B^*)$

Solve for New Basis

- $B^* = [B(1 + ((S/B)^{1/T} - 1)(1-t))^T - S(1-t)]/t$
- An example: a \$1 million asset that grows to \$2 million over 10 years, with a tax rate of 37%. The value of B^* plugging in all of these values is \$800,544.47. So that means you lower your basis from \$1 million to that amount.
- Without the adjustment the after tax net would be \$1,630,000. Had the asset been taxed on an accrual basis the after tax proceeds would have been \$1,556,201.45 which is what you get with the new basis B^* .

Benefits of Mark-to-Market

- Should raise around \$180 billion per year in additional revenue.
- Eliminates the realizations response as employed by the JCT which limits the ability to directly increase capital gains tax rates and raise revenue in official scoring. For example, a five percentage point increase would raise about \$40 billion without the response, but \$10 billion with it. At some point, raising the rate would lose revenue. (My view is that this response is too large, but it governs scoring conventions).
- In combination with a rate increase could raise considerably more revenue, for example \$250 billion with a five percentage point rate increase.

Concern About Effects on Growth

- Most tax increases, particularly on the savings side, would not reduce growth because they would increase government saving; especially given the evidence of a negligible savings response with respect to rate of return.
- If revenues were used to fund programs to benefit lower income families, the benefit would be a directed transfer of income and would not rely on “trickle-down” effects that evidence suggests are minimal.

Comparison to Other Options: Corporate Tax Increases

- Corporate tax increases (either with rates or addressing avoidance of tax on foreign source income) would be simpler and evidence did not suggest recent rate reductions had any important effects on investment.
- Corporate tax rate increases are not specifically targeted to high income. For U.S. parented firms about a quarter of stock is held by taxable individuals, about half by tax exempts (mainly retirement funds) and about a quarter by foreigners. Adding in U.S. subsidiaries of foreign parents, raises the share to foreign owners to close to 40%, lowers the share to taxable individuals to about 20% and the share to nonprofits to about 40%. Some retirement earnings are, however, received by higher income individuals.

Comparison to Other Options: Estate Tax

- Estate tax increases increase a familiar tax that applies to higher income individuals. It has a limited scope for gaining revenue; with the current \$10 million exemption and 40% rate, it raises about \$20 billion a year. The return to a \$5 million exemption would lead to \$40 billion a year, according to CBO projections.
- Some options exist to make the estate tax more effective. Adopting carryover basis would reduce the realizations response and allow higher capital gains tax rates on realized gains. Eliminating discounts for family limited partnerships is also an option.

Comparison to Other Options: Wealth Tax

- As compared to wealth taxation, mark-to-market would be easier to administer since valuation of wealth on an annual basis would not be required. Valuation would occur if death is a realization event, but estate assets need to be valued in any case.
- Mark-to-market also adds to an existing income tax rather than creating a new tax.

There Are Many Other Options for Raising Taxes at the High End

- Higher ordinary tax rates.
- Eliminate pass-through deduction at high incomes.
- Tax carried interest at ordinary rates.
- Tax dividends at full rates and capital gains at revenue maximizing tax rates (around 28%).
- Impose net investment income tax on the only income not subject to it: active income of Subchapter S.