Realization and Tax Base Progressivity

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Abstract: The realization requirement, under which taxes are only imposed when an asset is sold and not when it merely appreciates, is the income tax’s original sin. It is long-standing, yet widely considered the main source of tax complexity, inequity, and economic distortion. Despite its problems, realization is considered a basic and indispensable element of modern income tax regimes. It is explained early in most federal income tax courses as necessitated by problems of asset valuation and taxpayer liquidity. To the dismay of certain professors, this explanation usually generates little class discussion. More worrisome, it is also widely accepted outside the classroom—prompting few political objections or normative academic inquiries.

The goal of this presentation is to provide a normative framework to allow policymakers to better understand the role of the realization requirement. It makes two related arguments. First, with respect to certain emotionally non-fungible (personal) assets, realization is normatively justified because the market price is not a good indication of their value to their owners. Second, contrary to the traditional view of realization as a regressive element, taxing only these personal assets upon realization would promote income tax base progressivity. The key point is that personal assets represent a larger portion of the wealth of low- and, even more so, medium-income taxpayers than of the wealthy.

Our approach provides a heretofore absent basis for developing a more effective and coherent policy with respect to realization. This analysis contributes to the broader tax reform debate and opens a novel theoretical inquiry with respect to the distributive impact of different types of errors.